

# Vernons product life cycle theory economics essay

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Answer: The creation of the single market means that it may no longer be efficient to operate separate production facilities in each country. Instead, the facilities should either be linked so that each specializes in the production of only certain items, or several sites should be closed down and production consolidated into the most efficient locations. Existing differences between countries as well as the need to be located near important customers may limit a firm's ability to fully consolidate or relocate production facilities for production cost reasons. Minimizing production costs are only one of many objectives of firms, as location of production near R&D facilities can be critical for new product development and future economic success. Thus what is most important in location decisions is long run economic success, not just cost minimization.

### **Additional inform.**

Formed in 1967, the Association of Southeast Asian Nations (ASEAN) currently includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, and Thailand. The basic objectives of ASEAN are to foster freer trade between member countries and to achieve some cooperation in their industrial policies. In 2003, an ASEAN Free trade Area (AFTA) between the six original members of ASEAN came into effect. Vietnam, Laos, and Myanmar joined later, and Cambodia is expected to be a member by 2010. The goal of AFTA is to reduce import tariffs among the six original members by 2010, and for the newer members by 2015.

## Question 5

### Compare and c

**ontrast these explanations of FDI: the market imperfections approach, Vernon's product life cycle theory, and Knickerbocker's theory of FDI. Which theory do you think offers the best explanation of the historical pattern of horizontal FDI?**

In recent years, changes and development in the world economy have led to a significant expansion of international business activities. Multinational corporations have played a significant role in the global economy having a major share of the world trade and so has FDI increased dramatically in recent decades. The two drivers of globalization are foreign direct investment (FDI) and trade. There are two elements common to most definitions of FDI; FDI involves at least two countries, and the other is the issue of ownership and control. Foreign direct investment (FDI) is the acquisition, establishment or increase in production facilities by a firm in a foreign country. In simple terms, FDI is described as the ownership and control of foreign assets. Once a firm adopts FDI, it becomes a multinational enterprise. stated that FDI takes on three main forms; greenfield investment which involves the establishment of a new operation in a foreign country, the second involves acquisitions and mergers and the third is reinvestment which involves an already established foreign firm reinvesting its profits instead of repatriating them. A classic example of FDI is the case of Starbucks coffeehouse situated in Seattle. In 1995 with 700 stores across the United States, Starbucks began exploring foreign opportunities in the form of greenfield investments and by 2006 they were transformed by this FDI into a

global brand with operations in 37 countries (cited in Hill, 2008). The United States has remained the country with the most active share of FDI inflows. Other countries with relatively major shares are Japan, Germany, United Kingdom, Netherlands, France, Italy and other members of the EU15 (Mmieh, 2010). (Hill, 2008) noted that FDI has surpassed world trade more rapidly in growth in many countries due to certain reasons which have made these countries more attractive to foreign investors; to avoid trade barriers, political and economic changes such as adoption of democratic political institutions and free market economy by many countries, privatization programs open to foreign investors across Asia, Eastern Europe and Latin America, and eradication of many restrictions on FDI. Nevertheless, most FDI inflows have been directed at the less developed countries of the world with Asia as having the highest inflows, followed by Latin America and Africa which has received the smallest amount of world FDI due to its unstable nature caused by political instability and armed conflict to mention a few. Multinational corporations commonly engage in FDI to increase their revenues and reduce their costs. A firm will engage in horizontal FDI if it either possesses a unique asset which others do not have or due to the adverse effects of tariffs on its exports. Horizontal FDI is one of the features of oligopolistic markets where products are differentiated (Jones and Wren, 2006). Horizontal FDI occurs in a foreign country in a similar industry to that which the firm operates in the home country. Various scholars have postulated different theories on horizontal FDI but the market imperfections approach, Vernon's product life cycle theory and Knickerbocker's theory will be examined here. These three theories can be categorized under modern

theories of FDI and emphasize on the imperfection of domestic and international product and factor markets.

## **Vernon's Product Life Cycle Theory**

Vernon's product life cycle theory can also be used to explain FDI. Vernon argued that firms undertake FDI at particular stages in the lifecycle of a product they have pioneered. Vernon suggests that a product goes through three stages: it starts off as a new product, and then becomes a maturing product and finally a standardized product (Piggot and Cook, 2006). In the new product stage the product is invented by a country, which is usually an advanced country with high-tech advantage in response to domestic demand, more skilled labour is needed for testing and adjusting the product. In the maturing stage the product becomes standardized gradually and mass production begins, less skilled labour is needed and capital becomes more important. The product is marketed internationally and in search of export markets, producers look for similar markets in similar advanced countries. With increase in exports, producers begin to consider locating closer to these markets. The final stage is the standardization stage where factors such as production and location cost are vital in determining location decisions, and usually the product is made in other countries and imported to the original producing country. Gradually production and export from the original country ceases and subsequently production is shifted to less developed countries (LDC's) Vernon's theory was based on the observation that for most of the twentieth century a large proportion of the world's new products had been developed by the U. S. firms and sold first in the U. S. market for example televisions, photocopiers, personal computers and so on. He argued that

most new products were initially produced in the U. S. (Hill, 2008). An illustration is the photocopier which was first developed in the 1960's by Xerox in the United States and sold in the U. S. only. Initially, Xerox exported photocopiers mainly to Japan and advanced countries of Western Europe. As demand grew in those countries, Xerox entered into joint ventures and set up production in Japan (Fuji-Xerox) and Britain (Rank-Xerox). Once Xerox's patents on the photocopier expired, other foreign competitors entered the market such as Canon in Japan. As a result of this, U. S. exports declined and U. S. users began buying from mostly Japan due to lower costs. In recent times, Japanese companies have begun to switch production to LDC's such as Singapore and Thailand due to high manufacturing costs in Japan.

Knickerbocker's theory of horizontal FDI Knickerbocker's theory of horizontal FDI also known as Knickerbocker's theory of oligopolistic competition is based on the idea that FDI flows are a reflection of strategic rivalry between firms in the global market place. Knickerbocker argued that FDI and oligopoly have similar characteristics. An oligopoly is simply an industry composed of a few firms controlling a large proportion of the market industry. Knickerbocker examined the relationship between FDI and rivalry in industries practicing oligopoly. A critical competitive feature of such industries is the interdependence of the major players. The action of one firm will have an immediate impact on the major competitors constraining them to imitate that action. Competitors will usually immediately imitate a firm's initiative and as a result the interdependence between firms in an oligopoly leads to imitative behaviour. Knickerbocker insisted that this similar kind of imitative behaviour characterizes FDI. Such imitative behaviours could be in the form of a price decrease by one firm with a view to improve its market

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position, others will decrease their prices accordingly in order not to allow the firm develop a competitive advantage at their expense. An illustration of this theory is with regard to FDI undertaken by Japanese firms in the 1980's when Honda invested in the U. S. and Europe, Toyota and Nissan responded by undertaking their own FDI into the U. S. and Europe as well in order not to be left behind. Market imperfections approach

In a foreign market, the operation of a multinational corporation's subsidiary would most likely require a greater commitment of time, attention and control compared with operating a subsidiary in the home market. Additional costs are incurred in the foreign market such as communication, administration and transport. In essence, for FDI to be successful, multinationals must possess certain advantages not available to existing or potential local competitors (Buckley, 2004). The decision of a multinational corporation to invest in an overseas market can only be explained if the company acquires and can utilise certain advantages not possessed by its local competitors (Taggart, 1993). These advantages of market imperfections may be derived from product differentiation, proprietary technology, marketing skills, economies of scale and so on. Such advantages give multinationals a competitive edge over their competitors in foreign locations and this compensates for the additional costs of operating at a distance (Buckley, 2004). This invariably implies that whatever the source, the market for the sale of any of these advantages must be an imperfect one. According to, market imperfections are the reason for FDI. suggested that market imperfections relates to factors that stop markets from working perfectly particularly barriers in the free flow of goods/services and the sale of knowledge between nations. The market imperfections approach to FDI is generally referred to as the internalisation

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theory. The internalisation or market imperfections approach theory states that FDI will be preferred in place of exporting and licensing in the event that there are barriers that hinder exports and make licensing difficult. According, the market imperfections theory states that due to market failures or imperfections in products or factor markets, some firms enjoy advantages not shared by rivals which allow them to obtain rents in foreign markets.

Firms therefore invest abroad to capitalize on such foreign markets.

Internalisation as an extension of market imperfections approach entails the acquisition of control over activities previously carried out by intermediate markets through vertical integration. Under this perspective, multinational enterprises derive market power through their ability to efficiently internalise market transactions for intermediate products. According, the importance of imperfections in the intermediate product market provides an incentive for a firm to internalise. This incentive depends on the relationship between four groups of factors which are; industry-specific factors such as economies of scale; region-specific factors such as geographic distance and cultural differences; nation-specific factors such as political and fiscal conditions; and firm-specific factors such as management expertise. Findings

In its time, Vernon's product life cycle theory would have been an appropriate explanation of international trade with reference to his argument that most new products were produced in America considering the Xerox illustration cited earlier. (According to Hill, 2008), the United States dominated the global economy during this period (from 1945 to 1975) as such the U. S. had a competitive advantage over its competitors. (Hills, 2008) perceives this argument as being ethnocentric and an important exception is the fact that many new products are now first introduced in Japan such as video game

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consoles or Europe such as wireless phones. (Piggot and Cook, 2006) suggests that the theory accurately explains the U. S. offshore production in low labour-cost countries but the validity of this theory has declined as the United States no longer has the total dominant position with regards to FDI. Also, multinational corporations are now capable of developing, maturing and standardising products almost simultaneously. According to (Letto-Gillies, 2005), Knickerbocker's theory of horizontal FDI puts right at the centre of analysis a realistic oligopolistic structure and it attempts to deal with uncertainty and risk. It is dynamic as it is all about reactions and counter-reactions (imitative behavioural nature) and changes in the oligopolistic balance and strategies. Both (Letto-Gilles, 2005) and (Hills, 2008) noted that Knickerbocker's theory does not explain why the first firm in an oligopoly decides to undertake FDI rather than to export or license. (Hills, 2008) also suggested that the imitative theory does not address the issue of whether FDI is more efficient than exporting or licensing for expanding abroad. (Hills, 2008) suggested that the imperfect market approach addresses the two demerits mentioned above in Knickerbocker's theory of FDI. According to (Hills, 2008), licensing may result in a firm's loss of proprietary technology know-how to a potential foreign competitor. For example RCA licensed its new colour television technology to some Japanese companies such as Sony as a way of earning revenue from the Japanese market, Sony swiftly assimilated RCA's technology and used it to enter the U. S market to compete with RCA and Sony got a much bigger market share. Licensing does not give a firm the tight control over manufacturing, marketing and strategy that may be required for profit maximization. These demerits are dealt with in the imperfect market approach. Conclusion

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conclusion, theories of FDI have evolved through the years. Firstly, Vernon's product life cycle theory is stringently applicable to the United States in a particular historical period (1960's). It was based on the behaviour of United States multinational corporations which was relevant at the time. Although Vernon's theory of the stages a product passes through may still be relevant today, it was hindered by the emergence of FDI in Europe and Japan (1970's). This theory is less relevant today where we have several other advanced nations dominating the global economy besides the U. S. such as Japan, Germany, U. K and other European nations. Subsequently, with the pace of technological innovations in today's global business environment the three stages of the product life cycle model may not necessarily occur in this sequence having to go through the long length of time it takes a product to get to the standardized stage from the new product stage. Knickerbocker's theory emphasizes on the interdependence of major players in the same industry. Imitation is the name of the game where firms try to match each other's moves to keep each other in check so as not to allow a rival gain a competitive advantage over others. This is still relevant today for example it only makes sense that if a firm 'A' reduces the price of its canned drinks, similar firms like 'B' and 'C' will follow suit in order to retain their market share. A limitation of Knickerbocker's theory is that the theory fails to give a concise reason why the first firm makes a move before the others. This reason may be due to proprietary technology or product differentiation. The market imperfections approach emphasizes the knowledge market advantages, and sheds some light on locational efficiency and logistics in terms of transportation costs. In my opinion, the market imperfections approach seems to be the most ideal theory of FDI. Practically, the market <https://assignbuster.com/vernon's-product-life-cycle-theory-economics-essay/>

imperfections approach is relevant today as multinational enterprises are in competition with each other on product innovation and technological development with a view to surpass or outdo their competitors and increase their market share in the various industries in which they are situated.

Question3

### **Whose Interests Should Be The Paramount Concern Of Government Trade Policy – The Interests Of Producers (businesses And Their Employees) Or Those Of Consumers?**

Trade policy can involve various complex types of actions, such as the elimination of quantitative restrictions or the reduction of tariffs. Objectives of Commercial Policy: The main objectives of the commercial policy are: First, to appreciate trade with other nations. Second, to protect domestic market prevailing in the country. Third, to increase the export of particular product which will help in expanding domestic market? Fourth, to prevent the imports of particular goods for giving protection to infant industries or developing key industry or saving foreign exchange, etc. Fifth, to encourage the imports of capital goods for speeding up the economic development of the country. Sixth to restrict the imports of goods which create unfavourable balance of payments? Seventh, to assist or prevent the export or import of goods and services for achieving the desired rate of exchange. Eighth, to enter into trade agreements with foreign nations for stabilizing the foreign trade. Consumers: one of the most important disadvantages of trade restrictions is that it drives up the price of goods in a country where trade barriers artificially raise the price of imported products. The apparent effect of trade barriers is to prevent jobs from being lost to foreign competition,

which is an argument used by many special interest groups to justify various types of trade barriers. In the long run, however, trade barriers force consumers to pay higher prices, since products that could otherwise be made cheaply overseas take more resources to produce domestically. The trade policy hurts the individual consumer more than the producers of businesses. American trade policies have regulations that limit the percentage of a product that must be made or portion of the product has to be made in the United States. This limits the competition of foreign countries which cause the price of products to increase on imported goods or parts. Now, these foreign components create higher prices and the result is consumers will have to pay more for the products. The producers win because they are getting more money for the higher price goods due to foreign competition. Businesses win when it comes to trade because the government speaks for the producer and not as much for the consumer. Trade policies are implemented to help the producers or businesses by establishing tariffs to protect the competition from foreign companies. This causes prices to increase from these tariff restrictions. Goods produced in a foreign country have a reverse effect on producing goods efficiently by a domestic business when tariffs are involved. Imported items will cost more to the country receiving the goods and will cost less to the country exporting the goods. As the world is closing in due to computers and technology, it should lessen the tariff barriers in order to reduce prices consumers pay. An example would be if tariffs between Japan and the United States were lowered for automobiles, the cost to consumers in the U. S. would be more affordable. The interest of trade policy should be more balanced between businesses and consumers. The economy is changing and the small

businesses should be recognized as a growing segment while producing goods and services and helping the economy's increasing revenue. The government should continue to enforce policies that will protect businesses so that worldwide firms are not taken advantage of but help the consumer with pricing goods so they are more inexpensive....