

Chapter 2: LITERATURE REVIEW

2.1. Theories of FDI

Before examining some of the relevant literature regarding FDI, it is pertinent at the outset to make a distinction between portfolio investment and foreign direct investment. Hymer (1960) was one of the earliest economists to point out the distinction between portfolio investment and FDI. Portfolio investment is the purchase of foreign securities such as stocks or bonds and does not imply any direct control over foreign operations. Portfolio investment is short term capital which seeks to maximise profits from differentials in interest rates. It is also termed as hot money as it can move in and out of markets rapidly through electronic transfers. Portfolio equity investors are usually either financial institutions, institutional investors (pension funds, insurance companies or investment trusts) or individuals. Portfolio investment or hot money has been blamed as one of the causes for the Asian financial crisis.

In contrast, UNCTAD defines "FDI as an investment involving a long term relationship reflecting ownership of interest and control of a resident entity in an enterprise resident in an economy other than that of the foreign direct investor". FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the host country. It encompasses not only financial investment, but also the transfer of technology, management skills, production processes and other resources to the target or host country. FDI may be undertaken by individuals as well as business entities. Unlike foreign portfolio investment which responds to interest rate differentials, FDI responds to profit opportunities and costs within specific economic sectors in target countries. This explains why the business environment within the target countries is important in FDI decisions.

The **classical theory of FDI** suggests that the motive for international direct investment is profit maximisation. According to this theory, factors of production will tend to gravitate toward the location where the highest rate of return can be earned. For example, a country which has surplus labour compared to capital is likely to find its labour migrating toward better opportunities. This was the experience of relatively labour surplus nations which were short of capital, such as Indonesia, Bangladesh and the Philippines which saw its workers coming in the thousands in the early 1990s to seek employment in Malaysia. The logic of the classical theory of FDI is an extension of the classical trade theory, whereby capital rich countries tend to export capital intensive goods and to invest capital abroad. Similarly, labour surplus countries tend to export labour intensive goods and their workers tend to migrate to other countries in search of employment opportunities.

Another example is the case of capital-rich Japan in the 1980s when the yen appreciated significantly against the US dollar, thus making it more costly to manufacture in Japan itself. Capitalising on the high value of the yen, Japan invested substantially in the United States and in South-East Asian countries. Malaysia was one of the main beneficiaries of Japanese FDI. Similarly, the industrial policy of Malaysia in the 1970s was to create employment opportunities for the people. This was because Malaysia then was relatively labour surplus, and the priority of the government was to generate employment.

The 1970s marked the era when Malaysia embarked on an export-oriented industrialisation (EOI) phase. The Investment Incentives Act introduced in 1968 boosted the establishment of export-oriented industries by providing various incentives such as pioneer status, investment tax credits, accelerated depreciation allowances and export incentives. The EOI phase also witnessed the rapid development of export processing zones (EPZs) or free trade zones (FTZs) in the country. With such measures in place, foreign electronics industries began to relocate their labour intensive operations to Malaysia's stable

low-wage environments as offered by the export processing zones and licensed manufacturing warehouses (Jomo and Edwards, 1993)

The stance of the government soon changed. Since the recovery from the recession of 1985 – 1987 to the middle of 1997, the Malaysian economy has been enjoying favourable economic growth. This resulted in a tight labour market situation with labour shortages felt in most sectors of the economy. Foreign labour had to be recruited from the labour surplus neighbouring countries of Indonesia, Bangladesh and the Philippines. To alleviate the labour shortage problems in the country, the government then advocated a policy of encouraging FDI in capital intensive manufacturing projects which were labour-saving. In addition, the government encouraged reverse investments, that is to encourage our local investors to invest labour intensive manufacturing operations in relatively labour surplus countries such as China, Vietnam and Cambodia. Malaysia's reverse investment (FDI outflows) amounted to US\$7 billion during 1990 – 1995.

However, the main weakness of the classical theory of FDI is that it cannot satisfactorily explain the investment decisions of individual firms. Hymer (1960) suggests two motives or types of FDI by firms. Type 1 direct investment has to do with the prudent use of assets, thus explaining why the investor seeks control over an enterprise in order to ensure the safety of his investment. In the same vein, Kindleberger (1969) and Casson (1980) suggest that investors are motivated by gaining control over productive assets. Type 2 direct investment has to do with the purpose of maintaining or expanding a firm's market power.

However, the desire for growth alone is not sufficient to explain why firms find it necessary to service markets with local production than with exports. Hirsch (1976) states that a firm chooses to invest abroad over exporting if the cost of production in the host country, including the costs of control and marketing, is

less than the cost of production in the source country. In analysing the export-invest decisions of a firm, most papers share the common assumption that export and foreign investment are two mutually exclusive options. Supporting this stance are Krugman (1983), Smith (1987), Horstmann and Markusen (1992) and Motta (1992) who suggest that it is never profitable for a firm to export and invest at the same time. Disputing this view are Lipsey and Weiss (1981) who observed that simultaneous export and FDI by firms do occur in the real world.

This then is the essence of the **industrial organisation theory of FDI** which suggests that FDI came about as a natural consequence of the growth and expansion of oligopolistic firms. Hymer (1960) suggests that FDI is typical of oligopolistic firms which seek to exploit advantage of imperfections in product and factors of production markets. Market imperfections may be attributed to policies of firms and governments. For example, firms seek to create competitive advantages through product differentiation. Hymer (1960), Kindleberger (1969) and Caves (1971) noted that many government policies create market imperfections.

Such government policies may include tariff and non-tariff barriers to trade, tax policies and incentives, preferential purchasing arrangements and capital market controls. Thus, tariff jumping in order to overcome trade barriers is an important motivation for FDI (Graham and Krugman, 1993). Similarly, Bhagwati, et al (1992) suggest that trade restrictions may lead to a quid pro quo type of FDI. Evident of this was the huge wave of FDI from several Japanese automakers (Honda, Nissan, Toyota, Mazda and Mitsubishi) in the United States during the second half of the 1980s in response to controls placed on the import of Japanese cars into the U.S. markets.

The industrial organisation theory of FDI also states that the reason why a firm chooses to set up a plant in a foreign country is because it possesses some firm-specific advantages over local firms in the host country. Indeed, firm-specific

assets such as superior technology, brand name, managerial and marketing skills, greater efficiency, access to markets and economies of scale are increasingly playing an important role in generating FDI flows (Porter, 1986). An example of how MNCs achieve economies of scale is by producing different electronic components in different countries, such as locating labour intensive operations in relatively labour surplus countries where the cost of labour is lower, and locating skilled and higher value-added activities in locations where skilled, technical and knowledge workers are available.

In Malaysia's case, it welcomed labour intensive industries during the 1970s as the priority then was to create as much employment opportunities as possible. However, during the period of buoyant economic growth in the late 1980s to the 1990s, the government's focus was on attracting capital intensive manufacturing projects, due to the tightening of the labour market and the escalating wage rates.

The **product life cycle theory** of Vernon (1966) incorporates the elements of innovation, growth and firm-specific assets in explaining the motive for FDI. The theory suggests that the development of new and innovative products typically occurs in industrialised countries. This is attributed to the availability of R & D capabilities for new product development and the ability to generate demand for new products in the developed countries. The new product stage is characterised by less serious price competition with the majority of sales in the domestic market. Hence, production need not be sited at the minimum cost location, but is likely to be located near the site of product development and research.

As the product moves into the second phase, called the growth stage, demand picks up for the product in other industrialised countries. During this stage, the firm begins to export the product to meet foreign demand. Thus sales volumes and profits are likely to rise, and this attracts competition, including competition

from foreign producers who may have advantages (no tariff barriers and low transportation costs) over the exporter.

As the product moves into the maturity stage, the domestic producer has a strong incentive to undertake direct investment in the market formerly served by exports. FDI is motivated to circumvent tariff barriers and high transportation costs. The move from the maturity phase to the decline stage occurs due to more intense competition, forcing the firm to compete as a low cost producer. The firm is then motivated to shift production to a less developed country to capitalise on the lower labour costs. In the decline stage, the product's survival is dependent on the firm's ability to compete as a low cost producer (cost motivated), while FDI in the product's maturity stage tends to be market-motivated.

Evident of this is Malaysia's ability to attract FDI in the 1970s and through the 1980s on the basis of the economy's ability to compete as a relatively low cost producer. However since the late 1980s, the nation's competitiveness as a low cost producer has been eroded due to rising wages as a result of the tight labour market.

Knickerbocker (1973) developed the **bandwagon effect theory** of FDI. He observed that in oligopolistic industries when one competitor undertakes FDI, other competitors follow quickly with defensive direct investments into the market. This "follow the leader" behaviour is motivated by the desire to deny any competitive advantage to other firms, such as the benefits from economies of scale resulting from overseas operations. The presence of various American MNCs such as Intel, Motorola and Texas Instruments in the electronics industry in Malaysia is typical of such defensive behaviour.

Akamatsu's **flying geese theory** or **the catching-up product cycle theory** of FDI typically describes the pattern of industrial development in developing

countries. The product cycle starts with imports of a particular product, followed by an import substitution phase which is assisted by FDI. The expansion of the import substitution phase is then typically followed by the export-orientation phase. Each successive development of imports, domestic production and exports can be termed as the catching-up product cycle. Malaysia's experience in industrial development is indicative of the catching-up product cycle theory of FDI.

The flying geese pattern of FDI also describes the transfer of industry from more advanced or leader countries to less developed or follower countries. Examples include Japanese investment in the automobile industry in Asean countries and in higher-end consumer electronic products in China.

The **offshore type investment theory** of FDI best explains the recent phenomenon of the increasing flow of manufactured exports from the developing countries to the industrialised countries. It also explains the increased intra-firm trade of MNCs between their overseas branches in host countries and their head offices in the home country. Typically, offshore FDI deals mainly with intermediate goods vs. finished goods, and its primary objective is to manufacture goods for re-export to the home country or other countries, and not for the domestic market. Japanese investors have long been using Malaysia as an offshore base for exporting to the Japanese market and third countries, taking advantage of the relatively lower labour costs and to circumvent trade barriers that they would otherwise face in North America and Europe (Ariff, 1991).

The **location theory** of FDI emphasises cost considerations in deciding the location for the establishment of a production plant in order to supply a product to the consumer market. Weber (1929) suggests that locational decisions are highly determined by the costs of supply variables such as inputs, transport and marketing. Losch (1954) proposes that the location of production plants is determined by the distribution of markets and location of competitors. He further

opines that an optimal location is one where the firm can have a monopolistic edge over its rivals. Losch also argues that the international dispersion of production plants is considerably influenced by the location of their rivals. Likewise, Dunning (1977, 1981) refers to the advantage of a firm in attracting FDI as the country's locational advantage.

Dunning's (1980, 1993) **eclectic paradigm** of FDI integrates three theories, namely the industrial organisation, internalisation and locational theories to explain why firms undertake FDI. Firstly, firms own assets or advantages which are unique to the firms. Such specific advantages could include economies of scale, technological superiority, brand name or the firm's reputation. For example, Coca Cola and Kodak are world renown brand names. Similarly, this can be extended to the nation's economic standing. For example, a favourable rating from Standard and Poor or Moody's is essential for attracting FDI or in selling bonds (Nordas, 1997). Recently, the Malaysian government had to abort plans to sell bonds abroad in order to raise funds to aid national recovery. This was due to the downgrading of the country's credit rating to near junk bond status by these agencies.

Secondly, internalisation factors determine whether foreign production occurs through FDI within the firm. Firms decide to create an internal market among parent and affiliates or subsidiaries in order to control key sources of competitiveness e.g. competitive advantage in developing and marketing new products is best exploited by internalising production and marketing activities within a single ownership structure.

Thirdly, location factors contribute to the decision to employ firm-specific advantages to produce abroad. Location specific assets may not be easily mobile between countries or even within countries. Examples are natural resources, infrastructure, availability of labour and institutional features (e.g. political stability and government intervention) of a country.

Dunning (1993) suggests that investors seek to combine the firm's mobile ownership specific assets with the location specific assets to maximise returns. However, it is not predetermined that FDI will be the mode of combining the firm specific assets and the location specific assets, even when a firm has found a location which maximises the return to its owner specific assets. This is because there are other options available to the firm such as exporting, licensing, franchising or strategic alliance. Thus in addition to efficiently combining firm specific assets and location specific assets, there need to be additional benefits from internalising the exchange between the two for FDI to be the chosen mode. For example, widespread and rampant corruption in a country could be a deterrent to FDI, and the firm may then choose to export.

Thus it can be seen that Dunning's conceptual OLI (ownership advantages, locational factors and internalisation factors) framework is useful in making decisions on whether to undertake FDI over other alternatives, as well as in deciding where to locate FDI. Countries then compete for FDI inflow through the provision and enhancement of location specific assets, for example, streamlining approval processes, opening sectors to foreign investors, allowing the repatriation of capital and the remittance of profits with minimal government intervention and providing infrastructure and attractive incentives.

2.2. International Competitiveness

It is pertinent to discuss the concept of competitiveness. A competitive situation is one in which people or organisations try very hard to be more successful than others, while competitiveness refers to the ability of a company or a product to compete with others (*Longman Dictionary of Contemporary English*).

The exhortation to be competitive is often mentioned, for example to be competitive in sports, or to be competitive in the international market by increasing our productivity and in producing quality products. Firms compete

globally for markets between two countries or more. Being internationally competitive implies that a firm with a tradable product will try to outsell a competitor's product. Similarly, nations compete in the selling of goods and services and in trying to attract more FDI inflows in the international market.

WEF defines competitiveness as the ability of a country to achieve sustained high rates of growth in GDP per capita over the next five to ten years. WEF's *Global Competitiveness Report 1997* attempts to seek a measurement of global competitiveness by focusing on eight factors of competitiveness. The eight factors are:

- Openness of the economy to international trade and finance
- Role of the government budget and regulation
- Development of financial markets
- Quality of infrastructure
- Quality of technology
- Quality of business management
- Labour market flexibility
- Quality of judicial and political institutions

IMD defines competitiveness as the ability of a nation's environment to sustain the creation of value added, and by extension, the competitiveness of their companies. IMD's *World Competitiveness Yearbook 1997* focused on the following eight factors to assess competitiveness:

- Domestic economy: macroeconomic evaluation of domestic economy
- Internalisation: extent of participation in international trade and investment flows
- Government: extent to which government policies are conducive to competitiveness
- Finance: performance of capital market and quality of financial services
- Infrastructure: extent to which resources and systems are adequate to serve businesses

- Management: extent to which enterprises are managed in an innovative, profitable and responsible manner
- Science and technology: extent to which a country commits resources to R&D activities, and its scientific and technological capacity
- People: availability and qualifications of human resources

Both WEF and IMD measure competitiveness by aggregating several criteria into a single competitive index by which the countries are then ranked (**Appendix I** indicates WEF's ranking, and **Appendix II** IMD's ranking). It is pertinent to note that FDI inflow represents one of several criteria in calculating the competitiveness index used in ranking the countries.

According to the *Bank Negara 1998 Report* "The ultimate measurement of a nation's competitiveness is its ability to effectively sell goods and services in the international market and at the same time, attract substantial foreign investment".

The focus of the study is on international competitiveness in attracting FDI inflow. Due to the intense competition for FDI, nations compete by trying to make their location specific assets more attractive to foreign investors. Based on Dunning's OLI conceptual framework as mentioned earlier, investors will try to complement their firm specific assets with the location specific assets before deciding where to site their investments.

It is pertinent to note that investors targeting FDI to produce for the recipient country are termed as market servers, while FDI which is carried out mainly as platforms for export to other countries, including the source country, are exporters (Shatz, 1997). Market servers and exporters have different criteria and standards in deciding on investment sites. Generally, market servers seek large and fast growing markets, and are more willing to compromise on some country characteristics, such as lack of strength in contract enforcement, lack of property rights legislation and investment incentives. This perhaps explains why foreign

investors are rushing to invest in China, the world's most populous nation with 1.2 billion people, despite the many problems of doing business in China, such as inadequate legal framework and institutional infrastructure supporting the business environment, and corruption

In contrast, exporters look for low cost production sites, and are more concerned about the overall competitiveness of a particular country. Malaysia, though no longer recognised as a low-cost producer, is clearly used as a base for export to other countries. With a small domestic market due to its population of 21 million, Malaysia has been competing for FDI as an exporter. The Malaysian economy is an open one, and is dependent on trade. Exports have featured significantly in the economy, contributing to the balance of trade surplus. Foreign companies in the country have consistently been export oriented, with export propensities as high as 80 – 90 percent (Anuwar and Wong, 1991). Exports as a percentage of GDP has increased over the years, reaching 84.7 percent in 1995 (*Economic Report 1995/1996*). The location-specific factors contributing to Malaysia as a choice for FDI include political stability, generous incentives, good infrastructure and a relatively young and educated workforce