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## Article

# Foreign Direct Investment from Emerging Markets. Theory and Practice

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# Foreign Direct Investment from Emerging Markets. Theory and Practice

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## Abstract

This text presents a critical review of theoretical approaches to Foreign Direct Investment. Since, in recent years, the contribution of emerging markets to FDI has increased (especially on less advanced markets), it is interesting to define how the existing theory can explain the new players phenomenon on these markets. There are two hypotheses considered: one – the existing theoretical explanations of FDI are limited and, today, even historical; second – the essence of the comparative advantage of FDI from emerging markets is a smaller technological and organizational distance between investors and less developed host markets. The discussion is illustrated by Chinese and Indian FDI experience to support the authors' assumptions.

**Keywords:** FDI, emerging markets, theory, Chinese and Indian experiences

**JEL:** F2, F21, F23

## Introduction

In 2018, Kishore Mahbubani, professor of economics from Singapore, published a book entitled “Has the West lost it?” The author writes that the end of the West’s 200-year domination in the world economy is inevitably coming. With the adoption of pragmatic policies and the rejection of idealistic and dogmatic methods of governance (according to Machiavellian philosophy), many Asian countries (especially China and India) are becoming economic leaders in the world. There is nothing strange about it, because these countries were significant economic and political players until the 18<sup>th</sup> century. Over the last few decades, Asia has taken over from the West the ability to adopt a logical and scientific approach to problem-solving (Mahbubani 2018). In this context, this article provides a voice in the discussion on the place and role of the main Asian economic powers.

The theoretical discussion on foreign direct investment (FDI) has been taking place at least since the end of World War II. However, the history of FDI started earlier. For some US companies, the process of internationalizing their operations began as early as the mid-19<sup>th</sup> century, for example, when Colt established a subsidiary in the UK. Major direct investments were made by Americans after WWII. At the beginning of the 20<sup>th</sup> century, 90 percent of all international capital movements took the form of portfolio investment, that is, the acquisition of securities by individual actors or institutions without any associated control over or participation in the management. During the years 1914–1945, the FDI growth rate was very low. This state of affairs only changed after WWII by the activities of American companies in Europe (the Marshall Plan) and later on by multinationals, which developed first in the mining industries, then in manufacturing and services (like Amazon, Google, Yahoo, etc. today).

The main questions accompanying the existing theoretical discussion on FDI covered three key issues: what factors influence the internationalization of production? Why does the company invest directly abroad? Where does the company invest abroad? These questions are dealt with the theory of enterprises (management), with the first question being part of the theory of international exchange and industrial organization; the second one deals with investment theory in the microeconomic aspect, while the last one deals with location theory.

Interest in FDI expansion has highlighted the role of economic tycoons, i.e., investments from Americanas well as other highly developed economies, followed by investments from transnational corporations. Meanwhile, for more than two decades, competitors appeared from the emerging markets, i.e., those that were liberalizing their economies, achieving high economic growth and large trade volumes, and increasing the advancement of the national economy. Apart from China and India, today’s giants of the world economy, include other countries that represent emerging markets. Whether they are able to compete in terms of foreign investment and what influences it are issues that puzzle economists dealing with FDI.<sup>1</sup>

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<sup>1</sup> For more details see: Piasecki R., Gudowski J. (2015).

The above comments allow two hypotheses to be formulated for the purposes of this text. The first one concerns actual theoretical concepts that deal with FDI. These concepts focus on the investment activities of advanced economies and do not explain the cross-border activities of companies from emerging markets. They are, therefore, limited, and today, even historical.

The second hypothesis concerns the comparative advantage of companies from emerging markets, and it supplements previous approaches to the essence of FDI. Bearing in mind that companies from these economies often locate in niche branches of host countries, it may be assumed that the essence of the advantage is a smaller technological and organizational distance between investors and less developed host markets. Although the empirical verification of this thesis exceeds the possibilities of this article, let us note, however, that it is of great importance for the practical approach to FDI issues.

A supporting hypothesis may also be formulated, which concerns the circumstances which accompany an investment. There is the question of security as a prerequisite for attracting foreign investment of any origin, i.e., both large partners and those taking their first steps in the FDI market. The host state guarantees investment security (including protection against nationalization). The free transfer of profits, the reduction of the tax burden, as well as predictions concerning the economic situation in the host country are nothing more than circumstances that are favorable to the investment multiplier in Keynesian theory or visible today in the model of Porter's diamond.

## The essence of FDI

The practice of FDI is far ahead of the theoretical approaches since the beginnings of capital export took place in the colonial era. Smith's theory of trade and its extension by Ricardo gave impulse to the movement of physical capital. Theoretical approaches to FDI are much younger – in fact, they are only, at most, several decades old. Their origin deals with the cooperation of Western economies. A later impulse was the interest in supporting less advanced economies, which was followed by the growing trend of the open economy, globalization, and finally, the collapse of the Iron Curtain and the transformation of post-communist countries.

Theoretical considerations of FDI are based on various assumptions. Diversity is mainly due to the adoption of different criteria and methods for evaluating foreign investment. Greenfields, brownfields, and joint ventures have various consequences for the investor as well as for the host country (both micro- and macro approaches). Also, the micro-micro approach is considered (B2B, foreign investor – local partner; so again, brownfields or joint ventures), as well as the spatial approach (locating investment in centers or particular locations).<sup>2</sup> There might be different motives for investing,

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<sup>2</sup> Illustrated by Bilateral FDI Statistics 2016.

like transferring outdated products to new clients, seeking new markets, or searching for cheaper subcontractors. An investment might be focused on export (e.g., an export promotion strategy) or satisfying internal demand in the host country (e.g., the import substitution strategy). Investments related to exploiting mineral resources may reduce the costs of input supplies and transport. Another FDI variety results from privatization and selling former state companies to foreign investors. A foreign investor may act as the client, or – reversely – a host country applies for an inflow of foreign capital. The multitude of approaches to FDI issues means that some authors focus on classifying foreign investment according to the motives and circumstances that accompany investment decisions.

## Theoretical concepts of FDI: a literature overview

Few achievements in FDI research deserve the name “theory.” The variety of approaches allows us to use the term “paradigm,” which is mentioned in the FDI literature, especially since some studies are related to other disciplines.

Amongst the numerous works on FDI, the publications by Vernon, Dunning, and Markusen and A.J. Venables deserve special interest. Their works have been discussed many times; however, some thoughts which affect the character and functions of FDI should be emphasized. Raymond Vernon, using data on 1950s trade between the USA and Western countries, distinguished three stages of product life cycle: innovation, maturity, and standardization (imitation) (Vernon 1966). The first concerns the functioning of investment in the country of origin. It lasts as long as the marginal cost of producing the given goods plus its transport costs are lower than the marginal cost for this product in the partner country. Moreover, as Vernon said, in this stage, price elasticity for the good is low in the home country, which suggests monopolization, or at least limited competition, and it encourages the company to focus on the home market only. Incentives to export a product are, therefore, limited at this stage.

In the second phase, the demand for a good in the home country decreases, which results in a decrease in the supply. The opposite is true in the partner country, where there are relatively cheap labor resources but high income demand elasticity. This is a chance for the original producer to reduce the costs of production and to get new clients, but only if production is moved to a partner/host country. In the third phase, this situation encourages the relocation of production to the partner country, and, as a result, the original home country becomes an importer of the given product from the host country.

Vernon’s concept has found followers. The most interesting seems to be the Uppsala model designed by the Scandinavians Johanson and Wiedersheim-Paul (1975, and later modified). This is an interdisciplinary approach that takes into account elements of management and organizational behavior. According to this model, the internationalization of production is implemented in stages, according to Vernon’s cycle, al-

though critics indicate that, today, some companies are already focused on foreign activities from their inception (like FDI in IT services implemented in African countries). It is interesting to interpret where the production of a given good will be transferred. For Vernon, they were primarily developed in European countries. The authors of the Uppsala model assumed that the choice of the partner and product location depend on the “mental distance” between the home country and the partner country. They include linguistic, cultural, and legal barriers, which are smaller the closer the level of economic development between the home country and partner country. This assumption implicitly repeats Vernon’s approach of cooperation between developed countries but does not take into account the current trends in FDI around the world.<sup>3</sup>

However, the authors of that model go further than Vernon, as they write about setting up subsidiaries in the host country that are linked to greenfield investments, which Vernon omitted. It is worth emphasizing that the authors of the Uppsala model state that the main barrier to the internationalization of production is the lack of knowledge (the company in the home country is more inclined to relocate abroad the more knowledge about the conditions in the partner country it has). It brings this approach closer to the concept of development economics. Let us recall that Polish trials in FDI were often accused of lacking recognition of local systems, which resulted in the failures that occurred.

John Harry Dunning is the second figure after Vernon who is particularly notable for his FDI research. Dunning developed a model that describes the investment activity and the intensity of the inflow of FDI to the host country. It was an attempt to adjust various concepts, which led Dunning to call his proposal eclectic theory, while others described it as the eclectic paradigm, or the OLI paradigm (O – ownership advantage, i.e., own specialized staff, technology, know-how; L – location advantage, i.e., abundance of resources in the host country; I – internalization advantages, i.e., more favorable possibilities of transactions inside than on external markets). These advantages do not, obviously, exclude various forms of cooperation, such as subcontracting or outsourcing.

The last FDI researchers mentioned above are James R. Markusen and Anthony J. Venables. In one of their numerous works, they discussed in model form the influence of FDI on the development of local industry in the host country (Markusen, Venables 1997). An increase in prosperity in the country receiving FDI is supported by the production of intermediate goods produced by the domestic sector for the final good, generated by foreign investment. This is what we call investment cover of FDI, which brings economic recovery most often in the microregion. It has even a broader scope since it includes services development by subcontractors. The prosperity that results from FDI manifests itself in the form of higher employment and increased consumer demand.

<sup>3</sup> Even so, the Uppsala model has been proven by Chinese efforts to implement FDI by using Chinese diasporas in host countries.

## Critical comment

The multitude of FDI targets and scenarios results in the lack of universal FDI definition. The one elaborated by the OECD is partial and does not consider today's expectations of partners engaged in these investments. The OECD defines FDI as the acquisition of an effective influence on the management of an existing company, the lower limit of which is considered to be at least 10% of the shares.<sup>4</sup> This approach to FDI is close to what Dunning determined earlier. In 1972 he wrote in the Introduction to International Investment: "The main distinguishing feature of direct foreign investment is that, unlike portfolio investment, the investing unit (usually a business enterprise) purchases the power to exert some kind of control over the decision-taking process of the invested-in unit. This immediately suggests that something other than money capital is (or may be) involved in direct investment" (Dunning 1972, p. 12).

Like the OECD definition, Dunning did not avoid simplification. A direct investment, understood as gaining an appropriate position in an existing organization, may only concern brownfield solutions and it ignores the interests of the host country, apart from capitalizing an existing company. This kind of simplified approach to FDI is, therefore, of a historical character today. It concerns only the micro-micro approach mentioned above, and at the same time, it is an argument for the remaining few supporters of the opinion of threats to the national economy as a result of an inflow of foreign investments.

Meanwhile, what is most needed from the point of view of the host country, but with a lower level of development than the country of FDI origin, is greenfield investment. It provides jobs, generates budget revenues (although, depending on the arrangements, the investment may be exempted from contributions, even for many years), provides new technological opportunities, or has multiplier effects in the form of investment cover by local partners. Thus, when FDI is identified in the interest of the host countries, it can be referred to as measures that are intended to bring the above-mentioned effects to the host countries.

Commenting on the achievements of the authors mentioned above, it should be emphasized that those works appeared many years ago. Vernon's publication, referred to many times in the literature, was published more than fifty years ago, while the works of Heckscher, Ohlin, and Leontief, came out twenty to thirty years ago. Vernon used data on US trade relations with highly developed countries, and he takes little account of the markets of underdeveloped countries, which was logical at the time. In practice, however, even when it was created, Vernon's concept was disproved by research on the so-called Leontief paradox. Leontief showed that, at least in the US economy, the theory of Heckscher-Ohlin's abundance of resources does not work because, contrary to it, the USA was then an exporter of labor-intensive goods and an importer of capital-intensive goods, although it should be the other way round. So, how did Vernon manage to prove the three-phase product cycle, with the example of the American economy?

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<sup>4</sup> <https://www.oecd.org/daf/inv/investment-policy> (accessed: 12.03.2019).

Perhaps the solution lies in the post-war economic order of the Western world, which resulted from the Bretton Woods agreement. For more than two decades after the war, the dollar exchange ratio remained fixed in the trade between the US and Western Europe, and customs protection against the inflow of cheap imports existed even longer in the USA. Therefore, according to Vernon's assumptions, investment capital flows must have faced barriers, and these could have been the premises for the first phase of the product cycle. Growing competition in the domestic market increased the initially low price elasticity of demand, so it was no longer justified to maintain production in the domestic market. In addition, the abolition of the principle of the fixed dollar exchange rate made it possible to weaken national currencies in Western European countries, which caused cheaper export from these countries.

Does Vernon's concept fit in with today's situation, where emerging markets partly take over as a source of FDI? In other words, have some products in these countries reached Vernon's second stage, encouraging the transfer of the product to less advanced markets? The situation of emerging markets is, in some respects, incomparable to the conditions analyzed by Vernon. These markets have operated practically since their inception as open economies, and they were subject to external competition, and except for China and India, they have relatively little capital. However, since entrepreneurs from these countries look for niche solutions for their foreign activities, it cannot be ruled out that the investment flow mechanism nevertheless contains similarities to the model observed by Vernon.

Among such diverse FDI scenarios, the issue of competition between external investors in today's political and economic situation in the world has been treated as subordinate in theoretical terms. While in the era of the previous East-West division it was logical to locate investment in a given area of influence, i.e., the issue of investors' competition was hardly encountered, today, in an open economy, various players appear. Apart from multinational corporations and leading companies from highly developed countries, and apart from new giants of the world economy, i.e., China and India, there are also investors from medium developed countries, who are becoming increasingly active in terms of direct investments in foreign markets. However, there is a lack of empirical studies that justify the growing competitive strength of these investors.

The need for FDI in less developed countries is significant, and – apart from the mining sector – they are often niche industries, which are essential for the local recipient and, in the future, also for export. This applies primarily to agri-food products. The reduction in export subsidies for these products in developed countries as a result of WTO negotiations (developing countries may be subsidized until 2023 and the poorest until 2030) has not, however, had the expected result in increasing the export of these goods by developing countries. Was it due to previously popular hypothesis of the “backward bending supply curve by poor farmers” due to the increase in price of crops? Regardless, agri-food processing on the local markets is still an untapped opportunity for foreign investors, and not necessarily ones from the richest countries.



While speaking of investments in underdeveloped markets, it is worth recalling the statement of Paul Streeten, one of the leading proponents of development economics in the times of its splendor, i.e., in the years of scientific interest in the issues of the development of the Third World. Writing about these issues in 1969, Streeten stated that many of his reflections on the importance of foreign investment for development are burdened by the experiences of the nineteenth century. Paraphrasing these words today, one can say that the current approach to these issues is burdened with views from the early post-war years, conditioned by the Bretton Woods agreements that shaped relations between the USA and Western Europe. In other words, the adequacy of theoretical approaches to contemporary conditions is limited.

Streeten warned against excessive foreign capital participation in the economy of a less developed country, as this capital is located in strategic sectors of the economy, which may lead to a loss of economic independence. It can, therefore, be concluded that the public sector should dominate in sensitive areas of the poorer country's economy. In such an arrangement, niches would remain to be developed by external investors, and these, as a rule, are not of interest to large corporations.

Another observation by Streeten concerned the conditions under which FDI operates in a less developed economy. Streeten considered low tax burden and investment security as factors that attract investors. In practice, it means the well-known "open door" strategy and its current mutation, i.e., special economic zones, in which investments are guaranteed unchanging operating conditions.

Paul Streeten's insights, although written nearly half a century ago, contain many of today's elements. Development economics in its Third World view was dominated by post-Keynesianism, which assumed an active role of the state. Today one may observe a gradual return to this model, which is visible on more stable African or Latin American markets. This confirms the thesis of emerging opportunities for FDI from emerging markets.

## **FDI from emerging markets – an extension of existing theories?**

China and India are the leading FDI exporters from emerging markets. Today, both are active as investors in developing as well as developed markets. The remarks below emphasize some of the peculiarities when dealing with FDI from these countries, and they also show theoretical issues of FDI in a new light.

### **Case example: Chinese FDI in less advanced markets**

China is currently the world's second-leading exporter of investment. In 2016, FDI from China (including Hong Kong) accounted for 13% of FDI outflows from the 20 top investing countries (*World Investment Report 2016*). Over the last decade or so, China

has become a global player in the investment market, and investors are leading Chinese corporations that are interested not only in mining but also in modern processing or technologically advanced services. Chinese companies mostly enter the markets of South East Asia (annually 49–68% of Chinese FDI outflows), although they also look to Europe (8–19%), Northern America (4–13%), Latin America (5–13%) and, in recent years, Africa (4–8%)<sup>5</sup>, where they develop financial services, IT & software, transport and communication services, industrial production, and mining activities through acquisitions or greenfield investments.

The growing activity of Chinese investors is the result of a combination of various factors. The saturation of the internal market in China still seems to play a minor role there, which could suggest the second phase of a product's life according to the Vernon scheme. It is true that the consumer market in China has changed significantly in recent years due to the increase in local salaries, in particular, the lowest wages. The Atlantic Council's report talks about reducing the extent of poverty in China by nearly half the population (700 million) (Avendano et al. 2017). In addition, there is an increase in income in higher groups. The poor until recently, mainly buy basic goods. However, it is interesting to note that Chinese households store their savings in American dollars. This creates an additional impulse to support the devaluation of the yuan by the Chinese authorities. Therefore, it is unlikely that the Chinese market will be saturated with local products as part of the product life cycle. The reason for capital to leave the country is concentration, which gives it an advantage over competitors, as in the case of the Haier consortium, which currently controls more than 10% of the world's production of home equipment.

Growing investment activity of Chinese investors on external markets is also the result of the economic downturn in China, which triggers a "flight forward" mechanism. China's FDI activity is, therefore, diverse, as evidenced by FDI in Africa. This segment of FDI has met with great interest in recent years due to the dynamics of FDI and changes in the economic and political situation in several African countries, as the scale of Chinese investments is relatively low (only about 5% of Chinese FDI is located in Africa annually). It is, however, a very attractive continent for exporters in the future, hitherto struggling for years with enormous political, social, and economic problems, which are gradually being overcome in some countries.

Western investments, for a long time, mistrusted the possibility of entering the mining sector in less advanced economies, not only in Africa, with the numerous cases of the nationalization of foreign ownership fresh in their minds. Things have changed, but in the case of the mining sector, Chinese FDI is untypical. During particularly high economic growth in China, Chinese investments in the mining industry were guided by the idea of securing the supply of the necessary raw materials, thanks to which the Chinese economy avoided risky purchases on world stock exchanges or risky international contracts.

<sup>5</sup> Data for 2013, various estimates according to *China's Outward FDI 2016*, [bruegel.org/2015](http://bruegel.org/2015) (accessed: 12.03.2019).

In addition to investing in mining, which demands significant capital, Chinese expansion also concerns services, which account for 50% of Chinese FDI inputs, as well as the processing industry and agriculture (*Report on Development of Overseas Chinese Entrepreneurs* 2018). A significant number are greenfield projects, including those carried out by small and medium scale capital. They are able to enter external markets thanks to institutional and capital support from the State. Foreign branches of Chinese companies are installed to maintain a strategic position for future expansion. The Chinese diasporas, which has been present for many years, especially in South-East Asia, play an additional supporting role.

Is the smaller technical and organization distance between Chinese companies and local partners key in having a competitive advantage? It seems to be a temporary situation and concerns clients in developing countries with low-skilled labor resources. In any case, it is an impulse for the expansion of FDI in such markets. Lower local remuneration causes an additional impulse to invest. There is no need to look for examples in Africa. In eastern Poland, Korean companies benefit from the minimum wage allowed by the government, which is twice as low as the national average. A statutory wage increase is the only way to earn more in these companies.

### Case example: Indian FDI

As far back as the 1960s, several Indian corporations, such as Birla and the Shriram Group, founded branches in Ethiopia (textile industry) and Sri Lanka (sewing machines). After liberalization in 1991, the competitiveness of Indian companies visibly increased, which increased Indian FDI, as well. The aim was to gain a competitive advantage in terms of technology and brand, to increase the company value, or protect intellectual property rights. Indian expansion concerned various branches of the economy, such as electronics, pharmaceuticals, telecommunication, and metallurgy. For example, they included (Athukorala 2009):

- Mineral exploitation (crude oil, copper, iron ore): the Oil & Natural Gas Corporation Ltd, the Gas Authority of India Ltd, Suzlon Energy Ltd, and Hindalco.
- The automotive industry: Tata Motors.
- New technologies (purchase of technology, acquisition of management, marketing, and network distribution).

Indian companies not only gained access to foreign capital but also the possibility to take over foreign companies on a large scale. Corporations such as Bharat Forge (car parts), Moser Baer (optics), Reliance (polyester yarn), Arvind Mills (jeans), and Zee Telefilms (satellite TV channels) have become leaders of global competition. Indian FDI has achieved historic growth in the 21<sup>st</sup> century, symbolizing the country's growing integration into the world economy (Iqbal, Turay, Hasan, Yusuf 2018).

These companies easily adapted to foreign markets, especially in less developed countries, due to the similarity of Indian conditions of production, distribution, and sales of goods in terms of local poverty and limited capital in the host country. Local

companies in the host countries also lacked social capital, and they operated with extremely poor technical and economic infrastructure.

One of the crucial reasons for the success of Indian FDI in less advanced markets was the proper staff selection to coordinate geographically dispersed resources and use production factors. Indian corporations have demonstrated their ability to manage cultural, institutional, geographic, and market diversity. Those that introduced management change that was appropriate for foreign expansion achieved the best results. Those companies developed teams of talented managers with international experience and gave them decision-making autonomy. This is exemplified by the Dabur Company, for example, which operates through a Dubai-based subsidiary and controls all global operations and industrial subsidiaries in various countries.

## Conclusions

The suggested extension of the existing FDI theory, while considering investors from emerging markets, is as follows:

First, as the Chinese and Indian experiences prove, the first stage of a product's life cycle, i.e. the saturation of internal markets with own products, does not exist. The motive to export capital is either to secure demand in strategic raw materials or to achieve an advantage over competitors due to capital concentration. Considering the similarities between FDI sequences outlined by Vernon and the activities of Chinese and Indian investors, it seems sure that the second stage (maturity) of the product life cycle in emerging markets does not occur. This conclusion supports the first hypothesis.

The second hypothesis concerned the comparative advantage of companies from emerging markets due to the shorter technical and organizational distance between investors from emerging markets and local partners in host countries. The Chinese and Indian diasporas living in some host countries play an additional supporting role. This phenomenon confirms the Uppsala model regarding the low psychological distance between foreign investors and clients in the host country.

Finally, in the case of small and medium scale sectors from emerging markets, their FDI expansion is possible, to a great extent, thanks to institutional and capital support from the state.

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## Streszczenie

### Bezpośrednie inwestycje zagraniczne z rynków wschodzących Teoria i praktyka

Artykuł przedstawia przegląd teoretycznych podejść do kwestii bezpośrednich inwestycji zagranicznych, pochodzących z tzw. rynków wschodzących. Są to nowi partnerzy działający jako inwestorzy, których aktywność w ostatnich latach zwiększa się zwłaszcza w krajach słabiej rozwiniętych, gdzie inwestorzy z rynków wschodzących skutecznie konkurują z dotychczasowymi liderami bezpośrednich inwestycji. Rozważane są dwie hipotezy. Pierwsza dotyczy stanu koncepcji teoretycznych, wypowiadających się na temat bezpośrednich inwestycji zagranicznych. Koncepcje te są skupione na działalności inwestycyjnej wielkich partnerów i nie wyjaśniają podejmowania działalności za granicą w przypadku przedsiębiorstw pochodzących z rynków wschodzących. Są one więc jednostronne, a dziś mają nawet charakter historyczny. Druga hipoteza dotyczy występowania przewagi komparatywnej firm z rynków wschodzących i stanowi uzupełnienie dotychczasowych podejść do istoty BIZ. Przy zastrzeżeniu, że firmy z tych rynków lokują się często w niszowych gałęziach gospodarki krajów goszczących można przyjąć, że istotą przewagi jest mniejszy dystans techniczno-organizacyjny między inwestorami a rynkami słabiej rozwiniętymi.

**Słowa kluczowe:** bezpośrednie inwestycje zagraniczne, rynki wschodzące, teoria, doświadczenia chińskie i indyjskie