CHAPTER II

REVIEW OF RELATED LITERATURE

Thailand is one of the selected countries as trading partners of investment by Japan. This study considers the reasons of Japanese FDI. So in this chapter, I have reviewed the following related literatures.

2.1 The Definition of Foreign Direct Investment

The definition of foreign direct investment (FDI) that is mentioned by Moosa concludes that Foreign direct investment is the process whereby residents of one country (the source country) acquire ownership of assets for the purpose of controlling the production, distribution and other activities of a firm in another country (the host country).

The International Monetary Fund's Balance of Payment Manual defines FDI as an investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise.

The United Nations 1999 World Investment Report (UNCTAD, 1999) defines FDI as an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor or parent of the enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise, affiliate enterprise of foreign affiliate).

Sometimes another qualification is used to pinpoint FDI, which involve transferring capital from a source country to a host country. For this purpose investment activities abroad are considered to be FDI when (i) there is control through substantial equity shareholding; and (ii) there is a shift of part of the company's assets, production or sales to the host country. However, this may not be the case, as a project may be financed totally by borrowing in the host country.

2.2 Theory of Foreign Direct Investment

John H. Dunning and Norman G. puts forward ideas about three advantages including a firm to invest internationally in the location Choice of offices of International Companies in 1987 that is called the eclectic theory. It explains broadly why international investment lays out. The advantages are ownership advantage, location advantage, and internalization advantage.

2.2.1 Ownership advantage

Ownership advantages are broadly called proprietary advantage. Those advantages that an investing film is superior against other competitors in the competing market. It does not only refer to more advanced capital, but also mention higher productions skills, specialization, managerial know-how, marketing advantages, products properties, etc. the advantage always accompanies with monopoly power in some level.

2.2.2 Location advantage

Location advantage implies to advantages on market size, price, cost, sale volume, economy of scope, economy of scale, etc, which are induced by firm's location. Thus, it can be said that economics environment of a country defines the country's location advantage.

Moreover, as firms follow how to getting maximizing profit, firms must keep the total cost of setting of new affiliate that shall not be higher than the overall existed affiliate in order to enjoy higher profit. Thus, the location factors can highly affect the decision of international direct investment.

2.2.3 Internalization advantage

Providing proprietary advantage accompanying with location advantage a firm may acquire, firms lead to internalization advantage. It turns out higher operational profit to the firm by reducing transactional cost and the profit margin that the firm has to pay. Internalization will also yield more profit to the firms by increasing value added to the products. By internalization, the firm must give rise to higher rate of productivity and profitability.

2.3 Incentive Factors for Japanese FDI

Many studies try to identify the motive factors influencing the decision to invest abroad. This part will begin to review the evidence on the factors influencing to the decision to invest abroad.

Urata 1997, mention that to maintain international price competitiveness, export-oriented firms need to set up a production base where production can be performed at low cost, low wages, low inflation, undervalued exchange rates, and well-developed and well-functioning infrastructure such as telecommunications and transportation systems are important determinants of cost-saving FDI. Indeed, cost saving type FDI has been a major factor leading to FDI diversion in Asia.

Supanee 1985, this finding is also confirmed by literature review of Supanee's study. The examine of the foreign investment in Thailand by the Japanese investors found that securing, maintaining, and developing markets had been the dominant motivations for the Japanese investors in making overseas investment. The motives related to the cost factors (i.e. the desire to obtain low cost bases of the products manufactured), and the motive to enjoy special investment incentive provided by the government in other countries are considered as important. Supanee's literature review also point out that factors of good investment climate, which include the political and economic stability, stability of labor force, stability of currency, the availability of foreign exchange, and together with the favorable attitude of the local public toward foreign direct investment too.

According to Bayoumi and Lipworth 1997, the empirical analysis looked at FDI outflows of them, the results suggest that the main driving forces for Japanese FDI are domestic investment and the exchange rate, but that the investment climate of recipient countries influences the distribution of FDI.

Exchange rate is one of a factor that can affect FDI in various ways. The previous studies have generally found that a depreciation of the host country's currency has a positive effect on FDI inflow. Depreciation lowers the costs of production and investment in host countries relative to the cost in source countries, making foreign investment more profitable.

Urata 1998, examined that several push factors were responsible for the rapid growth of Japanese FDI in half of the 1980s. The rapid and steep appreciation of the yen exchange rate against other currencies was the most important macroeconomic factor leading to the expansion of Japanese FDI in the second half of the1980s.

Kinoshita 1998, study the location determinant of FDI in the context of Japan manufacturing FDI in Asia. She also analyzes factors endogenous to the investing firm's size and industry attributes as determinants of FDI. She found that investment by Japanese firm in Asia is generally motivated by large host market size, infrastructure, favorable policy environment, and intra-industry strategic rivalry. Among these, policy environment is the most important determinant. The availability of low-cost labor does not necessarily help increase the likelihood of their investment. Kinoshita also suggests that the appreciation of the yen since 1985 is often believed to have put cost pressures on many Japanese manufacturing firms to relocate their production sites to a country where they can utilize cheap labor

Urata 1998, point out that one important factor in attracting FDI in manufacturing to ASEAN has been the ASEAN countries from inward-oriented to outward-oriented strategies. For example of FDI inflows into China have also grown quickly since 1988-1989 due to China's gradual but persistent economic reforms, liberalization in trade and FDI policies, and its political and social stability.

As of 1994, China was the largest recipient of Japanese FDI in Asia. The attractiveness of China as a host to FDI has increased recently because some ASEAN countries have lost their attractiveness increases in the production costs including wages, material and services cost, currency appreciation, shortage of manpower, emergence of serious bottlenecks in infrastructure and other factors. In recent years, Japanese FDI to other Asian countries such as Vietnam and India has begun to increase because liberalization of FDI policies by these countries attracted Japanese investors.

On the other hand, FDI promotion policies by the host government appear to have played a important role in attracting Japanese FDI, since one out of four Japanese firms in manufacturing undertook FDI in response to the incentives given to FDI. It should be noted that FDI promotion policies by host countries are important for attracting FDI in developing countries in general.

Kinoshita also found that for smalls firms, low labor cost and availability of infrastructure are the major determinants of their location choices, while medium-size and large firms seek to invest in a country with large market size.

Supanee 1985, it has been found that the factors in the home country, which developed countries investors considered most important for making overseas investment, were the rising price of labor and over competition in their home markets. At this stage, various environmental factors in the host country are the choice of location, which may be essential for the decision to invest by foreign investors.

Supanee concludes about the factors in the home country, which developed countries investors considered to be the most important for making overseas investment were the rising price of labor and over competition in their home market. In case of the general motivating factors for overseas investment to obtain better access of expanding markets for the products manufactured and to gain advantage of lower labor cost are the most important factors considered by most developed countries investors in including them to make the overseas investment. The next important factors are environmental factors in the host country, which may be essential for the decision to invest by foreign investors and include production, existence of investment incentives, and the adequacy of infrastructure facilities. In case of the choice of location to invest, various environmental factors existing in the host country such as the availability of specific factors of production, the investment incentives provided by the host country government are regarded as important for foreign investors. In addition, an important factor that induces foreign investors to invest in Thailand is due to the invitation by Thai investors who have the business connections with them before making the direct investment.