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STRATEGIES OF MULTINATIONALS AND COMPETITION FOR FOREIGN DIRECT INVESTMENT

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1. INTRODUCTORY REMARKS

Objective of the inquiry

To test the existence an FDI trade-off between Mediterranean rim (Mediter.rim) countries and Central and Eastern European (CEE) countries. This issue was raised at the end of the 1990's by several governments in the Mediter.rim.

Methodology

Interviews were conducted with almost one hundred companies from the United States, Europe, and Japan belonging to 7 different industrial sectors (chemicals, electronics, electrical equipment, telecommunications, hotels, textiles and apparel, and automotive vehicles and parts).

An open questionnaire was designed on the basis of a classic dichotomy between two strategies:

- outsourcing or vertical strategy.
- market seeking or horizontal strategy.

At the end of the interview, the manager was asked to rank on an attractiveness scale of 1 to 5 a sample of countries (Hungary, Lithuania, Poland, Russia, Slovakia, Ukraine, Egypt, Morocco, Portugal, Tunisia, Turkey, Malaysia, and Thailand).

Theoretical background

The distinction between two FDI strategies was made on a theoretical background inspired by P. Krugman’s distinction between two kinds of trade specialization:

- North-South trade that is also called "vertical" or "Ricardian". This refers to inter-industry trade, and specialization is a result of different national factor endowments.

- North-North trade, also referred to as "horizontal" or "Krugmanian", is intra-industry trade, and specialization is a result of economies of scale and product differentiation in monopolistic markets.

Following the Krugman approach for trade, Brainard and Markusen suggested a transposition to FDI flows. As a result, two distinct types of Multinational Corporation (MNC) strategy have been proposed:

- A North-South or "vertical" or "outsourcing strategy": by investing abroad, MNCs are trying to minimize their costs. They are producing abroad in countries with lower labor costs, lower commodity prices, lower energy costs, and lower real estate prices. Two crucial assumptions have to be made for this strategy to work: transportation costs and tariff barriers must be low.

- A North-North, "horizontal", "market seeking" or "multi-domestic" (M. Porter) strategy: The main motivation for MNCs is to have access to big consumer markets. The crucial assumptions for this strategy are that transportation costs and tariff barriers are high.

The main results of the inquiry

- There is no trade-off between Mediter. Rim countries on the one hand and the CEE countries on the other.
- There is no clear-cut dichotomy between outsourcing and market seeking strategies.
- Almost all the firms interviewed, whatever their national origin or industry, shared the same opinion.

The inquiry was also very instructive in two other complementary areas:

- A better understanding of current and future MNCs strategies in emerging economies.
- A better understanding of the set of factors which make a country attractive to MNCs.

These two points are crucial for governments struggling to attract FDI to their countries as well as for FIAS' advisory work. These points will be developed in two different sections.

2. MNCs' GLOBAL STRATEGY

The results of the interview shows that in the future, most MNCs would like to combine both basic strategies (i.e., market seeking and outsourcing) at one location. We shall call such a strategy a global strategy.

The aim of such a global strategy is to shift FDI, guided by market-seeking and outsourcing motivations, on a regional basis. As a result of the availability of low cost natural and human resources (the so-called Ricardian argument), and of economies of scale and product differentiation (the so-called Krugmanian argument), worldwide firms' competitiveness will increase tremendously. The successful implementation of a global strategy implies a set of preconditions: first, FDI localization characteristics; and second, a selective approach of potential host-countries.

(a) FDI localization

Several conditions need to be fulfilled for a global strategy:

- A big domestic/regional market

- Lower production costs than in the home country/region.

- In the case where the two aforementioned conditions cannot be met in only one location, the country within a region with the best locational advantages (see later) will be chosen as a hub. In the meantime, a network of workshop affiliates or local partners will be implemented in various nearby countries with low costs of production and good transportation links with the hub country (in most cases the "just in time" concept implies geographical proximity).

- The choice of a good location will give them the opportunity to achieve a double objective: to sell to the regional market as well as to export to the home country/region. Product categories can be different for each option.

- NAFTA and ASEAN are good illustrations of new types of regional integration that fit well with the global strategies of MNCs. By a new type of regional integration, we mean a model very different from J. Viner's and B. Balassa's. Undoubtedly, such a model was relevant during the time the European community was set-up (i.e. at the end of the 1950's). One of its results has been a huge amount of US FDI lured by both a large new market and the fear of a future European fortress. However, in the current era of globalization, the classical model for regional integration is no longer relevant. The association of countries with unequal levels of development in the same regional association is more appropriate for MNCs' global strategies. It is worth noting that the European Union is now following a new pattern with its enlargements program towards, first, Eastern European countries, second, North African countries (EuroMed program).

(b) A selective approach

A global strategy does not necessarily imply a worldwide strategy. The choice of locating a direct investment within the framework of a global strategy is very selective. This is the main reason why the trade-off assumption has to be reformulated. The trade-off game is limited to a few countries, and they are precisely those that have to compete among themselves to attract FDI.

- The impact of a global strategy is very different from the impact as it was described by a great researcher in the field of multinational corporations, Prof. Raymond Vernon. Within his international product cycle theory, he demonstrated that FDI was the most efficient tool for transferring manufacturing activities from developed countries to developing countries. The so-called "sectoral drift" was implicitly based on the assumption that the whole planet was going to be involved in an industrialization process. No country was supposed to be left behind in a model which was meeting the mood of the 60's (for DCs, industrialization was identified with development). A spatial North-South FDI expansion based on the product cycle life was the bottom line for explaining MNCs' strategy. With the global strategy approach, this is no longer the case.

- MNCs following a global strategy are no longer ready to consider all UN member countries as places to invest; developing countries in particular. On the contrary, they are very selective in their decision-making regarding the locations most conducive to FDI. The inquiry made by FIAS, as well as FDI flows statistics, demonstrate that whatever their national origin and industry, almost all MNCs have a strict hierarchy of potential countries for their investments.

We propose to define four different “circles” of countries based on attractiveness as FDI locations:

In the first rank are the "triad" or "core" countries: North America, Europe, Japan (a reluctant host-country for FDI) and the first wave of Asian NIC's.

In the second circle are what I like to call the "new new frontier countries" (NNFC), a limited group of emerging economies which are attracting most of FDI directed to the developing countries. These countries include: in Asia, the most attractive region, China and the new wave of "tigers" like Malaysia, Thailand, Indonesia, Philippines, Viet Nam; in Latin America, Mexico, Brazil and well behind, Argentina and Chile; in EEC, Poland, Hungary and the Czech Republic.

A third circle is made of "potential countries", countries which are almost ready to join the global investors' short list, if they can improve some aspects of their investment climate. These countries might include Russia, Morocco, Tunisia, and Egypt.

There is a last circle that we called "peripheral". Countries within this group will have more trouble in entering the short list. They are able to attract FDI but only in a very limited number of activities, most of them are active in the natural resources sector like mining and export-oriented agribusiness, and have a very low wage unskilled labor force. To come back to the initial distinction between MNCs strategies, "peripheral countries" correspond to the Ricardian category of intersectoral, outsourcing FDI.

(c) To conclude, back to the "trade-off assumption"

From the answers given by the companies interviewed by FIAS, it is clear that if a trade-off assumption does exist, it will be relevant only for the countries that are part of the same circle; only those countries who are on the same indifference curve of global investors. Therefore, competition does exist for attracting FDI between triad countries, but it does not exist, or only marginally, between NNFCs and “potential” countries or between the potential circle and those in the peripheral circle. Nevertheless, it would be wrong to assert that no change is possible in the country composition of each circle. On the contrary, countries can climb from one circle to another, or indeed go down. It is one of our assumptions that competition between triad countries and NNFCs will intensify in the future for a growing number of activities, especially following the "delocation" process which is accelerating for those manufacturing activities which are not a part of the "new economy". We shall return to this last point later.

Finally, the trade-off assumption made by the Mediter.rim government was basically incorrect: Mediterranean rim countries do not belong to the same circle as the NNFCs. However, as pointed out, it would be wrong to think that the "circles" are forever closed to new entrants. Even if in most cases, a new FDI going into a CEE country is not a loss for a Mediter.rim country, the same Mediterranean country is not prohibited from climbing up from the status of "potential" country to that of an "NNFC" country. The key element of such a move has to be found in the concept of attractiveness. The move will be in great part the result of a proactive FDI promotion policy. But before reaching this point, the countries that are ready to move should know what the objective is. In other words, they have to have a clear idea on the following question: what makes a country attractive? This finding of the FIAS inquiry will be discussed further.

3. WHAT MAKES A COUNTRY ATTRACTIVE?

Interviews made by the FIAS team provide a good picture of what makes a country attractive from the viewpoint of global investors.

To put a country on their short list, global investors consider two separate sets of variables and both sets are prerequisites. The first group is made of what may be called the institutional background of an attractive investment climate. The second group is more directly related to doing business with a country's supply of economic and human resources. If the latter fits with what the MNC is looking for according to its strategy, and as long as the institutional background is fine, the country might be put on the short list. This step is a necessary condition for attracting FDI; however in most cases, it is not a sufficient one.

(a) The institutional background

For a country to be attractive, a set of institutional prerequisites has to be fulfilled:

- Political and macroeconomic stability: this is the most important prerequisite for non-footloose foreign investors. Investors in general are deterred by risk; moreover, they need to be able to evaluate their investment return on a medium to long-term period.

- A transparent, stable, and non-discriminatory legal and regulatory environment. Specific foreign investment laws or codes, mostly adopted in the 1960's, including a whole set of TRIMs, have to be liberalized before starting any promotion. Moreover, laws, regulations, and contracts must be followed. In cases of conflict, an efficient, non-corrupt judicial system is required. This point has very often been stressed by the managers interviewed by FIAS. At minimum, international arbitrage has to be permitted by the law.

- Finally, bureaucratic procedures and institutional rigidities must be banned. A global strategy is no longer compatible with wasting time in bureaucratic procedures and negotiations, with a myriad of different and uncoordinated services. MNCs now want a free foreign exchange regime with repatriation and a flexible labor market. In the past, during the time when MNCs were following a "multi-domestic" strategy, the situation was quite different. Bureaucratic procedures and its usual informal "payments" (i.e., bribes) were considered as the price to pay for having access to the domestic market and for benefiting from a rentier position due to the existing level of tariff barriers (those which deterred the current foreign investor from exporting). Global investors need free trade, on the one hand, to maximize economies of scale generated by manufacturing in different sites and in various countries and, on the other, by exporting to the world market. Transaction costs have to be as small as possible -- an objective not compatible with red tape. In the case when administrative procedures are too long and too complex, global investors prefer to move to another place.

With globalization, competition for attracting FDI is now among host-countries; it is no longer among foreign firms trying to have access to domestic markets.

(b) The economic and social background

The economic and social background is becoming primarily important when a global investor is deciding what business to do in a country with a good institutional background. To be able to decide, he compares what he needs to start a profitable activity with what factors the country is offering. This is the way in which a comparative local advantage for FDI is defined. Note that in the globalization framework, the country location advantage has to be an absolute advantage -- on this point, A. Smith is taking his vengeance on D. Ricardo.

According to the inquiry's findings, there are five main groups of economic and social factors that are necessary to make a country attractive:

- A big and growing market: for all the companies in the FIAS sample, market size is a prerequisite. However, it does not mean a big domestic market. More and more, as was previously emphasized, global investors are mainly attracted by big and growing regional markets. Ireland or Portugal each has a small domestic market. Nevertheless, they are attracting a huge amount of FDI because they have free access to a very big regional market by being members of the European Union. Similarly, the beginning of NAFTA increased Mexico's attractiveness as an FDI location. A high growth rate market is also very important for global investors whose home markets are saturated. This issue shall be discussed later.

- An efficient communication system is a key factor for MNCs to efficiently operate far-flung subsidiaries in the rest of the world, as well as the home office. Subsidiaries need to be able, on a day-to-day basis, to send and receive faxes, e-mail, and make telephone calls. They also need proper transportation links both within the country and to the outside world. All this may seem obvious, however a dysfunctional telecommunications system in a country can cause an investor to regret his initial choice to locate there. This point is of special importance to governments in the case where they are planning to implement an export-processing zone or to rehabilitate an existing one.

- Qualified labor is another major attractive advantage from a global investors' viewpoint. Cheap labor was playing a determinant role in the 1960's and 1970's, when most MNCs were following a vertical outsourcing strategy. Today, all the firms interviewed, whatever their home country or industrial sector, stressed that the availability of qualified manpower -- particularly for middle-ranking and senior technical positions -- is a major consideration. Most of the subsidiaries are using the same sophisticated technology as that employed in the home country units. Often, technology used abroad is even more sophisticated than in the home country because the plants are more recent and embody the latest technology. The presence of specialized engineers and scientists in key sectors, many of whom once worked in the military-industrial complex, is the major locational advantage of CEE countries.

- The presence of efficient local firms is at first sight an expansion of the qualified labor force argument, but in fact it is covering an increasingly important dimension of a countries' attractiveness value. Very efficient local support industries are defined by their capacity to meet the needs of subsidiaries in terms of technical specification, quality for product, and delivery time. With the growing externalization process followed by an increasing number of firms, the issue of efficient local support industries is drastically changing. It can no longer be limited to sub-contracting operations. Now it is in fact commanding the growth of a new type of MNC: the "network firms" or "hollow corporations" or "virtual firms'.

- Privatization programs are also an investment opportunity for most of the firms interviewed. It is particularly important in the case of the CEE countries. But for global investors, the main interest in buying a public enterprise is in most cases to acquire a market share. Taking over the productive facilities is generally a secondary consideration and may even be seen as a drawback. Most of the enterprises in the former Comecon zone will require heavy injection of new investments to rehabilitate them. However, the main attraction played by the existence of privatization programs has to be looked at from another perspective, i.e. that of the oligopolistic competition pressure among MNCs. As a matter of fact, a firm that fails in its bid under a particular privatization may find itself excluded from the market permanently or for a long time. This risk is especially severe in the case of sectors where economies of scale are important, such as chemicals, electricity generation, or luxury hotels, where there is room for only a very small number of players given the size of the market.

- Fiscal incentives (tax holidays or subsidies) have been mentioned by only a minority of firms polled as a factor that can enhance a country's attractiveness. The incentive issue is very broad and cannot be dealt with in the framework of this note. Nevertheless it might be of interest to stress two major points which are formulated in a more implicit than explicit way in the answers made by most of the firms surveyed. First, incentives cannot be a substitute for a country's lack of attractiveness, except for investors who are putting financial profitability above economic profitability. Most of the time, investors who are making such a choice are footloose investors. Attracting them is of a very limited interest for a host country. Second, in the case of countries which are competing for the same investment project and which are in the same circle as defined before, incentives are playing a different role: that of the icing on the cake. Unfortunately for public finance, the cost of getting an investment project is often too high compared to the benefit of having it. This is the rule in a non-cooperative game.

4. CONCLUDING REMARKS

I would like to conclude by making two kinds of remarks, both being oriented towards the future and going beyond the finding of the FIAS inquiry. On the one hand, I would like to return to the trade-off issue which was originally at the beginning of the story, and which might be changed in a backwash effect. On the other hand, I would like to raise incidentally the question of the future of FDI promotion involved by the new firm's organization.

(a) Trade-off vs. backwash effect

If a trade-off effect is going to be of noticeable importance, it won't be between the Mediter. rim countries and the CEE countries, but between the triad or core countries and the new frontier countries. This trade-off might have a "backwash effect". Global firms which are investing primarily in the core and "NNF' countries belong to industrial sectors that are characterized by an oligopolistic structure. Oligopolistic industries are those that are producing differentiated products and are also industries facing home markets that are saturated.

This point was mentioned specifically by firms in the chemical, automotive, electrical goods, and hotel industries. It concerns European firms (including US subsidiaries located in Europe) more than others. European firms, when the inquiry was conducted, were facing not only maturing markets in their industry, but also the effects of a prolonged economic recession. In this context, a repeated comment made during the interviews and a qualifying statement made on the importance of market size is of crucial importance: "those markets are offering new investment opportunities". New and profitable investments are no doubt more numerous in the fast growing circle of the NNF countries in Asia and, also in some Latin American and CEE countries than in the more mature economies of the triad. However, by the very fact that they are attractive for investors, the NNF countries are likely to become formidable competitors for the triad countries. In sectors where economies of scale dictate the construction of large production units, the opening of new productive capacity abroad as well as the acquisition and rehabilitation of former state enterprises in a growing number of countries to the South and to the East will tend to aggravate existing problems of over-capacity in the triad countries, especially in the European Union.

In the end, it appears that the trade-off issue is becoming totally transformed by taking the backlash effect into account. It becomes part of the process of industrial rationalization on a regional basis. Accordingly, the trade-off in practice has more to do, today, with redistributing industrial plants, rationalizing networks of final producers and their suppliers and putting together industrial clusters on a regional basis. However, the main point is that the regional basis is primarily designed by the existence of similar degrees of attractiveness. In the future, the circles that have been suggested before are more determinant than political geography.

(b) The future nature of FDI

The ultimate issue, which will not be fully developed here, raises the question of the future nature of FDI. In the restructuring process started by the backwash effect, global firms are going to stop making new direct investment abroad. Even now, mergers and acquisitions are much more important than greenfield investment. In the near future, MNCs are going to substitute networks of foreign local partners to the previous internalized markets. At the same time, specific contracts between partners will be a substitute for equity participation. Therefore, promoting FDI and a country's attractiveness will require new rules for countries. This might be a new program for FIAS.