SCHOOL OF ECONOMICS
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THE ECONOMICS OF
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- Lecture 4

Location Advantages-Kojima

- 5 ways in which Kojima contributed to the theory of FDI

1. To return to a macroeconomic approach
2. Focused on models addressing the relevance of location factors and discussed whether industries in certain countries possessed comparative advantage.
3. Approach took a normative or evaluative position on FDI. Thus, various aspects of FDI are explicitly modelled.
4. His normative approach aimed at drawing conclusions and policy recommendations concerning FDI in LDCS.
5. Kojima's ideas on FDI relate to a dynamic theory of the international division of labour.

Summary of Kojima's argument

- FDI should originate in the outward investing countries' comparatively disadvantaged industries (i.e. least internationally competitive) industries and be into host countries where these same industries posses a potential (but not realized) comparative advantage.
- He avoids discussing about firms
- Discusses the competitive capability and potentials of the industry in the investing and host country

Case A of FDI analysis

- FDI flows from comparatively disadvantaged industries in C1 into C2 where same industries are potentially advantaged i.e. have potential to become internationally competitive but so far operate below their potential productivity levels.
- C1 takes to C2 in these industries the missing complementary factors (e.g. technology, managerial skills, etc.)
- Then FDI production in C2 brings into competitive use the country's under-utilized source of comparative advantage.
- FDI itself has been carried out in pursuit of productive efficiency of investing firms from C1. C1 firms supply same customers, e.g. back in C1 or in third country markets but at a lower production cost.
- This improves efficiency and enhances welfare.
- Costs are lowered so new and old customers enjoy a more affordable product.
- Industry profits increase
- FDI relocating production makes many participants better off.
- Customers in C1 buy products from C2 , trade is generated which is **"trade creating FDI".**

Case B of FDI analysis

- Kojima here discussed FDI from comparatively advantaged indsturies in C3 into the same industries in C4.
- C4 industries may or may not be comparatively advantaged. However, Kojima argues that in C4 indsturies are much less efficient and competitive than they are in C3.
- He assumes that FDI may provide some small improvement in the efficiency of the industries in C4. However, if this improvement that does occur will mean that the industry in C4 remains less competitive than in C3.
- Then instead of FDI exports from C3 to C4 would have been more efficient.
- We have a case of “trade destroying FDI” because production that would have been carried out at a lower cost in C3 is being carried out at a higher cost in C4.

Comparing the two models

- In Case A motive for FDI was to find new sources of competitive advantages
- In Case B is to defensively protect profit levels against some threat e.g. tariff barriers or some type of strategic decision.
- The limitation of the models is its macro-level analysis which can be resolved if we include micro-level factors i.e. firm level Oas.
- Core question is how can we have Case A, per se?

1. Sources of industry-specific competitive advantage are embodied in the country's firms in the industry.
2. The ability of the economy of the country to supply in a cost-effective form certain inputs (eg. L) needed by all firms in the industry to allow the competitive use of their firm-specific capabilities (Oas). These are Dunning's Las.

Interpretation of models

- In case A: C1's Las decline over time whilst the industries' firms retain their Oas. Thus firms in C1 can still be internationally competitive but C1 is a less efficient location to do so. Thus C1 firms move to C2 bringing their Oas and combining them with C2 Las.
- Back in C1 there is no "hollowing out" process as resources not used in C1 are redeployed either into higher-value parts of the same industry or into other growth industries. This is a process supported by government policies.
- If development process in both C1 and C2 occur effectively then Case A FDI leads to a "new international division of labour".

The real story behind Case A

- There were two real scenarios behind Kojima's cases back in the 1970s.
- Case A was Japan (C1) and the other Asian countries (C2) (e.g. NICs).

Post-war export-effective competitiveness in Japan was achieved by using low-cost labour in conjuction with standardized labour intensive technology to produce well-established mass-market consumer goods.

This success was based on: a. LAS (low labour cost) as macro-source of comparative advantage and b. OAS of firms who made use of LAS. Thus OAS reflected both industry and national background (home LAS). Eg possession of marketing of mass-market products, marketing network world wide to distribute large quantities of the goods.

Loss of LAS basically meant rise in wages in Japan

In the late 1960s other Asian countries were sources of low wages- and comparative advantage

There was thus an effective complementarity between Japanese firms OAS and Asian countries LAS.

As we have transfer of technology from a DC to an LDC the fact that this transfer occurs in the industry that C1 has lost its comparative advantage, is easier to be assimilated by C2 and this could allow C2 to move upwards to the next step in technological evolution by a second wave of FDIs

Thus, we have an orderly technology transfer and a natural development process.

The real story behind Case B

- Case B was FDI by USA firms after the Second World War.
- No loss of comparative advantage in the US. Supply of foreign markets through exports still viable.
- FDI occurred because of trade restraints or as part of a strategic plan in oligopolistic and concentrated markets.
- Defensive reaction to threats of profitability but not because of loss of efficiency of production in the US.
- If US FDI goes to other DCs it might upgrade technology used there …in a however **marginal way** and industry there will not become more efficient compared to the US.
- **When US goes to LDCs this would generate a disorderly technology transfer** as this technology will be inappropriate to the countries developmental needs as this technology will be capital intensive, skill-intensive and thus irrelevant to the host countries' (LDCs) type of potential comparative advantage.

The role of LAS, an interpretation

- LAS can have normative or welfare implications. Thus they can be either positive or negative
- **Positive LAs** are generated when MNEs activities are expected to improve efficiency (lower costs).
- There is complementarity between MNEs' OAS (mobile internationally) and host-country LAS (not mobile in practice) (see mass relocation of cheap labour to Gulf countries from India, Nepal, etc….).
- **Negative LAS** occur then there is a transfer of OAS from a more efficient to a less efficient location in order to defend market and protect profitability.
- **This leads to a lowering of trade and an overall decline in welfare.**