Chapter 1

Theoretical Analysis of Foreign Direct Investment (FDI)

1. Theoretical Analysis of FDI by Large Multinational Enterprises

1.1. The theory of imperfect competitive markets and multinational foreign direct investment

The hypothesis of the traditional theory of international economics is established under the assumptions of perfect market competition, adequate information and immobile production factors among countries. In addition, international trade is assumed to be the major or even the only method for the international economic interaction. However, the framework of this theory does not account for the rapid growth of international economic integration or the activities of foreign direct investment (FDI) as well as the international capital movements after World War II. Many economists, therefore, started to criticize the traditional theory and conduct systematic research on the behavior of direct investment in multinational enterprises.

In 1960, Stephen Hymer, an American scholar and pioneer in the theory of FDI, proposed the imperfect market theory (or industrial organization theory) in his Ph.D. dissertation at MIT. He proved in his dissertation that the advantage of monopolistic enterprises and the imperfection of domestic and international markets are crucial factors in an enterprise's FDI. With additions and improvements by Charles P. Kindleberger (1969), the theory of monopolistic advantage was then proposed and was called Hymer–Kindleberger approach of multinational enterprise. The basic concept of this theory is that the realistic market is imperfect. In the goods market, the difference in products, trademarks, and marketing capabilities, and the varied complicit behaviors among manufacturers limit market power. The monopolization of technology formed by the patent system, the internal and external scale economy, and the natural monopolization of specific resources further contribute to imperfect competition in the market. In the international market, tariffs and exchange rate policies by governments also cause market imperfection. Non-market powers such as obstructed products and factors for unrestrained flow can also cause difficulty when applying the process of the free market described by traditional economic theory. Consequently, the efficiency of resource allocation will be destroyed.

Nevertheless, even confronted with the condition of market imperfection, some enterprises may still obtain an advantage due to monopolization, and some countries may benefit from the unbalanced resource allocation or their unique locations. This is because multinational direct investment, when combined with the two advantages mentioned above, will create immense profits. From this viewpoint, the behavior of proposed multinational direct investment will improve and reallocate resources across global boundaries, as well as lead to a Pareto-improvement. Kindleberger (1969) states that the prospering of direct investment must come from the imperfection in products or factor markets.

In short, the theory of imperfect markets successfully combines the theory of neoclassical economics with the theory of multinational direct investment. It also explains the original motivation of the behavior of multinational direct investment, and establishes the foundation of theory in the research of the theory of foreign direct investment of multinational enterprises. However, this theory does not explain why direct investment should be chosen among other varieties of multinational investment methods. Thus, based on this foundation of theory, many scholars have conducted relevant research and empirical studies of the crucial factors behind multinational direct investment.

1.2. Theoretical analysis of decisive factors for multinational direct investment

1.2.1. Theory of enterprise advantage

Compared with local companies, foreign investors are likely to incur additional costs in order to bridge the differences in culture, law, system and language, and to gain sufficient knowledge of local markets. To ensure a profit from these additional investments, the multinational enterprises should have certain advantages that local competitors do not have. Based on this concept, researchers focused on one or several core advantages that enterprises held, then analyzed each one systematically, such as patent right, special permission to obtain capital and market entry, economies of scale, product differentiation, etc. In the early stages, the existence of these factors allows multinational direct investment to obtain higher profitability than other investing methods. This method, therefore, has become one of the major investing methods for investors.

In general, the advantages of multinational enterprises are as follows: firstly, the technological advantage. Almost all theories of multinational direct investment emphasize the core effect of this factor. In practice, new products and new technology are the essential elements of technological advantage for multinational corporations. The product difference is a vital factor that can be advantageous if the quality and functions of the product surpass those of competitors. The market technique and superior organizational management of enterprises can also be seen as technological advantages. Through FDI, multinational enterprises are able to internalize the technology transfer, which not only guarantees the technology nondisclosure, thereby making it hard for competitors to imitate, but also increases profit.

Secondly, the advantage of monopoly. The advantage of monopoly will not only create a great margin, but also obtain better economies of scale for enterprises. Multinational direct investment encourages enterprises to extend their monopolistic advantage through the consolidation and development of a worldwide market share; this direct investment will be more direct and effective than other investing methods. In response to this, the oligopsonistic competition model developed by American scholar Nick Brooks holds that a strategy of prevention will be carried out by other multinational enterprises to ensure an advantage of oligopoly worldwide during the process of direct investment. Thus, while one enterprise may establish a branch abroad, other enterprises will also follow suit in order to reduce any advantage that the first enterprise gained. Obtaining the advantage of monopoly is therefore a priority as enterprises practice multinational direct investment. Enterprises must also continually maintain and expand their monopolistic advantage.

Thirdly, the advantage of capital and currency. If the currency of the capital in export countries is relatively strong, there will be a currency surplus from FDI, and its investing benefit may not only be higher than that of the domestic investment, but also higher than the host countries' within the same conditions. In addition, the surplus of inflation will lead to the surplus of interest rate. According to the Abberley Model, this may enable multinational investors to reduce operation costs and become more competitive by collecting the capital with lower interest rates than the host countries'.

Finally, FDI will allow the enterprise to avoid risks from the diversification of investment and achieve the purposes of profit and diversified risks, which have been explained and proven by the theory of portfolio selection or assets choice. This factor has become extremely important after the system of fixed exchange rate collapsed and inflation and economic differences grew worldwide since 1973.

1.2.2. The internalization theory of direct investment by multinational companies

The advantages discussed above not only benefit multinational investors, but also achieve enormous profit that cannot be gained while enterprises invest only in the domestic market. However, based on this idea, enterprises are also able to achieve the advantage of economic benefits through domestic production, followed by export to other countries. The existing advantages of enterprises do not explain why enterprises are unable to achieve a method of export to gain further advantages.

In order to analyze this issue, economists refer to the equilibrium model proposed by Ronald H. Coase (Coase Theorem) in his discussion of the origin of the multinational corporation. The model brings forth the internalization theory related to activities of multinational direct investment. This theory states that transaction costs are always present in the trading market. These costs include those of price determination, contract signing, supervising the contract execution, and risk. For certain types of trading, the cost of market dealing is rather high and inefficient, which sometimes renders the deal difficult and unprofitable. At this time, enterprises should make use of internal management instead of dealing through the market, provided the cost of internal management trading is less than that of market trading. This concept could also be applied to the multinational production of enterprises. Generally speaking, export and technology transfer are the methods of marketization through which enterprises are able to apply their advantages of capital and technology. Direct investment is the method of internalization, however, if the cost of the former is higher than the latter; the difference in cost between the two methods would then create a surplus.

In comparison with general activities of market trading, exporting activities make for a more complicated trading process and create higher trading costs due to the influence across borders of countries, tariffs and long-distance transportation. However, there will be higher profit if the activities of multinational direct investment can be internalized. When the place has less cost of international resource allocated, the multinational enterprises will be established. Internalization will be useful for multinational enterprises to internalize their specific advantages. American scholars Buckley and Casson (1976) later integrated the theory of ownership-specific advantage and the theory of internalization (i.e., intra-firm trade) successfully. Magee (1977) even proposed the adequate reward theory based on the foundation of this theory; he emphasized that the advantages of multinational enterprises come from the guarantee of adequate capabilities from their investment in technologies and products. In addition, the internalized technological capability in multinational enterprises is one of many factors leading to high profit.

1.2.3. The location theory and the eclectic theory of international production

When explaining the decisive factors in the circulation of investment for multinational enterprises, researchers have also included the location factor of host countries into the theory framework. In practice, the circulation of multinational investment is influenced by the following factors: firstly, the labor cost. The obstruction of international circulation of labor due to population control for each country renders the international labor market imperfect. This results in the cost differences in worldwide labor. When industrial technologies enter the mature stage and the market advantages become dependent on low cost, arranging for production activities to take place in a location with low labor cost becomes more attractive. As a result, the labor cost is a major factor when deciding the circulation of investment. Other similar factors include the cost of raw materials and specific resources. After World War II, many enterprises in developed countries were eager to create investments in developing countries for these reasons.

Secondly, the market situation. The market size, market growth rate, the stage of development and the degree of competition in a host country can strongly influence an enterprise's decision regarding direct investment. Many surveys on investment by multinational companies express that most multinational companies invest to win large market share in host countries; several investigations conducted by FDI enterprises in Mainland China have also proven this viewpoint. When the economic effect of industrial scale is significant and the market of investors' home countries is small and unable to allow investors to develop scale advantages, then the market situation of the host countries will likely become the main issue when deciding the circulation of investment. Other factors similar to the market situation factor are free trade zone, tariff union, trade barriers and local stability. All these factors play a crucial role in deciding the circulation of multinational direct investment.

Thirdly, the policy of host countries. Generally speaking, the policies of method of entry, stock share by shareholders, and the arrangement of the market of foreign enterprises in host countries will influence the amount of revenue from foreign investors directly and indirectly. These policies have much influence when enterprises make investment decisions. The above factors and the standard of infrastructure in host countries are normally categorized as part of the investing environment that will be considered in the early stages of investment. Most investments take place in countries or areas with ideal conditions and significant regional advantages as stated above.

2. Theoretical Analysis of FDI by Small- and Medium-Sized Enterprises in Taiwan

According to data from the International Monetary Fund (IMF), inward FDI in developing countries has increased more than 12 times since the 1980s. Long-term inward FDI has provided many benefits to developing countries, one being the significant increase of infrastructure for public sectors. Long-term inward FDI also expands the capital stock for the host countries. Inward FDI became active in East Asia after the 1990s. Taiwan, South Korea, Hong Kong, Singapore and Japan are the major countries supplying inward FDI. Mainland China and Southeast Asian countries, on the other hand, are the major countries seeking inward FDI.

The Asian financial crisis, which took place from 1997 to 1999, has changed the circulation of inward FDI. This can be seen in the allocation of investments between Mainland China and the countries of Southeast Asia that were affected by the financial crisis. For example, the investment flow from Taiwan to Mainland China has been increasing sharply in the past decade, compared to the stable flow of inward FDI from the Southeast Asian countries affected by the financial crisis to China after 1997. Although there is much motivation behind the integration of the regional economies in East Asia, such as technologies, preferences, and public policies, the private enterprises seem to play the principal role in this issue.

According to the inward FDI theory proposed by the Japanese economist Kiyoshi Kojima in 1973, 1978 and 1982, the models of inward FDI show differences that are due to the difference in source of investment. He pointed out that the comparative advantages between the FDI supply in Japan and the investments of host countries are consistent. It would, therefore, result in trade promotion effects. On the other hand, the supply of inward FDI in the United States is entirely different. The comparative advantages of FDI in America normally represented are inconsistent. The weakness of trading is this: FDI supply in Japan is provided by the competitive small- and medium-sized enterprises (SMEs), whereas inward FDI supply in the US is provided by the monopolistic major enterprises. Thus, the market composition differences between Japan and the United States lead to diverse types of inward FDI.

Kojima's theory challenges the traditional inward FDI theory proposed by Hymer in 1960. The traditional theory holds that foreign investment would only be established on the intangible rather than tangible property in the competitive industries. In contrast, Kojima states that the reason competitive Japanese enterprises are investing overseas is the changing macroeconomic situation, which makes local production near impossible. The competitive enterprises, however, also hold intangible property in several particular industries; otherwise, they would have already moved into new industries in order to adapt to the new economic environment rather than transferring their capital overseas to maintain their existing businesses. Kojima also states that the changing macroeconomic environment in domestic markets may lead to less competition among those companies. The reason is that their intangible property originally comes from the non-existing economic rent in those competitive industries. When the current market is not able to obtain the rent by providing authorization or direct export, organizations will try to derive the economic rent from multinational management of FDI.

The argument Kojima holds in this theory of competitive industry originally came from his observation of the size of the Japanese organizations that had FDI; they were all SMEs. In addition, all of them were smaller than the companies in America. The enterprises in Taiwan started to have direct investment in Southeast Asia since the 1980s and in Mainland China since the 1990s. Kojima argues that the majority of this outward FDI was from SMEs, which is proven by this model. The intangible property they owned was the ability to manage the small amount and flexible production. This ability came from the support of an efficient production network, which was provided by the manufacturers with a highly specialized facility of integration.

The manufacturers in the network are also SMEs. They all possess the same characteristics of independence and the relationship of mutual competition. The sharing of production and market information also enables a prompt reaction to changes in technology and market situation. Since the mid-1990s, their percentage of outward FDI has increased in order to exploit their property, including patent rights, other technological property, goodwill, production skills and marketing. The role of inward FDI has played an important role in the international markets where local production has been gradually adopted. The SMEs in Europe and America can refer to the above-mentioned experiences before making investments in Mainland China.

The research regarding investment in developing countries like Mainland China or Southeast Asian countries by enterprises in Taiwan show that the investment in Mainland China improves when its purpose is market extension. In addition, production becomes more efficient if the investment by Taiwanese companies aims at reducing cost. In other words, either the market extension or the reduced production cost, or both, is improving the production of Taiwanese SMEs. In conclusion, the investment of Taiwan enterprises in Mainland China improves the production in cross-Straits trade. That is, the investment that Taiwanese enterprises put into Mainland China will be promotional and complementary to the production in cross-Straits business. The horizontal and vertical integration will take place in the countries with FDI.