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# Intellectual property rights and foreign direct investment in emerging markets

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## Abstract

With the continued progression towards a more globalized economy, multinational businesses are having increased difficulty in protecting their intellectual properties from theft or infringement. This is most especially true when they have employed their intellectual property in foreign direct investments (FDI) in emerging markets. This paper details many important considerations regarding the security of intellectual properties that have been largely ignored by management in its environmental scanning and decision-making prior to undertaking FDI. The author proposes an auditing procedure, the cross-environmental technology audit (CETA), to ensure that all decisions specifically consider intellectual property issues prior to unnecessarily risking it in a foreign venture.

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## Introduction

One of the greatest problems plaguing multinational corporations (MNCs) in many of the developing economies around the world is intellectual property theft. A US Congressional study placed the total annual cost to American companies from foreign economic espionage at US\$100 billion (Lee, 1997). A Web poll (though not scientific) on a popular business Web site for Asian business, Asia-Pacific.com! (<http://asia-pacific.com>) indicated the importance given to the issue by people active and/or interested in international business and affairs. As of January 31, 2000, in a poll on whether China should be permitted to enter the World Trade Organization (WTO), and if so, what conditions should be made, 15 percent of respondents voted for better intellectual property protection, while 13 percent opted for the all-of-the above option. Hence, 28 percent of respondents would require better intellectual property protection.

When their technology involved in foreign direct investment (FDI) is pirated, many MNCs' managers decry their losses and demand relief from their home and host country governments; yet, much of the blame for intellectual property theft lies squarely on these managers' shoulders. MNCs' managers should keep in mind an old custom of the Afghan tribes – when the victim of theft was found to have contributed to his loss through his own carelessness, the victim was considered as guilty as the thief, and received the same punishment. The basic difference in the instance of intellectual property theft is that often, only the victim is punished: the thief frequently not only goes completely unpunished, but is rewarded and viewed as a national hero. See the treatment

Robert Fulton has received in American history textbooks to confirm this statement.

When intellectual property is pirated, MNCs' managers are faced with the fact that their company's intellectual property, often a major element of their competitive posture and possibly their primary competitive advantage, is no longer theirs exclusively and can be used against them. MNCs' managers attempt to regain control of their technology by demanding that third parties, usually home and/or host countries' governments, retrieve it for them. Though MNCs' managers usually have their feet planted firmly in reality, in this instance, it truly seems as if they are living on Cloud 9. Home countries' governments are generally sincere in their efforts to champion their MNCs' causes, yet geopolitical factors often intrude to reduce the home country government's efforts and/or effectiveness. Host countries' governments of developing economies are more problematical. First, they would rather have proprietary technology in their own citizens' and companies' hands than solely in foreign MNCs' hands. This fact is neither new nor only a non-European cultural characteristic. Those doubting this should read Alexander Hamilton's Report on Manufactures to the US Congress. Intellectual property theft was the fledgling US government's official policy in the late eighteenth and early nineteenth centuries (Heilbroner and Singer, 1984). Today, the government of China does not advocate intellectual property theft; yet, it does have as one of its primary economic policies the acquisition of free technology and encourages both its government-controlled companies and its private sector companies to acquire free technology at every opportunity (Blackman, 1997). Second, even when host countries' governments feel that their long-term interests are advanced



by protecting foreign investors' intellectual property, they often cannot easily do so due to inherent situational limitations (Haley *et al.*, 1998). These limitations may be legal, but are more often cultural and/or political (Haley *et al.*, 1998) or established business practice (Austin, 1990). Given the circumstances, MNCs' managers have to take greater responsibility for the protection of their intellectual property when they make their strategic FDI decisions.

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### **How managers evaluate intellectual property environments**

Prior to making any significant capital investment decision in a foreign country, management often conducts what it considers a full situational examination. This examination generally centers around the development of a net present value analysis of the different potential investments; it includes scanning the foreign country's or region's legal, labor, technological, infrastructural, regulatory, political, competitive, cultural and economic environments where the investment is to be situated. Net present value analysis, assumes that any decision made by an organization can be unmade without prejudice to that organization (Haley and Goldberg, 1996); consequently, there is never any reason for the analyst to consider the potential negative consequences of a decision.

With respect to the examination of the various aforementioned environments, when one looks into how they are interpreted, managers rarely make any connection between cultural, economic, or even the technological environments and intellectual-property theft. The managers assume that the basic premises underlying a country's or a region's primary economic philosophy originated with Adam Smith, David Ricardo, their philosophical heirs, or simply have no importance. Any perusal of popular texts on international business, international management, or international marketing such as Bartlett and Ghoshal (2000), Hill (2000), Jain (1995) or Czinkota *et al.* (1998) will confirm these conclusions. Even more specialized texts such as Austin and Kohn (1990), Clegg and Redding (1990), Lasserre and Schütte (1995) or Putti (1991) fail to discuss (in the case of Austin and Kohn, fail to list) these issues. When authors do consider intellectual property rights, such as in Ghemawat (1999), they do not cover intellectual property theft in the pertinent discussions. If the home and host countries' societies enjoy basic similarities in economic, historical and

cultural premises, one can undertake environmental scanning under such assumptions. When the home and host countries' economic, historical and cultural bases differ significantly however, managers must take special precautions (Haley *et al.*, 1998).

Most Asian markets differ significantly in their underlying cultural, economic and historical underpinnings from the West, where Smith, Ricardo, *et al.*, reign supreme. Fei (1992) has argued that Asia's Confucian-influenced cultures not only differ culturally from Western cultures, but actually differ on a civilizational level, and that merely considering cultural differences is inadequate. Additional differences exist between societies with public-law systems and those with legal-right law systems. Carver (1996) argued that Sinicized cultures never developed legal systems based upon universal rights that form legitimate demands for the state's enforcement of an individual's claims; rather they developed a public-law system that consists of duties owed by the individual to their governments and elders. Sinicized cultures are not the only cultures with public-law systems. Haley *et al.* (1998) point out that in Confucian societies, traditional Confucian economic principles heavily influence socio-economic perspectives; the Confucian economic principles appear much more similar to Marx's and Lenin's economic principles than to Smith's and Ricardo's.

Chan and Chiang (1995) in their excellent historical study of Chinese entrepreneurs, gave a detailed description of how the Chinese traditionally acquired the necessary technical knowledge to go into their chosen business. In the process, they provided tremendous insight into the difficulties that MNCs are having with regard to intellectual property theft in Asia. No universities existed to provide Chinese entrepreneurs with the required training and knowledge or well-accepted scientific methods to develop independently the needed technology. The Overseas Chinese acquired needed technology by going to work for people who had the necessary knowledge, and learning what they needed on the job as apprentices. The question of who owned that technology never came up because the concept of privately-held intellectual property did not exist.

Western managers make insupportable assumptions about the similarity of cultural, economic, and procedural factors when entering into such disparate societies and economies as China. For example, some Western companies entered the Chinese

market without realizing that the Central Banking system generally arbitrates contract disputes rather than their being adjudicated in the courts. Yet, such differences in business procedures constitute only a small proportion of the countless differences that can exist between two highly disparate societies and business cultures. Thus, prior to risking their technology and capital in foreign markets, companies must perform an audit of, not only the traditional business environments, but of the business environments' interactions with one another, and especially with perceptions of technology and intellectual property rights. For convenience, I refer to this audit as the cross-environmental technology audit (CETA).

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### **The cross-environmental technology audit**

Kotler *et al.* (1977) developed the marketing audit as a process to determine the state of a company's marketing efforts, and its marketing position within the environment in which it is operating. Determining the company's technological position within an environment that it is, soon will be, or is considering operating in, is very similar to determining its marketing position. This paper argues that the CETA can help a company to ascertain its relative technological position, including its opportunities and threats within a foreign business environment.

In the CETA, cross-environmental, as indicated above, refers to the interactive effects of the various business environments. It is not enough, for instance, to know that an economy is technologically advanced or backward, but also the cultural perceptions of technology that exist within a society. In Asia, for instance, countries were technologically backward and the concept of privately held intellectual property did not exist, but technology and its benefits were viewed favorably in many Asian cultures. In those countries influenced by Hispanic Catholicism, however, technology was, historically, commonly viewed as un-Godly, and the Church often openly campaigned against technological education. Hence, the general perception of technology in the various traditional Asian and Hispanic/Latin American cultures could be quite different.

The term audit is used in many disciplines, but always to the same effect, thus its usage is well defined. Webster's dictionaries define an audit as "a methodical examination with

intent to verify." It is thus, an attempt to verify data or a state of affairs in such a way that all important factors are considered objectively and systematically so that nothing of importance goes unnoticed or unconsidered.

Technology, on the other hand, is often misperceived. Many perceive it as tangible representations of applied knowledge, usually of an advanced nature. Hence, though many would perceive technology as a physical product or piece of production equipment, technology is much more. Technology is any kind of specialized knowledge, tangible or intangible, physical or procedural, which provides the owner with the capacity to perform specific actions to his/her or their employer's benefit. Thus, when a company performs a technology audit, it is striving to examine methodically and to review all important factors that will, or may, substantially impact the company's technological capabilities now and in the foreseeable future.

When managers apply the CETA to consider the foreign markets in which to invest, or the kinds of investment to make in a foreign market, they must explicitly incorporate into their decision-making frameworks several variables they may not consider in their home markets. Socialization, both as children and as managers, will have taught managers most of what they need to know about the social and legal aspects of doing business in their own society. However, managers do not have this advantage when they are moving into a different culture and society – they must relearn these factors. Hence, when investing in a foreign market the CETA must incorporate substantial consideration of all factors that have evolved into the present-day society in which the company will invest, especially that evolution's economic aspects. This requires management to gain a solid understanding of the historical and socio-economic roots of the society in question.

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### **A representative cross-environmental technology audit**

The balance of this paper will present a representative CETA. The questions proposed for the audit are far from comprehensive and managers do need to tailor them to specific circumstances. Additionally, as the proposed CETA has been developed with no specific country, industry, company or technology in mind, the questions are very general and should be

adapted to the specific situation that managers will face to maximize the CETA's benefits for the company.

Figure 1 presents a graphical representation of the web of influences that the CETA attempts to capture and that impact and influence the intellectual property and technological environments in which companies must operate. The CETA not only considers a country's intellectual-property-theft situation as a separate environment, but also requires the auditor to investigate:

- The relationships between the technology environment and other business environments, both individually and conjointly, to the national intellectual property/technology environment.
- The effects that the host country's economic, political and cultural histories have had on the intellectual property/technology environment.
- The effect of the host country's historical relationships and experiences with the MNC's home country, the MNC's industry of investment, and with technology in general on its intellectual property/technology environment.

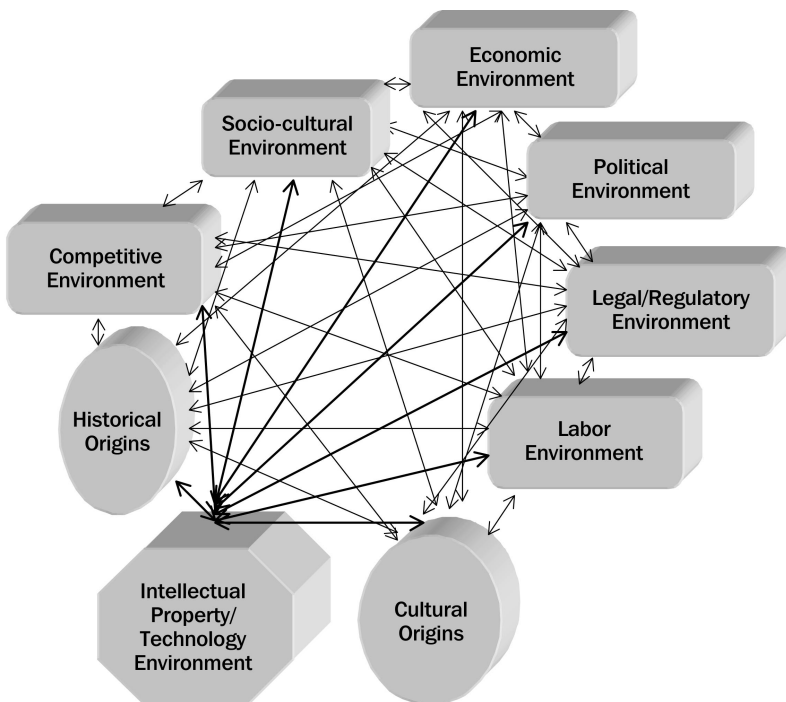
**The company's competitive position**

Any environmental analysis must begin with an investigation of the company's own competitive positioning. How dependent are the company's competitive position and

advantages on its technology? On what kinds of technology is the company dependent? Can the company exploit substantial learning curve advantages? The relative degree of risk a company can afford to take with its technology largely depends on the importance of technological superiority to maintaining the company's success. Managers may consider the following questions to ascertain the company's competitive position:

- How important is technology to our company's competitive position?
- On what kind of technology are we dependent – product? process? procedural; organizational; all of the above?
- Are learning curve effects a significant aspect of our advantage? If so, will learning curve effects allow us to maintain our advantage even if we suffer intellectual property theft?
- How susceptible are we to intellectual-property theft at present? If we employed our technology in foreign markets, would we be any more susceptible to intellectual property theft? Any less?
- Is our technological advantage divisible? If we employed our technology overseas, could we withhold crucial elements of our technology which would render what we risk overseas relatively useless to the thief?
- How badly would our company be hurt by the loss of our technological advantage? What proportion of our future revenue streams might be lost or threatened if we were to lose our technological advantage(s)?
- Is our technological advantage sufficient to ensure our future revenue and profit growth if we remain in our present markets and export to other, technologically riskier markets? If so, for how long?
- How many years lead time does our technological edge over our competition give us? How rapidly evolving is technology in our industry? How rapidly can we expect to see our technological superiority erode if we do not expand overseas? If we do?
- Do we have more advanced technologies ready or in the latter stages of development to replace those we will risk overseas? How long before we can bring them on line?
- How important a competitive factor is market share in our industry? Is the risk of exposing our technology in an FDI warranted by the potential market share,

**Figure 1**  
 The web of the cross-environmental technology audit (CETA)



- market access, or cost advantages gained by making the investment?
- How intense is competition within the market? What is the primary type of competition, MNC or domestic company? How dependent is/are our competitors on technology?
  - Are there significant barriers to entry other than technology into our industry such as, size of capital investment, distribution, cost of promotion, brand equity, and etc.?

### **The economic/labor environments**

The economic environment can have a tremendous effect on the host country's perceptions of intellectual property. If its national economy is advanced and a generator of intellectual properties, the government will probably be committed to protecting intellectual property rights. Advanced technologically based economies are likely to evolve where developers can benefit from their investments in time and capital in the development of those advanced technologies. Where developers cannot benefit from that investment, and where little value is placed on the private sectors' rights of technology ownership, companies will need significant efforts to protect their technology, and widespread intellectual property theft will prevail. This is the situation found in many emerging economies. Additionally, for host countries' governments, especially in the short term, few economic returns accrue to protecting foreign companies' intellectual property from exploitation by local businesses or governmental agencies (Heilbroner and Singer, 1984); hence few economic reasons exist to protect the foreign investors' intellectual property.

Other than the relative comparability of economic development between the home and host countries' economies, managers may have to consider various other factors. For example, the successful introduction of many innovative technologies can be highly dependent on the economic state – the likelihood of success being much greater during economic growth and prosperity than during recessions. The host country's ideological bent can also affect the desirability of investing in a particular economy as can the history of economic relations between the home and host countries' governments and investors.

Additionally, the host country's labor environment can also have significant effects on the desirability of a technological investment, and to a great extent, even on the danger of intellectual property theft.

Managers may consider the following questions to ascertain the economic and labor environments:

- How does the host country's economy compare with our home country's? Is it more advanced, about the same, or less advanced? Given the host country's level of economic development, is our technology appropriate? Is our technology capital intensive when labor intensive technology would be more desirable? Could the technology be considered economically or militarily strategic?
- Does the host country's economy show signs of technological dynamism? Are there significant, private domestic developers of technology?
- If the potential host country has an advanced economy, do technologically active companies tend to have a greater, equal or lesser propensity to file patents as similar companies in our home market[1]?
- Is our technology's acceptance in a market sensitive to the state of the economy? If the economy is weak or in recession, will our chances of success be substantially reduced? If so, what will be the likely state of the host country's economy when our technology comes on line?
- Does the host country display a significant ideological bias in its economic policies? Does either a pro- or anti-technology bias exist? Might this bias help or hinder our efforts to protect our technology or to attain profitability?
- What is the basis of the host country's economic philosophy? Is it traditional Western capitalist, communist, Confucian, or some other economic philosophy? If any of the latter, does the economic philosophy incorporate the concept of privately-held intellectual property[2]? If it does not, has the host country's government shown it can successfully protect intellectual property? Has it shown the will to protect intellectual property?
- How rapidly evolving is the host country's economy? If evolving towards industrialization at a rapid pace, how long will the economic environment be favorable for our technology? Will we have time to recoup our investment and earn our desired profit?
- What is the host country's labor situation like? Does it have a tight labor market? Does the host country possess a relatively small or large population? How well educated/trainable is the labor force? Is the labor force radicalized? Is the union movement strong? How rapidly are wages

rising? Once trained, will we be able to retain our labor or be forced to bid for it?

- What is the availability of necessary managerial and technical personnel? Will we be able to staff positions with local personnel or be forced to recruit more expensive expatriates?

Obviously, many other economic issues of importance exist when considering FDI, and many companies consider these same points before undertaking FDI. However, the key is not that companies do not perform environmental scans, but that they rarely consider the relationships that exist between individual environments and their technology.

#### **Political/regulatory/legal environments**

The political/regulatory/legal environments are crucial to any effort to protect an MNC's technology; yet once again, companies investing overseas frequently ignore these environments' technological aspects. If a country's political and legal institutions are weak or corrupt, it renders problematic even honest and well-intentioned government officials' abilities to protect a company's technology from piracy. Even when host countries' governments are not corrupt and/or weak, it may be difficult for an MNC to protect its technology if it invests in a particular country. The government may have enacted laws that require the sharing of technology. Canada once did so within the pharmaceutical industry. The government may have an unstated policy to favor the acquisition of technology by its citizens and companies; or the host country's legal and regulatory agencies may pronouncedly favor locals whenever the slightest excuse can be found to do so. While the Canadian policy operated openly through enacted statute, managers may need to discern other governmental policies by tracking a country's history of dealings respecting MNCs, and most especially their intellectual property. Managers may consider the following questions to ascertain the political, regulatory and legal environments:

- Do any statutes exist that require the sharing of technology? Are any such statutes being debated within the host country government's legislative or executive branches? Are influential interest groups, such as the press or important industrial or labor organizations, proposing such statutes?
- What is the history of previous investors that have moved proprietary technology into the country? Have they suffered intellectual property theft? What was the

host country government's response? Were they successful in enforcing intellectual property protection if the effort was made?

- What baggage will we have to carry due to the history of political/economic relations between home and host countries? Will this baggage introduce an ideological bias against our company? Will it introduce a bias against our technology?
- What has been the host government's history in dealings with MNCs in general? With MNCs from our home country? With MNCs from the industry in which we plan to invest? Has there been abuse of political rights by either the government or by MNCs or domestic business interests?
- Have there been serious prior difficulties with technologically based investments such as industrial accidents[3] or serious environmental degradation due to waste[4]?
- Does the host country possess multiple jurisdictions of significant influence, e.g. state/provincial and federal? If so, which governmental authority has the greatest control over economic activities? Does the federal authority control activities of the lower governmental agencies? If not, can the lower-level governmental agencies enforce control of their own governmental mandates within their jurisdictions?
- What record of dealings with foreign MNCs have the host country's legal and regulatory agencies built over the years, especially with respect to intellectual property theft? Have they shown a pronounced tendency to favor local interests whenever an excuse can be found?

#### **Socio-cultural environment**

A country's socio-cultural environment often constitutes one of the most misunderstood factors in making an FDI decision. Many managers fear making judgments about a society's socio-cultural elements for fear of appearing prejudiced or politically incorrect – and especially if those judgments appear to imbue a society's culture with negative aspects. Yet throughout history, societies have taken severe, sometimes drastic, actions that have influenced perceptions and acceptance of technology. Throughout history, those societal and institutional elements most influential in building cultural perspectives and values (such as organized religion, universities, political parties, philosophies and social organizations) have taken positions inimical to technology and business. For example, when the Catholic Church charged scientists

with heresy for announcing discoveries in disagreement with the Church's dogma, Europe's most powerful and technologically advanced nations, Spain and Portugal, fell behind in competition with their Protestant neighbors to the North. Similarly, Confucius and his philosophical heirs did not recognize private parties' intellectual property rights (among other anti-business positions), and the most technologically advanced, powerful and wealthiest society in the world, China, became an object of scorn and poverty in the international political and economic arenas. Corporate managers must take international socio-cultural considerations into account to represent adequately their shareholders' interests. Managers may consider the following questions to ascertain the socio-cultural environment:

- What is the socio-cultural context of economic activity in the host country? Is it conducive to modern business practice? Does it embrace technology? Does it embrace privately held property rights, and especially, does it embrace privately held intellectual property rights? What is the traditional form of technology acquisition in the society?
- Is the host country's society hierarchical in nature? Is it individualistic or collective in nature? Can we assure the retention of our technology by coming to a few agreements with a limited number of patriarchs? Where the company's technological assets are concerned, will employees be more loyal to their employer or to their social class, group, family, host-country associates, and society? Would the host country's citizens, as a rule, perform acts of intellectual property theft or similar behavior for their society's or local reference group's perceived benefits, where they would not normally do so for personal profit?
- Does the host country have a highly traditional culture? What adaptive behavior is likely to be observed? How prone will a society's members be to adopt new technologies and ideas? If prone to adopt innovations, is intellectual property respected? What is the host country's perspective towards the centrality of its culture and society?
- What is the host country culture's perspective and history with technology? Have there been serious negative repercussions from technology based investments in the past, especially from those in our company's industry?
- How much experience has the host country's society had with foreigners? With foreign businesses? With foreign

business practices? If it has had any experience, what have the experiences of the foreign nationals and their businesses been? Generally favorable or unfavorable? If favorable or unfavorable, what has been the end result for the foreign nationals with respect to their investments? With respect to their intellectual property?

- Has the host country's society built the institutional infrastructure to develop its own technology? What is the university system like? Are there significant government laboratories? Private laboratories? Do the host country's researchers and institutions generate a significant number of domestic and/or international patents?
- Is the host country a signatory of international patent conventions? Are there inimical regulatory practices regarding intellectual property[5]? How long has the society practiced intellectual property protection? How successful has it been?

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## Implications

The CETA poses many obvious implications for both managers and researcher. Corporate managers must change, not necessarily their approach to selecting foreign markets in which to invest, but most certainly the considerations factored into their analysis. Socio-cultural and historical considerations previously not considered, should assume more importance, especially with respect to their effects on investments' intellectual property aspects. Researchers must begin the task of identifying more precisely and more completely what socio-cultural and historical elements of society appear inimical to protection of intellectual properties.

### Implications for managers

Managers must first start to learn their present analysis's limitations. They should then re-analyze their present investment portfolio to determine the relative risk they are running. The analysis would initially, perforce, be subjective, but managers can develop a preliminary idea of what proportion of their overseas investments are at risk. In each instance, managers must estimate both the total market value and the total strategic value of their technology at risk. In developing these estimates, managers should try to determine to what degree their intellectual property's risk of theft increased by placing their technology overseas rather in their home markets. It is possible that due to the labor situation found in some high-tech

industries and the nature of some modern technologies, such as software, no substantial increase in intellectual property theft occurs by investing in foreign facilities. If however, an excessive proportion of their technology is at risk specifically because that technology has been located overseas, managers need to generate a plan to minimize their risk as quickly and as cost effectively as possible.

#### Implications for researchers

Researchers must catch up with managerial needs in this area. The present paper presents a subjective audit that attempts to identify important societal influences that tend to increase the risk of intellectual property theft. So far, no studies have quantified or even developed correlations of the relative risk associated with particular cultural, societal and historical characteristics and intellectual property theft. Very few studies (e.g. Haley *et al.*, 1998) have tried to develop an understanding of how particular societal characteristics affect intellectual property theft risk. Many more studies must be undertaken on many more societies to develop a firmer, more complete understanding of what characteristics represent a true risk of intellectual property theft. It is also crucial that our understanding be moved beyond the present realm of speculation to the realm of fact.

#### Notes

- 1 A greater or equal propensity to patent would indicate that local investors may have at least an equal degree of trust in their country's intellectual property protection as we do in our own country's; a lesser propensity to patent would indicate a greater dependence on maintaining secrecy as long as possible, and possibly less faith in their country's intellectual property protection.
- 2 The Confucian economic philosophy, for example, does not incorporate the concept of privately-held intellectual property.
- 3 For example, the environmental disaster that Union Carbide created in Bhopal in the late 1980s prompted the Indian government to view FDI even more skeptically for several years.
- 4 For example, the serious degradation of environments in virtually all the former Soviet-block countries has led to environmental regulations that increase MNCs' costs of operation.
- 5 For example, the previous sub-section has described the now rescinded Canadian law for pharmaceuticals; similarly, an old Japanese law required companies to file their patents in each of Japan's 250+ prefectures.

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