

Analysis of motives and prospects within the oli framework: a case study of germa...

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Introduction

There are a number of theories that explain motives and prospects of FDI. OLI framework is the one that is most widely used by economists. According to OLI, there have to be advantages that can offset costs of making direct investment abroad.

In this paper we apply the OLI framework to understand the motives behind German FDI in China. A case study of Volkswagen China is conducted to show the application of OLI in practice, and to demonstrate why FDI abroad can be a success story despite all the difficulties a company faces in a foreign environment.

Literature Review

One of the earliest theories explained FDI in terms of market imperfections. Kindleberger (1969) argued that for companies to gain advantage by investing abroad market has to be imperfect. If we assume that markets are perfect there is nothing foreign companies can exploit to make enough profits that will offset costs and risks associated with investing abroad (Kindleberger 1969). The concept of firm-specific advantages was introduced to explain how market imperfections lead to foreign investment. Among these advantages are superior technology and marketing (Caves 1971), cheap labour (Grubel 1968), management skills (Wolf 1977), and exclusive access to natural resources (Lall and Streeten 1977). Only when a foreign company possesses these firm-specific advantages can it successfully invest and become a major player in a foreign market and

compensate for the disadvantages of being foreign in the country of its operation (Hymer 1976).

Vernon's product life cycle is another major FDI theory that tries to explain motives and the rationale behind FDI. Vernon (1966) dissected product life cycle into three distinct phases - innovation, maturity and standardisation. Established companies in developed economies invest in new projects to design innovative products that will sell in future and guarantee a new profit channel for them. When a new product is designed, it is sold in the domestic market. Consumers gradually get used to it and demand new products. This leaves the company with two not mutually exclusive choices - get back to the innovation phase and design something new, or go abroad and produce the same products there. Going abroad is sometimes a better choice because foreign producers (such as China) start to imitate the existing product and become so good at it that the differences with the original become marginal (Vernon 1966).

A later theory developed by Dunning (1977) has become widely used in attempts to understand the motives behind FDI. The theory became known as OLI: Ownership, Location and Internalisation. All three elements should be present in order for FDI to occur. This theory will be explained in greater detail in a separate chapter of this paper.

Theoretical Framework

Definition of FDI

According to the Organisation for Economic Co-operation and Development (OECD) (2008) 4th Edition of Benchmark Definition of FDI, FDI is “ a category of cross-border investment made by a resident entity in one economy (the direct investor) with the objective of establishing a lasting interest in an enterprise (the direct investment enterprise) that is resident in an economy other than that of the direct investor” . Companies carry out FDI because they want to have direct control over their enterprise. This is what makes FDI different from portfolio investments which usually result in an ownership of less than 10 per cent of a foreign company’s capital. Hence the investor does not have real control over the foreign company (OECD 2008).

Mergers and Acquisitions (M&A) and Greenfield investments are the two different types of FDI. The choice between them has different implications for the parties concerned. M&A happen when an existing company is bought out by a foreign firm. In contrast Greenfield investments are investments into new assets. For developing economies, including China, M&A are more common, for developed economies like Germany Greenfield investments are a popular choice (Shatz and Venables 2000).

FDI are divided into horizontal and vertical; only in a few cases do the two occur simultaneously. Horizontal FDI occurs when a company invests in a firm built to serve the foreign market (Shatz and Venables 2000). . This foreign firm then performs the same activities as the host firm does in its own domestic market. With vertical FDI, the production cycle is fragmented

so that each phase can be completed in a country where it can be done cheapest of all (Shatz and Venables 2000).

OLI Framework

The OLI framework is a theory that explains motives and the rationale behind multinational corporations' (MNCs) decision to choose FDI instead of licensing use of their name or product to foreign producers or sellers (Lynn 2008). . FDI is a foreign investment so, for it to occur, the investing firm has to acquire assets in a foreign country. FDI is called direct investment because it results in a direct and real control over the acquired capital. MNC acquires a right to produce what it wants in a foreign country and decide where it wants to sell the product. As explained above, the whole product (horizontal FDI), or parts of it (vertical FDI), can be produced in a foreign country based on the considerations of cost-effectiveness (Shatz and Venables 2000)..

FDI occurs because there are advantages to it. The first one is ownership advantage which stands for " O" in the OLI abbreviation. There has to be some advantage to owning the foreign asset. These can be lower costs, greater reputation, or swifter transition to a foreign market. Take for example Apple. The company has a reputation for high quality products so by owning a production facility in a foreign developing country it can still make profits that will offset costs of FDI (Lynn 2000). .

Ownership advantage alone is not enough for FDI to occur. Here is when the " L" comes into play. " L" denotes the location advantage. A less costly

labour force, access to the natural resources needed in manufacturing and a better geographic position (which leads to more efficient logistics), are some of the location advantages that can make companies seriously consider investing abroad (Lynn 2000). . Again this is not enough for FDI because everything described above can be achieved by brand licensing or through establishing joint ventures. FDI needs a third element – internalization, or control, advantage. This is the “ I” in OLI. When it is believed that MNC can lose market share in case another company gets access to the same asset, FDI becomes the only choice available (Lynn 2000). . It is known that at some stage, foreign producers start copying products produced in the developed world and when they do it they are able to offer cheaper prices thus outperforming foreign producers in sales. To prevent this scenario many companies prefer to go with FDI and gain exclusive control over their assets.

Methods and Data

In this research, we conduct a critical review of the main theories of FDI, paying special attention to the OLI framework. While we acknowledge the importance of OLI in understanding international business and FDI in particular, we provide a short overview of criticisms of the paradigm so that readers have an understanding of the potential limitations of this research.

A case study of German car manufacturer Volkswagen is used as a method of understanding FDI under the OLI framework as applied to the German investor interest in China and the two country’s bilateral economic relations.

Additionally, we use statistical information to put some numbers into perspective and cite a research by Deutsche Bank which includes some forecasts as to the future of German FDI in China.

Volkswagen (VW) Case Study

Volkswagen was founded in 1937 (Datamonitor 2011). The name of the brand translates as “ the car of the people” (Datamonitor 2011)..

Volkswagen is represented in China through two ventures – with Shanghai Automotive International Company founded in 1985 and with First Automotive Works started in 1990 in Changchun (VW Annual Report 2010).

VW has always regarded China as an important market. Today, there are 9 production facilities in China and 2 more are planned. VW’s target is to sell 3 million cars per year. Through 2015 VW is set to invest a total of 10. 6 million euro to expand its production in China. VW is actively involved in producing electric vehicles in China. Both E-Golf and E-Lavida were presented in China and the first electric test was made here in 2011. VW is also set to produce a new brand specifically for the Chinese fast-paced economy (VW Annual Report 2010).

Volkswagen Analysis Based on the OLI Paradigm

Ownership advantage

VW is one of the world’s most successful car manufacturing companies and, as such, it has a lot of advantages. VW is known in Europe for its technological advances and efficient production system. VW brand is strong all over the world. Many consumers associate vehicle design innovation,

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cost-effectiveness, and high safety standards with VW and consider it as their first choice when making decisions on buying a vehicle (VW official website 2011). Not surprisingly, VW had a competitive advantage over all Chinese manufacturers at the time of the entry into the market (VW official website 2011). In fact, VW is still superior to any of the Chinese car producers. VW exploited its technological dominance and increased its brand recognition. Chinese consumers were happy with the product offered and enjoyed VW's presence in their country. Currently, VW strives to adjust its technology to meet changing customer needs and develop sustainable models for future (Yu 2010).

Location advantage

VW's joint venture in Shanghai was the most successful car enterprise in China at the time it was established in 1985 and it retains the top position today (Li 2000). Locating in China, and Shanghai in particular, was the best possible decision for VW in terms of location because the region is rapidly developing and the people's life standards are improving. Shanghai is the most densely populated and prosperous city in China and it has close ties with the central part of the country (Li 2000). Products from Shanghai are considered to have high quality across China and do not face any obstacles due to local protectionism. It should be also noted that at the time VW entered China it received many incentives and support from the government. The government still stimulates the automobile industry to increase domestic sales and contributes to the development of the sector. Thanks to these location advantages, VW China became a success and

continues to be a source of decent income for the parent company (Li 2000)..

Internalization advantage

VW had the first mover's advantage which helped it to become a major player in the new market. The company managed to take control over the major share of the Chinese market and realise all its ownership advantages. This first mover advantage till today helps VW to be very competitive with regards to Japanese and American rivals. To retain its market share, VW continues to innovate according to the changing tastes of the Chinese consumers and requirements to reduce the strain on the environment resulting from manufacturing and exploitation of automotive vehicles (VW official website 2011).

Future of German Interest in China

China has attracted German interest more than any other emerging country since 1997 (Deutsche Bank Research 2004). German companies explain their excessive interest in China by citing the country's huge market potential. In 2001 there were about 76 million prosperous consumers in China – a population that is worth FDI in any country despite possible barriers and foreignculture-related challenges (Deutsche Bank Research 2004). This number of prosperous consumers in China is greater than the total population of Germany and it is set to increase tenfold by 2015. The second most important argument for German FDI in China is the “ extended low-cost assembly line” (Deutsche Bank Research 2004). Cost has always been one of the most important considerations in business decision-making.. Heated

global competition for competitive advantage and market shares across virtually all industries means that companies need to find cheaper options for manufacture. China is often the best solution because of the low-cost labour force it offers. Not surprisingly, Germany, alongside other strong economic powerhouses, chooses China as a low-cost manufacturing site and actively invests there (Deutsche Bank Research 2004).

Another reason for German FDI is the growing economy of China and its potential to become a dominant power. Germany has to defend its interest in a country which is set to become a global leader with an over 1 billion of potential buyers of products and services.

Of course, China is a completely whole new world for German businesses that has to be explored until there is sufficient understanding required for making informed decisions. Usually, most foreign companies entering China lack information vital for their success and have to be quick to adapt or risk becoming a failure. China cannot be considered "one country - one market". It is bigger than both Eastern and Western Europe put together (Deutsche Bank Research 2004) and it is naive to think that one product design or pricing strategy will work across the whole country (Deutsche Bank Research 2004). Hence a lot of prior planning is required (Deutsche Bank Research 2004). Among other obstacles that can potentially deter German interest in China are high input prices. There are a lot of protectionism locally, and also many logistic and bureaucratic inefficiencies that are not easy or cheap to overcome. Moreover, the global prices for raw materials and energy resources are growing which adds to the cost of production even in China

(Deutsche Bank Research, 2004). The final commonly-cited obstacle to German interest in China is the heated competition amongst different foreign companies coming from such developed nations as USA, Canada, and Australia. Everyone knows about advantages of investing in China and hence there is a lot of competition for assets and control over the market.

Criticism of OLI framework

The OLI framework offers a very useful insight into the motives and the rationale behind FDI. The paradigm has evolved over the time to adapt to changes in the way international business is conducted (Narula 2010). Critics of the theory argue that because of expansion of OLI's application to all MNE-related phenomena, it now risks becoming tautologous (Narula, R. 2010). Narula proposes a return to the classic OLI framework and using alternative theories to understand the more complex new developments rather than internalising everything so that it fits OLI. Narula acknowledges the importance of OLI in early research on the international business and FDI, but argues that it is not suited for explaining everything that happens in business (Eden 2003). In fact, it is becoming cumbersome to apply OLI to understanding international business, as the latter has become complex (Eden 2003). There is a need for new frameworks. OLI can still be a valuable tool in understanding some aspects of international business and FDI, but should lose its dominance in the academic community (Narula, R. 2010).

Conclusion

German interest has been present in China for almost half a century.

Because Chinese market is huge and has a big growth potential, German

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companies are likely to look for more opportunities there. Before a decision to invest is made, companies always assess its prospects. OLI framework is often used to see whether FDI is justified. OLI's critics now say that there should be some additional analysis involved in decision-making, because, as good as the paradigm is, it still cannot explain every complex aspect of international business.

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