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New trends of globalization: Do we need new theories?

by Dr. Wi Saeng Kim*

1. Theories of Globalization

Globalization is the process of corporations moving their money, factories and products around the world to maximize a firm's value. If a domestic firm can increase its value by investing in foreign economies, it will become a multinational firm. The U.S.-based multinational corporations (MNCs) were the dominant foreign direct investment (FDI) providers with a 42.4% share of global FDI outflows in the 1970s. Since the U.S. MNCs were major actors in international operations during the 1960s, early FDI theories mainly focused on the managerial behavior of U.S. multinational firms.

One of the well-accepted FDI theories is 'the monopolistic advantage theory' of Hymer (1976), which claims that a firm invests abroad in order to capitalize on imperfections existing in the product market. To the extent that a multinational corporation obtains rent-yielding firm-specific assets that local competitors do not possess, the firm can compete successfully with local firms that have better connections and knowledge of the local market. The industrial organization theory of Caves (1971) explains that firms in oligopolistic industries tend to become MNCs, because they invest heavily in R&D, which generate monopolistic rents. The product life cycle theory of Vernon (1966) states that new products will be introduced in advanced economies because of technological know-how and demand for new products. But as production know-how becomes standardized over time, the production location moves from advanced economies to lower labor cost economies. The internalization theory postulates that FDI occurs when a firm can increase its value by internalizing its intangible assets. Such assets may include superior production skills, patents, marketing abilities, management skills, or consumer goodwill on brand names.

2. New trends of FDI flows

Globalization, in the form of FDI accelerated in the mid-1980s as many developing countries received a bigger share of global FDI flows than before

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Figure 1 shows that in 1989, total FDI inflows to developed countries amounted to about $150 billion, while developing countries received less than $30 billion of FDI inflows. Interestingly, by 1996 the developing economies received about $130 billion of FDI and advanced countries received over $200 billion.

Prior to the 1980s, many developing economies adopted FDI regimes that restricted FDI inflows. Since the 1980s, however, policymakers in developing countries realized the benefits of FDI and utilized it as a key element of their economic development strategies. The general consensus on the impact of FDI is that inflows from advanced countries function as a vehicle for the transfer of technology and managerial practices that create growth-promoting efficiencies in the recipient economies. The labor productivity of FDI recipient countries will be improved because of the advanced equipments and machineries. The inflow of FDI will also create new jobs. Consequently, FDI inflows are believed to increase the economic growth rate. To this extent, at least 143 countries by 1997 had enacted FDI-specific legislation to create more favorable conditions for FDI providers. Consequently, the share of world FDI by emerging economies increased from 15% in 1990 to approximately 40% in 1997.

It is also interesting to note that long-term capital flows within advanced economies were quite different from earlier FDI. In the 1950s and 1960s, greenfield FDI was the most popular method of market entry. Since the mid-1980s, cross-border mergers and acquisitions have become an increasingly important means of entering foreign markets. According to UNCTAD, the total value of worldwide cross-border mergers and acquisitions rose in 1996, for the sixth year running. (UNCTAD, 2002).

3. Globalization and theoretical background

The previous discussion suggests that globalization activities create a 'win-win' scenario, for both FDI-providing MNCs in advanced countries and FDI-receiving developing economies. Note that the formal theory of globalization dates back to at least as far as Adam Smith. The Wealth of Nations (1776) claims that the free movement of goods and production factors will increase the wealth of all nations involved. The theory suggests that it is not a coincidence that economically developed countries were the major players with international capital flows in the early stages of globalization. Further, several Asian countries, referred to as newly industrialized economies, have achieved higher economic growth rates in recent decades than other developing countries and experienced an influx of foreign technologies and capital. For instance, Asia and the Pacific countries received only 13% of all FDI flows to developing countries in 1970 but this figure jumped to approximately 52% in 1997.

Another country that has experienced impressive economic growth in recent decades is China, which also has attracted an influx of FDI. The total stock of FDI in China has jumped from $6,251 million in 1980 to $346,694
million in 2000. Similarly, FDI stock as a percentage of the gross domestic product of China increased from 3.1% in 1980 to 30.9% in 1999. The gross domestic product of China has increased from 362.4 billion Yuan in 1978 to 9,593.3 billion Yuan in 2001. Since 1993, China has been the largest recipient of FDI in the developing world (UNCTAD, 2000).

Figure 2 shows that FDI inflows to developing countries jumped from $33 billion in 1992 to $120 billion in 1997. We also notice that China and East Asian countries received a large portion of world FDI flows. In contrast, however, Latin American countries received about 53% of all FDI flows to developing countries in the early 1970s, but their share declined to 33% in 1997 (UNCTAD, 2000).

4. Globalization and Agency Problems in recipient economies

We have seen anecdotal evidence that globalization is a powerful engine of economic growth for the parties involved, as Adam Smith claimed. Poor countries that receive FDI enjoy a faster economic growth and the share values of multinational corporations (MNCs) that provide FDI are advanced. MNCs that provide FDI immediately benefit because they can reap ‘monopolistic rents’ from the intangible assets that they possess. FDI improves the employment opportunities of local workers, and enhances the consumer welfare of underdeveloped countries, as consumers have more choices to shop for better prices and a higher quality of goods and services.

Then why do some developing countries receive FDI inflows, experience rapid economic growth and later move up to a higher economic status such as ‘newly industrialized economies’ while other developing countries do not receive foreign capital and technologies and stay poor? There are many possible reasons why this happens. First, a developing country may have legal restrictions on long-term foreign capital inflows. Second, even if there are no legal restrictions, there may be cultural barriers to entry. Third, even if there are neither legal restrictions nor cultural barriers to entry, the developing countries may not present profitable FDI opportunities. The FDI provider will not take investment projects that do not generate a positive net present value. If the policy makers of developing countries are interested in the economic growth of the nation, then they may give enough financial incentives so that FDI projects will generate positive value to the FDI providers.

The agency theory of the firm by Jensen and Meckling (1976) argues that the corporate managers (agents) make business decisions based on personal interests rather than on shareholders’ (principals’) interests. The managers (agents) would do so unless they are closely monitored and fired for neglecting shareholders’ interests. This means that the agents (managers) will have more freedom to help themselves at the expense of the shareholders (principals) in an economy where managerial monitoring is not active and where the managerial labor market is not competitive.
If we apply the agency theory of the firm to a democratic nation-state, policy makers will be the agents and the public will be the principals. The principals (public) want economic growth and improvements in living standards. But the agents may not necessarily pursue the policy to enhance economic growth and living standards. The agency theory suggests that local policy makers may be interested in personal gains and losses rather than in the economic growth of the nation state. The policy makers may weigh the personal benefits of FDI inflows against the personal cost of FDI inflows, rather than evaluating whether FDI inflows will expand or contract the wealth of the nation. To the extent that the agents currently reap rents from the public as a result of their bureaucratic position and to the extent that the FDI inflows take away these bureaucratic rents, the agents would not welcome FDI inflows. Instead, they may use their power to restrict FDI inflows by erecting legal barriers or to selectively emphasize the negative aspects of FDI inflows to the public so that the public opinion turns against an opening of the market.

Domestic firms that enjoy monopolistic power under closed economy are another interested party that may lose, if FDI inflows intensify. Since the FDI providers are based in advanced countries and incoming foreign firms obtain more advanced technologies than local producers do, domestic producers are potentially on the losing side. Domestic producers do not like new competition from multinational corporations, so they also have an incentive to launch a campaign against the market opening. Resistance from domestic producers in developing countries will be greater in countries where the corporate ownership is entrenched and leadership is inefficient. Economic power group of these countries may eventually yield their ownership of the national economic pie. Therefore, they are the potential losers in globalization.

A case in point is the recent development in Africa. Because of prevalent government corruption in many African countries, multinational corporations kept a distance from pursuing FDI there. Therefore, in an effort to attract foreign capital into Africa, leaders of African countries have admitted that corruption exists in the African continent and have promised collectively to the eight richest nations that they would better monitor foreign capital inflows. Although these eight nations welcome the movement from African leaders, FDI inflows into Africa may not significantly increase unless profit opportunities exist in the continent.

5. Globalization and Agency problems of FDI providers

The firm’s objective is to maximize the return to shareholders within legal limitations, whether domestic or multinational. In general, corporate managers maximize share values to pursue their objectives. Therefore, FDI providers seek the maximum return from their investments, so they invest in foreign economies only when the investment project creates value to shareholders. According to the monopolistic advantage theory of FDI, FDI providers must have technological and/or managerial skills that local producers do not possess. By definition, therefore, multinational corporations based on advanced economies obtain
monopolistic advantages over local producers; and FDI providers can exploit local consumers to a certain degree. Empirical studies have shown that multinational corporations command a higher premium over domestic firms, allowing multinational corporations that operate in foreign economies be another beneficiary of globalization.

Total annual global FDI outflows amounted to $1,149 billion in 2000. Approximately 90% of the world FDI outflows are provided by developed economies, and about 12% is provided by US-based MNCs. Total annual global FDI inflows amounted to $1,270 billion in 2000; developed economies received about 79% of world FDI inflows, and the US economy received about 22% of global FDI inflows. This suggests that most economic gains of globalization will accrue to MNCs that are based in advanced economies.

Such a domination of FDI outflows can be viewed as an opportunity, where an underdeveloped and weak host country can be easily exploited by the developed and strong country, not only in economic gains but also in the sovereignty of the nation-state. Statistical evidence and/or anecdotal observations of historical events support the possibility of such potential. The potential opponents of globalization are quick to use these fears as ammunition to fight against globalization.

6. The promotion of global prosperity

We have shown that globalization is a powerful engine of world prosperity, and we have argued that the agency problems on the issue of globalization exist in both FDI-receiving economies and FDI-providing companies. Both will be hurdles for speedy globalization and world prosperity, to the extent that policy makers of FDI-recipients merely seek out their self-interests rather than national wealth and/or corporate managers of FDI providers pursuing short-term gains rather than long-term gains.

The undesirable scenario of globalization and world prosperity is that while FDI providers seek the maximum return from their investments, domestic economic power groups of FDI-recipient countries accentuate the fear of economic ‘imperialism’ through FDI inflows and thereby enjoy unchallenged domestic economic power at the expense of domestic consumers. In the long run, the pro-growth logic of globalization will prevail. But the short-term battle is likely to be won by the domestic power groups, suggesting that the globalization process will be further delayed.

A Pareto optimal solution to promote globalization and world prosperity is to align the interests of both FDI providers and recipients, and specifically to alleviate the fears of the FDI-receiving countries. If we calculate the global wealth that a smooth process of globalization can create, and if we calculate the contributions of each party, then we can figure out a fair way of distributing the created wealth. To the extent that about 90% of the total global FDI was provided by advanced economies in year 2000, initiatives to promote the globalization should come from MNCs based in advanced economies.
7. New trends in FDI and research questions

A couple of noteworthy trends in global capital flows have developed in recent decades. In contrast to the 1950s and 1960s, when Greenfield FDI was the most popular method of market entry, since the mid-1980s, cross-border mergers and acquisitions have become an increasingly important means of entering foreign markets. According to UNCTAD, the total value of worldwide cross-border mergers and acquisitions rose in 1996, for the sixth year running. Cross-border merger and acquisition sales totaled $274.6 billion in 1996. Most of these were majority ownership sales (UNCTAD, 2002).

Another noticeable change in the pattern of FDI flows is that there has been a significant shift in the regional distribution of FDI flows. Developing countries in Asia are the driving force in the surge in FDI flows. Developing economies have attracted a larger share of global FDI inflows. Asian countries in particular have been recipients of more than half of the total FDI flows into developing countries, and they have also been providers of about 90% of total FDI outflows by developing countries. Intra-regional investment flows make up nearly 40% of FDI in Asia and multinational corporations in newly industrialized countries (NICs) are at the heart of this phenomenon.

The Greenfield FDI theories for U.S. MNCs were developed and empirically tested. For example, Errunza and Senbet (1981), Kim and Lyn (1986), and Morck and Yeung (1991), among others, supported the monopolistic advantage theory of FDI. These studies found that excess value of U.S. firms is positively related to the degree of international operations. However, there have not been strong research interests in the FDI theories for emerging economies.

Interestingly, recent papers document that corporate environments in emerging economies differ quite significantly from those in advanced economies [see, for example, La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) and Shleifer and Vishny (1997)]. Unlike most U.S. corporations, firms in emerging economies are characterized by deviations of control from cash flow rights. These practices allow owners to gain affective control of their firm with minimum amount of cash investment. Claessens, Djankov and Lang (2000), La Porta, et al. (1998), Claessens, et al. (1998) report that business group affiliation and large block-holders are prevalent features of public corporations in Asia.

The above discussions present an interesting question about whether U.S.-oriented FDI theories are applicable to emerging economies. The extant FDI theories, for example, explain FDI flows from advanced economies to developing economies. However, for intra-regional investment flows in Asia, MNCs in emerging economies may not have firm-specific monopolistic advantages, and therefore, may not have been motivated to capitalize the monopolistic rents of technological advantages. A recent study by Kim (2003)
addresses this question and, based on Korean FDI data, investigates whether U.S.-oriented FDI theories were applicable to the case of Korean MNCs. Kim (2003) finds that FDI for Korean multinationals resemble the Japanese model more closely than the U.S. FDI model. Continued research interests in FDI flows may shed light on whether the extant FDI theories can be extrapolated to global uses, or whether we need new theories for multinational corporations in emerging economies.
References


**Figure 1**

FDI inflows to developed and developing countries in 1981-1996

Source: UNCTAD
Figure 2

East Asia and Latin America and Caribbean: FDI inflows in 1991-1996

Source: World Bank