

Theories of foreign direct investment (fdi)



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This report has discussed different theoretical framework of FDI that takes place. These theories briefly explain why firms go to trouble when establishing or acquiring abroad. Theories that use on this report are Hymer's contributions, product life-cycle theory, caves theory, internalisation theory, the eclectic paradigm, strategic motivations of foreign direct investment and investment path development (IDP) theory. This report also evaluates Honda automotive as an example on how they survive and compete in the competitive international markets nowadays with using FDI models, statistics and theories. Based on these analyses, I feel that FDI takes an important role to both foreign and host countries and also impact firm behaviour or effects on host economies.

Introduction

This report will discuss Foreign Direct Investment theories and evaluate the FDI of a leading player industry that chosen, Toyota, Japan. Foreign direct investment (FDI) is the name given to process where a firm from a country provides capital to an existing or newly-created firm in another country (Jones, 2006 #1). For example, a foreign firm may decide to set-up production in the UK and by so doing will engaging in the process known as FDI. Firms locating production in more than one country are often referred to as multinational enterprises (MNEs). Dunning (1981) notes there are two main problems with viewing FDI. First, FDI is more than just the transfer of capital, since just as importantly it involves the transfer of technology, management and organizational skills. Second, the resources are transferred within the firm rather than between two independent parties in the market place, as is the case with capital (Jones, 2006 #1). These factors give FDI

own a unique key theories and often cited as Hymer (1960) international operations of national firms; Vernon's (1966) product life-cycle theory; Cave's (1971) horizontal and vertical theories; Buckley and Casson (1976) Internalization theory; Dunning (1977) eclectic theory; Graham (1978) strategic behavior of firms and John Dunning (1981) investment development path (IDP) theory. This report will begin by examining the Hymer (1960) theory.

(Keywords: Foreign Direct Investment, FDI, theory, Japan FDI, Honda)

Literature Review

1. 1 Hymer (1960) international operations of national firms

Hymer's (1960), who saw flaws in the prevailing view that direct investments and portfolio were synonymous with one another. Hymer noted that direct investment was mainly performed by firms in manufacturing, whereas there was a predominance of financial organisations involved in portfolio investment (Jones, 2006 #1). Hymer was also explained why direct investments across various countries (Kogut, 1998 #2). Hymer (1960) expressed his dissatisfaction with the theory of indirect (or portfolio) capital transfers to explain the foreign value-added activities of firms (Dunning, 2008 #3). In particular, he identified three reasons for his discontent. The first was that once uncertainty and risk, the cost of acquiring information and volatile exchange rates and making transactions were incorporated into classical portfolio theory, many predictions, for example, with respect to the cross-border movements of money capital in response to interest rate changes, became invalidated. This was because such market imperfections modified the behavioural parameters affecting performance of firms and the <https://assignbuster.com/theories-of-foreign-direct-investment-fdi/>

conduct and, in particular, strategy in servicing foreign markets (Dunning, 2008 #3). Second, Hymer stated that FDI involved the transfer of a package of resource (i. e technology, entrepreneurship, management skills, and so on), and not just finance capital which portfolio theories such as Iversen (1935) had sought to explain. The third and perhaps most fundamental characteristic of FDI was that it involved no change in the ownership of resources or rights transferred, whereas indirect investment, which was transacted through the market, did necessitate such a change. In consequences, the organisational modality of both the transaction of the resources, for example, intermediate products, and the value-added activities linked by these transactions was different. Moreover, Hymer's theory of FDI draws its influence from Bain's (1956) barriers to entry model of industrial economics (Teece, 1985). Hymer begins by noting that there are barriers to entry for a firm wanting to set-up production abroad. These are in the form of uncertainty, risk, and host-country nationalism (Kogut, 1998 #2). Uncertainty gives rise to costs in overcoming informational disadvantages associated with unfamiliarity with local customs. Each country has its own languages, legal system, economy and government, which place firms from outside of the country at a disadvantage compared to firms that are naturally resident to the country. The second barrier is nationalistic discrimination by host countries, which may occur by the government with a protectionist agenda, or by consumers of the host country who prefer to purchase goods from own national firms for reasons of patriotic or loyalty tendencies. The final barrier manifests itself as an exchange rate risk (Kogut, 1998 #2). As the firm has to pay a dividend to its shareholders in the home country it has to repatriate the profits back to its own currency.

Given these barriers to international productions, why do firms engage in foreign direct investment? According to Hymer there are two reasons, whether of which could apply, and both of which are expected to increase its profits (Kogut, 1998 #2). First, the firm removes competition from within the industry, by taking-over or by merging with firms in other countries. Second, the firm has advantages over other firms operating in a foreign country. Examples of the latter are the ability of the firm to acquire factors of production at a lower cost, the use of better distributional facilities, the ownership of knowledge not known to its rivals or a differentiated product that is now known in the other country. Both reasons stress the importance of 'market imperfections' (Dunning and Rugman, 1985), and underlying these the investor has direct control of the investment.

Overall, these reasons are not sufficient for a firm to engage in direct foreign investment, as what is necessary is that it must enter the foreign market in order to fully appropriate the profits, for example, a firm could license its product to a firm in the foreign country, so that it need not directly invest in the market. However, there are problems with licensing the product. These include the failure to reach an agreement with the licensing firm over the levels of output or prices, or the costs involved in the monitoring an agreement made between the firms.

1. 2 Product Life-Cycle Theory

Vernon (1966), argued that "the decision to locate production is not made by standard factor-cost or labour-cost analysis, but by a more complicated process" (Kogut, 1998 #2, p. 29). The product cycle model was introduced in the 1960s to explain market-seeking production by firms of a particular

ownership or nationality (Dunning, 2008 #3). On the other hand, the product cycle was the first dynamic interpretation of the determinants of, and relationship between, international trade and foreign production (Dunning, 1996 #5). It also introduced some novel hypotheses regarding demand stimuli, technology leads and lags, and information and communication costs, which have subsequently proved useful tools in the study of foreign production and exchange (Dunning, 1996 #5). According to Vernon, a product has a life cycle that has three main stages. These stages are important as they have implications for the international location of a product as follows.

Stage One: Product development process. In other words, the nature of the product that the firm is making is not standardised (Kogut, 1998 #2).

Stage Two: Maturing product. This means that the need for the product to be situated near to its market declines, which allows for economies of scale. These impact on the locational decision of the firm, especially as the demand for the product is likely to grow in other countries, and the firm will have to decide whether it is worth setting up production abroad. Furthermore, this could even mean that the home country experiences exports back to it from the foreign plant.

Stage Three: Standardised product. This is an extension to the maturing product stage, where the standardisation of the product has reached its 'zenith', and a final framework of the product has been found (Kogut, 1998 #2).

1.3 Caves Theory

Caves (1971), expanded upon Hymer's theory of direct investment, and placed it firmly in the context of industrial organisation theory (Jones, 2006 #1). The importance of Caves work is that this theory will linked Hymer's theory of international production to the then current theories of industrial organisation on horizontal and vertical integration. Caves identify between firms that engage in horizontal FDI and those that undertake vertical FDI (Dunning, 2008 #3). Horizontal FDI takes place when a firm enters into its own product market within a foreign country, whereas vertical FDI happens when a firm enters into the product market at a different stage of production (Jones, 2006 #1).

1.4 Internalisation Theory

Coase (1937), examines the role that transaction costs play in the formation of organisations known as internalisation theory (Jones, 2006 #1). In brief, Coase was concerned with why firms exist and why not all transactions in a n economy occur in the market. Coase also answered this in terms of the transactions costs involved in using the market, where this is the cost of searching and determining the market price, or, once the price is found, the cost of negotiation, signing and enforcement of contracts between the parties involved in the transaction. The process of internalisation is developed to explain international production and FDI, and one of the leading proponents is Buckley and Casson (1976). They present the MNE as essentially an extension of the multi-plant firm (Dunning, 2008 #3). Bucley and Casson note that the operations of firm, especially large firms, take the form not only of producing services and goods, but activities such as

marketing, training, development and research, management techniques and involvement with financial markets. These activities are interdependent and are connected by 'intermediate products', taking the form of either knowledge or material products, and expertise. A key intermediate product in the internalisation theory of FDI is knowledge. One reason is that knowledge takes a considerable period of time to generate, for example through development and research, but is highly risky, so that futures markets do not exist. Sellers of markets may be unwilling to disclose information, which has uncertain value to the buyer, causing market fail. Further, sellers and buyers of knowledge can often hold a degree of market power, which leads to a 'bilateral concentration of power' (Williamson, 1979), and uncertain outcomes (Dunning, 2008 #3). These problems indicate the severe difficulties in licensing and contracting where information is crucial.

In regards to internationalisation, the public good property of knowledge means it is easily transmitted within the firm, regardless of whether it is inside or across national boundaries. This creates internal markets across national boundaries, and as Buckley and Casson state, as firms search for and exploit knowledge to their maximum potential they do so in numerous locations, with this taking place on an international scale, leading to a "network of plants on a world-wide basis" (Jones, 2006 #1, p. 45). The internalisation theories of FDI played an important role in advancing and developing the theory of FDI in the 1970s and have remained popular since that time (Dunning, 2008 #3).

1. 5 The Eclectic Paradigm

(Please refer to table 2. 1 and 2. 2 in reading this section)

Reflecting upon the history of the theory of FDI, Dunning (1977) noted that it was very much couched in terms of either the structural market failure hypothesis of Hymer and Caves or the internalisation approach of Buckley and Casson (Dunning, 1996 #5). Dunning provided an eclectic response to these by bringing the competing theories together to form a single theory, or paradigm as it is more often referred. The basic premise of Dunning's paradigm is that it links together Hymer's ownership advantages with the internalisation school, and at the same time adds a locational dimension to the theory, which at the time had not been fully explored (Jones, 2006 #1). Further, Dunning does manage to introduce some new considerations, such as the impact that different country and industry characteristics have on each of the ownership, locational and internalisation advantages of FD (Jones, 2006 #1).

The eclectic paradigm of FDI states that a firm will directly invest in a foreign country only if it fulfils three conditions. First, the firm must possess an ownership-specific asset, which gives it an advantage over other firms and which are exclusive to the firm. Second, it must internalise these assets within the firm rather than through contracting or licensing. Third, there must be an advantage in setting-up production in a particular foreign country rather than relying on exports (Blomstrom, 2000 #8). Different types of ownership (O), locational (L) and internalisation (I) factors are given in Table 1 (collectively known as OLI) (Jones, 2006 #1).

Internalisation advantages are the ways that a firm maximises the gains from their ownership advantages to avoid or overcome market imperfections (Dunning, 1996 #5). Internalisation-specific advantages results in the process of production becoming internal to the firm. Reasons for internalisation include the avoidance of transaction costs, the protection of the good, market and finance, avoidance of tariffs and the ability to capture economies of scale from production (Dunning, 2008 #3).

Moreover, not all of the OLI conditions for FDI will be evenly spread across countries, and therefore each condition will be determined by the factors that are specific to individual countries (Dunning, 1996 #5). Links between the OLI advantages and the country-specific characteristics are summarised in Table 2. For example, the ownership-specific advantage of firm size is likely to be influenced by market size in the firm's home country (Dunning, 1996 #5). This is because the larger the market is, the more likely will a firm be able to gain ownership-specific advantages in the form of economies of scale. In terms of location-specific factors, labour costs will vary across developed and developing countries, while transport costs are determined by the distance between the host and home countries. Finally, country-specific factors are likely to affect the degree to which firms internalise their advantages.

1. 6 Strategic Motivations of Foreign Direct Investment

Despite the advances made by the eclectic approach to FDI, the theory has been criticised for ignoring another aspect of FDI theory. Knickerbocker (1973), and then advanced by Graham (1978, 1998). The distinguished feature of the strategic approach to FDI is that it believes that an initial

inflow of FDI into a country will produce a reaction from the local producers in that country, so that FDI is a dynamic process. The process from the domestic producers can either be aggressive or defensive in nature. An aggressive response would be a price war or entry into the foreign firm's home market while a defensive response would be an acquisition or merger of other domestic producers to reinforce market power (Dunning, 1996 #5).

1. 7 Investment Development Path Theory

John Dunning's 'investment development path (IDP)' theory (1981) and its latest version (Dunning and Narula 1994) are implicitly built on the notion that the global economy is necessarily hierarchical in terms of the various stages of economic development in which its diverse constituent nations are situated. The IDP essentially traces out the net cross-border flows of industrial knowledge, the flows that are internalised in foreign direct investment (FDI) and that restructure and upgrade the global economy, although there is also the non-equity type of knowledge transfer such as licensing, turn-key operations, and the like. In this way, the IDP can thus be viewed as a cross-border learning curve exhibited by a nation that successfully moves up the stages of development by acquiring industrial knowledge from its more advanced 'neighbours'. A move from the 'U-shaped' (i. e. negative NOI) portion to the 'wiggle' section of the IDP indicates an 'equilibration in knowledge dissemination' (Dunning, 1996 #5, p. 143) and that is, a narrowing of the industrial technology gap between the advanced and the catching-up countries. Thus, IDP curve conceptualised by Dunning is an idealised pattern based on free-market exchange of knowledge among countries (Dunning, 1996 #5).

Japan Automotive Industry

2. 1 Components-intensive assembly-based manufacturing and FDI

(first, trade-conflict-skirting, but later rationalising type)

Automobiles and auto-parts had long been targeted by the Japanese government as one of the most promising industries in which both higher technological progress and productivity were possible and whose products were highly income elastic. In addition to automobiles, another components-intensive, assembly-based industry that successfully emerged in Japan in the 1970s was consumer electronics (Dunning, 1996 #5). Both automobiles and consumer electronics came to capitalise very adroitly on Japan's dual industrial structure in which numerous small and medium-sized enterprise coexisted alongside a limited number of large-scale firms; the former specialised at the relatively labour-intensive end, while the latter operated at the relatively capital-intensive, scale-based end of vertically integrated manufacturing (Dunning, 2008 #3).

Furthermore, it was also in Japan's auto industry (at Toyota Motor Co., to be exact) that a new manufacturing paradigm, 'lean' or 'flexible' production, originated as a superior alternative to 'Fordist' mass production (Womack, Jones and Roos, 1990). This technological progress came to be reflected in rising technology exports in the transport equipment (mostly, automobile) industry. But the very success of building up the efficient, large-scale (hence exploitative of scale/scope economies) hierarchies of assembly operations in highly differentiated automobiles and electronics goods, along with increased R&D and technological accumulation (which is reflected in

increasing technology exports), resulted in Japan's export drive and expanding trade surplus. These situations in turn quickly led to trade issues and the sharp appreciation of the yen (Dunning, 2008 #3).

To circumvent protectionism, Japanese producers of automobiles and electronics goods began to replace their exports with local assembly operations in the Western markets, mainly in North America and Europe. Meanwhile, they also started to produce fairly standardised (ie. Relatively low value added) parts and components, or those that can be cost-effectively produced, locally, both in low-wage developing countries, especially in Asia, and in high-wage Western countries- in the latter, with the installation of labour-cost-reducing and labour-quality-augmenting automation equipment mostly shipped from Japan. Therefore, a network of Japanese overseas ventures began to 'straddle' the advanced host countries and the developing host countries at the same time (Dunning, 2008 #3).

Recently, these assembly-based FDIs are going beyond the trade-conflict-skirting phase to reach a new phase of rationalised cross-border production and marketing. More and more components are produced at supplied home to the overseas manufacturing outposts. Also, low-end products (models) are assigned to production and marketing in the developing host countries, especially in Asia; some are imported back into Japan. Thus, we can discern a more refined or more sharply delineated and specialised form of trade within an industry (i. e intra industry) or more appropriately within a firm (i. e intra-firm trade) and within a production process (i. e inter-process trade), a new form of trade made possible by rationalisation-seeking type of FDI (Dunning, 1996 #5).

2. 2 Toyota

(Please refer to appendix 1 & 2 in reading this section)

The Japanese market is the most consolidated of all triad markets. Toyota, is a transnational Japanese international car manufacturer where headquartered in Aichi, Japan (Dunning, 2008 #3). According to appendix 1, in 2011, Toyota was the fifth biggest transnational companies with foreign sale as 60. 8 percent of total. Also, it has 38% of its 326, 000 workers abroad (Economist, 2012 #7). In 2009, Toyota alone has 36. 88 percent of the passenger car market, 18. 29 percent of the truck market and 79. 72 percent of the bus market (M. Rugman, 2012 #6). Excluding Japan, Toyota is the market leader in two of the six largest countries in Asia Pacific which are Malaysia and Thailand (M. Rugman, 2012 #6). Furthermore, in 2009, two regional markets accounted for 78 percent of Toyota's revenue Asia (with Japan at 48. 3 percent of revenues) and North America (at 29. 70 percent of revenues); Europe was only at 14. 1 percent of revenues and rest of the world 7. 9 percent, and hence, it is a bi-region-focused company. According to appendix 2, In term of units sold, the geographic distribution is similar where Asia and Oceania account for 14 percent, North America 32 percent and Europe 14 percent. Therefore, in terms of revenue and units sold, Toyota is a bi-regional company (Dunning, 1996 #5) .

Over 10 years, Toyota's intra-regional percentage of sales has decreased from 57. 1 percent to 46. 2 percent. One major reason for this is the Japanese market itself, where sales decreased for 48. 4 percent of total revenues in 1993 to 38. 3 percent in 2002. As comparison, North American, European, and non-triad sales have steadily increased in importance. Toyota

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manufactures locally over two thirds of the car sells in United States. Local responsiveness is important for Toyota. Toyota introduced its luxury models to accommodate the wealthier and aging North American baby boomers in the 1990s. Today, the company is introducing cars to target the young American customer, the demographic echo of the baby boomers. Since 60 percent of US car buyers remain loyal to the brand of first car, it is thus imperative to service this young market (M. Rugman, 2012 #6).

Furthermore, american consumers, have been responsive to the company's reputation for lower price and quality at which Toyota's cars are sold (M. Rugman, 2012 #6). Also, the resale value is also higher for Toyota cars. One major advantage for Toyota is that it has some of the best manufacturing facilities in the world, and it combined this with excellent relationships with its suppliers. Until recently, Toyota was one of the most efficient companies at outsourcing production to suppliers with whom it enjoys amicable long-term, sometimes keiretsu-style, relationship (Dunning, 2008 #3). If the auto industry is to become more like the electronics industry, vehicle brand owner (VBOs), such as GM, and VW, will be the equivalent of original equipment manufacturers (OEMs) in the electronics industry, such as Nokia, and will concentrate on designing, engineering, and marketing vehicles to be sold under their brand while others take care of manufacturing (Dunning, 1996 #5). Toyota is probably further along this outsourcing route than other triad auto makers.

Overall, although Toyota has much intra-regional trade and FDI, this does not mean that trade or FDI between them has declined (M. Rugman, 2012 #6).

As discussed, all of them have invested large amounts of money in each

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other. For example, in 2008, the EU country has \$1, 622. 911 billion of FDI in the United States and \$86. 915 billion in Japan. The United States imports \$377 billion from the EU and \$143. 4 billion from Japan. So they are closely linked in terms of both trade and FDI (M. Rugman, 2012 #6).

3. Conclusions

Overall, this report has reviewed the theoretical literature on foreign direct investment and Honda automotive in the FDI international markets. Since Hymer, there have been attempts to address a number of issues, such as why FDI occurs and where it locates. This report has also take on board developments in Dunning's eclectic paradigm of FDI, which not only encompasses ownership and internalisation advantages of multinational enterprise, but the role that location plays in a firm's decision to invest abroad. Since the time of the eclectic paradigm, other theories have emerged that have stressed the importance of the role of strategy in FDI in the face of ' globalisation' and a corresponding growth in competition between firms. In this, the role of the traditional barriers to entry across countries, such as the differences in the legal, economic environments and linguistic, have become less important, and FDI is now be viewed as competition between a few firms on an international stage (Dunning, 1996 #5). Dunning's IDP paradigm provides a thought-provoking framework to examine the Japanese industry experience, because the case of Japan seems so ' deviant' from the ' norm' set forth in the macro-IDP pattern. The Asian NIEs and the new NIEs (ASEAN-4) and now ' new' new NIEs (China, Vietnam and India) have moulded their developmental strategies along the line of MNE- facilitated development in order to ' swing up'. Indeed, Japan

automotive seems to have been a role model for other East and South East Asian countries to match in their drive to economic modernisation.

In addition, to the high level of international business conducted across the triad, companies in the triad are constantly looking for new ideas from other regions that will make them more competitive. In the United States, for example, the head of the Federal Reserve System has expressed the belief that US antitrust practices are out of date and that competitors should be allowed to acquire and merge with each other in order to protect themselves from world competition (Dunning, 2008 #3). This idea has long been popular in Japan where Keiretsus, or business groups, which consist of a host of companies that are linked together through ownership and/or joint ventures, dominate the local environment and are able to use their combined connections and wealth to dominate world markets.

(2000 words)

Table 1

The Three Conditions of the Eclectic Theory

Ownership-specific advantages (internal to enterprises of one nationality)

Size of firm

Technology and trade marks

Management and organisational systems

Access to spare capacity

Economies of joint supply

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Greater access to markets and knowledge

International opportunities such as diversifying risk

Location-specific advantage (determining the location of production)

Distribution of inputs and markets

Cost of labour, transport and materials costs between countries

Government intervention and policies

Commercial and legal infrastructure

Language, culture and customs (ie psychic distance)

Internalisation-specific advantages (overcoming market imperfections)

Reduction in search, negotiation and monitoring costs

Avoidance of property right enforcement costs

Engage in price discrimination

Protection of product

Avoidance of tariffs

Source: Dunning (1981)

Table 2

Characteristics of Countries and OLI-specific Advantages

Owbnership-specific advantages

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Country characteristics

Size of firm

Large markets

Liberal attitudes to mergers

Technology and trade marks

Government support of innovation

Skilled workforce

Management and organisational systems

Supply of trained managers.

Educational facilities

Product differentiation

High income countries

Levels of advertising and marketing

Location-specific advantages

Country characteristics

Costs of labour and materials

Developed or developing country

Transport costs between countries

Distance between countries

Government intervention and policies

Attitudes of government to FDI

Economies of scale

Size of markets

Psychic distance

Similarities of countries' languages and cultures.

Internalisation-specific advantages

Country characteristics

Searching negotiating monitoring costs.

Greater levels of education and larger markets make knowledge type ownership-specific advantages more likely to occur.

Avoid costs of enforcing property rights.

Protection of products.

Source: Dunning (1981)

Appendix 1

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