International Trade: An Explanation of Today’s Foreign Direct Investment into Emerging Economies

Dr. Etienne Musonera, Stetson School of Business and Economics, Mercer University, USA

ABSTRACT

In this paper, we trace the evolution of international trade and foreign direct investment (FDI) theories from their origins to the present. We describe the comparative advantage (Ricardo), and the competitive advantage (Porter) theories of international trade and we review the international product life cycle (Vernon), and the oligopolistic reaction theories (Knickerbocker). We also discuss theories of monopolistic advantage, transactions costs, internalization, and eclectic and internationalization theories as related to multinational firms’ activities and FDI. We believe that one or more of these theories might provide an explanation for today’s FDI across emerging countries.

Keywords: International Trade, Foreign Direct Investment, Emerging Economies

INTRODUCTION

Theories on Foreign Direct Investment (FDI) have generated different explanations of why FDI occurs. Kindleberger (1969), Hymer (1972), and Horaguchi and Toyne (1990) have stated that FDI is the direct result of an imperfect global marketing environment. The internalization theory postulates that FDI takes place as multinationals replace external markets with more efficient internal ones (Rugman 1985, 1986), and when internalization of such imperfect markets occurs across boundaries, it leads to the creation of multinational corporations (Rugman, 2002). Dunning (1986, 1988), in his eclectic theory of international production, states that FDI emerges because of ownership, internalization, and location advantages. Most empirical studies classify FDI determinants into demand and supply side determinants (Root and Ahmed, 1978, 1979; Agarwal, 1980). They all argue that the demand determinants of FDI are aggregate variables grouped into three main categories: economic or marketing, social, and political. Some studies have given limited consideration to social and political influences (Root and Ahmed, 1979; Dunning, 1981; Schneider and Frey, 1985). Other studies have concentrated on economic factors (Dunning, 1973; Lunn, 1980 and 1983; Scaperlanda and Balough, 1983; and Culem, 1988). Hence in light of these conflicting studies, we believe that one or more of these theories might provide an explanation for today’s FDI across emerging countries.

MERCANTILISM

Between 1500 and 1800, most of the states of Western Europe were heavily influenced by a policy known as mercantilism to achieve economic unity and political control. Mercantilism theory states that a country’s wealth is dependent on its holdings of treasure, especially gold, and that country should export more than it imports in order to increase national wealth and to have a favorable balance of trade. Hill (2001) argues that mercantilism may be an old doctrine, but its impact is still echoed in modern political debate and in the trade policies of many countries. One argument that mercantilism still persists nowadays is the view that a current account deficit is bad, and that imports reduce domestic employment. When a country runs a current account deficit, it is borrowing capital from the rest of the world in order to purchase more goods and services than it sells. However, this borrowing policy may promote economic wealth if the return on the capital borrowed exceeds the cost of borrowing. Regarding the way markets and modern economies work, the mercantilism era led to what is known as the “Neo-Classical Theory,” which refers to work done in the eighteenth and nineteenth centuries by classical economists such as Adam Smith, David Ricardo, Jean Baptiste Say, and Irving Fisher.
ABSOLUTE ADVANTAGE

Absolute advantage is the ability of an economic actor, an individual or a firm, to produce some particular good or service, with fewer resources, labor, capital, and land per unit of output (Hill, 2001). The theory of absolute advantage was first presented by Adam Smith in “The Wealth of Nations” in 1776. Smith stated that a country has an “Absolute Advantage” over its trading partners if it is able to produce more of a good/service with the same amount of resources or the same amount of good or service with fewer resources. He argued that markets would guide economic activities and act like an invisible hand allocating resources, that specialization would lead to mass production with much greater output as each part of the process is carried out much faster and quicker. Prices would play a major factor: they would rise where and when there is a shortage of something and fall when it is plentiful. He argued that market forces ensured the production of the right goods and services. Smith made a number of important criticisms of mercantilist doctrine. First, he demonstrated that trade, when freely initiated, is a positive-sum game and benefits both parties. Second, he argued that specialization in production allows for economies of scale, which improves efficiency and growth.

Finally, Smith argued that a collusive relationship between government and industry was harmful to the general population. In a laisser-faire environment, with no intervention from government, public well-being would increase because of competition. In this case, if producers try to outsell each other, prices will be brought down, and there will be minimal profits. However, if there were no competition, producers or sellers would make more profit, but would attract more firms to join in competition, thereby bringing prices down.

COMPARATIVE ADVANTAGE

David Ricardo argues that absolute advantage was not a necessary or sufficient condition for trade to occur. For him, if one country has an absolute advantage in everything, then it would produce and export everything and import nothing. But if one of the reasons countries export is to get foreign exchange to buy imports, this absolute advantage theory will not hold. Therefore, he proposed another alternative basis for trade known as “Comparative Advantage” in 1817. Along with Thomas Malthus and Jean Baptiste Say, Ricardo developed important areas of economic theory, such as money markets, stock exchange, distribution theory, international trade, and the comparative advantage theory. In his later work, he developed the theory of “diminishing returns” and “economic rent.”

Distribution Theory

Malthus was concerned about the impact that rising populations would have on the economy. He argued that more people would lead to more land to be cultivated. However, the return from the land will not be constant, as the amount of capital available will not grow at the same rate. The land will suffer from diminishing returns. The extra land will become more marginal in terms of profitability, and returns will not be enough to attract further capital. At this point, the maximum level of economic rent would have been earned. The allocation of each factor of production to each area of economic activity would be determined by the level of economic rent, and because of diminishing returns, capital would shift and be allocated to more profitable resources.

International Trade Theory

International trade theory focused on comparative costs, and on how a country could gain from trade and on where and when it has relatively lower costs (comparative advantage). According to Ricardo’s theory of comparative advantage, a country has a comparative advantage of a good or service if it produces at lower opportunity costs than its trading partners. Some countries have an absolute advantage in the production of many goods relative to their trading partners, and some have an absolute disadvantage: they are inefficient in producing anything relative to their trading partners. The theory of comparative costs argues that it is better for a country that is inefficient at producing a good or service to specialize in the production of that good at which it is least inefficient, compared with producing other goods. In analyzing the theory of trade and economic specialization, it is important to distinguish absolute from comparative advantage. Comparative advantage determines the potential welfare gains from specialization and trade, and not absolute advantage.
Comparative advantage explains that trade between developed countries and less developed countries occurs because of different factor endowments and because they tend to produce different types of products. However, there is too much trade between countries that have similar factor endowments, and most of the time the trade is in similar products. For example, the U.S., Germany, and Japan are all industrialized, developed countries. They all have strong comparative advantages in manufacturing and technology know-how, and they often trade similar products with each other (e.g., cars). When the market is dominated by a monopoly, duopoly, or oligopoly, imperfect competition can lead to intra-industry trade of the same product. Moreover, countries trade independently of comparative advantage because a firm will gain economies of scale if its average cost of production falls when it increases its scale of operations.

**Factor Proportions Theory (H-O)**

The factor proportions theory, developed by Hecksher and Ohlin (1933), states that differences in a country’s proportionate holdings of factors of production (land, labor, and capital) explain differences in the costs of the factors, and that export advantages lie in the production of goods that use the most abundant factors. For example: Japan specializes in the manufacture of many high-tech products because it possesses a high-knowledge labor pool and lots of investment capital. Argentina specializes in the production of many agricultural products because it possesses much good agricultural land and lots of low-cost labor. However, the Leontief Paradox (1953) refuted the factor proportions theory by showing that American exports tend to be labor intensive and American imports capital intensive.

**THE COMPETITIVE ADVANTAGE OF NATIONS**

Competitive advantage exists when one firm has an advantage over another, permitting it to compete more effectively to maximize revenues and/or minimize costs, so as to maximize profits. Pursuing and achieving low cost and differentiation strategies can achieve competitive advantage. In order to increase the perceived benefits, or superior value to customers, Porter (1990) developed a framework of generic business strategies based on the two sources of competitive advantage, low cost and differentiation.

Competitive advantage derives from the ability of industries to focus on competitiveness, and to innovate increasingly as global competition intensifies. Therefore the strategic intent must be the means for achieving competitive advantage. “Few competitive advantages are long lasting. The essence of strategy lies in creating tomorrow’s competitive advantage faster than competitors mimic the ones you possess today; an organization’s capacity to improve existing skills and learn new ones is the most defensible competitive advantage of all” (Prahalad and Hamel, 1989). The basic source of competitive advantage is innovation, which is the process of creating or improving products, processes, technologies, and techniques. Deming (1986) insists that the most important form of innovation for sustainable competitive advantage is continuous improvement. Therefore, innovation can manifest itself in many ways: a new product design, an improvement in a production process, a new marketing technique, a new way of training employees, etc. However, most of us wonder why certain companies in certain nations are capable of consistent innovation, and why they are able to overcome the considerable barriers to change. Porter’s diamond model provides some of the determinants of national competitive advantage.

Porter used a diagram to illustrate the four mutually reinforcing determinants of national competitive advantage: demand conditions, related and supporting industries and firm structure, strategy, and rivalry. He stated that these factor conditions can create an environment which enables industries and firms to compete, and explains why some industries and nations are more competitive than others. In theory, when analyzing the determinants of FDI, firms seek an environment which fits and is conducive to success. Thus, the national home base of an enterprise plays a key role, and can provide basic factors to support or hinder industry competitiveness.

**Firm Strategy, Structure, and Rivalry**

Strategies and structures help to determine in which type of industries a nation’s firms will excel. The conditions in a country determine how domestic companies are created, organized, and managed. Firms may prefer less rivalry and enjoy low factor costs advantages, but in the long run local rivalry is better because it puts pressures on a firm to
innovate and make improvements. Often, firms will not innovate unless there is sufficient rivalry. Porter (1990) argues that domestic rivalry creates pressures to innovate, while local competitors imitate new ideas, and consequently the whole industry benefits from overall industry innovation and competition.

**Factor Conditions**

Porter (1990) argues that the most important factors in comparative advantage are not inherited, but rather are created. For example, factors of production such as qualification level and cost of labor, material and knowledge resources, and capital and infrastructure necessary to compete in given industries provide initial advantages, and play a key role in explaining the pattern of trade both in classical theories and in Porter’s concept of competitive advantage. Porter (1990) points out that these conditions may be developed or changed. National policies, the political environment, and technological and sociological changes shape national competitive advantage conditions, and government may encourage firms to raise their quality performance by enforcing product standards, stimulating local rivalry, and enforcing antitrust laws. We must remember that a key rationale behind FDI is its positive spillover benefits to the host economies, and a well-developed infrastructure, and an educated and trained labor supply are important factors in competitiveness, since they reduce the costs of doing business and encourage private investment.

**Demand Conditions**

Porter (1990) states that host country demand is at the base of national competitive advantage in the sense that firms first supply their domestic market before exporting to markets with similar demand patterns. Usually home markets have much higher impact on an enterprise’s ability to recognize local consumers’ needs than foreign markets do, and a more demanding local market leads to national competitive advantage and anticipation of global trends. Porter (1990) states that home demand depends on customers’ needs and wants and on the scope and growth rate of domestic preferences for specific products and services. He argues that home-market demand conditions have an impact on the nature, pace, and direction of product development and innovation.

**Related and Supporting Industries**

The presence in the nation of appropriate suppliers, competitors, and complementary firms to support given industries reinforces innovation and internalization in industries at later stages in the value system. “An ongoing coordinating process of innovation and upgrading will result where access to information, new ideas, insights and innovation will occur,” and if competitive advantage exists in related industries, the “opportunities abound for positive interchanges and new opportunities are continually perceived” (Porter, 1990). In this study, we assume that when operating within a mass of related and supporting firms, local firms can use and coordinate particular activities in the value chain, and gain advantages through information and knowledge synergies, economies of scale and scope, and access to appropriate or superior inputs. Indeed, the presence of spillover effects would cause more demand for inputs and strong supply linkages, therefore forcing host country firms to become more competitive.

**INTERNATIONAL PRODUCT LIFE CYCLE (IPLC)**

The product life cycle concept, typically expressed as an “S” shaped curve in the marketing literature, is based on an analogy with the human biological cycle. Products, like living organisms, go through stages of birth, development, growth, maturity, decline, and demise. The product life cycle identifies four phases that trade patterns go through: export strength, foreign production starts, foreign production competitive in exports markets, import competition begins. Vernon’s IPLC model suggests that many products go through a cycle during which high income, mass consumption countries are initially exporters, then lose their export markets, and finally become importers of the product. Vernon’s product cycle model describes how new products are created in the developed countries (where production first occurs) and then as the production process is standardized production will shift to lower wage developing countries. Vernon (1966) claims that many products go through the same trade cycle as IPLC.
Raymond Vernon (1966), attempting to explain patterns of international trade, observed a circular phenomenon in the composition of trade between countries in the world market. Advanced countries, which have the ability and competence to innovate, high-income levels, and mass consumption, become initially exporters of goods. However, they lose their exports initially to developing countries, and subsequently to less developed countries, and eventually become importers of these goods. Vernon’s hypothesis was an attempt to advance the trade theory of David Ricardo and other classical economists. It explored unexplained areas of international trade theory such as timing of innovation, effects on scale economies, and the role of uncertainty and ignorance in trade patterns. To summarize, product life cycle is an essential tool for firms to design marketing mix strategies for different states of the life span of a product or service. Vernon stresses the degree of standardization as evidence of maturation of the product. Even though Vernon’s model does not focus on consumer socio-cultural and behavioral variables, and virtually ignores trade in intangibles such as services, it is fundamentally important for our study because it is based on industrial and manufacturing value added activities. More importantly, Vernon’s approach is more likely to provide insights for national policy formulation at macro levels. According to Vernon (1966), the overall scarcity of capital in the less-developed countries will not prevent investment in facilities for the production of standardized products.

OLOGOPOLISTIC REACTION (OR)

The OR theory states that the decision of one firm to invest overseas raises competing firms’ incentives to invest in the same country (Knickerbockers, 1973). Knickerbockers introduced “oligopolistic reaction” to explain why firms follow rivals into foreign markets. He argues that the more concentrated the industries, the more likely they would be to exhibit oligopolistic reactions. He proposed another motivation in location choice: firms might invest in a country to match a rival’s move, and he argued that firms in industries characterized by oligopoly would tend to follow each other’s location decisions, because the follower is uncertain of the production economies that the leading firm might gain by manufacturing locally. This supports Knickerbockers’ (1973) argument that firms obtain greater profits from clustering than dispersing when there exist positive spillovers (agglomeration economies between firms locating in geographic proximity). Therefore, Knickerbockers’ oligopolistic reaction hypothesis can be formalized in terms of FDI decisions being strategic complements (Caves, 1993). He points to the role of risk aversion: firms want to minimize their risk by matching the FDI of rivals. Oligopoly, uncertainty, and risk aversion are the principal elements of Knickerbockers’ theory, and combined they generate follow-the-leader investment behavior.

MONOPOLY BEHAVIOR

Schumpeter (1942) stresses the point that monopolization of a market may make it less costly for a firm to plan its activities. He argues that large firms have some advantages, such as the spread of fixed costs of innovation, and economies of scale in securing financing for risky R&D projects (e.g., Microsoft has a monopoly on its operating system). In the orthodox theory, competition and monopoly are situations labeled as “competitive” or “monopolistic.” Schumpeter (1942) has stressed the beneficial role that monopoly profits can play in the process of economic development, but places considerable emphasis on innovation and the ability of particular types of firms to achieve technical advances. In this context the profits that monopolistic firms earn provide funds that can be invested in R&D.

THE NEOCLASSICAL THEORY

The term “Neo-classical Theory” refers to work done in the eighteenth and nineteenth centuries by classical economists such as Adam Smith, David Ricardo, Jean Baptiste Say, and Irving Fisher. The neoclassical theory argues that places that offer the highest rates of return will attract the most capital. Following WWII, FDI among industrialized nations initiated a rise in the scale and scope of international production. The theoretical explanation offered at that time was the neoclassical capital arbitrage theory of portfolio flows. Based on assumptions of perfect competition, absence of transaction costs, and perfect information, the neoclassical theory explained international capital flows as responding to interest rate differentials (Williamson, 1985).
THE INDUSTRIAL ORGANIZATION APPROACH

In the 1960s, neoclassical theory was questioned because it did not distinguish foreign direct investments from portfolio investments. The neoclassical approach neglected to recognize the role of multinational enterprises and market imperfections. Hymer (1960) was the first to see that FDI could not be coupled with portfolio investments. Hymer was in fact the originator of the industrial organization approach and his dissertation is considered the landmark piece of literature in the field of multinational companies (MCs) and FDI and other contributions to the FDI literature can be seen as an extension of Hymer's initial work. According to Hymer (1960), in order to analyze foreign investment, one must first analyze the multinational enterprise which thrives on market imperfections. Foreign firms face greater risks in making investments than do domestic firms because different and unfamiliar laws, different languages and cultures, and possible discrimination add to the costs of firms investing abroad. Therefore, MCs must have some advantage over competitors or other reasons to invest directly in a foreign country. Hymer (1960) based his analysis on the so called “Joe S. Bain-type advantages” or barriers to entry such as economies of scale, cost or knowledge advantages, product differentiation, and credit access. These specific advantages allowed multinationals to invest abroad as well as to close markets and increase market power. A multinational company would use foreign subsidiaries to remove competition between the foreign affiliate and domestic operations already present. Raymond Vernon (1966, 1973), Charles Kindleberger (1969), and Richard Caves (1971) added to the link between industrial structure and FDI established by Hymer (1960). They argued that often multinationals invest overseas to protect the foreign market from tariffs or other trade restrictions imposed by foreign governments. Richard Caves (1971) summarized Hymer's thesis and then added other advantages that foreign affiliates have over domestic firms, such as start-up costs, economies of scale, credit ratings in the home market, and risk sharing.

THE INTERNALIZATION APPROACH

Critics of Hymer (1960), Kindleberger (1969), and Caves (1971) claimed that their approach was a one-dimensional at the multinational enterprise as a monopolistic rent seeker rather than an efficiency seeker. Buckley and Casson (1976) reasoned that firms could overcome market imperfections, like tariff or non-tariff barriers, by internalizing economic activities. Hymer (1960) would argue that the firm used the asset to restrict entry of other firms and establish a monopoly situation. In his approach to industrial organization, Williamson (1985) asserted that the multinationals internalized intangible assets in order to generate adequate private returns instead of licensing or trading an intangible asset and firms choose to invest directly via a foreign affiliate to maximize returns.

INTRA-INDUSTRY RIVALRY APPROACH

Another extension of Hymer's reasoning is Frederick Knickerbocker's intra-rivalry approach. Knickerbockers (1973) stated that firms trigger a bandwagon effect as a strategic response to oligopolistic rivalry, and invest overseas because of a perceived threat of market loss. If one firm in a competitive industry decided to invest abroad, others in that industry would feel compelled to do the same. If no one matched the investment, the new investor might move on the rest of the industry in the foreign market, perhaps finding a cheaper supply source or developing a new technology to give advantages in the home market.

CONCLUSION

Every theory is the result of economists finding a previous theory lacking in some manner. The neoclassical theory was the prevalent one post-WWII, but its dependence on perfect competition and perfect knowledge, as well as its limitation in viewing all foreign investments as the same, prompted Stephen Hymer to apply the industrial organization theory. However, Hymer's view stressed the monopolistic activities of multinationals and neglected the Williamsonian (1985) efficiency characteristics of MC behavior. The result was an internalization extension of industrial organization theory. Krugman (1985) defines, analyzes, and gives empirical data on recent trends of FDI.
Krugman (1992) provides the most comprehensive study of FDI, explains the economic costs and benefits, describes misconceptions of the political and national security threats imposed by the presence of foreign nationals, and finally lists current policy toward FDI and offers policy alternatives within the design of the industrial organization approach. Because economists and marketers do not rule out any possible reason why a firm might decide to invest directly in another country, our study framework of FDI determinants in emerging countries may be explained by Dunning eclectic theory-ownership, location, and internalization.

REFERENCES


