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De-industrialisation, comparative economic performance and FDI inflows in emerging economies

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ABSTRACT

We address calls to incorporate comparative political economy considerations into IB scholarship. In particular, we conceptualise and test empirically the hitherto unexplored relationship between de-industrialisation and relative performance of groups of countries, and FDI inflows in emerging economies. Using a panel dataset over the period 1996–2004 and employing conceptual and methodological innovations (not least the use of comparative independent variables), we find support for the ideas that relative de-industrialisation of developed economies will increase FDI inflows into emerging economies, while the relative under-performance of developed countries will reduce it. We also find that divergence in business cycles-de-coupling between the two groups of countries fosters FDI inflows in emerging economies. These help explain and predict recent changes in the global business landscape and inform public policy and managerial practice.

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1. Introduction

In recent years, the global landscape of foreign direct investment (FDI) has shifted to the developing and emerging world. In 2010, FDI inflows into developing and emerging economies exceeded that to the developed economies for the first time. At the same time, FDI is widely seen by many scholars and policy makers alike as an important contributor to the development process of the developing and emerging economies (UNCTAD, 2011). The ability of some such countries, notably the BRICs (Brazil, Russia, India and China) to grow at much higher rates than 'developed countries', in part through appropriate and innovative uses of trade, FDI, investment and domestic (such as industrial) policies (Lin, 2011; Rodrik, 2004; Stiglitz, 2008), point to a novel dimension to the issue of the antecedents of FDI. An important question is to what extent and how FDI in emerging economies is affected by the relative economic performance of developed and emerging countries. In particular, de-industrialisation and the need for re-industrialisation are becoming major concerns in developed countries, with renewed calls for the adoption of industrial policies, to improve overall competitiveness in the global environment (EC, 2010).

Despite some conceptual work (EC, 2010; OECD, 2009; Warwick, 2013), however, the impact of de-industrialisation and comparative economic under-performance on FDI inflows in emerging economies remains unexplored. Given the current prominence of the BRICs, and their FDI-attracting record, this is no longer satisfactory. Our aim in this paper is to shed some light on this important and under-researched issue.

We aim to fill the following research gaps in IB scholarship. (1) The limited incorporation of comparative political economy concerns (Jackson & Deeg, 2008), more specifically theories of economic crisis, economic performance and de-industrialisation. (2) The lack of focus on the impact of comparative/differential (not absolute) performance on FDI inflows – this is simply not measured – tested in extant literature. (3) The importance of de-coupling between developed and emerging economies on FDI.

There is a very extensive literature on the determinants of inward investment: starting with early surveys by Agarwal (1980) and Schneider and Frey (1985), to more recent reviews by Biswas (2002), Blonigen (2005), Dunning and Lundan (2008), Faeth (2009), and Sawalha, Mazouz, and Pellet (2013). From the articles summarised in these surveys (in excess of one hundred) none explores the impact of comparative/differential performance of host/home economy, and the role of business cycle divergence-de-coupling on inward

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investment. These are important because they test hitherto unexplored relationships and, in the case of the focus on comparative/differential effects, because they provide fresh evidence on an extensively explored and important topic, in novel way, which also captures the 'opportunity cost' of investment decisions. This is because any investment to invest cross-border involves the opportunity cost of not investing these resources domestically.

By way of an example, when Mexican cement company CEMEX decided to invest in the cement industry cross-border, it faced the opportunity cost of not investing these same resources into a different activity within Mexico. By focusing on the absolute, not relative, effects, extant literature ignores the opportunity cost of using resources in cross-border activities, vis-à-vis employing them in order to diversify into activities within the country, in this case Mexico. This is an important omission in general, and in particular, given the return of the debate on the relative advantages of national conglomerates, relative to cross-border MNEs, that has recently grabbed the attention of the media (see, for example, The Economist, 11th of January 2014). Our focus on the comparative determinants of home/host country, accounts for this very important aspect.

Hence, in addition to addressing the aforementioned gap, and/or because of this, our intended contributions involve the following. (1) The first study on the role of de-industrialisation and comparative economic performance on FDI inflows in IB scholarship. (2) The first study to acknowledge and empirically account for comparative/differential performance, not just absolute, on FDI inflows. (3) The first attempt to conceptualise and test for the role of business cycle divergence-de-coupling on FDI inflows.

In all, the aforementioned help offer a better appreciation of globalisation and the currently highly debated apparent disconnect between firm-level and national level performance. Moreover, they provide a hint as to the future of FDI into developing countries and partly predict the emerging slowdown of the BRICs. We consider these, and other innovations discussed in the text, to be reasonably important contributions to IB scholarship and answer the call for more comparative political economy input into IB (Brouthers, 2013).

In terms of the structure, Section 2 critically assesses extant theories of de-industrialisation and relative economic performance, examined in the context of more secular views on economic crises, and conceptualises their relationship to internationalisation of production, paying specific attention to FDI.[2] Section 3 presents our data and operational measures. Section 4 discusses the evidence from our empirical investigation. Our last section summarises, provides a discussion, and concludes with policy implications, limitations and scope for further research.

2. De-industrialisation, relative economic performance and FDI

The question of de-industrialisation and the associated comparative-declining, at least in relative terms, economic performance ('relative decline') of some developed countries, had been discussed by political economists for a considerable time (see Coates & Hillard, 1986; Rowthorn & Wells, 1987; Singh, 1977), but has found no application to IB scholarship, in particular the analysis of FDI. This is a research gap we aim to fill in this paper.

Usually de-industrialisation and 'relative decline' are linked to the industrialisation and the relative ascendance of emerging economies, recently the so called BRICs (Brazil, Russia, India, China) and the 'Next ones', such as the CIVETS (Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa) – an acronym coined by the Economist Intelligence Unit (EIU), and Goldman Sachs' 'Next Eleven' (Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, Philippines, South Korea, Turkey, and Vietnam); see Wilson and Stupnytska (2007) and O'Neill and Stupnytska (2010). In comparative political economy, de-industrialisation and 'relative decline' are in turn sometimes linked to secular theories of economic crises (Stafford, 1989). In this context we first provide a short background of theories of economic crisis and their hypothesised impact on internationalisation of production, and then focus on the impact of relative de-industrialisation tendencies between different groups of countries, and FDI inflows in emerging economies.

2.1. Background: the political economy of system-wide economic crises

The standing of the theory of economic crisis in mainstream 'neoclassical' and in international business economics is peculiar.[3] In mainstream neoclassical economic theory, economic crises theoretically cannot exist. If markets are perfectly competitive and the government does not fail and/or create problems with undue and misguided interventions, markets should allocate resources in a Pareto-efficient way. This is the 'first fundamental theorem of welfare economics', see Dasgupta (1986) for a critical account. In this context, crises can only emerge if there are 'policy errors'. Monetary economists, for example, such as Milton Friedman, have explained the Great Crash of 1929 in terms of such policy errors, notably the unduly restrictive monetary policy by the Federal Reserve (Friedman & Schwartz, 1963). Another possibility for economic crises arises from 'market failures'. Such failures can be the result of 'externalities' and/or imperfect market structures, such as oligopolies-monopolies (Kindleberger, 1988; Stiglitz, 2000). Transaction costs theorists, such as Ronald Coase (1960) and Kenneth Arrow (1963), generalised such failures in terms of high market transaction costs (Williamson, 1985). In their analysis, the optimal mix between the private and public organisation, is where the sum of transaction and organisational costs are minimal. Transaction cost reductions within and between countries can be a potent determinant of economic development (North, 1990; North, Wallis, & Weingast, 2006; Wallis & North, 2010). Political hazards in particular can impact on internationalisation and FDI (Henisz & Williamson, 1999; Henisz & Zelner, 2004).

At the macroeconomic level, market failures can be the result of insufficient 'effective demand' (Keynes, 1936). In the Keynesian tradition it is expected that such failures can be solved through appropriate government intervention, such as a fiscal stimulus. Therefore, here too the manifestation of crises can be viewed as the result of 'policy errors' (Bleaney, 1976). The fiscal stimulus packages adopted by many countries at the beginning of the recent recession were regarded by some as a vindication of Keynesian theory and prescriptions (Skidelsky, 2010). The subsequent 'austerity drive', instead, is motivated by the perception that sound finances, are sine qua non for resumed growth. Here too the current savage crisis is attributed to policy errors, in terms of the lack of fiscal discipline, the political business cycle, and/or corruption - in a word 'government failures' (Dow, 2008). The arguments by Bacon and Eltis (1976) that an increasing role of the state would tend to engender secular underperformance, due to

[2] Despite the rise of non-equity forms of cross-border operations by multinational enterprises (MNEs), see UNCTAD (2011), FDI remains important, not least in that it afford MNEs more power in shaping the rules of the game in host countries (Pitelis and Teece, 2010).

[3] 'Crisis' (from the Greek word 'κρίσις' meaning 'judgement') refers to an abrupt disruption ('judgement time') of economic activity. It differs from cyclical fluctuations in economic activity, the 'business cycle' (Kenway, 1987; Mullineux, 1990).

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