Dual Governance of Focal Subsidiary on Capabilities Development in Multinational Enterprises

Shih Chin Tai*
Doctoral Candidate
Graduate School of Management
I-Shou University
1, Section 1, Hsueh-Cheng Rd., Ta-Hsu Hsiang, Kaohsiung County, Taiwan 840, R.O.C.
Tel: (886)-7-6577711
e-mail: derek9671@so-net.net.tw

Fu-Sheng Tsai
Assistant Professor
Department of Business Administration
Cheng Shiu University

* Correspondent author
Dual Governance of Focal Subsidiary on Capabilities Development in Multinational Enterprises

Abstract

Capabilities development of focal subsidiaries is not only the source of subsidiary-specific advantages, but also one of the determinants of competitive advantages of MNEs. This paper investigates how the focal subsidiary develops and builds capabilities. Based on a dual governance perspective, it is noted that capabilities development is dependent on how the focal subsidiary manages knowledge flow from headquarters and local environment, as well as rely on how the focal subsidiary manages internal and external relational embeddedness. It can provide a close understanding about the role which the focal subsidiary plays in MNEs. This paper shows that knowledge inflow and learning are positively related to capabilities development, while internal and external embeddedness are positively associated with capabilities development.

Keywords: subsidiary’s role; capabilities development; governance; competence
Introduction

While research in strategic management highlights one of the major issues – “Why firms differ”, research in international business examines the big question – “What determines the international success and failure of firms” (Rumelt, Schenel & Teece, 1994; Peng, 2004). The logic of two big questions indicates that if any firm wants to gain competitive advantages, it should make the differences. Especially in an international context, what is the source of the “differences” and competitiveness? When multinational enterprises (MNEs) face with many challenges of complexity and globalization, the differences not only stem from their home country and parent company, but also derive from local subsidiaries within dispersed external networks. MNEs not only exploit firm-specific ownership advantages to cross-national host country, as traditional scholars emphasized, but also pay more attention to different and heterogeneous capabilities that focal subsidiaries possess. Focal subsidiaries’ capability may contribute to ownership advantages of MNEs and enhance MNEs’ competence. Thus, MNEs are no more necessary source of unique competitive advantages. Rather, MNEs need to make use of local subsidiaries, which are embedded in external business relationships and have heterogeneous capabilities, to make the “differences” among other firms (Birkinshaw & Hood, 1998; Andersson, Forsgren, & Holm, 2002; Andersson, Forsgren, & Holm, 2007).

Competitive advantages of MNEs depend on how MNEs recognize the significance of focal subsidiaries and how focal subsidiaries build, create and develop capabilities within and across MNEs’ boundaries (Rugman & Verbeke, 2001; Andersson, Forsgren & Holm, 2001). However, past research in subsidiary management mostly focuses on the views of MNEs (e.g. headquarters) to examine the impacts of capabilities, embeddedness and performance of subsidiaries on competence and competitive advantages of MNEs (Andersson et al., 2001; Birkinshaw, Hood & Jonsson, 1998; Holm, Holmstrom & Sharma, 2005). Little research has systematically examined how subsidiaries develop capabilities form the view of the focal
subsidiary. The view of the focal subsidiary, which could be similar to subsidiary autonomy or subsidiary initiation, emphasized the role is assumed itself rather than assigned from MNEs (Birkinshaw et al., 1998; Young & Tavares, 2004; Johnston & Menguc, 2007). This paper mainly focuses on how focal subsidiaries develop capabilities, rather than how MNEs perceive the significant role of focal subsidiaries [e.g. subsidiary’s importance for MNE competence development (Andersson et al., 2001)]. Nevertheless, we do not neglect the link between headquarters and focal subsidiaries of MNEs, and neither do we ignore the fact that focal subsidiary as a member of MNEs. When focal subsidiaries develop subsidiary-specific advantages from interaction with external networks, the advantages may have an impact on competitiveness of MNEs and enhance MNEs’ knowledge stocks (Rugman & Verbeke, 2001). Based on this view will be useful to deepen and clarify our understandings of contribution of focal subsidiaries to MNEs.

A focal subsidiary is not only a part of internal MNE networks, but also embedded in distinctive external networks where unique and local knowledge can be acquired (Andersson et al., 2002; Rugman & Verbeke, 2003). In order to develop effectively capabilities, there are two important actions, which a focal subsidiary can use, to build and develop its own capabilities. One is to manage internal and external embeddedness, while the other is to manage knowledge flow between headquarter and a focal subsidiary, as well as knowledge flow from external networks that are specific to a focal subsidiary. The former primarily emphasizes how a focal subsidiary governs transaction with headquarter and external partners, as well as has the ability to search and process information in the exchange. The latter is concerning a focal subsidiary as a social community that has superior capabilities to manage knowledge flow. While the former pertains to the mechanism for governing transaction, the latter is the mechanism for governing competence. Amin and Cohendet (2000) use ‘dual governance’ approach (perspective) to view the firm as a mechanism of governing transaction
and governing competence. We follow this approach by arguing that a focal subsidiary could develop heterogeneous capabilities to enhance competitive advantages of MNEs, if it governs (or manages) dually transaction and competence well.

In this paper, we first will review research in subsidiary’s role, as well as examine the relationship between capabilities development of subsidiaries and competitive advantages of MNEs. We also explore the determinants of capabilities development of subsidiaries. Second, we attempt to show what dual governance is, review international business literature in terms of dual governance. Third, we will propose propositions about how subsidiaries govern transaction and competence to develop capabilities, based on a dual governance perspective. Finally, we will discuss important implications.

**Theoretical Background**

**Significance of Subsidiary’ Role**

In the past, traditional motives of MNE to go abroad are market-seeking, efficiency-seeking and resource-seeking (Bartlett & Ghoshal, 2000). Form a point of view of MNE, subsidiary, that is viewed as a role of competence exploiting or a passive recipient of head office assignment, is only for the sake of accessing local resources or accepting headquarters’ technology transfers (Cantwell & Mudambi, 2005). Recently, Due to drastic technological change, increasing R&D investment and shortening product life cycles, subsidiary begins to perform specific value-creating activities, which are embedded or located in innovation networks of host country such as R&D and strategic initiatives beyond traditional activities of sales. Hence, an apparent change in the motives of MNE is from competence exploiting to competence creating or knowledge seeking (Nachum & Zaheer, 2005). Similarly, research in subsidiary’s role also expresses the importance of heterogeneity within MNEs, shifting the focus from MNE level to subsidiary level (Paterson & Brock,
2002). Such evolution and changes are closely associated with growth and decline of the subsidiary's capability development and overall competitive advantages of MNEs (Birkinshaw & Hood, 1998).

Overall speaking, competitive advantages of MNEs will not only depend on their stock of firm-specific advantages (FSAs), but also rely on how they take advantages of country-specific advantages in various locations (Rugman & Verbeke, 2003). Firm-specific advantages refer to the capabilities to develop internal coordination and control mechanisms under the considerations of costs and benefits of MNEs. Firm-specific advantages could be viewed as bundles of intangible assets, learning capabilities and linkages with outside actors. However, firm-specific advantages are closely associated with the country-specific advantages, which represent a home country, host country operation, and an internal network, of MNEs (Rugman & Verbeke, 2001). Especially in knowledge management activities, the value of knowledge transfer abroad may be very limited, if MNEs do not take into account country-specific advantages such as complementary assets, learning capabilities and external relationships in the subsidiaries. Due to MNEs as a network of internationally dispersed unit, each subsidiary which has the features of unique business relationships and opportunities of new knowledge can increase resources and capabilities of MNEs (Holm et al., 2005). Thus, it is worthy of exploring advantages of subsidiaries as a source of firm-specific advantages (or competitive advantages) of MNEs.

Following Birkinshaw and Hood (1998), research in subsidiaries’ advantages can be classified into two major aspects – capabilities and charters. One is to examine how subsidiaries enhance their competitive advantages, from the point of view of capabilities. For instance, Holm et al. (2005) examine the impact of competence development of subsidiaries on competence and performance of MNEs. Mudambi and Navarra (2004) focus on the effects of knowledge flow and knowledge intensity of subsidiaries on bargaining power of
subsidiaries. The other is to highlight the responsibility of subsidiaries within MNEs, from the point of view of charters. For instance, Andersson and his colleagues (2001, 2002) investigate the relationship between technical embeddedness, performance of subsidiaries and importance for MNE competence development. In this paper, we will examine how subsidiaries improve their competitive advantages based on the point of view of capabilities rather than charters. In other words, we will only examine capabilities (or competence) development which reflects subsidiary-specific advantages, rather than examine the extent to which subsidiaries capabilities are important for MNEs’ competence.

Different subsidiaries may have their own distinct roles in the MNEs, which depend on capabilities of deployment of tacit and local knowledge as well as their idiosyncratic patterns of network linkages (Andersson et al., 2002; Rugman & Verbeke, 2003). The former is to examine capability development of the subsidiaries or knowledge flow between the subsidiaries and HQs (or other subsidiaries), based on resource-based view of the firm (e.g. Birkinshaw & Hood, 1998; Mudambi & Navarra, 2004; Nachum & Zaheer, 2005). The latter is to focus on how MNEs or the subsidiaries manage internal and external embeddedness, based on the interorganizational network perspective (e.g. Ghoshal & Bartlett, 1990; Andersson et al., 2002; Holm et al., 2005). Therefore, capabilities development (subsidiaries’ advantages) would not only depend on how subsidiaries can exploit their knowledge and resources globally to combine with other local knowledge (Buckley & Carter, 2004), but also rely on how subsidiaries build specific relationships with internal headquarters and external actors in local networks. Namely, in order to build and develop capabilities, subsidiaries should manage (govern) competence and transaction activities. While the former indeed belongs to capability-based view of the firm, the latter refers to the logic of TCE. Those two distinctive perspectives are viewed as ‘dual governance’ by Amin and Cohendet (2000). Based on the perspective of dual governance, we can examine how subsidiaries govern their
competence and transaction to enhance subsidiary-specific advantages. Next, we will demonstrate what dual governance is and review similar concept of dual governance in international business field.

**Dual Governance**

In explaining the main issues of “theory of the firm” – the existence, the boundary, and internal organization (e.g. control, coordination and governance) of the firm, two perspectives have been widely discussed. One is to see the behavior of the firm as a reaction to the environmental signals (Amin & Cohendet, 2000); that is, the traditional contractual approaches such as transaction cost analysis. The second perspective is view the firm as a social community to coordinate knowledge; namely, competence-based approach. The major theoretical foundations of dual governance are derived from these two perspectives. We will interpret as follows.

“Governance” has been commonly defined as a ‘mode of organizing transactions’ (Williamson & Ouchi, 1981). Transaction cost analysis (TCA), derived from Coase and Williamson, views firms and markets as alternative governance structures of coordination. The basic logic of TCA, from a comparative institutional analysis (Hennart, 1994), argues that “transactions, which differ in their attributes, are aligned with governance structures, which differ in their costs and competences, in a discriminating (transaction-cost-economizing) way” (Williamson, 1991, p. 277). Governance structures, such as markets, hybrids and firms, may be defined as institutional arrangements that structure, organize, and coordinate the behaviors of the partners in the relationship (Dyer, 1996; Sobrero & Schrader, 1998).

Another growing stream of work in strategic management, which is represented by resource- or capability-based view of the firm (RBV), indicates that firm’s resource endowment plays an important role in creating sustained competitive advantages (Barney,
RBV researchers viewed a firm as a collection of physical and intangible assets and capabilities. How a firm performs its activities efficiently and effectively depends on such assets and capabilities (Collis & Montgomery, 1995). In contrast with TCA, they argued that there could be differences in capabilities such as past experiences, learning and path dependence even if two firms have the same transaction costs and inputs (Madhok, 2002). It is only the considerations of transaction and management cost that could lead to neglect the main task of a firm: running a business (Demsetz, 1988). There exists an interrelationship of production and exchange in the business activities of firms. Thus, a firm can be simultaneously viewed as a nexus of transactions and as a bundle of resources (Madhok, 2002); that is, there should be close linkage between ‘exchange-oriented’ governance perspective and ‘production-oriented’ competence perspective (Foss & Mahnke, 2000).

The traditional theories such as TCA and agency theory see the behavior of a firm as an optimal reaction to the environment, and view a firm as a governance mechanism to provide coordination and control for solving the incentives problem from asymmetric information, which is a consequence of the inability of ex ante selection, measurement of partners’ competence and ex post monitoring to detect shirking. Firms with information processing advantages would identify external situation and reduce transaction or information costs (Stump & Heide, 1996; Amin & Cohendet, 2000). However, the traditional theories take the cognitive capabilities of all the firms as given. Actually, firms differ in the perception and interpretation of environment as well as acquisition, transfer, and utilization of knowledge. Information could be converted into knowledge following the learning process and partly stored in knowledge stocks. Namely, knowledge is not only itself an input in processor of knowledge creation, but also is an output of decision-making and problem-solving (Amin & Cohendet, 2000; Kyriakopoulos & Ruyter, 2004). In addition, Yamin and Otto (2004) indicate that management of the amount, types, and directions of internal and external across-border
knowledge flows have important implications for organizational exploitation learning and knowledge creation. Hence, dual governance of the firm is not only associated with solution of information asymmetry, but cared about coordination of dispersed knowledge and learning (Amin & Cohendet, 2000). Thus, while governing transaction is related to managing information flow, governing competence is associated with managing knowledge flow.

**Dual Governance in International Context**

Precious international business (IB) research has mostly focused on why MNEs engage in foreign direct investment rather than licensing (Peng, 2004). According to HK (Hymer-Kindleberger) theory, MNEs can utilize Bain-type advantages such as scale economies, product diversification, and distribution networks (based on structural imperfections) to enhance their asset power (Dunning & Ragman, 1985). Because this market imperfection could lead to which MNEs cannot appropriate fully the returns on certain investment, MNEs which possess the transferable ownership advantage should produce abroad (Hymer, 1960). Contrast with structural market imperfection of HK theory, research in internalization theory emphasizes imperfections in intermediate product markets rather than final product market and focuses on relative efficiency rather than market power considerations. Cognitive imperfections which internalization theory highlights are Williamson-type transaction costs (Dunning & Ragman, 1985). Due to opportunity and boundary rationality, it is costly to write and enforce complete contracts in the exchange activities. This, in turn, results in transactional difficulty. Moreover, MNEs could have the ability to integrate dispersed knowledge and employ know-how abroad under premises of “public good” characteristics. Thus, MNEs can be viewed as an organization that internalizes various international transactions such as intermediate product markets and markets for proprietary knowledge (Buckley & Casson, 1976; Teece, 1981).

Researchers who interpreted efficiency consideration argued that there is an incentive
to internalize a market if the benefits of market imperfection outweigh the cost (Buckley & Casson, 1976; Teece, 1981). We could further examine relative efficiency in terms of information, bargaining and enforcement costs of the tasks that MNEs or markets perform (Hennart, 1991); that is a comparative institutional analysis. On the one hand, when intermediate product markets are imperfect, there is an incentive for MNEs to control and protect the firm-specific ownership advantage, as well as search for reliable low-cost supplies of materials or human capital (Buckley & Casson, 1976; Teece, 1981). On the other hand, how MNEs which possess internalization advantages control their foreign activities across national boundaries will depend on comparing information, bargaining and enforcement costs of MNEs with those of markets (Hennart, 1991). While the former refers to transactional ownership advantages (internalization capability of MNE), the latter refers to MNE’s willingness to internalize (Dunning, 1988).

Based on early theories such as HK and internalization theory, the eclectic paradigm is useful to explain and analyze the patterns of international production by configuring three types of advantages: Ownership-specific (or monopolistic) advantages, location advantages, which are associated with “where” of production and internalization advantages (Dunning, 1988). In other words, international operations of MNEs are explained by a combination of the resource requirements of particular economic activities (i.e. factor endowments), geographical disposition and transactional market failure. However, in the face of new challenge associated with the process of globalization, there is a fundamental change in the activities of MNCs, such as increasing cross-border interaction of ownership and location strategies (Cantwell & Narula, 2001; Buckley & Ghauri, 2004). For instance, based on competence-based approach, Cantwell and Narula view technological evolution of MNCs as a path-dependent learning process. MNCs could enhance their own capabilities and innovative activities through interactions of local suppliers and customers in multiple geographical sites. In addition to
considering MNEs’ home country-based advantages, host country could provide complementary assets and local knowledge (location advantages) to enhance such advantages of MNEs; that is, management of the stocks and flows of knowledge in dispersed networks of MNEs has become an important source of competitive advantages (i.e. ownership advantages) (Madhok & Phene, 2001).

New perspectives of internalization or TCA thinking also result from the influence of globalization and the evolutionary view of modern firms (Kogut & Zander, 1993; Cantwell & Narula, 2001; Rugman & Verbeke, 2003; Verbeke, 2003). Knowledge-based view criticizes that internalization theory assumes that knowledge-based assets have a public good characteristics (Martin & Salomon, 2003). Because knowledge is dispersed in self-interest specialists or carriers, it is difficult to transfer this tacit knowledge across bonders and combine effectively this knowledge for MNEs (Kogut & Zander, 1993; Buckley & Carter, 2004). Especially in the area of innovative activities and technology development, hierarchical control or full internalization is no longer a first-best option to MNEs. Firms should engage in inter-firm cooperation to acquire necessary knowledge, enhance their own capabilities and reduce innovation time spans. Fuzzy border problem derived from a great increase in the use of external networks and alliance capitalism (Cantwell & Narula, 2001). The firm-specific internalization and ownership advantages that result from the managerial ability to coordinate inter-firm and intra-firm transactions play an important role in the competitiveness of MNEs. Thus, it is necessary to explore the new ideas and approaches from a combination of different perspectives (Cantwell & Narula, 2001; Rugman & Verbeke, 2003).

Even though MNE has the superior organizational routines in transferring tacit knowledge, it should be closely aligned with the contractual arrangements of past transactions and future expansion; that is, transaction ownership advantages or governance structure of
MNE (Verbeke, 2003). The alignment between knowledge characteristics to be transferred abroad and transaction modes of transferring depends on the extent to which the firm-specific competence (i.e. governing competence) and governance structure (i.e. governing transaction) could fit. In addition, researchers also attempt to examine the potential synthesis or complementarity of resource-based and transaction-based perspectives on MNEs and transnational corporations (Buckley & Casson, 1998; Pitelis & Sugden, 2000; Kay, 2000). For instance, Kay (2000) indicates that MNE which pursues expansion opportunities has a dual nature of making a choice of both directions of expansion (e.g. foreign market entry such as diversification) and modes of organization (e.g. licensing or FDI). The former concerns resources characteristics drawn on resource-based perspective, while transaction cost economics might be appropriate for analysis of the latter. Besides focusing on internal resources, MNE which pursues expansion may also have external opportunities to cooperate with suppliers and customers; that is, the issue of modes for organization. Thus, transactions and coordination regarding governing transaction would play an important role in this foreign expansion of MNEs. Corresponding with this view, Madhok (2002) argued that the triangular alignment between transaction particulars, resources characteristics and governance structure can determine the competitive advantages in the context of inter-firm collaborative relations.

In sum, after reviewing those relevant theoretical perspectives and studies, international exchange and production activities of MNEs can also be classified to two categories – governing transactions and governing competence. In this paper, we mainly focus on internal relationship between focal subsidiary and HQs of MNEs as well as external relationship between focal subsidiary and external actors such as suppliers (as Figure 1 shows). According to dual governance of the firm, we will also view a focal subsidiary as a processor of knowledge and a processor of information. We view the former as governing competence and the latter as governing transaction in terms of dual governance.
Governing competence

Research in the governance of the firm indicates that using, developing and organizing of knowledge flow are a core issue of IORs governance (Amin & Cohendt, 2000; Nooteboom, 2004). By summarizing the literature of knowledge flow, Mahnke and Pedersen (2004) argue that there are two views of point in addressing the governance of knowledge. First, scholars mostly focus on motivational and cognitive (e.g. knowledge-related barriers, Szulanski, 1996) factors to examine the problems and challenges of knowledge flow. On the basis of moral hazard and performance measurement, the sender of knowledge has to be motivated to make knowledge understandable and transferable (Mahnke & Pedersen, 2004). Researchers have examined how organizations provide incentives structure to share knowledge, foster trust to exchange know-how, and overcome the coordination or decision losses (Gupta & Govindarajan, 2000; Nahapiet & Ghoshal, 1998; Buckley & Carter, 2004). Additionally, cognitive factors are related to tacitness, ambiguity and context-specific relationship (Szulanski, 1996). Based on boundary rationality of individuals and tacitness, stickiness of knowledge characteristics (Conner & Prahalad, 1996; Kogut & Zander, 1992), it is an important challenge and problem associated with the alignment and organizing of the amount, types and directions of knowledge flow that organizations encounter. Other researchers in cognition problems concern whether local knowledge is dispersed and examine how MNE combine or integrate dispersed knowledge (Buckley & Carter, 2004). Hence, under a network of internationally dispersed subsidiaries, MNEs have to be in face of trade-off between
control, acquiring local knowledge and autonomy of subsidiaries (Mahnke & Pedersen, 2004).

Second, so the same as traditional organization theory, research in IB also explore the issue about which valuable knowledge is acquired internally or externally; that is, governing internal and external knowledge relations in terms of governance perspectives (Gupta & Govindarajan, 2000; Mahnke & Pedersen, 2004). The former concerns knowledge flow from HQs to subsidiary, vice versa and among subsidiaries in MNEs context, labeled internal network or embeddedness. In addition to internal relations, many scholars focus on external network relations such as alliances with suppliers, customers and international joint ventures (Dhanaraj, Lyles, Steensma, & Tihanyi, 2004). Mudambi and his colleagues adopt an integrative perspective to analyze knowledge flow between HQs, subsidiaries and location of subsidiaries through source-target dimension (Mudambi & Navarra, 2004; Cantwell & Mudambi, 2004). Owing to the view of focal subsidiary, we will be principally concerned with two knowledge flows: knowledge flow from HQs to a focal subsidiary (labeled as knowledge inflow) and knowledge flow from external actors to a focal subsidiary (termed as learning). These knowledge flows will play an important role on developing capabilities for a focal subsidiary.

Knowledge inflow, which is traditional flow, reflects the motivation and experience of MNEs in managing systematic knowledge flow (Gupta & Govindarajan, 2000; Mudambi & Navarra, 2004). There exists richness of transmission channels in the relationship between HQs and the focal subsidiary. Thus, the greater knowledge inflow is, the greater its knowledge stock (Mudambi & Navarra, 2004). Knowledge stock will be helpful for knowledge production and capabilities development of the focal subsidiary. Learning is concerning learning intent, absorptive capacity of the focal subsidiary (Hamel, 1991; Mudambi & Navarra, 2004). When the focal subsidiary has initial propensity to view collaboration as an opportunity to learn, it can access to abundant skills and knowledge. When the focal
subsidiary has absorptive capacity and similar knowledge base, it is more likely to graft a new competence (Dussauge, Garrette & Mitchell, 2000). According to the above argument, we propose as follows:

**P1a:** The level of knowledge inflow is positively related to the focal subsidiary’ capabilities development.

**P1c:** The level of learning from external actors is positively related to the focal subsidiary’ capabilities development.

**Governing transaction**

Researchers in network model consider MNE as an interorganizational network and stress the significance of subsidiaries that move from a position of subordination to a position of equality or leadership (Ghoshal & Bartlett, 1990; Birkinshaw & Hood, 1998). They emphasize heterogeneous organizational systems rather than internal homogeneity. In the networks of dispersed and unique subsidiaries, ownership and hierarchical power could be the “last resort” mechanism of control. HQ-subsidiary relations vary from one subsidiary to another. Thus, it makes sense to explore how the focal subsidiary governs transaction – namely, the relationship between the focal subsidiary and HQs, based on network or embeddedness theory.

Subsidiaries are not only linked with internal relationships with HQs and other subsidiaries, but also embedded in their external network (Andersson et al., 2002). The latter, which can be viewed as buyer-supplier relationship, is associated with a subsidiary’s relationship with customers and suppliers. There is the difference in institutional context between MNEs’ HQs and the subsidiaries as well as among the subsidiaries. Institutional context refers to the institutional distance between HQs home country and subsidiaries host country (Kostova, 1999). The interaction between the subsidiary and external actors is needed
for close and extensive business routines, information, and commitment. Differences between the selection, judgment and interpretation of information among the subsidiaries depend on their institutional context and their external network. If a subsidiary involves in its capacity to enhance the intensity of information exchange, it will reflect a good relationship with local actors in an external network (Andersson et al., 2002; Verbeke & Yuan, 2005).

In this paper, we will use relational embeddedness as closeness of the focal subsidiary in its external network. We will not examine structural embeddedness that refers to the position of the focal subsidiary in its external network. Because MNEs can be viewed as interorganizational networks, we use relational embeddedness to examine the internal networks within MNEs. Subsidiaries and HQs are dispersed in various locations. If they could build strong social ties, trust each other and have shared values, norms, it is useful to speed the exchange of knowledge and obtain greater understandings to absorb others’ knowledge and enhance capabilities development (Dhanaraj et al., 2004). In addition, there are lasting relationships between the focal subsidiary and local suppliers/customers in external networks. They would be inclined to exchange extensive information about market, technology and production development processes. Partners could access to each others’ capabilities more easily (Andersson et al., 2002). Accordingly, we can state these propositions as follows:

P2a: The level of embeddedness in intra-MNE network is positively related to the focal subsidiary’ capabilities development.

P2b: The level of embeddedness in external network is positively related to the focal subsidiary’ capabilities development.
Discussion

The purpose of this study is to examine how the focal subsidiary develop and build capabilities to enhance the competitive advantages of MNEs and make the differences among other firms. Because the focal subsidiary is embedded in unique external network with local suppliers and performs specific value-creating knowledge activities to enhance competence, we adopt a dual governance perspective to show that the focal subsidiary should simultaneously manage their competence and transaction activities to develop capabilities. We further provide the managerial and theoretical implications.

From the view of MNEs, due to the forces of technological change, subsidiaries begin to perform specific value-creating activities. The competitive advantages would be not confined within internal networks of MNEs. Each HQ-subsidiary relationship is unique and idiosyncratic. We would suggest managers of MNEs give the focal subsidiary more autonomy and strategic independent (Canwell & Mudambi, 2005). It will be useful to gain sustained competitive advantages for MNEs. In addition, from the view of the focal subsidiary, capabilities development is important for both subsidiary-specific advantages and competitive advantages of MNEs. How subsidiary develop and build capabilities is not only dependent on managing internal and external networks of MNEs, but also rely on how they manage the patterns of knowledge flow.

The role of subsidiary changes from assigned to assumed, from passive to proactive,
from centralization to autonomy, from demand-driven views to supply-driven views (Paterson & Brock, 2002; Young & Tavares, 2004; Cantwell & Mudambi, 2004). Past research has created various typologies, such as integration-responsiveness framework (Prahalad & Doz, 1987) and Bartlett and Ghoshal (1989), to classify the role that subsidiaries play in MNEs (Paterson & Brock, 2002). Following suggestions of Paterson and Brock, based on a dual governance perspective, it is useful to overlook the role of subsidiary from the view of managing knowledge flow and information flow. We could closely understand how subsidiaries develop its capabilities to enhance competitive advantages of MNEs from this perspective.
References


Johnston, S. & Menguc, B. 2007. Subsidiary size and the level of subsidiary autonomy in


Figure 1 Sources of capability development of focal subsidiary

<table>
<thead>
<tr>
<th>Governing competence</th>
<th>Governing transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Knowledge inflow</td>
<td>Embeddedness in internal network</td>
</tr>
<tr>
<td>Learning</td>
<td>Embeddedness in external network</td>
</tr>
</tbody>
</table>

P1: Subsidiary-specific advantages
P2: Capabilities development

Figure 2 Conceptual framework