

# **Foreign Direct Investment for Development: Concepts and the Case of ASEAN**

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## **Importance of foreign direct investment for development**

The world economy is globalizing, and economic activities increasingly take place in a supranational dimension. Industrial products, once manufactured in stand-alone factories, are now manufactured with visible materials, physical assets and invisible technical know-how, and these inputs are sourced from nearly every part of the globe. Factories themselves are also frequently located outside of their home economies, even though these factories are viewed as internal organizations of a single business entity (Dunning, 1992). This type of global economic activity, which stretches across borders, has been labeled foreign direct investment (FDI). The scale of FDI in Asian economies has increased relative to economies in other parts of the world. The performance of FDI undertaken by multinational firms (MNFs) as supranational entities is therefore one of the key phenomena of economic globalization, and is a timely and important topic for research.

In the 1950s, the countries of Association of South East Asian Nations (ASEAN) adopted industrialization policies in pursuit of rapid economic development. Both import substitution and export-oriented industrialization policy measures were adopted by national governments in ASEAN. Since the late 1980s, these economies experienced a period of economic “take-off”, with high growth rates of sometimes more than 10 percent per annum. This rapid economic growth was sustained, to a large degree, by international capital inflows, employment generation and technology transfer, all of which were facilitated by the FDI surge into these ASEAN economies undertaken by MNFs. As with many of its neighbors, Malaysia, for example, has been enjoying FDI-driven economic development over the past three decades.

Portfolio investment inflows and bank lending to Asian countries affected by the so-called Asian financial crisis of 1997, are two other important types of capital flows (Table 1.4). It is notable that, with the exception of Indonesia, FDI inflows were positive during and after the Crisis period, while portfolio investment and bank lending exhibited net outflows. The unexpected occurrence of the Crisis in mid-1997, triggered by the sharp

devaluation of Thai baht, caused a net outflow of portfolio investment from the Thailand as well as from other ASEAN economies including Indonesia and Malaysia. However, FDI flows largely stayed positive. MNFs, as foreign direct investors in ASEAN countries, have also been streamlining their production operation in response to the changing economic circumstances following the Crisis and free trade negotiations involving the ASEAN region. However, the difference in growth rates and sustainability of FDI as opposed to portfolio investment and bank lending raises an interesting question as to the factors behind the performance of FDI as opposed to other types of capital flows. A systematic theoretical and applied investigation into the factors contributing to these differences is one clear reason for further research into FDI.

The main objective of FDI by MNFs is to capture benefits in cost terms exemplified by the existence of cheap labor force in the ASEAN economies. However, foreign governments often seek different benefits from FDI, including technology transfer, skill building of the labor force or other benefits. As Tejima (1998) points out, MNFs aim to construct the most efficient international production network driven by the motivation of profit, whereas host countries crave for FDI for the “full-set” of production facilities, which become a “full package” within their own territories. In other words, MNFs shift, in certain economic circumstances, only their labor-intensive and therefore low-value-added production processes to foreign economies, in spite of host governments’ policies designed to attain economic development through the establishment of all-encompassing domestic industries.

It is the right of MNFs to decide whether to undertake FDI or not. Depending on the policy circumstances, once FDI has been undertaken, a decision on the type of the MNFs’ operations to shift to foreign economies rests with the MNFs themselves. For example, Japanese MNFs shifted much of their production facilities abroad, mainly to the neighboring East Asian (including ASEAN) economies, after the appreciation of the Yen in the wake of the Plaza Accord in 1985. Unlike official development assistance, the decisions of MNFs regarding FDI behavior has been motivated primarily by their profit seeking objectives obtained through cost reduction by FDI in ASEAN economies. The nature of FDI undertaken by MNFs and its effect on an Asian country’s economic development in the face of globalization are other important theoretical and empirical research.

Perfect market functioning underlies the analytical foundations of the conventional neoclassical theory of firm behavior. Empirically, however, firms in developing countries are known to engage in production activities under market imperfection. They operate in their value-adding activities with incomplete knowledge of what constitutes the optimal set of corporate decisions. In general, imperfect information, arising from economic agents' bounded rationality—in perception, calculation and action—renders market functioning imperfect. In other words, price signals do not reflect the “true” opportunity costs of the raw materials, factors of production and final products/services involved. The market-entry mode of FDI, too, may be chosen as a response to market imperfection, which would make the causes and effects of FDI very different from under the conventional theories of FDI.

### **The OLI Framework as Determinants of FDI**

Dunning's (1992) so-called “eclectic framework” is a useful taxonomy of FDI determinants according to the source of comparative advantages conducive to the choice of FDI. More specifically, the ownership-specific advantage, locational advantage and internalization advantage are considered pertinent to a firm's FDI decision. With due consideration to this eclectic framework, an attempt is made to identify sources of comparative advantage which account for MNFs' decisions to engage in FDI.

MNFs' motivations for undertaking FDI are also influenced by host economies' industrial policy formulation regarding FDI. International free trade and investment regimes/negotiations involving the ASEAN region, including the concept of ASEAN Free Trade Area (AFTA) and Asia Pacific Economic Cooperation (APEC), should also be put under the scope of the analysis. It is therefore essential to be concerned with host governments' historical and current policy prescription in the international context of trade and investment liberalization, before undertaking the firm-level study. In this light, a “country analysis” should precede firm-level analyses.

According to Dunning (1992), the extent to which a firm possesses its firm-specific assets (O-advantages) vis-à-vis firms of other nationalities in a particular market functions as a determinant of FDI. These O-advantages largely take the form of the privileged possession of intangible assets as well as those which arise as a result of the common governance of cross-border value-adding activities (Dunning, 1992).

Assuming that the above condition is satisfied, another component of FDI determination is the extent to which the firm perceives it to be in its best advantage to add value to its O-advantages rather than to sell them, or the right to use them, to foreign firms. These advantages are named I-advantages since market mechanisms are internalized by organizational fiat systems. This advantage can be interpreted as Williamson's transaction cost argument adapted to the specific context of FDI determinants. Then, assuming the above two conditions are satisfied, the extent to which the global interests of the firm are served by creating, or utilizing, its O advantages in a foreign location functions as the third determinant of FDI. The distribution of these resources and capabilities, or O advantages, is assumed to be uneven and hence location-specific, that is, the L advantage is critical in determining the geographies in which to utilize the O- advantage.

One criticism of the OLI paradigm is that it is eclectic in nature, with little original insight into the determinants of FDI in that it derives from a variety of theoretical approaches, i.e., international trade theory, the theory of the firm, institutional theory and location theory. At the cost of being eclectic, though, it is comprehensive enough to incorporate the widely differing attributes of MNEs. It is therefore more useful than original in a substantive sense. It is more useful as a taxonomic framework than applicable to particular circumstances of time and place determined by MNEs involved.

Another critique is submitted by Casson (1986, 1987), who points out that these OLI components are not mutually exclusive; as a matter of fact, O-advantages could be viewed as a special type of I-advantages. This critique supports the view that economic determinants of FDI can be divided into two sorts of advantages: those external to firms (i.e., L-advantages) and internal to them (O- and/or I-advantages).

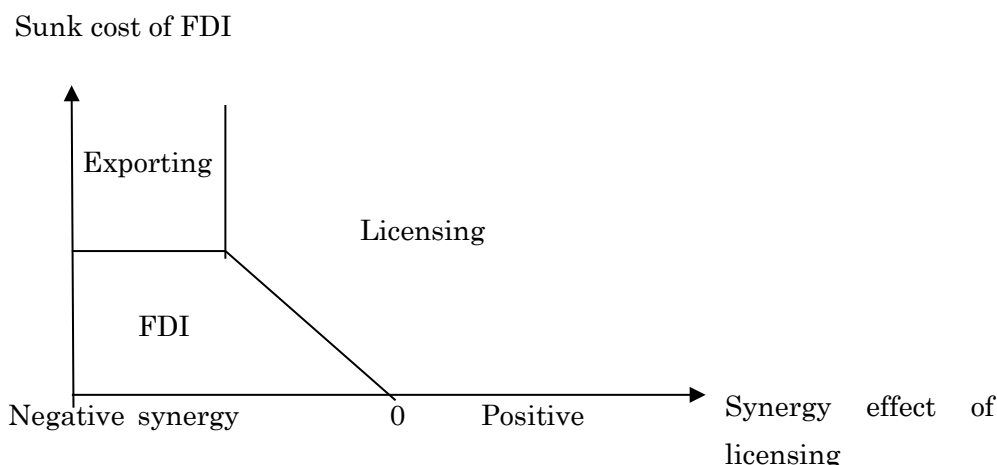
The impact of FTAs can be captured by incorporating Dunning's (1992) OLI framework and Williamson and's (1993) transactions costs concept, both under the new institutional economic view. The three modalities of exporting, licensing, and FDI are always equally profitable for the MNE without sunk costs, synergy effects and transactions costs. Under "low technological capacity" or a positive "synergy effect" on the part of the licensee firm, however, licensing could be less/more advantageous, respectively. And when transaction costs remain relatively high while sunk costs are reduced through FTAs, FDI would be selected.

Depending on which of the three *institutional* factors—the sunk costs, synergy

(as externality), and transaction costs—dominates, the most advantageous (profitable) mode of market entry is chosen by the MNF (Figure 1). These figures indicate, *ceteris paribus*, that:

- (1) in a perfect market where transaction costs, sunk costs, and synergy are all zero, or under the perfect market assumption, there is no difference in the MNF's profit between the three types of foreign-market-participation modes, that is, exporting, licensing, and FDI<sup>1</sup>;
- (2) the higher the transaction cost is, the less advantageous exporting becomes;
- (3) given constant transaction costs, licensing becomes more advantageous when both the technical externality of licensing and the sunk cost of FDI are high;
- (4) given positive transaction costs, a negative technical externality of licensing, and a low sunk cost of FDI, FDI is favored.

**Figure 1. Choice of the Most Profitable entry mode**



Source: Made by the author.

Licensing is similar to mergers, at least in its logical formulation, as elaborated by Falvey (1998) and Falvey and Lloyd (1999), who construct microeconomic models

<sup>1</sup> From this standpoint, there can be no economic development driven by technological accumulation of local firms. If the licensee firm is a local firm in a developing country and is charged a “fair” licensing fee so that there can be no synergy or spillover that can enhance the firm’s profits, this “perfect” pricing reduces, by definition, to setting the licensing fee at the level that just offsets the firm’s profit increase. Considering that profit increase is the very motivation of licensing firms in general, and that it is not feasible to impute “fairly” (and in a verifiable manner) the realized profit increase to both the licensor and licensee firms, this line of argument seems to indicate the innately imperfect nature of market transactions.

and demonstrate production cost changes due to the merger of two firms into a single decision making unit. Access to the licensor's firm-specific asset, at a cost in the form of a licensing fee, has the same effect as a merger. Assuming the canceling out of outgoing and incoming licensing fees from the licensor and licensee respectively, together with the additive separability of a joint production function in the case of a merger, licensing is equivalent to merging firms under the neoclassical framework. Perfectly rational firms, however, would have already entered into licensing contracts or would have already merged. Cost changes due to licensing or mergers can therefore stem from bounded rationality of the contracting firms: initial "ignorance" and only subsequent knowledge gains—although still limited in scope—are the perspective from which the institutional economic framework views licensing and mergers.

Assuming the existence of synergy effect, sunk costs and transactions costs, theoretical hypotheses can be made as follows:

- (1) Under market imperfections (existence of sunk costs and wage differences), progress in firm-specific assets motivates FDI. In addition, growth in foreign demand facilitates FDI. Under neoclassical assumptions (market perfection or zero sunk costs), foreign demand can equally be accessed through exports. In other words, market imperfection plays a crucial role in the actual economic determinants of FDI.
- (2) The existence of intra-firm technical externalities between upstream and downstream production processes is self-enforcing due to the "learning" effect in the manufacturing process. Therefore, if downstream-FDI is in place, *ceteris paribus*, upstream-FDI can be induced because of the cost-reduction (process innovation) realized through technological interactions between the upstream and downstream production processes.
- (3) Track records for exporting to a country lead to reductions in sunk costs for FDI, that is, establishment of a production facility in the country.

Thus, the main theoretical implication of FDI can be summarized as follows: market imperfection necessitates FDI as a non-market consequence or solution of the market imperfection. Unanticipated benefits from *usus* and *fructus*<sup>2</sup>, or the right of

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<sup>2</sup> According to Salanie (1998:180), "Roman law defined property rights as the combination of *usus* (the right to use the good), *fructus* (the right to what it produces), and *abusus* (the right to sell or give away the good)." He continues that the Anglo-Saxon legal tradition defines property rights as *residual rights of control*: when an unforeseen contingency arises, the owner of the property possesses the right to decide how the property should be used. What is meant by being internal to, or

appropriating any “fruits” of the proprietary assets (Furubotn and Richter, 2000), are not imputed in the market price of raw materials and capital assets.<sup>3</sup> It would be feasible, under the assumption of perfect information, to assign the “true” value to the market price of an asset. In reality, however, the instantaneous equalization of market price and intrinsic or fair value (as shadow value) is not attainable. The choice of production activities abroad or FDI is hence made with a view to exploiting or arbitrating the disparity between the market price and the shadow value of proprietary assets.

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inside, the firm can then be interpreted as possessing *usus*, *fructus*, and *abusus*, or residual rights of control.

<sup>3</sup> From this perspective, the value of the money asset is perfectly imputed to its “price,” unlike in the case of other proprietary assets.