

A contrast of theories of horizontal fdi economics essay



Foreign direct investment is mainly carried out by multinational enterprises whose economic entities are cross-bordered and presented in two or more countries. This investment often requires a firm from one country account for 10% share at least in the equity capital of another firm in different country. Because of its important role in speeding the process of globalization and its dramatic increase for recent 20 years in the global economy, FDI has been a significant feature in multinational enterprises. Horizontal FDI is FDI is the same industry abroad as a domestic firm operates. Actually, compared with either exporting or licensing, FDI is relatively expensive and risky for the firm usually builds a new enterprise from scratch and with a long distance and difficulties in communication, it may result in a different culture.

The preference of FDI to other options is concerned with these factors, transportation costs, marketing imperfections, competition and the product life-cycle. When transportation costs of low value-to-weight products are added to the production costs, it becomes less profitable. The other four factors are considered as the 'Theories of horizontal FDI' (Hill, 2005). These factors have resulted in fiercer competition among firms and in turn lead to a boom in many cross-border enterprises to enhance innovation and competitiveness in the process globalization. Dunning (2000) suggested that FDI is not merely the transfer of capital but refers to the transfer of technology and management strategies. These factors donate FDI unique explanations to different theories, such as the market imperfections approach, Hymer's (1976) international operations of national firms, Vernon's (1966) product life cycle theory, and Knickerbocker's Oligopolistic

Competition theory. Following passages will present a brief contrast and analysis of these theories to have a thorough understanding of PDI.

2. An Overview of Main Theories of FDI

2. 1 The Market Imperfections Approach

At mere mention of the market imperfection, we usually associate it with financial markets involving taxes and transactions. However, market imperfection is never confined to this and actually it interferes with almost every transaction in some way, generating costs which would affect rational trades or make in the absence of imperfection. With a clear understanding of these costs, people can obtain an insight for costs of transactions to know where to place or how to undertake them. Then, market imperfection can produce profit business opportunities for entrepreneurs (Jensen & Meckling, 1976), for many costs are paid to individuals or entities after all.

Most economists favor the market imperfection explanation of PDI (Ramon, Market Imperfections) which is considered as the major factor of why firms are in preference to FDI with other two options of exporting or licensing. The market imperfection approach to PDI is traditionally considered as international theory referred in the international business literature. In terms of horizontal FDI, there are two circumstances leading to market imperfections; one is the impediments to the products' free flow and the other is hindrances to the sales promotion (Carton & Perloff, 2005). With regard to impediments to exporting, governments are the primary resource to impede the products' free transactions among nations. In order to promote the cost of exporting, governments usually expose tariffs on

imported goods relative to FDI and licensing. In turn, governments can increase the attractions of FDI and licensing through limiting imports quotas.

As for impediments to the sale of know-how, it is mainly presented in the competitive advantage which is derived from the technology, marketing and management skills of firms. Technology know-how promotes better products of a company and meanwhile it can improve the production process. If the expertise is viewed as a competitive entity, the larger asset applied in the market, greater profits can be obtained from the asset.

2. 2 Vernon's Product Life -Cycle Theory

With regard to the product-cycle theory, Vernon (1966) suggested that the location of products can not be decided by standard factor-cost or labor-cost but by a rather complex process. The evidence of the theory was drawn from two important features of the United State's economy at that time: the highest average income in the US and relatively higher unit labor costs than other countries in the world. In view of Vernon, a product has a life cycle including three stages which are quite important for they have implications for the international location.

Stage one: the process of product development. The nature of products made by firms is generally not standardized and only when the input in the process of production is precisely calculated, a product can be in standard. The lack of standardization implies a potential uncertainty around the product so the communication and negotiation between producers, suppliers and customers become essentially importance, which results in a location decision to situate the product near its markets (Jonathan & Colin, Foreign <https://assignbuster.com/a-contrast-of-theories-of-horizontal-fdi-economics-essay/>

Direct Investment and Regional Economy). Stage two, maturing product. With an increase demand in the product, the product cycle emphasizes a greater degree of standardization. Then the product is not constrained in local markets but form economies scale to meet the larger demands, particularly the growth of demands in other countries. These will influence the decision of the firm whether it is right time to set up production abroad. The decision is much dependent on the degree of competition abroad, like the patented product and tariffs abroad. Stage three, standardized products, is an extension of the second stage where a final framework of products is formed. Then the international market has been established and the price competition can decide sales. Cheap labor costs can motivate firms setting up in these areas and less-developed countries can enjoy relative benefits.

2. 3 Knickerbocker's Theory of FDI

The theory of oligopolistic competition is the core part of Knickerbockers which is another approach to horizontal FDI. An oligopoly means a limited number of firms controlling most of the market in one industry. Hill (2005, p. 226) once presents an example of the oligopoly that four firms account for 80% of a domestic market in an industry, particularly in oil industries or global tyre. Such oligopolistic companies are sensitive to market share for loss of market share is the primary factor of the extinction of a firm.

Knickerbockers' theory insists that one member of an oligopoly undertaking FDI can affect or even limit this initiative of other members, which is also a crucial competitive feature, namely the interdependence of the major

players. One firm cuts prices in an oligopoly can occupy more market share, forcing its competitors to follow the similar price cuts to maintain

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competition in market share, which is a kind of imitative behavior shaping many forms in an oligopoly.

The theory of Knickerbockers also contains multipoint competition. Two or more enterprises of in different regions, national markets or industries encounter together, arising multipoint competition. Economic theory argues that a rival does not merely occupy a commanding position in one market but strengthen competitive attacks in other markets by using the profits generated there.

3. Best Explanation of FDI___ Oligopolistic Competition

As regard to the market imperfections, it provides an explanation why a firm in oligopoly decides to undertake FDI and also addresses the preference of FDI to other options of exporting or licensing. Alternatively, the product life-cycle theory merely insists that FDI will occur once a foreign market is large enough to support local production, but it fails to identify the most profitable time to invest abroad. Although Knickerbocker's theory dose not addresses efficiency issues of FDI, it provides an explanation to imitative FDI behavior of firms in oligopolistic industries. Comparing these theories, I believe oligopolistic competition is the best explanation of FDI.

3. 1 A Brief Introduction of the Theory

Global oligopolistic competition undoubtedly plays an important role on FDI while this factor is usually ignored in FDI literature. Since the late 1950s, the apparent gap in FDI has been recognized duo to disproportional operations of in oligopolistic markets (Marcusen, 1995; Graham, 1998). The features of an oligopolistic industry indicate that in an industry, decisions of one firm are <https://assignbuster.com/a-contrast-of-theories-of-horizontal-fdi-economics-essay/>

immediately affected by other firms and therefore, the strategies of other companies are usually taken into consideration in the industry. The strategic interactions of firms can transform many competitive strategies to the cooperative (Brandenburger & Nalebuff, 1995). One apparent feature is that under oligopolistic industry structure, the actions of firms are based on rivals' actual behaviors and influenced by the mutual independence between players so the oligopoly is distinct from monopoly because a company should take the behaviors of others into consideration to draw out a best strategy for itself (Carton & Perloff, 2005: 153). In general, IO based explanations emphasizing the leveraging power of market and oligopoly as the main explanation for firms' global expansion (Teece, 2006; 127).

3. 2 A Strategic Management Perspective on FDI

Oligopolistic competition theory offers the best explanation for FDI, for it provides a strategic management to illustrate the shift of FDI. Economic theory often focuses on the effectiveness in individual activities while strategy tends to combine a whole system of activities (Porter, 1996). Actually, the strategic management literature is mainly concerned with the uncertainty and particular sides brought by firm environment to the manager and the way of interpreting these environmental conditions and combining internal competences. In terms of strategic management of oligopolistic competition, it can provide additional insight for some situations where direct economic reasoning or some arguments based on the asset can not explain FDI strategy. Under this circumstance, FDI is merely viewed as a part of its broader context, such as a managerial direction or a competitive situation of a firm.

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The strategic management does not agree with that multinational corporations respond in similar ways when faced with similar situations or opportunities in global economy. This perspective plays a leading role in guiding the manager to make decisions through complexity of allocation of global resources. What's more, the respective take a form from a concentration on a firm to a concentration on firms' interaction. Besides, the strategic management perspective also argues that individual FDIs should be given a comprehensive view, concerning their significant strategic and operational contributions to the investing firm. Kogut (1989) once argued that compared with the decision to invest overseas to gain the strategic value from operating assets in global countries, the significant change in thinking about global competition accounts for a much heavier position (Kogut, 1989: 385). Over the past two decades, the request to integrate strategic management into FDI theory has been strengthened and in increasingly globalizing marketplace, the advantages of this perspective have become more apparent.

3. 3 Manifestations Strategic Interaction in FDI

The strategic interaction in FDI is associated with the timing of the investment and a final category of strategic interaction is usually motivated with competitive activities in other regions. As noted by Porter (1986), a firm's competitive position in one market is mainly determined by its competition in other markets, which is a significant of a global industry. Therefore, FDI is probably promoted by a company's superior global positioning to its rivals instead of individual properties on investment.

Sometimes, MNCs are likely to pursue assets and positions, not for their <https://assignbuster.com/a-contrast-of-theories-of-horizontal-fdi-economics-essay/>

properties but because they can supply opportunities to investors for future games in given locations. Dominant firms in oligopolistic industries controlling global markets is a special issue in global competition. So many MNCs usually do not move into an inhabited market of competitors to avoid direct competition and instead they will strive for a potential market. This will increase profits for a firm in the industry but not social welfare.

When talking about strategic interaction of oligopolistic competition in FDI, we often refer to the 'first mover' phenomenon which is associated with the investment motives. A first mover is an essential way to generate, coordinate or further strengthen oligopolistic advantage. First movers play a crucial role in deterring or preventing followers from developing by occupying and carving for new markets through FDI. First mover is crucially important in oligopolistic industries, acting a role of "winners-take-all" and we may find "competition for markets" in such industries (Tacobsen, 2008; 62). Horizontal FDI is a typical example to illustrate the creation of dominance through pro-purchasing. First movers are not likely to control the whole market first but they may benefit in larger competitive games through forcing competitors to take on premature investment in locations (Miller and Folta, 2002).

3. 4 Examples of Strategic Interaction Shaping FDI

The example I will discuss is related to the waves of mergers and acquisitions (M & As) with a surge in emerging markets since the early 1990s. M&As occupied a proportion of 70-80% of FDI between 1995-2000 and 2003-2007. Actually, in 2007, the total value of M&A reached to \$1700

billion out of 2000 billion of total global FDI (UNCTAD, 2009). The current growth taking place in M&As in industries may suggest that strategic interaction also exposes an effect on cross border M&A (WIR2000; 155). Following passage will present an example of the brewing industry to illustrate global strategic interaction in M&As.

Currently, the brewing industry gives an explanation for the global consolidation game. Because of dramatic cuts in large companies over the last decade, finally, the top twenty brewing groups dominated about half volume of total beer in world by the end of 1990s while today merely four players occupy the same volume of global beer sales. The process of consolidation is motivated by both scale factors and market power factors. To make profits in this industry, firms must have abilities to generate effective scale advantages in the process of production, sales, marketing and distribution. Besides, a competitive position in markets you are engaging in is necessary. For example, the Danish brewery Carlsberg spreads in 150 markets over world and has expanded from a national brewery to a major player in global market for beer in recent years. Carlsberg through the acquisition of Scottish Newcastle has maintained a leading position in Russian market and enjoyed a fifty-fifty joint venture in the dominant brewery, Baltic Beverages Holding in Russia. The success of Carlsberg, to a great extent, is contributed to its positive acquisition strategy though it is viewed as an independent player.

4. Conclusion

Following a brief introduction of the main theories of Foreign Direct

Investment, the marketing imperfections, Vernon's Product Life-Cycle theory
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and Knickerbocker's oligopolistic competition theory, this paper presents a brief contrast and analysis among them. Then it mainly focuses on the oligopolistic competition theory, a best explanation for the horizontal FDI from aspects of strategic management prospective on FDI, strategic interaction in FDI and examples of strategic interaction in FDI. Every theory possesses its own emphasis and also has its limitations. For example, the product life-cycle theory merely insists that FDI will occur once a foreign market is large enough to support local production fails to identify the timing of investment abroad and Knickerbocker's theory dose not addresses efficiency issues of FDI. Actually, FDI of companies are complex institutions and their motivations and behaviors are not merely determined by economic theories. However, theories or strategies can be developed in terms of rivals, markets and customers or the innovation and workforce of governments. In conclusion, with a thorough understanding of theories of FDI is necessary for future business.