2. LITERATURE REVIEW AND THEORETICAL FRAMEWORK

2.1 RATIONALE FOR OVERSEAS INVESTMENT

From a management perspective, the differences between domestic and international operations are substantial. Business activities across national boundaries require an understanding and appreciating the environmental and institutional peculiarities, including international trade and investment, operation of the foreign exchange markets, cultural environments, and the politically motivated presence of trade and investment barriers and incentives. Thus, international business activities involve new elements of risk, conflict, environmental adjustment, as well as influence over social and economic changes.

Fundamental to understanding the motives for overseas investment is the need to understand the need to trade internationally. There are a number of theories used to explain this; and for centuries, the international trade theory has been used to explain and predict international business patterns. However, with the emergence of supra national business enterprises that conduct inter-nation transactions in many new forms other than traditional importing and exporting.

THE CHOICE BETWEEN HOME AND FOREIGN INVESTMENT

There has been extensive discussion on striking a balance in the overall allocation of investment, between investment overseas on the one hand and investment at home on the other. The recognition that an investment abroad is an opportunity to be pursued and examined is a necessary part of an organisation's strategic management. Generally, the decision to look abroad is actually a specific one. It is a decision to look at the possibilities of a specific investment in a specific country, not a general resolution to look around the globe for investment.

The forces leading to an organisation to consider the possibility of launching a project outside its own country, may be those arising within the organisation, or those exogenous to it stemming from its environment.

a) External stimuli, coming from the foreign governments, the distributors of the company's products, and its clients.

b) Fear of losing a market.

c) The "band wagon" effect: successful activities abroad of competing firm in the same line of business, or a general belief that investment in some area is "a must".

d) Strong competition from abroad in the home market.

In any specific case it is generally very difficult, if not impossible, to pin down one reason for a decision to look abroad, or to find out precisely who is the initiator of a project. In general, the decision to look abroad is brought about by the interaction of several forces - partly environmental and partly inside the organisation - influencing different persons at different times.

2.2 THEORY

2.2.1 The International Trade Theory

The principle underlying the international trade theory is the doctrine of **comparative cost theory** of international trade, or comparative advantage. The doctrine, as developed by David Ricardo and later refined by Heckscher, Ohlin and Samuelson, states that if a country specialises in the products in which it has the greatest comparative advantage relative to other nations, and trades these products for goods in which it has the greatest comparative disadvantage, then the country's total availability of goods secured from a given amount of resources will be enlarged. Through the comparative advantages, rather than the absolute advantages, the theory has shown that every country has a basis for trade, and that specialisation and trade are more efficient than a nation's self-sufficiency policies.

Notwithstanding, however, the theory does have its limitations. The theory of comparative advantage states that the production possibilities of a country arise from the productive capabilities of its factors of production. It assumes that the factors of production are completely mobile within individual countries, but yet completely immobile between countries (Hood & Young, 1979)

2.2.2 Foreign Direct Investment (FDI) Theories

Most of the literature on FDI is concerned with explaining the origin of ownership and control of value-added activity, rather than the financing of that activity. To this extent, the intellectual heritage of FDI theory is that of industrial organisation and location theory, rather than that of portfolio investment theory. FDI represents the territorial expansion of business activities, and generally is undertaken by a firm that seeks to serve a new market for its products or services, or seeks to obtain additional supplies for its existing market. The main concept behind FDI is the ownership and control of assets in another country, in a foreign country, in exchange for the investing company transferring some of its financial, managerial technical, trademark and other resources to the foreign country. FDI involves the transfer of a package of resources (such as finance capital, technology, management skills and entrepreneurship) that remains in the possession of the investing firms.

So far, studies undertaken on the **determinants of FDI** can be categorised into three main theoretical streams of thoughts (Dunning, 1970). First, there are those who attempt to evaluate, mainly from data supplied by individual businesses, the main factors influencing the decision to invest in a particular country and/or industry. Investments vary in type; they are undertaken for different reasons, and economic conditions in one country are often so different from those in another. The decision-making process behind any foreign investment is often very complex and time-consuming, and involves many different personalities.

The second type of approach is more macro-oriented. As its starting point, this takes into consideration such published data as are available on direct investment by one country in either various countries abroad, or certain industries, and seeks to establish some kind of functional relationship between this and possible determinants.

The third approach runs parallel to the above two, and is perhaps the most interesting intellectually. Basically, it addresses the question as to why FDI is preferred to other forms of resource allocation, such as portfolio investment, and why direct investment should be preferable to other ways of exploiting a foreign market, e.g. by exports or licensing agreements. The approach also attempts to evaluate the cost of foreign investment in terms of forgone investment opportunities at home.

Dunning (1993) identifies four main motives for FDI activities by companies, as follows.

* to seek natural resources,
* to seek market,
* to seek increased efficiency, and
* to seek strategic asset or capability.

a) THE GLOBAL HORIZONS APPROACH

The approach (developed by Yair Aharoni, 1966) states that as an organisation grows, its geographical horizons change due to forces arising from within the organisation, or those exogenous to it stemming from its environment. The exogenous forces may be those coming from the foreign governments, the distributors of the company's products, and its clients, or those arising due to major world crises. The internal forces may be due to technological development, company's strategies and so forth. While these horizon-widening factors explain the awareness of global opportunities, they provide an essential, but inadequate explanation of the modern day international business patterns.

b) THE MARKET IMPERFECTION APPROACH

The model, propagated by Stephen Hymer and Kindleberger (1960), suggests that firms with monopolistic advantage expand into foreign markets to exploit their advantage abroad. Hymer further identifies that the imperfection in international markets for products and factors of production is the precondition for FDI. He asserts that FDI involves the transfer of resources (technology, management skill, entrepreneurship and so on) and not just finance capital that portfolio theorists, namely Iversen (1935) has sought to explain. Firms are motivated to produce abroad through their expectation of earning, an economic rent on the totality of their resources. Lastly, and perhaps the most fundamental characteristic of FDI is that there is no change in ownership of the resources, or the rights being transferred; while portfolio (indirect) investment involves a change in ownership.

However, the theory does have its limitations. It does not explain why firms choose to exploit the foreign markets through investment, instead of exporting or licensing. It offers little explanation to the country pattern of foreign investment. Finally, the theory does not explain the FDI through takeovers.

c) VERNON'S PRODUCT CYCLE THEORY

The approach, pioneered by Raymond Vernon (1966) and his colleagues at Harvard, suggests that US direct investment in manufacturing industry is part and parcel of a cycle in the goods it trades, and a means of ensuring the US competitive position in the products it innovates; and that ove time, the investment is both influenced by and influences the structure of world trade.

Vernon used a micro-economic concept to help explain a macro-economic phenomenon, viz. a period of controversy about the comparative advantages possessed by the US MNEs after the war. The product-cycle theory was a response to the observation that US firms were among the first to develop new labour-saving techniques due to the high costs of skilled labour and a large domestic market.

The model relates trade and direct investment as sequential stages that follow the life cycle of a product. It explains that firms innovate new products at home and in relation to the home market. In the first, *new product stage*, expansion into overseas markets is by means of exports. This is referred to as the "technological gap" trade. Because countries are at different stages of economic development, new markets are readily available to receive new products through demonstration effect from richer countries.

As the product becomes sufficiently stadardised and matures in the *mature product stage*, price competition and minimisation of costs become important. As cost factors begin to dictate that foreign markets be serviced by local production, foreign manufacturing facilities are set up, generally countries serving as its markets. Then, in the *standardised product stage*, when price competitiveness becomes even more important, production may shift to low-cost locations and low-income countries; certain labour intensive phases of production may even be separated to be carried out in countries where the labour is cheapest. The goods are then exported back to the home country or other markets.

d) THE INTERNALISATION THEORY

The internalisation theory was put forward by a group of Swedish, Canadian, British and American economists in mid-1970s. The theory seeks to explain why cross-border transactions of intermediate products are organised by hierarchies, instead of being determined by market forces. The basic hypothesis is that multinational hierarchies represent an alternative mechanism for arranging value-added activities across national boundaries to that of the market. Furthermore, firms are likely to engage in FDI when they perceive that the net benefits of their joint ownership of domestic and foreign activities and the transactions arising from them are likely to exceed those offered by external trading relationships. The theory also seeks to explain the international horizontal and vertical integration of value-added activities in terms of the relative costs and benefits arising from this form of organisation compared to the market transactions.

e) DUNNING'S ECLECTIC PARADIGM

The eclectic paradigm (J Dunning, 1977) suggests that there are three sets of variables which determine the extent and form of foreign-owned production. The *first* comprises the ownership-specific (O) resources and capabilities of the investing firms; or in this context, those possessed by Malaysian companies as opposed to those owned by the host country of investment. The *second* set of variables that are mainly (but not completely) exogenous to firms at the time the FDI decisions are made, comprises the location-bound assets of countries. Such assets comprise both natural resources, e.g. land, unskilled labour, as well as created resources, such as infrastructure (telecommunication and transport), an efficient legal and commercial system, an educated labour force, the presence or absence of industrial districts, business practices and customs, and the attitudes and actions of governments. Such immobile endowments are called location (L) advantages, and over time FDI may affect these advantages. It is the location-bound (L) advantages that determine the "where" of the economic activity, particularly whether the O advantages of firms are exploited by trade or foreign production. The *third* set of variables, the internalisation variables, determine the organisational form by which the O advantages of firms are combined with the L advantages of countries.

Dunning's view is eclectic in that it packages a number of competitive advantages together and uses the concept of internalisation to provide decision-making rules. His eclectic views state that FDI decisions should be made on grounds of the following three factors: ownership advantages, location advantages and internalisation. Dunning (1993) has used the eclectic paradigm of international production to review the literature on the **determinants of FDI**. The eclectic paradigm avers that the propensity of a country to engage outbound FDI and to attract inbound FDI is a function of :-

(a) the unique competitive advantages of its nationally owned firms, *vis-à-vis* those of foreign ownership;

(b) the competitive advantages of its location-bound assets *vis-à-vis* those of other countries which might compete for the same FDI;

(c) the actions taken by governments that might affect (a) and (b); and

(d) the extent to which firms choose to exploit their competitive advantages (or acquire new ones) from a foreign location, by way of horizontally or vertically extending their domestic value-added activities, or by some form of non-equity cooperative relationship with a foreign firm or group of foreign firms.

In his paper, *Re-appraising the Eclectic Paradigm in an Age of Alliance Capitalism*, Dunning (1995) discusses the implications of the advent of alliance capitalism on the determinants of the MNE activity. Over the past decade, a series of landmark technological advances, political changes and globalisation of many kinds of value-added activity, suggest that the socio-institutional structure of market-based capitalism is undergoing change. Due to the increasing porosity of the boundaries of firms, countries and markets, the eclectic paradigm of international production needs to consider more explicitly the competitive advantages arising from the way firms organise their inter-firm transactions, the growing interdependencies of many intermediate product markets, and the widening of the portfolio of assets of districts, regions and countries to embrace the external economies of inter-dependent activities. To the firms engaging, or wishing to engage, in cross-border transactions, the OLI configuration is affected by three evolving concepts : innovation-led growth, a voice reaction to market failure, and cooperation as a competitiveness-enhancing measure.

2.3 FORMULATION OF STRATEGIES FOR INTERNATIONALISATION

Most firms decide to go international through a process of creeping "incrementalism", rather than by strategic choice. In some ways, international business is an extension of the domestic business; while in other ways it is quite distinct. More often than not, the initial moves are rarely part of a comprehensive global strategy. Instead, the decision to go international usually develops from a less explicit global activity such as foreign sources of raw material, unsolicited export orders, opportunities to acquire foreign technology and so forth. However, as the globalisation of competition becomes more apparent, and as the awareness of the synergistic benefits increases, the need to formulate an international strategy and global planning procedures takes on greater prominence. A global strategy combines the role of location with the role of the entire global network of activities as a system in creating competitive advantage. It is an enterprise plan for achieving its objectives through geographical allocation of its limited resources, taking into consideration the global competition, geographical opportunities and alternative forecasts of the firm's external environment. Authors, such as Ohmae (1990), Reich (1991), and Bartlett and Ghoshal (1989) see the global firms as transcending national boundaries.

The formulation of a global strategy must originate from an understanding of the nature of international competition. The decision-maker should take a macroscopic view of the world market and its resources. The firm should not treat the international activities as a portfolio of separate businesses in various countries but instead, create integrated strategies involving all countries simultaneously. Thus, a number of crucial factors need to be considered when developing a global strategy.

First, an in-house assessment of the firm's existing philosophy and policies on international marketing is carried out. An introspective and comprehensive assessment will appropriately position the firm in the right spot in order to develop a global strategy. The firm would then need to have a long-term perspective of its operations, looking ahead all the time, and in the process, the following factors have to be considered.

a) the future political, social and economic environment;

b) evolution of the particular industry that it is in;

c) the problems and opportunities.

Secondly, after assessing its position, the firm should develop appropriate strategies both from corporate as well as subsidiary levels, in order to penetrate and skim the targetted foreign market.

2.3.1 Assessment of Internationalisation Philosophies and Policies

In its decision-making to enter into the international market-place, a firm needs to consider the following factors.

a) <u>GEOCENTRIC ORIENTATION</u>

At the onset, the firm should have appropriate management orientation towards multinational business, i.e., a geocentric orientation. The strategic focus of the firm should be global, and it should look at the world market as a whole with no demarcation between the domestic and international businesses.

b) COMMITMENT TO INTERNATIONAL BUSINESS

The venture overseas should not be a "flash in the pan" experience, but instead, the firm should be committed in its endeavour. The commitment should be accompanied by long-term strategic objectives towards globalisation. It should be translated into the extent by which the firm invests its managerial time to study the respective foreign markets as well as to make site visits, and into human resources, as well as the firm's response to risks and uncertainties.

This "pre-internationalisation" stage is considered very critical as it will affect the firm's future internationalisation success or failure. The psychological commitment that is manifested through changes in attitude of the firm is more important than its financial commitment.

c) THE STRATEGIC APPROACH TOWARDS INTERNATIONAL COMPETITION AND MARKETS

In order to survive in the international arena, a strategic perspective needs to be adopted for the international competition. Strategic competition is comprehensive in its commitment, and it involves the dedication of the whole firm. It refers to the firm's ability to understand the competitive interaction as a dynamic system that includes the activities of the competitors, the customers, the finance and resources of the firm. With this understanding, the firm should be able to predict the outcome of a given intervention in the system.

Strategic competition should also have a new definition of time and risk as these factors become relatively critical in view of the socio-economic, cultural and political differences in a foreign setting. The success or failure of the venture overseas would thus require sensitivity toward these factors.

d) IDENTIFICATION OF EXISTING COMPETITIVE ADVANTAGES

The identification and understanding of its existing strengths will enable a firm to position itself in the international as well as domestic markets. The firm's competitive position depends on its competitive advantages or disadvantages) vis-a-vis its rivals'. Competitive advantage is manifested either in lower costs than the rivals', or the ability to differentiate and command a premium price that exceeds the extra cost of differentiation.

e) ADOPTING THE VALUE-ADDED CHAIN CONCEPT

To understand the underpinnings of competitive advantage, the various stages of economic activities of the firm are identified using the value chain model. These activities involve the human resources, physical assets, technologies, routines and information. The configuration of the activities and how they interrelate are defined in the firm's strategy. The value chain concept can be adopted as an aid in formulating global strategies, through:

- identification of the various stages of economic activity that make up a production sequence of a specific product or service from start to finish, e.g. R&D, design, manufacturing, distribution, etc.

- choice of a particular value chain and the stage in which a firm may be involved as determined by its perceived resource-based and marketing advantages, and the strategy it adopts to exploit these advantages.
- geographical configuration of the activities depending on the company's perception of the relative attractions of possible production locations.

f) CLEAR COMPETITIVE STRATEGY IN THE INTERNATIONAL MARKET-PLACE

The globalisation of competition has allowed firms to gain competitive advantage independent of location, through the way they configure and coordinate the value chain on a global basis. However, it has not eliminated the importance of location in competition. While global firms may have transcended boundaries, one needs to identify whether it is adopting a standardised single-market strategy that is based on the perception of an increasingly similar consumer desire throughout the world, or a country-centre strategy that perceives each country, or a group of countries as having independent and different competitive forces. The former is essentially a market penetration strategy, which is in pursuit of the economies of scale in production, distribution, marketing and overall management deriving cost efficiency and potential competitive advantage. However, the latter is a market skimming strategy with focus on specific market segments or countries, where it can carve a niche by responding to whatever the local differences present. The selection of strategy would depend very much on the company's strengths and customer advantages that it has developed over the years.

2.3.2 Formulation of Strategies to Penetrate Market

The strategies to penetrate the international market-place include the following.

a) FOREIGN MARKET-ENTRY STRATEGIES

There is no single mode of entry into the foreign market; it is dependent on the reason for going international. Adoption of the right strategy will thus influence how a company enters the foreign market.

b) STRATEGIC MARKETING PLAN WITHIN CORPORATE LEVEL

The strategic marketing plan should be incorporated within the framework of a firm's corporate strategic plan. In view of global competitiveness, strategic marketing planning is crucial for maintaining leverage in the overseas markets. A good marketing plan will influence the behaviour of competitors and the evolution of the market in the host country to the company's advantage.

c) STRATEGIC MARKETING PLAN WITHIN SUBSIDIARY LEVEL

Centrally developed strategic plans tend to be standardised and in certain cases, unrealistic. Companies should be able to entrust the task of developing the local marketing plans to their subsidiaries as the latter may be in a better position to understand the local market conditions and needs. In formulation of its strategic marketing plans, a company should conduct comprehensive studies on the following.

- domestic environments, including the political, economic, socio-cultural and technological issues.

- various factors that influence the domestic consumer behaviour, including the cultural, social, personal and psychological aspects.

d) <u>HEADQUARTERS-SUBSIDIARIES RELATIONSHIP</u>

An effective headquarters-subsidiaries relationship is crucial for global competitiveness. While the headquarters may formulate a company's global strategies, some of its strategic marketing plans should be decentralised to the subsidiaries. The latter should be allowed to decide on certain operational issues. This would encourage the development of a close headquarters-subsidiaries relationship in the interests of the company.

2.3.3 Forms of Entry

The process of business expansion or investment overseas may be through import and export; development of domestic operations on a multi-plant basis; licensing and related technical agreements; portfolio investment; foreign direct investment; strategic business alliances; or international joint-ventures.

An **international joint-venture (JV)** refers to any long-term alliance that falls short of a merger, and in which two or more economic entities own a sufficiently large proportion of the equity capital to give each of them some degree of control or influence over key areas of decision-making. Besides capital investment, control or influence is also dependent on other contributory factors like, technical skills, management skills, access to markets, contacts with government officials, and so forth. A JV can be initiated by setting up new enterprise, or by one party acquiring the asset of the other.

The reasons for JV include the initial mode of entry, particularly when entering unfamiliar markets; a way of acquiring intangible assets, or knowledge about the local supply capabilities and labour conditions; a way of facilitating dealings with the host government, of gaining contracts from the public authorities, or of securing financial resources; to promote a more efficient deployment of existing foreign-based assets; and other strategic reasons.

Another mode of entry by companies is the **strategic business alliances (SBAs)**. Such alliances are formed between firms supplying different products, but emerging in broadly similar activities. SBAs are deliberately designed to advance the sustainable competitive advantage of participating firms, rather than part of a multi-domestic strategy of participants where the JV tend to be self contained entities, and where their success is largely judged in terms of contribution to profits of the enterprise of which they are part. This also implies that the SBA may not necessarily yield direct financial profit to the parent firm, especially in the short-run. Reasons for SBA include:-

- the increasing costs of R&D in the technologically advanced countries and global competitive pressures.
- to exploit better O advantages arising from economies of large scale production, scope, specialisation and rationalisation.
- to co-opt or counteract the O advantages of competitors deemed to work against their interests.
- relative unpopularity of other forms of organisation of multiple activities.

2.3.4 Ownership Strategies

Ownership strategies constitute a very important component in a company's overall global strategy. The company may embark on a project overseas by way of a wholly-owned foreign subsidiary, a JV with either the public or private sector locally, or a strategic partnership.

Strategic partnership or strategic alliance is a form of JV that is becoming increasingly important. It is a partnership of two or more multinationals that are generally competitors. The strategic alliance is designed to aid the partners in serving the global markets. The new ventures typically combine the technologies of two or more firms from industialised countries and have, as their motivation, increased research capability, cost reduction through joint production, and enlarged market access.

2.4 INTERNATIONAL BUSINESS PROBLEMS

While international business is an extension of the domestic business in some ways, it does involve certain unique risks that are not present in a typical domestic investment. Business activities across national boundaries require adjustments to environmental, socio-economic, political and cultural issues, as well as considerable familiarity with the international means of payments. Companies need to consider carefully various aspects when their businesses cross national boundaries.

2.4.1 International Risks

These include the uncertainties and problems relating to financial, political, regulatory and tax issues. They arise from causes such as the existence of different currencies, monetary standards and national policies. They also refer to the probability that events in the non-market (political, economic and social) environment of business will cause financial, strategic, or personnel losses to the business enterprises. These non-market forces lie within that part of a MNC's external environment that is not associated with the purely industrial, technological or competitive dynamics, and encompass a broad spectrum of events, including demographic changes, expropriation, debt restructuring or non-payment, terrorism, as well as the impact of government policies on a MNC's financial and competitive position.

2.4.2 Political Instability and Expropriation Risks

Among the greatest concerns in the decision-making for overseas investments are political instability and expropriation risks. Surveys of business executives that were carried out, have shown that the two factors mentioned played a significant role when the risks of doing business abroad were considered. However, it has been argued that political instability is neither a necessary nor sufficient condition for political risks, and that not all military coups or revolutions of socio-economic and political systems resulted in expropriation. Hence, firms with technological advantages and proprietary knowledge are believed to have better chances of avoiding adverse intervention by the host governments. Management of firms involved in international businesses should be also highly skilled in respect of dealing with political instability and expropriation.

2.4.3 Multinational Conflicts

Conflicts may arise due to differences in the nationality of the owners, employees, customers and suppliers; the divergence between interests of the sovereign national states and the business goals of the MNCs themselves. These refer to issues such as transfer of funds, production, employment recruitment from different countries, contribution to local exports or reduction of imports, national interests in strengthening local research and management, and so forth.

2.4.4 Multiple Environments

A MNC that is operating in the international arena needs to be very sensitive to the multiplicity of environments, such as the following.

a) types of business activity opened to MNCs, and forms of business organisation to be adopted, differ from country to country.

b) different country has different institutional settings and practices, such as the financial systems, labour unions, and so forth.

c) varying cultural differences may affect the business management, as well as relationship between local and foreign employees. The management of the MNCs thus needs to be aware of the significance of these differences on the behaviour of customers, suppliers and workers.

Multiple environments give rise a wide range of operational problems that require information, new concepts and various analytical methods. Generally, the environmental framework needs to encompass forces operating at a supranational level, such as ASEAN.

2.4.5 International Business and Development

Many less developed countries regard the international business as a major change agent, a mode of technology transfer, and a key force in the economic and social development. MNCs should be familiar with the roles that they are expected to play in the respective host countries besides from a purely commercial perspective.

2.4.6 International Legal Disputes

In view of the various socio-economic and cultural differences, it is inevitable that negotiated international contracts sometimes give rise to disputes. Therefore, such a contract should as far as possible be specific in its terms on how such disputes are settled, and equally explicit in its form, language, location and governing laws.