this prompted was: how can it be that certain countries are fairly systematically in deficit and others in surplus. In so far as this occurs between the major industrialised blocs, as in the 1980s, in particular, it can be regarded as macro-economic imbalances presenting a potential threat to the stability of the world economy in the long term. In theory, this type of imbalance is attributed to such factors as differing time preferences which are known to exist between different countries.

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5 Direct investment and multinational enterprises

5.1 Introduction

By direct investment, a national company can set up production facilities abroad, thus developing into a multinational enterprise (MNE). This chapter will first examine what direct investments mean and how this type of capital flow has developed (section 5.2). Since it is typically MNEs that account for the bulk of foreign direct investment activities, section 5.3 specifically discusses the MNE phenomenon.

However, if a company engages in direct foreign investment, the question is: why does it not use the alternative, namely international trade, or international licensing agreements if an invention is to be exploited? Some theories which specifically focus on these selection processes, such as the product life cycle theory and the so-called eclectic theory of international entrepreneurial behaviour are therefore considered in section 5.4 of this chapter.

5.2 Foreign direct investment

The possibility of transferring capital across borders not only exists for the investor or speculator interested solely in return and risk, but also enables businesses to pursue their activities beyond national frontiers. This option is usually of interest if a high proportion of sales are destined for other countries (see the DSM case, for example, or the car market case study). If the investment crosses the border of goods or services instead, and the capital provider also gains a degree of influence or control over the foreign activities (e.g. by acquiring ownership of at least 25 per cent of the business), we call this *foreign direct investment* (FDI). The control associated with FDI can be acquired in practice by setting up foreign subsidiaries or branches, or by purchasing a substantial proportion of the share capital in the foreign company. The investment activities of multinationals through their foreign subsidiaries are one of the clearest examples of FDI. Traditionally, it was principally entrepreneurs in the mining and energy sector who engaged in FDI; later the emphasis shifted more towards the industrial sector, while nowadays there is more and more FDI in the services sector.

The term FDI causes some confusion because people mix up stocks and flows. If we refer to FDI as flows, we usually mean the volume of the capital

flows to be classed as direct investment, transferred from or to a particular country in one year. We can consider either gross flows or net flows by balancing inward and outward flows against one another. If we concentrate on stocks of FDI, then we have to add up the total of all annual flows during the preceding periods. Here, too, it is very important to state whether we are ultimately referring to gross or net stocks.

Apart from the need for a precise definition of the FDI concepts, it is equally important to be as accurate as possible in valuing FDI. In practice, various complications arise in determining the precise value of FDI, the lack of reliable statistics being just one of them. Thus, it is often difficult to ascertain how much of the profit reinvested in the subsidiary in fact constitutes direct investment. If the profit were first paid out to the parent company and subsequently reinvested in the subsidiary as FDI, the volume of FDI would be fairly transparent; however, if the profit remains in the subsidiary and is used direct to finance new investments, the position is often far less clear. Another problem is the basis of valuation. Let us assume that a parent company invests $20 million in a Brazilian subsidiary, but the latter has already been running at a loss for several years; in that case, how should we value the direct investment (as a stock variable) if it is clear that this cannot be done by adding up past flows? This is not the place for closer investigation of these technical questions; however, it is important to point out that statistics on FDI must always be used with great caution.

FDI is playing an ever greater role in internationalisation. We can illustrate this with some figures. Over the period 1984/5 to 1989/90, direct investment flows grew by 33 per cent while world GNP expanded by only 12 per cent and exports of goods and services by 13 per cent. If the trend represented by these figures continues, FDI will hold an increasingly important position in the future, in relation to the traditional forms of trade. Table 5.1 sets out the volume of inward and outward FDI broken down by countries for 1980, 1985 and 1990. We see from the table that the total world volume of net FDI flows was around $1,500 billion in 1990 (the fact that the inward and outward flows for the world as a whole are not exactly identical is presumably due to shortcomings in the records). This is three times the value of the FDI flows in 1980.

In order to provide a further illustration of the growing importance of FDI in the international economic process, Table 5.2 relates both inward and outward FDI flows to the GNP of the countries concerned. From this we see that the volume of FDI flows represented 5 per cent of GNP in 1980, and that this figure had already risen to 8 per cent by 1990.

Tables 5.1 and 5.2 show that internationalisation via FDI takes place mainly between companies in industrial countries. In 1980, one quarter of FDI went to developing countries; however, the pattern is rather variable: in 1985 the figure was 27 per cent, in 1987 (not in the table) it was 12 per cent and in 1990 18 per cent. It is only recently that companies from developing countries have also been active themselves in outward FDI, and these are almost exclusively from the Asian growth economies; however, their share in outward global FDI was less than 4 per cent in 1990.

Table 5.1 Value of inward and outward FDI flows broken down by countries for 1980, 1985 and 1990 ($ billion)

Country	Outward			Inward		
	1980	1985	1990	1980	1985	1990
US	220	251	423	83	185	404
Canada	23	36	73	52	59	109
Germany	43	60	155	37	37	94
UK	79	107	249	63	63	206
Netherlands	40	50	105	20	25	66
France	45	19	100	16	20	78
Italy	7	18	64	9	19	61
Switzerland	22	24	66	9	11	18
Japan	20	44	202	3	5	15
Total	499	609	1,437	292	424	1,051
Other industrial countries	25	40	140	70	90	200
Developing countries	8	20	60	120	185	270
World	532	669	1,637	482	699	1,521

Source: Jungnickel, 1993, p. 120.

Inward FDI can be particularly important to developing countries in providing the necessary capital to achieve satisfactory economic growth and the transfer of technology and employment. That is why many of these countries are willing to offer major tax concessions and other favourable arrangements for setting up businesses in order to succeed in attracting foreign investment and retain that already acquired. At the same time, however, it is specifically in developing countries that we find some opposition to the introduction and presence of FDI. First, the opponents claim that there is often no effective transfer of technology. Second, they point out that foreign companies take advantage of the low wages and other favourable production conditions, but often channel much of the resulting profit back to their home country. Finally, a common criticism is that the national authorities have hardly any control or influence over foreign companies because they can easily threaten to leave the country, owing to the *footloose* character of their international activities (i.e. they are not tied to production in a particular location). As a result, it is alleged that foreign companies are not much bothered about national regulations.

5.3 The multinational enterprise

Decisions which lead to international transactions are usually made in the company. It is therefore important to examine the factors which cause individual

Table 5.2 Inward and outward FDI flows as a percentage of the GNP of the country concerned for 1980, 1985 and 1990

Country	Outward			Inward		
	1980	1985	1990	1980	1985	1990
US	8	6	8	3	5	7
Canada	8	10	13	20	17	19
Germany	5	10	10	5	6	6
UK	15	24	26	12	13	21
Netherlands	24	39	37	12	20	24
France	2	4	9	2	4	7
Italy	2	4	6	2	5	6
Switzerland	22	26	29	9	12	8
Japan	2	3	7	–	–	1
Total (weighted average of percentage)	7	8	10	4	5	7
Other industrial countries	3	5	7	8	10	10
Developing countries	–	1	2	5	9	8
World	5	6	8	5	6	8

Source: Jungnickel, 1993.

companies to adopt an increasingly international approach as time goes by. In the initial phase of their development, most companies focus on the home market; in fact, this type of business predominates in most countries. If expansion is held back by the limitations of the home market, the company in question may be inclined to try selling abroad. Chapter 3 sought reasons why certain companies in a country export certain goods. In the first instance, the company need not always organise these exports itself. For example, it is possible to export via another domestic company (indirect export) or even by selling licences to other countries for the production method or the specific characteristics of the production process. However, export activities usually start by first making use of foreign sales agents; if exports go well, businesses then often set up their own foreign sales offices or take one over. Thus, the latter case can be the start of a process towards FDI.

Taking this a step further, the company may then consider making an actual foreign investment, e.g. in the form of a *joint venture*. In this case, the company together with one or more foreign companies participates in some way in a joint foreign subsidiary. For example, the joint venture may then be aimed at joint production activities, or it may be set up for the purpose of jointly organising foreign sales, etc. Particularly where there are still many legal uncertainties on the foreign market (consider the situation in Eastern Europe or in various developing countries), a joint venture may be an attractive interim solution in the process towards setting up independent subsidiaries abroad. It is also common

for the host country's government policy to be aimed at restricting the influence of foreign companies set up in its territory by deliberately requiring a certain national share in the management of those companies.

Continuing the progressive transfer of a company's activities to foreign countries, we automatically arrive at the final stage in which the company relocates a part of its production activities abroad. In such cases the company develops into a *trans-national enterprise*. If it then wants to become a true multinational, then the whole management of the business needs to be based on an internationally oriented strategy.

A diagram showing the successive stages which may lead to the point where we can refer to an MNE is given in Figure 5.1. This illustrates how companies might develop into an MNE by various channels and successive intermediate stages.

5.3.1 *Definition of the term MNE*

If a company owns production facilities in several countries and the business management comprises an internationally oriented strategy, that company is called a *multinational* or *multinational enterprise* (MNE). Obviously, this constitutes a very diverse category of businesses, ranging from groups with annual sales in excess of the GNP of a medium-sized industrial country to companies with a turnover of just a few million dollars but a very strong international orientation. Thus, not all MNEs are massive. That is why attempts have been made to devise a typology of the MNE so that various sub-categories of MNEs can be meaningfully distinguished. Although any typology contains arbitrary elements, it can be useful to classify MNEs on the basis of criteria such

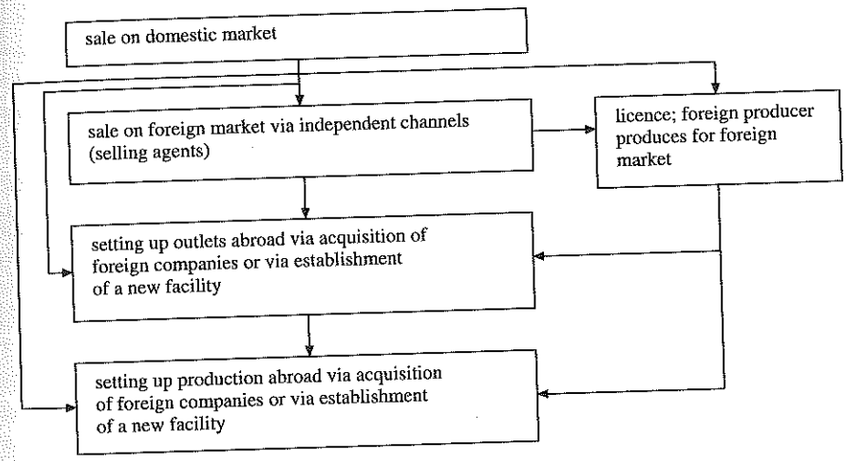

Figure 5.1 Possible process of development into a multinational enterprise
Source: P. Dicken, 1986, p. 129.

as: turnover, the number of countries where a processing activity takes place and its regional distribution, the share of foreign activities in overall operations, and the degree to which the organisational structure is internationally oriented. The typological classification to be built up on this basis may be important, for example, in determining the degree to which the conduct of a particular MNE can be controlled by the local government; because the larger the MNE, the wider its international distribution, the greater its dominance of the various markets and the more *footloose* it is, the weaker the national government's negotiating position in relation to the MNE (see also Case study 5.1).

Case study 5.1 Hoover relocation not contrary to EC rules

In February 1993 the American vacuum cleaner manufacturer, Hoover, decided to transfer production from France to Scotland, partly because workers there had made major concessions regarding conditions of employment. This caused uproar in France, one reason being the more or less simultaneous decision by the management of a Grundig television factory in Creutzwald (France) to transfer production to Austria. Almost a thousand French workers went to Brussels to protest against this form of what they called 'social dumping'. However, the European Commission could do little for the protestors, even if it had wanted to, because the relocation of the vacuum cleaner factory was not contrary to EC rules.

This case was also influenced by the fact that Britain had not committed itself to the social chapter of the Treaty of Maastricht. Nor had Britain signed the Social Charter (a political declaration of intent to lay down European rules on social matters) at the end of 1989. Some of the basic social rights endorsed by the Social Charter are: improvement in living conditions and terms of employment, the right to social protection and the right to freedom of association and collective bargaining; since Britain had not committed itself to the Charter, conditions of employment which deviate in a number of respects from those elsewhere in the EU are permissible in the UK.

Apart from that, in the EU negotiations Britain had also blocked the introduction of a directive obliging large multinationals to set up a European staff council and to supply that body with information. If such a directive had been adopted in the EU, then in any case the Hoover management would have had to consult the workers in France and Scotland on the relocation plans at an early stage. (Of course, this need not mean that the relocation would not then have gone through.)

In spite of the need to distinguish between different categories of MNEs, there are still a number of common characteristics shared by MNEs in general:

- companies in the group are legally linked by a common ownership structure;
- member companies have economic links with one another since they have access in varying degrees to a common source of resources, information and control instruments; this concerns not only common access to financial

resources, but also common participation in information and information systems, organisational structures, marketing strategies, patents, brand names, etc.
- the various companies are all subject to a common overall management philosophy and group strategy, and each one usually has an international orientation.

The above implies that subsidiaries of MNEs have not only financial obligations towards the parent company as a result of the control and/or shareholding relationship, but also have to accept the organisational structure of the parent company. These characteristics mean that financial relations between the parent company and the subsidiaries are greatly complicated by the fact that there is often two-way traffic: the parent company may finance new activities in the subsidiary while the subsidiary may transfer profits to the parent company. Since the various international financial dealings offset one another to some extent, there is often some scope in practice for exploiting an ever-existing certain amount of freedom in accounting, e.g. in order to minimise the group's total tax burden. This aspect of the multinational may be further reinforced if there is internal trade, e.g. in components or semi-manufactures, between the parent company and the subsidiary or between subsidiaries themselves; it is estimated that this type of transaction accounts for a quarter of world trade. In such cases, in particular, there is a degree of freedom within the enterprise as regards the valuation of these transactions, so that an attempt can be made to transfer the profit internationally to the country with the most favourable tax rules.

The policy on valuing transactions within the MNE is known as *transfer pricing*. The possibility of making use of this is a typical example of the relatively independent position of the MNE in relation to local and/or national government policy. This independence is sometimes translated into a strong negotiating position vis-à-vis the local government, especially in countries where foreign investors are also regarded as the driving force of the local and/or national economy.

5.3.2. The relative importance of MNEs

The first point which we notice on examining the social importance of the MNE phenomenon is the huge growth in their numbers and in their share of the world economy and world trade. United Nations (UN) researchers have calculated that there were at least 35,000 MNEs at the beginning of the 1990s, controlling 170,000 subsidiaries. According to the same source, the 100 largest MNEs owned $3,100 billion of the world's assets in 1990; $1,200 billion of this related to assets outside the MNE's home country. According to a rough estimate by *The Economist*, the total assets of businesses worldwide in 1990 came to approximately $20,000 billion altogether.[1] This would mean that the top 100 MNEs

1. For the basis of this estimate, see *The Economist*, 27 March 1993, p. 6.

owned roughly a sixth of the total assets in 1990; at that time the top 300 MNEs held perhaps a quarter of the world's assets. The importance of MNEs for the world economy is even greater if we remember that an estimated 40 to 50 per cent of the international transfer of assets takes place via the same 100 leading MNEs. This means that MNEs in fact play a very dominant role in international economic relations.

The enormous quantitative significance of MNEs in the world economy is a fairly recent phenomenon in historical terms, which is typical of this century and has surged ahead mainly in the past few decades. Essentially, this strong growth mostly began after the Second World War. The volume and quality of the statistical information on direct investment made it impossible to give any accurate idea of the international activities of MNEs during the period up to 1970. At the end of the 1960s, with the exception of the US and the UK, most countries did not have sufficient data to determine the cumulative value of FDI, so that they had to confine themselves to estimates, based on annual flow figures which were difficult to compare with one another.

Thus, businesses are unmistakably becoming ever more international. In 1970 the UN identified 7,000 MNEs, more than half of them from the US and the UK. Today, almost half of the 35,000 MNEs identified as such by the UN come from the US, Japan, Germany and Switzerland. The UK has now slipped to seventh place in the list of home countries. As already mentioned, FDI by businesses from new industrial countries such as Taiwan and South Korea is evidently also on the increase.

It is estimated that about half of all industrial production now takes place in MNEs or similar organisational structures, at least if we leave aside businesses in the former planned economies. As already remarked, trade within multinational groups can be estimated as representing around a quarter of world trade in goods. Figures for the latter half of the 1980s indicate that the share of foreign-owned companies in the total national volume of business fluctuates around 20 per cent in Europe, 10 per cent in the US and 1 per cent in Japan. The corresponding share of foreign companies in national employment is usually somewhat lower.

Just as the distance factor is very important in explaining the regional pattern of trade, so distance is equally important in the choice of region for direct investments. As we can see from Figure 5.2, there are clusters of countries around Japan, the US and the EU receiving FDI from the three respective blocs.

5.4 The international relocation of production activities: some theories

The enormous growth in the importance, number and size of MNEs after the Second World War prompted ever increasing interest in the reasons why businesses develop into multinationals. To begin with, the literature was dominated by the simple, neo-classical idea that international investment flows

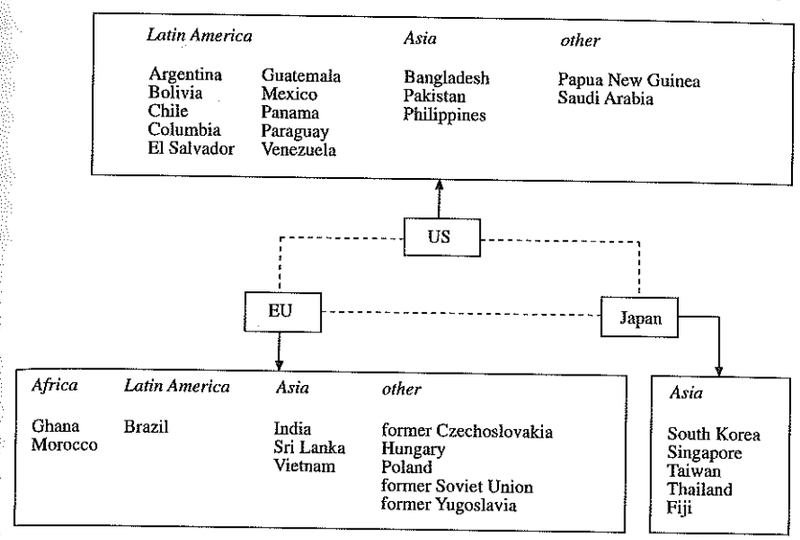

Figure 5.2 Principal countries of destination for foreign investment flows from the US, the EU and Japan, 1986–9
Source: UN

come from countries with low productivity of capital and are directed towards countries with high productivity of capital, thus enabling businesses investing internationally to achieve the maximum return. When the late 1950s brought an increase in FDI from the US to Europe, this theory actually appeared to be correct. At that time, the return achieved after tax by American subsidiaries in Europe was higher than that made by American industry. In the 1960s the return achieved by American subsidiaries in Europe generally dropped below the level of returns in the US; however, the net flow of direct investment from the US to Europe continued to increase.

In the face of trends such as this, the simple neo-classical theory therefore came to be seen as increasingly unsatisfactory. First, it was difficult to explain the normal two-way traffic in FDI, and also the fact that FDI takes place mainly between fairly similar industrial countries. Second, if companies were principally interested in the return, it was not entirely clear why they should want to retain control over the business use of the financial transfer (see also the eclectic approach in sub-section 5.4.2). Third, there was growing doubt about the neo-classical explanation for FDI as it became increasingly apparent that the return on foreign investments could hardly be estimated in many cases, owing to risks and institutional obstacles. This led to the subsequent search for new explanations for the MNE phenomenon.

Initially, the emphasis was mainly on partial explanations, often based on case histories. Thus, for example, in the case of MNEs in the mining and energy sector, people referred to such factors as securing lines of supply from other

countries; in the case of FDI in highly protectionist countries, they referred to the evasion of protective trade restrictions; as regards the wave of direct investment flowing at that time from the US to the newly-established EC, they mentioned the exploitation of economies of scale; and in other cases they pointed to factors such as risk spreading, tax advantages or market strategy.

Although all this type of arguments will, in practice, have played some part in decisions about FDI – in most cases there was some empirical evidence supporting these arguments – they do not offer a sufficiently systematic explanation for the multinational phenomenon.

5.4.1 *Product life cycle theory*

One of the first ideas to incorporate a number of the above elements in a theory was the Vernon product life cycle theory of the mid 1960s, applied mainly to the rise of the American MNEs. On the basis of this theory, people tried to explain the start and subsequent decline of US production of such goods as radios, televisions, plastics, transistors, simple electronic products, etc. According to this theory, which was particularly popular in the 1960s and 1970s, the MNE phenomenon is attributable to the recognition of various phases in the life cycle of a product. Table 5.3 summarises the features of the product life cycle theory.

While the HOS model was based on stable, identical production functions for certain goods, the production functions in the Vernon model depend on the current phase in the production process. In the initial phase, many alterations and adjustments are made to the product design, so that the production process necessitates non-standard work, much use of special skills and a short time-scale. When a new product is introduced, it is difficult for consumers to compare it with those made by other producers. Total demand for the product therefore has a low price elasticity in the initial phase. (This means that the volume of demand is fairly insensitive to price changes. In this case, the rise in demand is disproportionately small if the producer cuts the price of the product, so that turnover declines. A price reduction of 15 per cent, for example, generates an increase in demand of less than 15 per cent, say 5 per cent. This is therefore called inelastic demand.)

If, as time goes by, the producer has gained an understanding of what the consumer wants, the product and the production process can be standardised. In this growth phase, the production process is characterised by internal economies of scale while the consumer has become more familiar with the product and can compare prices. This causes price elasticity to increase, and the producer will begin to compete on the basis of price. (High price elasticity means that the increase in demand for a given product is disproportionately great if the price falls. This is known as elastic demand.)

In the maturity and saturation phase, the production process is totally standardised and the level of education of the workers is no longer important. Competition then takes place via price or product differentiation. Businesses which do not produce efficiently enough price themselves out of the market;

Table 5.3 The product life cycle

	Stages		
	Launch	Growth	Maturity
Demand structure	– low price elasticity of aggregate demand – nature of demand not quite known	– growing price elasticity of demand – start of price competition	– manipulating demand via marketing techniques, product or price differentation
Production	– short processes – rapid technological changes depending on degree of training – capital intensity low	– mass production methods	– long processing using stable techniques – degree of training irrelevant – capital intensive
Industrial structure	– small number of companies	– large number of companies, associated with losses and merges	– number of companies declines

those which are efficient, e.g. because they have better access to particular factors of production, can hold their own. It is particularly in this final phase that traditional comparative cost differences regain their importance.

Assumptions

From this we see that Vernon assumes that products are subject to predictable technological changes and marketing methods, and that the production process may vary between countries. In addition, consumer incomes and their associated preferences may also differ from country to country. Another important assumption incorporated in other models but dropped by Vernon is the free availability of information. According to Vernon, this is mainly true within national borders, but even then there are costs associated with the transfer of knowledge from the market to the company. This leads to the following three conclusions:

(a) if there is strong consumer demand in a given country for product and process innovation, the chance of innovation is greater than in countries where consumer demand is more conservative;

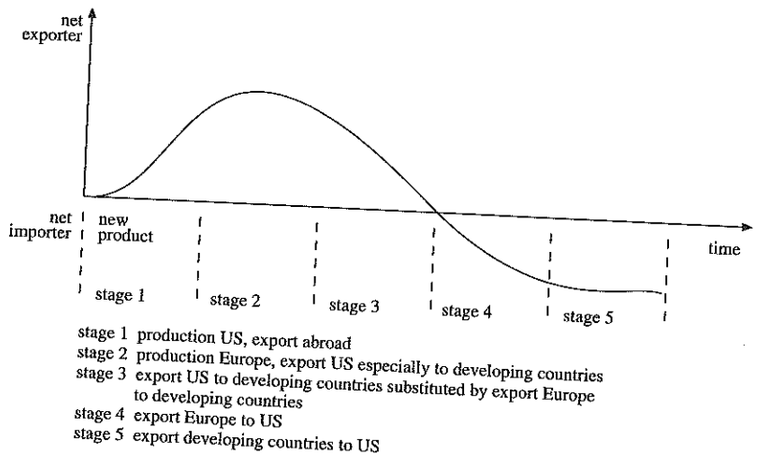

Figure 5.3 Patterns of trade for a product introduced in the US during the stages in the product's life

(b) an entrepreneur generally prefers to invest in innovations for the home market rather than those for the foreign market;
(c) the closer the producer is to the market, the lower the costs associated with the transfer of market knowledge.

The Vernon model explains the MNE phenomenon as follows. From the assumption that information is not freely available, it follows that during the introduction phase it is mainly local producers who are aware of the possibilities of introducing a new product on to a specific market. This causes the new products to have special characteristics for the home market. In the case of the US, for example, the high incomes and high labour costs are reflected in strong domestic demand for expensive, high-technology products, and the corresponding high level of domestic supply. During the introduction phase (stage 1 in Figure 5.3), the non-standardised character of the production process means that direct communication between consumer and producer is essential for further product development. In this phase, production takes place on the local market, which means that any foreign demand is supplied by exports (see also Figure 5.3).

If the product is so standardised that direct communication between producer and consumer becomes relatively less important than production costs, production starts up in other countries: the growth phase, as it is called. The timing of this depends on economies of scale, duties, transport costs, income elasticity of demand and the level of incomes and market size in other countries. According to Vernon, in the first instance the company mainly sets up production facilities abroad to reduce production and distribution costs or because of the potential threat to its market position. The nature of the production cycle means that foreign production will first take place in high-income countries. Thus, US companies, for example, will start by setting up their subsidiaries in Canada or

Western Europe. In the beginning, foreign production will also be limited by the fact that the products are only sold on the local market in the foreign country (stage 2).

As a result of cost advantages, exports (stage 3) from the foreign subsidiaries will gradually increase until, in our example, the US imports the product altogether (stage 4); meanwhile, new products are naturally introduced in the US and go through the same phases. In the end, the production process is totally standardised so that there is scope for economies of scale and mass production, and the product can actually be made at low-cost locations in developing countries (stage 5); this is called the saturation phase. Thus, as the product life cycle progresses, so the optimum production location also changes.

Companies which, in our example, continue to concentrate on traditional production of goods in the saturation phase will, according to this theory, be confronted by stagnant and declining demand and keen competitors who have often also set up their production facilities in low-wage countries. This causes the 'traditional' businesses to lose their profit potential and they will generally have to cut back their production, eventually diversifying or turning to other products.

Comments

Although the product life cycle theory abandons a number of assumptions of the HOS model, the basis for them still exists in the familiar comparative cost concept, albeit in a dynamic context: labour-intensive assembly is located where labour is cheap, e.g. in developing countries; the design phase takes place where there is plenty of technological know-how, while the production phase, for example, can be sited where raw materials are readily available.

However, in the course of the 1970s the product life cycle theory was considered increasingly unsatisfactory, e.g. to explain the rise of the American MNEs. It began to seem less and less necessary for a product to be developed on the home market first, before export and FDI can be considered, since the MNEs were acquiring ever greater knowledge of markets and technological developments outside the US. (In this connection, Vernon himself referred as long ago as 1979 to the ever increasing 'global scanning capabilities' of the MNEs.) Moreover, the technological and income differential between the US and other industrial countries has declined over the years, so that the locational characteristics of the US became increasingly unimportant in explaining the optimum production location. As a result, the theory lost its attraction. One might argue that the theory is now mainly relevant in explaining FDI by small firms or certain FDI in developing countries.

5.4.2 *The eclectic theory of the MNE*

Apart from the fact that the product life cycle theory was constantly superseded by reality, some fundamental questions concerning the MNE phenomenon still

remained unanswered. For example, it was unclear why certain companies in a country develop into multinationals while others do not; because any company in a country can take advantage of the special characteristics of the home market. It is also unclear why MNEs wish to retain control over the production process. If a company has developed a particular product and this product can be produced more cheaply abroad, then the argument is that the company can easily sell the product via a licence for the know-how or export it to other countries. Why should anyone transfer the production to another country and yet want to retain control over it?

In other words, to explain the existence of MNEs, we need a theory which provides a satisfactory answer to all these questions. This is so in the case of Dunning's *eclectic approach*, for example (i.e. an approach which combines elements of various theories). This states the conditions for the creation of an MNE as the presence of advantages dependent on ownership, the presence of locational advantages and arguments for internalisation.

The first condition, the presence of an *ownership advantage*, means that a given company enjoys specific, unique production conditions enabling it to generate a future flow of income and profits. Thus, these unique production conditions are reserved for the company in question, but can be combined with other production resources, both in the home country and outside it. These unique characteristics may relate to tangible goods, such as exclusive access to certain natural resources, manpower or capital. They may also relate to intangible production conditions such as specific technical knowledge, including market knowledge, more advanced information, specific organisational and entrepreneurial qualities or market access. There are, of course, many conceivable combinations of circumstances which create advantages. The condition concerning ownership advantage will always have to be fulfilled to some degree if investment is to be successful.

The second condition is the existence of *locational advantages* relating to production in the host country. The production conditions responsible for the additional profitability of the investment are then not linked to ownership of a particular business but to a specific production location. These advantages are therefore available to any company investing in production in that location. *Export processing free zones* are extreme examples of measures creating locational advantages. These are special zones, often situated in emerging industrial countries, with many special facilities for the foreign companies being set up there as regards tax rules, available infrastructure, an adequate supply of very cheap labour, subsidies, etc. But of course, many more general factors, such as a low wage level, low levels of taxation or a high standard of education, can also be important positive factors for a location.

An ownership advantage for a national company combined with a locational advantage on a foreign market appears to provide an explanation for direct foreign direct investment, because the company will be keen to invest and will choose the most appropriate location for the purpose: another country. Examples of this are legion. They include the subcontracting of manual assembly work to

firms in developing countries or production on sales markets because of the shorter lines of communication between producer and customer. However, there is also a third requirement.

This third factor is the existence of arguments for *internalisation*: exploiting ownership advantages by not contracting out the associated activity but deliberately pursuing it and retaining control over it oneself. Generally speaking, there are arguments for internalising economic activities if there is an advantage in the certainty created by incorporating part of the company's economic environment in one's own business. This is the case, for example, where people want to be more certain about market events connected with the technology process, which is known as the *technology transfer* problem. In the case which we are discussing here, this means that the option of selling a licence for the said advantage is not appropriate. There may be various reasons for this. Let us assume that the ownership advantage is based on the combination of a unique set of workers, their unique organisational structure and their unique use of equipment. We can see that logistical reasons might prevent this advantage from being sold to another company by licensing (unless part of the business is transferred complete). Also, any negotiations on the transfer of licences are hampered by the fact that both parties can initially conclude only a rather general agreement, because too much detailed information passed to the purchaser in the pre-contract phase would often essentially mean the transfer of the licence. This hinders the process of reaching agreement on (the price of) the licence. Finally, the seller is often worried that if other people use his specific knowledge, that information may either be liable to leak out or it may be used so inexpertly as to damage the reputation of the original owner.

Finally, parts of the production process may be internalised, e.g. with a view to reliable supplies or sales. This constitutes *vertical integration*. It should be clear that in this type of case, too, licences cannot be granted for the ownership advantages. Thus, in practice there are countless arguments which explain why companies need to keep control over the exploitation of the exclusive right to use innovations, ideas, organisational characteristics, etc.

The three factors mentioned in this section together explain the existence of FDI and thus MNEs as follows. Assume that a company has an ownership advantage. There are then three options: invest internally in the company, invest abroad, and finally, sell a licence for the advantage and thus leave the investment to others. It is easy to see that if there is a simultaneous locational advantage in foreign production and advantages in internalisation, the first and last options automatically cease to apply, leaving the direct investment option.

5.5 Summary

Since the 1980s in particular, flows of foreign direct investment (FDI) have increased very rapidly in relation to flows of goods and services. FDI means that an entrepreneur invests in foreign activities and also acquires a certain degree of

influence or control over them. If a company has acquired several production facilities in various countries via direct investments, we can call it a multinational enterprise (MNE).

Vernon's product life cycle theory tries to explain the MNE phenomenon on the basis of the different phases in the life of a product. Dunning's eclectic approach combines a number of conditions for the existence of MNEs into a single theory. That theory is based on the following elements: locational advantages, ownership advantages and markets which function imperfectly, so that internalisation is the best option.

It should be clear that the policy of national governments influences all three of the above elements in the eclectic theory explaining the conduct of MNEs. That relationship between companies operating internationally and government policy will be examined in more detail in the next chapters.

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6 Trade policy: a classic welfare theory analysis

6.1 Introduction

Discussion of the advantages and disadvantages of international free trade for national welfare (see Chapter 3) is of direct relevance to the question whether one should attempt to influence international trade directly or indirectly via government intervention. For a long time, traditional trade theory held that free trade maximised overall welfare for all those concerned (jointly). There was fairly general recognition that two important assumptions of this theory, namely perfectly efficient markets and constant economies of scale, did not hold true in practice. The modern trade theories which form the focus of Chapters 7 to 11 also initially supported and reinforced the impression that free trade can produce the best result in the end for all parties. This automatically means that the objections to protectionism prevailed in the theoretical literature. This idea was likely to be further reinforced by the tendency illustrated in Chapter 1 for national economies to become more closely interlinked and for businesses to operate increasingly internationally.

Against this background, we may express surprise that in current trade policy practice very divergent trends are observed, ranging from escalating protectionism to countries being systematically opened up to international competition. This chapter gives an example of both using an introductory case study. One of these case studies illustrates a sector in which protectionism is greatly increasing and the other a country which is reversing the direction of its trade policy, trying to switch from a strongly protectionist tradition to a policy oriented more towards free trade.

The ambivalence evident from these examples can be partly explained by the considerations taken into account in applying protectionism. These vary according to the viewpoint from which protectionism is considered: that of the world as a whole, that of national welfare or that of specific interest groups. In general, the advantages of free trade become clearer the higher the level of aggregation applied. At national and international level, the advantages of free trade outweigh the disadvantages; at branch or sector level this need not be so, certainly not if a sector is liable to be driven out of business as a result of free trade. In trade policy practice, a combination of different considerations is often applied, based partly on international and national interests and partly on those of specific interest groups. This often makes the discussion of trade policy rather confusing.