Chapter 2

Literature Review

In Chapter two the focus will be on some of the main theories of FDI. This second Chapter, which acts as a literature review, will also represent some existing empirical studies in the area of FDI. After a brief introduction to the Chapter, the discussion of the Product Life Cycle theory will be presented in the next section. In the following section, the Eclectic Paradigm theory will be discussed. Finally, apart from theoretical point of view, some empirical studies will be presented in the last section.

2.1 Introduction to FDI literature

The studies of FDI are still rather fragmented according to approach of each work. Therefore, the theoretical foundation of FDI is compiling bits and pieces from different fields of economics. In general, the theories can be categorized into three approaches, which are ownership-specific factors, internalization theory, and location-specific factors. All of these following theories focus on determinants of FDI. However, this study is focused only on Product Life Cycle Theory and Eclectic Paradigm. The former falls into the ownership-specific factor approach while the latter combines all the above three approaches.

Prior to the 1960s, there was no established theory of FDI. In order to explain the activities of enterprises outside their national boundaries represented and amalgam of fairly well formalized theory of (portfolio) capital movement, a number of empirical and largely country-specific studies on the factors influencing the location of FDI (for example, Southard, 1931; Southard *et al.*, 1936; Barlow, 1953; Dunning, 1958) were presented. Recognition by some economists, notably Williams (1929), state that the internationalization of some industries required a modification to neo-classical theories of

trade. Also an appreciation that the common ownership of the cross-border activities of firms could not only be considered as a substitute for the international cartels and combines (Plummer, 1934), but could also be explained, at least, by the perceived gains of vertical or horizontal integration (Penrose, 1956 and Bye, 1958). Moreover, Bye (1958) is the one who coins the expression 'multi-terrirorial firm'.

Until 1960, MacDougall presented the standard theory of international trade by using the theory of capital movement, resulting from the difference in inter-country interest rates. He tried to examine the inflows of foreign capital both in the form of FDI and portfolio capital, which could raise the marginal product of labour and reduce the marginal product of capital in the host country. Moreover, Blomstrom and Kokko (1997) still follow this theory by examining the direct effects of foreign investment on factor rewards, employment and capital inflows. However, the theory of international portfolio investment is inadequate to explain FDI. Indeed, by assuming perfect competition, this theory rules out any FDI. Therefore, many theories have been developed to explain FDI phenomena more specifically in the following periods.

By focusing FDI on the selection of resources transferred, we will now focus on some theories, which relate to ownership-specific factors.

The first contribution is from Stephen Hymer (1960) in his Ph.D. thesis. He expresses his dissatisfaction with the theory of indirect (or portfolio) capital movement to explain the foreign value-added activities of firms. He also identified three reasons for his dissertation. The first is that once risk and uncertainty, volatile exchange rates and the cost of acquiring, and transferring information are incorporated into classical portfolio theory, some predictions such as the cross-border movements of money capital in response to interest rate changes become invalidated. This is because of market imperfections. Secondly, Hymer corroborates that FDI involves in the transfer of a package of resources (technology, management skills, entrepreneurship, etc.) and not just finance capital which

portfolio theorists, such as Iversen (1935), have explained. Thirdly, he separates FDI from other foreign capital movement by firms to own and control foreign value-added activities.

Moreover, Kindleberger (1969) intensifies Hymer's study by emphasizing on the monopolistic advantages. In addition, Johnson (1970) suggested that the difficulty in transferring knowledge lead to monopolistic advantage of FDI.

To summarize, the monopolistic advantage theory asserts that FDI occurs because imperfections of a market enable individual firms to achieve monopoly power in foreign markets. FDI embodies in imperfect markets and would not exist in a world of perfect competition. However, while Hymer viewed FDI as an aggressive strategy by enterprises to advance their monopoly power, Vernon's Product Life Cycle theory and Dunning's Eclectic Paradigm theory perceived FDI as a defensive strategy by enterprises to protect their existing market position.

2.2 Product Life Cycle Theory

Raymon Vernon uses a micro-economic concept, the Product Cycle, to help explain a macro-economic phenomenon which is the foreign activities of US Multinational Enterprises (MNEs) in the post-war period. He is the first scholar who employs the Product Life Cycle theory to explain the pattern between trade and FDI of a commodity depends on the three stages of the product cycle of that commodity. First, the new product stage, the new product is innovated, produced and sold in its home market where there is a large domestic market and high-income elasticity. Following these conditions, all the home countries usually are developed countries where technological development starts in. In this stage, there is risk and uncertainty because of an under standardized product. This product has been developed to its proper standard before exporting to other countries. Secondly, the maturing product stage, the product becomes much more standardized and is exported to other countries, which are similar to the home country in demand patterns and supply capabilities. At the same time, demand becomes more price

elastic, labour becomes a more important ingredient of costs and the attractions of siting value-added activities expand in a foreign, rather than domestic, location. In addition, Vernon argues that if conditions in the host country are right, the subsidiary could replace exports from the parent company or even export back to it. Finally, the standardized product stage, the innovated product now becomes completely standardized and the market becomes more competitive. This production technology is no longer different from other producers. To lowering cost, especially labour cost, is an important target among producers. Therefore, the production base is moved to other developing countries to seek cost advantages.

The Product Life Cycle is introduced to explain market-seeking production by enterprises of a particular nationality or ownership. It ignores resource based, efficiency seeking or strategic asset acquiring FDI. Both Vernon and Hymer introduce a theory which is partial explain to only some of the issues surrounding FDI. However, the Product Life Cycle is the first dynamic interpretation of the determinants of and relationship between international trade and foreign production.

Also, Product Life Cycle theory can only explain FDI pattern of import-substitution goods. Vernon tries to show that FDI leads to a complete trade diversion; but actually it is not true. Since in many home countries, after investing in other foreign countries, still have high export volume.

In the mid-1970s, Vernon expanded his theory by pointing at MNEs activities. MNEs have network and research and development (R&D) section all over the world. Therefore, the new product has been easily distributed to other foreign countries.

2.3 The Eclectic Paradigm

As stated, the theories of monopolistic advantage and internalization have been used to explain FDI pattern. However, these theories do not explain why the pattern of

foreign involvement, such as export, licensing and investment, by MNEs differs across countries. Therefore, alternatively, according to Dunning (1993), the Eclectic Paradigm of FDI helps explain cross-border differences in the pattern of international involvement by MNEs.

The Eclectic model sets up three conditions for engaging FDI: the ownership-specific advantages, the internalization-incentive advantages, and the location-specific advantages. The ownership-specific advantages mostly are intangible assets such as size and established position, proprietary technology, product or process diversification, monopoly power, better resources capacity and usage, and ability to take advantage of division of labour and specialization. Further, the internalization-incentive advantages can occur when enterprises use their ownership-specific advantages themselves. Finally, having obtained the above two advantages, the enterprise will find itself more profitable to utilize these advantages in conjunction with at least some resources in other countries outside its home country otherwise foreign involvement would be replaced either by exports or licensing.

The Eclectic theory has strong explanatory power over other FDI theories, even though it is criticized as not a genuine theory of FDI because it derives most of its contexts from other theories of FDI.

2.4 Empirical studies of FDI

In terms of empirical analysis of the FDI, even though most previous studies employed qualitative analysis, there are still some econometric studies on this area.

Caves (1971) examines the industries characteristics and welfare effects of FDI in both home and host countries. These studies make clear that MNEs may reduce monopolistic distortions and induce higher technical efficiency.

Dunning's (1996) study, which is still based on the Eclectic theory, presents some results of a new field survey of the geographical sources of firm-specific competitiveness. The study is designed to assess the extent to which the executives of some of the largest industrial corporations in the world perceived how they had augmented their global competitive advantages as a result of their foreign direct investment. Among other interesting findings, a more it derived its competitive advantages from its foreign affiliates, a more proportion of such competitive advantages were obtained from abroad.

There are a number of studies about FDI determinants in Thailand. Tambunlertchai (1975) studies the behaviour of multinational corporations that receive promotion privileges from the Board of Investment (BOI) in 1971. He found that foreign investors produced products to serve the domestic market and wanted to protect their market shares in the host country. It can imply that the factors attracting inward FDI are size and growth of the domestic market, trade barriers from imposing tariffs, availability of low-cost labour and natural resources that are scarce in their home countries. This result is the same as Attakorn (1975).

Besides these two studies, Kanchanapanka (1978) is another researcher who found that FDI in different industries usually has varied motives. For example, foreign investors in resource-based industries such as food, mining, agriculture and paper were more concerned about the exploitation of domestic resources than other factors while foreign investors in market-oriented industries such as those in chemical industry were concerned about local market access. Foreign investors in market-oriented and labour-intensive industries such as textile industry considered accesses to domestic market and labour cost as the two most important factors. Kanchanapant (1985) found that the different kinds of industries investing by foreign investors are determined by different factors, which is similar to the study of Kanchanapanka (1978). In addition, Kanchanapant (1985) also investigated inflow FDI compare between Less Developed Countries (LDCs) and Developed Countries (DCs). She found that among the motivating factors that most DC investors concerned as important for investing in other countries are the drive for growth

of the firm, and the scarcity and high prices of certain resources in their home countries. On the other hand, to diversify risks caused by the unstable political environment in their home countries, LDC investors thus sometime invest outside their countries.

At the same time, Pupphavaesa and Pussarungsri (1994) focus on determinants of foreign direct investment in Thailand by using causality test method to find a relationship between FDI and other determinants such as GDP, an average tariff rate of Thailand, infrastructure in Thailand and exchange rate of Japanese Yen based on US dollar. They found that only GDP was significant at a 1 percent level while the other determinants were significant at a 5 percent level.

Moreover, the study of Jarurungsipong (1996) intends to examine the macroeconomic impacts of foreign direct investment in Thailand. His study deals with domestic private investment function, import function, export function, inflation function, growth function and foreign direct investment function which is different from the previous discussed studies in this Chapter: he concerns specifically on domestic inflation rate, political instability, real income growth rate of foreign investors, growth rate of non-oil developing countries and also inflation rate of Asian developing countries. He found that FDI in Thailand was consistent with Location Theory and Product Life Cycle Theory. Moreover, the inclusion of the political dummy strongly supported the hypothesis that foreign investors tend to prefer political stability.

Laplertsuk (1996) makes a contribution on factors affecting direct investment from EU in Thailand for his MSc thesis. His work deals with both trade and investment aspects. It is different from other studies in this area by focusing on source of FDI only (the EU). He employed OLS method and found that gross domestic product (GDP), consumer price index (CPI), minimum wage in Bangkok and Metropolitan, fixed deposit interest rate, foreign exchange rate and local situation affected direct investment from the EU at different significant levels and varied among countries of the EU.

All the above studies are concentrated in only one country while Wang and Swain (1995) try to compare two countries, which are Hungary and China. The study analyzes what determinants best explain foreign capital inflows into these two countries during the same period. Apart from GDP, which has been used in this model, similar to Jarurungsipong's work. This study deals with the ratio of Hungary's and China's average wage to the U.S. average wage, the U.S. government long-term bond yield, the exchange rate between host country and the U.S., the changes in host country imports and the average growth rate in the OECD countries. Their results suggest that FDI is positively determined by the size of the host country and negatively determined by the cost of capital and political stability. Labour costs also appeared to be an important factor for China, but not for Hungary.