

Changes in Trade Policies and the Heterogeneity of Domestic and Multinational Firms' Strategic Response: The Effects on Firm-Level Capabilities

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Summary. — After the Multi-Fiber Agreement ended in 2005, most Asian-owned subsidiaries exited the Mauritius export processing zone (MEPZ), while most European-owned subsidiaries and domestic firms remained and further integrated their presence in the MEPZ. Based on the heterogeneity of their strategic response to changes in trade policies, we hypothesize that Asian-owned subsidiaries did not, during their operating life-time in the MEPZ, actively engage in creating technological capabilities when compared to their European-owned and domestic counterparts. Our results support our hypothesis and we discuss their serious implications for other Sub-Saharan African textile-based EPZs in connection to the African Growth and Opportunity Act.
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1. INTRODUCTION

There is existing evidence of a strong correlation between growth in the export processing zones (EPZs) and the Multi-Fiber Agreement¹ (MFA) as a result of foreign direct investment (FDI) flows into these zones by those who circumvented textile quotas for over 30 years (Jayanthakumar, 2003). Similarly, much has been written about the potential winners and losers of the MFA dismantling in 2005 and the general consensus is that Asian countries will benefit the most and at the expense of other developing countries (Appelbaum, 2004; Bair, 2008; Broadman, 2007; Cammett, 2007; Cling, Razafindrakoto, & Roubaud, 2005; Kaplinsky & Morris, 2008; Lall & Albaladejo, 2004; Loo, 2002; Martin, Kathuria, & Bhardwaj, 2001; Mattoo, Roy, & Subramanian, 2003; Nordas, 2004; Terra, 2001; UNCTAD, 2003)

Similarly, the World Bank (WIR, 2006: 45) reported that, “In recent years, countries such as Kenya, Lesotho, Mauritius and Uganda had begun to receive FDI in their textile and apparel industry, in part under the African Growth and Opportunity Act (AGOA), but the trend changed following the end of MFA quotas in 2005. A number of TNCs in that industry in Africa have been relocating. In Mauritius, there was a 30% decline in the volume of garments manufactured in 2005 following the departure of some Hong Kong (China) companies. In Lesotho, six textile firms closed, leaving 6,650 garment workers jobless.”

The World Bank infers that,

“This shows that the value of preferential market access is limited when domestic production capabilities are inadequate. Barring a few countries such as Egypt and South Africa, most African countries lack linkages between foreign TNCs and local enterprises, and their efforts to promote regional integration have been too limited to allow economies of scale.”

We argue that the above inference does not fully apply to the case of the textile and apparel industry in Mauritius. The end of the MFA and the simultaneous phasing out of prefer-

ential trade agreements (PTAs) with Europe should have entailed serious capital flight by all textile investors—Asian, European, and domestic—from the Mauritius Export Processing Zone (MEPZ). However, our data show that these events only coincided with considerable exit and capital flight by Asian-owned subsidiaries from the MEPZ. Furthermore, there is evidence of increasing expansion and regionalization process (Kaplinsky & Morris, 2008) post-MFA, in the textile industry by both European-owned subsidiaries and domestic MEPZ firms. These events are in line with the literature on hysteresis and trade policies, whereby temporary trade arrangements entail permanent shifts in the location of production. It was initially argued that economic systems could contain hysteresis, making economic processes path-dependent (e.g., Layard, Nickell, & Jackman, 1991; Soskice & Carlin, 1989) and eventually the approach gained recognition within labor market theories (Gottfries & Horn, 1987; Lindbeck & Snower, 1988), while Baldwin (1989), Baldwin and Krugman (1989) and Dixit (1989, 1989a) showed how exchange rate fluctuations could produce persistent effects on foreign trade flows. Similarly, the infant industry case for trade protection is based on the notion that temporary assistance at an early stage will have lasting favorable effects on an industry due to the presence of learning curves and/or sunk costs (Greaney, 2000).

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Thus, in the case of the MEPZ, six years after the protective effects of the MFA and PTAs ended, the presence of European-owned subsidiaries and domestic firms persists.

So the question then becomes: if the strategic response of domestic firms and European-owned subsidiaries to stay in, and of Asian-owned subsidiaries to flee from the MEPZ post-MFA was anticipated, then would that be reflected in their efforts to create local technological capabilities² (TCs)? We conjecture that if Asian-owned subsidiaries were set up in the MEPZ with the short-term strategic aim of circumventing MFA quotas and benefitting from duty-free access to Europe, then those subsidiaries would not have engaged in actively upgrading and painstakingly creating long-term sustainable TCs to the same extent as did European-owned subsidiaries and domestic firms. In the same vein, if European-owned subsidiaries and domestic firms had the strategic intention of remaining, post trade liberalization, within the MEPZ, then their TCs would be higher than those of Asian-owned subsidiaries by the time the MFA and PTAs were phased out.

The empirical evidence in this study demonstrates that, just prior to the mass Asian capital exodus from the MEPZ in 2005, the level of created TCs for Asian-owned subsidiaries was significantly lower than that of European-owned subsidiaries and domestic firms. As a central contribution, we argue that some firms which evolve under specific trade regimes, namely those governed by PTAs, do not engage in TC upgrade due to their strategic intention to exit the host-country once those regimes are dismantled. For development economics and firm capabilities research, this proposition suggests a need to revisit the basic premise that firms which fail to upgrade their capabilities do so due to some technological trap or due to some inherent weakness in their innovative structural environment. Secondly, our research raises another debate. Comparative studies within the developing country context in which foreign subsidiaries have been found to have lower TCs than domestic firms have systematically overlooked a possible cause behind such lack of technological development, associated with cases in which the anticipated mobility of the international location of production is high rather than low. In this connection, we address TC development, or lack of, in both categories of firms and we argue that, especially in the case of Africa and PTA-induced inward FDI such as the current African Growth and Opportunity Act³ (AGOA), overlooking such factors behind limited TC development in foreign subsidiaries can have serious long-term implications.

The structure of the paper is as follows: Section 2 provides a review of comparative studies between the TCs of foreign subsidiaries and domestic firms; Section 3 presents an overview of the MEPZ background and our main hypothesis; Section 4 explains the analytical framework of the study; Section 5 describes the data, methodology and variables; Section 6 presents and discusses the results of the study and presents the case of a domestic firm and an Asian-owned subsidiary; Section 7 concludes the paper with emphasis on the implications of the study.

2. COMPARATIVE STUDIES ON TCS OF FOREIGN SUBSIDIARIES AND DOMESTIC FIRMS

Over the last two decades, much research has been carried out on the innovative TCs of developing country firms. This, unlike previous related strands of research, is primarily focused on incremental innovations by developing country firms which are on, or behind, the technological frontier instead of major Schumpeterian breakthroughs in the technological fron-

tier. Thus, TC of the firm refers to the resources needed to generate and manage technological change (Bell & Pavitt, 1995) and involves technology-changing skills, knowledge, and experience which are different and more advanced than those needed to operate existing systems. Considering the country focus of our study, the following literature review is limited to those on firm-level TCs and not innovation, as well as the developing country context and not the developed country context.

The axiomatic consensus from existing theoretical and empirical literature is that in order to create higher levels of TCs, firms need to move beyond “elementary learning” (Lall, 1980) and “passive learning-by-doing” (Bell & Pavitt, 1995) as witnessed during the early stages of industrial development and constantly improve techniques by actively engineering technical and organizational change.

One emerging trend in the research on the determinants of TCs is that they increasingly involve a comparison between foreign subsidiaries and domestic firms located in developing countries. This research stream has focused on factors such as the size, age, and skills intensity of firms, general education and formal education of employees, as well as in-house training and external technical assistance and their effect on TCs of firms (e.g., Deraniyagala & Semboja, 1999; Rasiah, 2004, 2005, 2006; Romijn, 1997; Westphal, Kritayakirana, Petchsuvan, Sutabutr, & Yuthavong, 1990; Wignaraja, 1998, 2002, 2008).

In these studies, when domestic firms are found to have low levels of TCs or have failed to progress to higher levels of TCs, the causes are attributed to three common technological traps. These are (i) the reality that technological learning processes are costly and, therefore, not within the reach of all domestic firms, (ii) the misperception that technological learning processes are automatic, and/or (iii) an endemic weakness in the innovative structural environment of the developing country's firms. Similarly, the literature states that these traps cannot be broken without the support of appropriate government policies.

Regarding the few comparative studies where foreign subsidiaries and domestic firms are technologically on par, or where domestic firms have higher TCs, one common lacuna has been observed. None of the studies explained the possible causes behind foreign subsidiaries' limited technological development. These include firstly a study on foreign subsidiaries and domestic firms in the electronics industry of Malaysia, Philippines, and Thailand, which showed that foreign subsidiaries generally produced higher human resource and process technology capabilities than domestic firms in Malaysia and Thailand (Rasiah, 2004a). Although foreign subsidiaries were generally endowed with higher R&D capabilities in Malaysia and Thailand, domestic firms enjoyed higher TCs than foreign subsidiaries in the Philippines. Secondly, there is evidence from South Africa's auto parts, electronics, food, pharmaceutical, and garment industries (Rasiah, 2006). The evidence is also mixed whereby foreign subsidiaries enjoyed higher overall technology, process, and R&D intensities than domestic firms in pharmaceuticals and higher process and R&D intensities than domestic firms in garments. Domestic firms, on the other hand, enjoyed higher skills and process technology intensities and invested more in training than foreign subsidiaries. Thirdly, a cross-sectional study of Brazilian electronics and textiles and garments industries, showed foreign subsidiaries had high levels of product and process related capabilities but domestic firms enjoyed a higher incidence of patent take-up than foreign subsidiaries (Rasiah, 2004b). These three aforementioned studies mention the government and

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