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**POSITIONING OF FOREIGN
SUBSIDIARIES IN MULTINATIONAL
ENTERPRISE NETWORK: DOES THE
LOCAL EMBEDDEDNESS MATTER?**

Abstract

Recent literature emphasizes the role of foreign subsidiaries (FS) as contributors to competitive advantage of the entire multinational enterprise (MNE) network. This contribution affects the positioning of focal subsidiary in the MNE structure – its power in relationships with corporate headquarters and other business units. The paper – conceptual in character, based on recent literature – aims at analysis of scope and contents of subsidiaries' relationships with local partners, and its possible influence on FS systemic power (i.e. power derived from subsidiary specialization within value chain), its resource-dependency power, institutional, and bargaining power (related to subsidiary management initiatives). The outcomes of the paper will be used in a study of positioning of foreign-owned subsidiaries located in Poland.

Keywords: *foreign subsidiaries, local embeddedness, multinational enterprise network*

Introduction

The international expansion, growing number of organizational units located in numerous host countries results in increasing complexity of intra-organizational relationships within the multinational enterprises (MNE). The issue of division of power (i.e. decision-making and control) between the parent company (or corporate headquarters [HQ]) and foreign subsidiary (FS) is widely discussed in the recent literature. Division of power results in the FS's positioning (FS importance, level of its decision making autonomy and bargaining power) within the MNE structure, and affects FS's growth, performance, and contribution to the competitiveness of the whole MNE. The paper – conceptual in character – aims at the analysis of factors that determine FS power, and at analysis of types of this power. In this context the influence of FS local embedding on its power (and positioning within the MNE) will be discussed.

Local embeddedness can be defined as a firm's (or FS's) efforts to interact and to build relationships with local (i.e. host country) actors in order to exchange resources, knowledge and information (Wright, 2010, p. 127). Embedded business relationships are characterized by a larger number of functional areas of a given firm that are involved with business partners, a higher dependence on business partners, mutual commitment and trust (Andersson et al., 2001; Fors-

gren et al., 2005). Literature suggests that understanding of local environment, and the amount and features of local embeddedness, result in enhanced firms' competence development, innovation, and market performance (see e.g. Schmidt and Hartmann, 2011 for literature review).

1. Factors affecting the division of roles and power between corporate headquarters and foreign subsidiaries

The economic theory approach to the analysis of locus of decision-making in the MNE suggests that its centralization at the corporate HQ level (in parent company) is most likely, where the competitive advantages of the MNE are highly idiosyncratic and need specialized and experienced support, or when they arise from the ownership of geographically diversified activities. Moreover, centralization should be preferred when the relative costs of decision-making services are higher in a foreign location (subsidiary). The centralization of decision-making may also be preferred when the intra-firm market failure means that the transaction costs of delegating decisions to the management of the FS are unacceptable to the management of the parent company (Dunning and Lundan, 2008, p. 251).

Management theory and organization behavior perspective explains the parent company roles in the context of decision-making processes. Roles of parent company include:

- Ownership role, which covers issues of accountability, reporting, maintaining integrity and stewardship.
- Entrepreneurial role, which includes corporate mission and strategic objectives' setting, initiating new businesses, and closing or divesting other activities.
- Enabler role that means creating the right environment for using resources, necessary infrastructure, communication patterns, exchange and sharing of knowledge, management development etc., so that individual FSs could perform better than if they were operating independently (Strikwerda, 2003; Besanko et al., 2007).

The role of FS in the MNE is a function of subsidiary's structural and functional context, and mandates assigned by the HQ.

Literature on strategic management emphasizes changes in corporate strategies and organizational forms. Business opportunities related to globalization and the efficiency of market mechanism result in reduction of the degree of vertical integration in MNE (through outsourcing/offshoring and divestments) and modification of the firms' relations to external business partners. In this context,

Ghoshal and Bartlett (1997) have proposed that the MNE organizational form could be described by a portfolio of three key processes: the entrepreneurial process, the integration process and the renewal process, that are embodied into a new organizational model with redefined management competencies and roles. The new organizational model is based on a network of relationships – heterarchical systems (Hedlund, 1986; Johanson and Mattson, 1988; Ghoshal and Bartlett, 1990) as opposed to traditional hierarchical structures. The contemporary view of the MNE as a flexible, decentralized network implies the coordinated effort of “unbundled” business units (Hagel and Singer, 1999) including subsidiaries, as well as strategic-alliance partners and external independent partners. The role of the FS is viewed as a node in a network; a potential source of ownership-specific advantages, and potentially powerful partner with HQ. Moreover, FS is embedded in local (host-country) network, which can be a significant source of influence vis-à-vis HQ.

Doz et al. (2002, cited in Lasserre, 2007, p. 451) have argued that in the context of growing importance of innovation and knowledge management in the globalized world the competitive advantage depends on:

- Firms’ ability to identify and access new competencies, innovative technologies and market knowledge;
- The speed and effectiveness with which firms are able to combine and recombine pieces of knowledge and use them in innovation processes;
- The ability to ensure the efficiency of global marketing, sales, and supply management to leverage product and process innovations across global markets.

This implies new challenges and roles for both corporate HQ and FSs in knowledge management. Abilities to generate, protect, transfer knowledge and use it in innovation augment significantly the power of knowledge owner and provider.

As MNE increases the geographical scope and the intensity of value-added activities conducted abroad it faces growing complexity and diversity of the environmental factors, as well as new opportunities and threats that require adaptations in corporate strategy and organization. Growing complexity of MNE global activities and necessity to maintain optimal local responsiveness provides arguments for decentralization of decision making, and assigning adequate power to the FSs.

International business literature suggests the necessity to assess the pressures for international/global integration and pressures for local responsiveness, and to balance in the corporate and business strategies the benefits from cross-border integration and the benefits from responsiveness (Bartlett and Ghoshal, 1989; Devinney et al. 2000; Hollensen, 2011). These pressures are reflected in

corporate strategies based on integration-responsiveness framework. The multidomestic strategy emphasizes differences between national markets, and benefits from local responsiveness and flexibility, which should be reflected in locally adjusted business (and marketing) strategies, and implies higher management autonomy of FS. The global strategy is oriented on achieving maximum efficiency, learning, and worldwide integration of firm's activities (often reflected in their standardization) through central control and coordination by corporate HQ, which results in limited autonomy of FS business and marketing strategies. The transnational strategy in which MNE strives to combine benefits from global and multidomestic strategies, while minimizing their disadvantages, following the rule: "*standardize where feasible; adapt where appropriate*".

The firm's strategic orientation and related corporate strategies imply the division of power and responsibilities between corporate HQ (or parent company) and FSs. In general, the larger the financial outlays, the bigger strategic importance of foreign target market and the bigger size and scope of foreign operations, the bigger involvement of strategic resources, or the higher risk involved with these operations, and the higher rationale for worldwide standardization of firm's activities, the more involved the HQ should be in decision making. Therefore, literature suggests that the HQ is the primary contributor to the following activities: setting the business scope of subsidiaries; mergers and acquisitions, major divestments and restructuring; capital planning, and global profitability; government and shareholders relations; appointing the top management of subsidiary. The FS is usually the primary contributor to: local market research and sales, compliance with local laws and human resources management (e.g. Strikwerda, 2003). Shared responsibilities of HQ and FSs with the HQ lead usually include: broad corporate strategy and global product strategy, basic R&D, global product development, global procurement (incl. product sourcing), and development of global managers, whereas the FSs usually lead in: implementation of geographic strategy, local product development, local marketing, manufacturing and procurement, and customer service (Cavusgil et al., 2012, pp. 356-357).

Roles assigned to FS are also related to MNE major motives to enter foreign markets (Dunning and Lundan, 2008):

- market seeking (which is reflected in emphasis on down-stream value-creating activities);
- resource seeking and efficiency seeking (emphasis on procurement, manufacturing, human resources management),
- and strategic asset or capability seeking (emphasis on up-stream activities, incl. R&D).

Many economies, including major emerging and transition economies, provide opportunities for MNE to engage in all of the four motives (Singh, 2012). The relative importance of these motives and resulting FS mandates is changing along with forms and intensity of firm's (MNE) international involvement with host markets, and with development of FS capabilities.

It is worth noting that the list of factors that determine the FS roles (and FS power) includes many other factors, e.g.: the types of business(-es) in which the firm is engaged (characteristics of business operations, technology); firm's degree of internationalization (and types of activities performed in host countries, e.g. manufacturing, service providing, sales, etc.); the legal form of FS, etc.

In general, the FS roles (and resulting power) and their evolution are determined by the FS mandate (charter) assigned by the HQ according to perceived capabilities of the FS, and the strategic importance of the host country market. Second determinant of FS role is "subsidiary choice", which reflects the decisions taken by FS management to define its role in MNE network. Moreover, the FS role is determined by "local environment determinism", which is a function of opportunities and threats appearing in local market, related to the dynamism and attractiveness of host country business environment (as described in Porter's diamond [Porter, 1990]), and incentives offered by host country supporting institutions, e.g. development agencies (Birkinshaw and Hood, 1998). These three determinants interact to determine the FS role at given point of time and the evolution of FS position over time.

Numerous studies provide evidence of the increasing role of MNE subsidiaries in parallel to decentralization of decision-making, and FSs' increasing abilities to influence the corporate strategy, based on their competence building and strategic initiatives (e.g. Dunning and Lundan, 2008).

2. Types of subsidiary power and the impact of local embedding on its positioning within the MNE network

It is worth to distinguish between the power that results from formal authority (the right to make decisions) derived from the assigned position of given unit in the organizational hierarchy, and the real power (real authority) that refers to effective control over assets and ability to sustain strategic autonomy. The corporate HQ has both formal and real authority, whereas the FSs as subordinate units hold the formal power assigned by parent organization, but also strive to build real authority which reaches beyond their formal authority.

The literature shows that the roles initially assigned to the FSs are abandoned by them. The main reasons for this are the following:

- FSs strive to exploit attractive business opportunities identified in their respective local markets;
- FSs aim at strengthening their position in the MNE structure and to ensure their long-term survival and growth by implementing business strategies that are independent from, and often contradictory to HQ's corporate strategy.
- Some FS managers take initiatives themselves, and do not view their role as restricted to implement the decisions made by HQ only (Delany, 2000; Dörrenbächer and Gammelgaard, 2006).

The question is, whether the HQ views the FS initiatives and independent strategies as acceptable "subsidiary entrepreneurship" (Birkinshaw, 1997), or as FS arrogance, which needs to be punished (e.g. by laying-off the FS management) and eliminated (e.g. by implementing tighter control instruments). In any case, HQ has to install the appropriate, balanced level of coordination and control in relations to the reported units. On the other hand the FS needs to know what are the sources of its power to be used in building the relations to corporate HQ, and to other FSs within the MNE structure, as well as to independent firms within collaborating network.

The literature identifies the following interrelated types of FS power: the systemic power, resource-dependency power, micro-political bargaining power, and institutional power (Dörrenbächer and Gammelgaard, 2011).

The systemic power comes from specialization assigned to focal FS within a value chain activities dispersed across the MNE. Systemic power depends on volume of the activities and scope of value added in activities performed by the FS, and on critical importance of these activities for competitive advantage of the MNE (Dörrenbächer and Gammelgaard, 2011). This power is positively influenced by FS specialization based on access to locally available (country-specific) resources, when FS power is related to the location-bound sources of competitive advantage. In this context one should emphasize the role of local embedding of the FS in building its power. Local embeddedness is viewed as one of the most important sources of the development of FS competencies (Andersson et al., 2001). Extensive partnership linkages of the FS to local collaborators (e.g. competitive suppliers, subcontractors, demanding local customers, efficient R&D centers, universities) create relational resources, that can be viewed as critical resources controlled by the FS. FS power can be developed through effective acquisition of knowledge from local environment, that contributes to competitive advantage. FS's local embedding makes it easier to benefit

from the (host) country-specific resources, technological, and organizational capabilities and FSs' linkages to local and international partners, that operate in given host country (Campbell and Verbeke, 2000). In other words, it enables to internalize by the FS (and eventually by the MNE) the country-specific advantages to build new FS-specific or firm (MNE)-specific competitive advantages or augment existing ones (Rugman and Verbeke, 2001). According to Rugman and Verbeke (see also: Nonaka and Takeuchi, 1995; Birkinshaw, 1997) the FS-specific advantages are determined by the following factors:

- The relevant FS competencies and capabilities must incorporate knowledge that is tacit and fundamentally context-specific (locally embedded); thus they are unique and difficult to imitate, and may be difficult to diffuse within MNE network.
- Sustainable FS-specific advantages must reflect the capability gap with other MNE subsidiaries; this means that the FS controls the specialized resources that are superior to those available elsewhere in the MNE network.
- FS-specific advantages can only be sustained, and will only be supported by the parent company, when there are no negative externalities on other MNE activities; there must also be the "interest interdependence" between the FS-specific advantages and the MNE-level nonlocation-bound firm-specific advantages, which creates synergies.

FS-specific distinctive capabilities developed internally, capabilities resulting from local embedding, and HQ support influence the creation and development of FS based centers of excellence, that enhance its relative power vis-à-vis HQ and other FS (Holm and Pedersen, 2000). The center of excellence is a subsidiary recognized by other MNE units for its distinct competencies in certain value-creation activities, regardless whether it is formally designated as such by the headquarters. The FS power related to centers of excellence depends on the scope of activities that are performed superior to other units within the MNE, and on intensity and effectiveness of organizational learning and knowledge management that help sustain that excellence (Holm and Pedersen, 2000; Frost et al., 2002).

The systemic power of FS may decrease as result of migration of value added within the value chain (and shrinking relative importance of the assigned value-creation activities) caused by technological advances and changes in customer preferences. The systemic power is also not very strong, when outcome of the FS's activities (e.g. highly specialized component of the final product, or customized service) cannot be used outside the MNE system (Forsgren et al., 2005). The degree of autonomy allowed to FS is directly related to the benefits that they offer to the HQ (Mudambi and Pedersen, 2007). Thus the sustainability

of the systemic power is questionable, when the HQ provoked by the demanding FS is able to change the value chain configuration aiming at reduction of FS's power (and bargaining position within MNE structure). However, restructuring of value chain requires investments and may create disadvantages (Dörrenbächer and Gammelgaard, 2011), especially when the "in subordinate" FS has developed extensive relations to its business partners, which should also be reconfigured.

The resource-dependency power is very typical for MNEs. MNEs are embedded in diverse economic, socio-cultural, legal and political environments in each host country, that may be critical for the competitiveness and growth of both the FS and the MNE as a whole. This implies, on the one hand, the need to delegate more decision making authority to the FS. On the other hand, FSs' knowledge of local environment and control over key resources owned or accessible to them, and over developed capabilities (e.g. market knowledge, market access or involvement in local entrepreneurial, innovative networks) (Andersson et al., 2007) creates the HQ resource dependency on FSs, which builds the FS's power. HQ resource dependency can be linked to FSs' abilities to exploit opportunities, and to solve critical problems that appear in the host country. Another source of HQ resource dependency power is FS ability to generate, acquire and use specialized knowledge, expertise, and technologies, that result from close relationships with local business partners and other organizations.

In general, the literature suggests that understanding of host country environment, and the scope and features of local embeddedness, result in enhanced FS competence development, innovation, and market performance (e.g. Mu et al., 2007; Al-Laham and Bort, 2011; Schmid and Hartmann, 2011; Gammelgaard et al., 2012).

FS resource dependency power grows when its autonomy is a significant source of competence creation, when MNE uses the subsidiary extensively throughout the MNE network, and when the FS creates competencies which are difficult to appropriate (Mudambi and Pedersen, 2007; see also: Pfeffer and Salancik, 1978; Forsgren et al., 2005; Andersson et al., 2007).

Rugman and Verbeke (2001) have proposed alternative patterns of FS competence building and diffusion in the MNE, that affect either systemic or resource-dependency power of focal FS. These patterns refer to the location, where the FS competitive advantages are created and where they can be exploited. The location-bound competencies, and resulting advantages may be developed by FS in its host country and intentionally exploited there. This pattern reflects the polycentric (multidomestic) strategic perspective. In our view, FS systemic power is derived from its performance of assigned value-adding activities, whereas the resource-dependency power is related to the scope and value of these

activities in relation to the whole set of MNE activities. Some location-bound advantages inspired and created by FS operations may also be transformed by the subsidiary into nonlocation-bound MNE-specific advantages and subsequently diffused and exploited by the entire MNE. This, typically requires corporate HQ approval and support, which means that FS competencies are perceived as superior to those available in other MNE units. This reflects strong FS's systemic power and increased resource dependency power in relations with both HQ and other subsidiaries. Finally, the location-bound competencies may be developed by a network of MNE operations, usually to serve a large national market, and transformed into nonlocation-bound MNE-specific advantages to be exploited on the regional or global scope. This pattern includes the development of focused centers of excellence formed by collaborating units located in different countries. The recognition of such center by the HQ results in additional resources provided to the knowledge dissemination regionally or globally (Rugman and Verbeke, 2001). The power of individual FS, that can be derived from this type joint initiatives depends on its ability to use and diffuse specific knowledge acquired with the local (external) embedding and intra-MNE collaboration. Gammelgaard et al. (2012) have revealed that increases in local relationships (embeddedness) increase intra-organizational relationships of the FS. FS that have developed extensive internal and external relationships are likely to perform important functions within their MNEs.

Growing FS power, and HQ resource dependency that results from the development of FS capabilities and creation of subsidiary-specific advantages, based at least partly from interactions with external networks specific to the subsidiary, can be perceived by HQ as a threat to the integrity of corporate strategy. In this situation, when the FS may be a key agent in nonlocation-bound knowledge creation, HQ attempts to reduce the local embeddedness of the knowledge creation process are likely (Rugman and Verbeke, 2001), which in turn may actually reduce the FS ability to assimilate and exploit externally available knowledge.

The micro-political bargaining power comes from FS management's ability to influence the parent company's decisions on investments and FS competence-creating mandates through attracting HQ attention to particular issues, information policies and their own initiatives (Cantwell and Mudambi, 2005; Bouquet and Birkinshaw, 2008). The FS's micro-political bargaining power depends on the strength of subsidiary within the MNE network and the strategic importance of local environment (and efficiency of local embedding), that determine the perception by the HQ of FS "weight" and builds positive attention

that FS receives from HQ. Moreover, the HQ positive attention may be derived from FS initiative taking directed toward innovation and new market opportunities, that represent an extension to the mandate assigned to FS. In addition, the FS has to shape its profile as a reliable and trustworthy, which is reflected in FS track record of successes, commitment to parent's objectives, and ability to manage impressions with HQ decision-makers (Bouquet and Birkinshaw, 2008).

Although this type of power is relatively important, especially for weak and poorly performing FSs, it is not particularly strong since it can be easily outweighed by HQ bargaining power. Moreover, this type of FS's power is not sustainable, as the bargaining skills are not unique – other FSs may develop them as well (see: Dörrenbächer and Gammelgaard, 2011). Therefore, the micro-political bargaining power can be viewed as supplementary to other sources of FS power, as an instrument of influence on development of systemic and resource-dependency power.

The institutional power originates from support offered to the FS by host country institutions, that create favorable environment for FS's growth and performance, which is motivated by various economic and socio-political reasons (e.g. increasing technology transfer, protecting employment and development of local labor, providing networking opportunities for local businesses, fiscal benefits). In this context it is to note, that the issue of survival and growth of those FSs that are strategically important from MNE perspective and strongly supported by HQ can be used in inter-governmental political game, especially when the future growth of FS is also vitally important from host country authorities. FS can also use their embedding in institutional environment (knowledge of the institutional system and linkages to central and regional authorities) in host country in a proactive way, e.g. while asking for subsidies or searching for protection against the implementation by the MNE HQ of strategic decisions unfavorable for the FS (e.g. closing of production sites, reduction of investment outlays or cutting technology transfer to the FS). FS power is perceived as strong and sustainable because host country institutions change incrementally and are difficult to be analyzed in detail by outsiders. Literature suggests that FSs have better opportunities to create their institutional power in the interventionist states, and coordinated market economies (such as Germany) (Dörrenbächer and Gammelgaard, 2011), as well as in transition economies (Wright, 2010).

An overview of factors affecting the division of power between corporate HQ and FSs, and review of types of FS power gives some insights into the role of local embedding in creating of this power and positioning of the FSs in the MNE network.

Concluding remarks

Literature suggests that the major determinants of FS power are: the level of formal authority (mandate) assigned by the corporate HQ, which is influenced by parent company strategic orientation, and assessment of FS capabilities, as well as strategic importance of host country market; FS initiatives aimed at FS capabilities enhancing (and building its power vis-à-vis HQ and other units in MNE network); and dynamism and attractiveness of host country market. FS position in the competitive MNE network is influenced by interrelated types of power, that FS may create and exploit to build its bargaining position.

Numerous studies provide evidence that one of the most significant factors that underlie the FS power is its ability to create, and well as acquire, share and use knowledge, available both in FS, within MNE network and in the environment (e.g. Mudambi and Navarra, 2004). FS deeply embedded in stable local knowledge network, with developed relational trust, seem to be effective in learning. FS autonomy and location characteristics on skills and knowledge also impact on knowledge creation and management processes. The knowledge creation and learning are easier and more effective, when FSs have prior knowledge of the subject, are strongly motivated and share the similar dominant logic (common values, culture, routines) with their partners (Johansen, 2007). It is to stress, that learning and value of the knowledge that flows between FS and other actors in MNE depends on intensity and scope of value-chain activities performed by FS, and depth of local embedding. Moreover, the economic development of host country also impacts on the benefits from knowledge transfer. Literature suggest that knowledge that flows from less advanced – emerging and transition economies is perceived as less beneficial or valuable than knowledge from developed economies (Ambos et al., 2006). This may discourage the FS operating in less developed host countries to engage in deep local embedding (or at least in some dimensions of embedding, e.g. technical embeddedness).

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