Foreign Direct Investment Theories: An Overview of the Main FDI Theories

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Abstract

Foreign Direct Investment (FDI) acquired an important role in the international economy after the Second World War. Theoretical studies on FDI have led to a better understanding of the economic mechanism and the behavior of economic agents, both at micro and macro level allowing the opening of new areas of study in economic theory.

To understand foreign direct investment must first understand the basic motivations that cause a firm to invest abroad rather than export or outsource production to national firms. The purpose of this study is to identify the main trends in FDI theory and highlight how these theories were developed, the motivations that led to the need for new approaches to enrich economic theory of FDI. Although several researchers have tried to explain the phenomenon of FDI, we cannot say there is a generally accepted theory, every new evidence adding some new elements and criticism to the previous ones.

Keywords: foreign direct investments, internalization theory, eclectic paradigm

JEL Classification: E60, F21

Introduction

Nowadays the issue of foreign direct investments is being paid more attention, both at national and international level. There are many theoretical papers that examine foreign direct investments (FDI)'s issues, and main research on the motivations underlying FDI were developed by J. Dunning, S. Hymer or R.Vernon. Economists believe that FDI is an important element of economic development in all countries, especially in the developing ones.

The conclusion reached after several empirical studies on the relationship between FDI and economic development is that the effects of FDI are complex. From a macro perspective, they are often regarded as generators of employment, high productivity, competiveness, and technology spillovers. Especially for the least developed countries, FDI means higher exports, access to international markets and international currencies, being an important source of financing, substituting bank loans.

There is some evidence to support the idea that FDI promote the competitiveness of local firms. Blomstrom (1994) finds positive evidence in Mexico and Indonesia, while Smarzynska (2002) found that local suppliers in Lithuania benefited spill over from supplying foreign customers.

Caves (1996) considers that the efforts made by various countries in attracting foreign direct investments are due to the potential positive effects that this would have on economy. FDI would increase productivity, technology transfer, managerial skills, know-how, international production networks, reducing unemployment, and access to external markets.

Borensztein (1998) supports these ideas, considering FDI as ways of achieving technology spillovers, with greater contribution to the economic growth than would have national investments. The importance of technology transfer is highlighted also by Findlay who believes that FDI leads to a spillover of advanced technologies to local firms (Findlay, 1978).

On the other hand, FDI may crowd out local enterprises and have a negative impact on economic development. Hanson (2001) considers that positive effects are very few, and Greenwood (2002) argues that most effects would be negative. Lipsey (2002) concludes that there are positive effects, but there is not a consistent relationship between FDI stock and economic growth. The potential positive or negative effects on the economy may also depend on the nature of the sector in which investment takes place, according to Hirschman (1958) that stated the positive effects of agriculture and mining are limited.

When multinational corporations enter different foreign markets it is market failures that attract FDI and give them the advantage in those markets. Foreign investors consider that their superior technology and knowledge will give them the opportunity to obtain market share.

Despite the fact that many researchers have tried to explain the phenomenon of FDI, we cannot say there is a general theory accepted. But, according to Kindleberger (1969) everyone agrees on one point, in a world characterized by perfect competition, foreign direct investment would no longer exist.

Thus, if markets work effectively and there are no barriers in terms of trade or competition, international trade is the only way to participate to the international market. There must be a form of distortion that determines the realization of direct investment, and Hymer was the first who noticed this. He believes that always local firms will be better informed about local economic environment, and for foreign direct investments to take place, two conditions are necessary:

- foreign firms must possess certain advantages that allow them that such an investment to be viable;
- the market of these benefits has to be imperfect (Kindleberger, 1969).

From a macroeconomic point of view, FDI is a particular form of capital flows across borders, from countries of origin to host countries, which are found in the balance of payments. The variable of interest is: capital flows and stocks, revenues obtained from investments.

The microeconomic point of view, tries to explain the motivations for investment across national boundaries from the point of view of the investor. It also examines the consequences to investors, to the country of origin and to the host country, of the operations of the multinationals rather than investment flows and stock. (Lipsey, 2001)

In the period immediately following the Second World War, international production was a small part of international affairs, while the attention was directed towards those components which had an important share (e.g. international trade). Since the 1960s, the phenomenon of transnational corporations and FDI has begun to gain importance.

The first attempt to explain the FDI was considered Ricardo's theory of comparative advantage. However, FDI cannot be explained by this theory, which is based on two countries, two products and a perfect mobility of factors at local level. Such model could not even allow FDI. Thus, as Ricardo's comparative advantage theory fail to explain the rising share of FDI, other models were used, such as portfolio theory. This attempt was designed to fail, because the theory explains the achievement of foreign investments in a portfolio, but could not explain the direct investments. According to the theory, as long as there is no risk or barriers in the way of capital movement, the capital will go from countries with low interest rates to countries with high interest rates. But these allegations have no basis in reality, and the introduction of risk and barriers to capital movement erodes the veracity of the theory, and capital can move freely in any direction (Hosseini 2005).

Although more realistic, the new theories of international trade still cannot capture the entire complexity of FDI and other forms of international production. The new theories of international trade, still cannot explain foreign direct and other forms of international investment (Hosseini 2005).

Robert Mundell has tried to explain the FDI through a model of international trade, involving two countries, two goods, two production factors and two identical production functions in both countries, where production of a good requires a higher proportion of a factor than the other. Neither Mundell's model could explain international production through FDI, because foreign investment incorporated were portfolio investment or short-term investment (Mundell, 1957).

Japanese researchers Kojima and Ozawa have tried to create a model to explain both international trade and foreign direct investment. They started from the model developed by Mundell and tried to develop it and improve it. Thus, in the model developed by the two Japanese FDI takes place if a country has comparative disadvantage in producing a product, while international trade is based on comparative advantage. (Kojima and Ozawa, 1984).

Internalisation theory provides an explanation of the growth of the multinational enterprise (MNE) and gives insights into the reasons for foreign direct investment.

Theories of FDI may be classified under the following headings:

1. **Production Cycle Theory of Vernon**

Production cycle theory developed by Vernon in 1966 was used to explain certain types of foreign direct investment made by U.S. companies in Western Europe after the Second World War in the manufacturing industry.

Vernon believes that there are four stages of production cycle: innovation, growth, maturity and decline. According to Vernon, in the first stage the U.S. transnational companies create new innovative products for local consumption and export the surplus in order to serve also the foreign markets. According to the theory of the production cycle, after the Second World War in Europe has increased demand for manufactured products like those produced in USA. Thus, American firms began to export, having the advantage of technology on international competitors.

If in the first stage of the production cycle, manufacturers have an advantage by possessing new technologies, as the product develops also the technology becomes known. Manufacturers will standardize the product, but there will be companies that you will copy it. Thereby, European firms have started imitating American products that U.S. firms were exporting to these countries. US companies were forced to perform production facilities on the local markets to maintain their market shares in those areas.

This theory managed to explain certain types of investments in Europe Western made by U.S. companies between 1950-1970. Although there are areas where Americans have not possessed the technological advantage and foreign direct investments were made during that period.

2. The Theory of Exchange Rates on Imperfect Capital Markets

This is another theory which tried to explain FDI. Initially the foreign exchange risk has been analyzed from the perspective of international trade. Itagaki (1981) and Cushman (1985) analyzed the influence of uncertainty as a factor of FDI. In the only empirical analysis made so far, Cushman shows that real exchange rate increase stimulated FDI made by USD, while a foreign currency appreciation has reduced American FDI. Cushman concludes that the dollar appreciation has led to a reduction in U.S. FDI by 25%.

However, currency risk rate theory cannot explain simultaneous foreign direct investment between countries with different currencies. The sustainers argue that such investments are made in different times, but there are enough cases that contradict these claims.

3. The Internalisation Theory

This theory tries to explain the growth of transnational companies and their motivations for achieving foreign direct investment. The theory was developed by Buckley and Casson, in 1976 and then by Hennart, in 1982 and Casson, in 1983. Initially, the theory was launched by Coase in 1937 in a national context and Hymer in 1976 in an international context. In his Doctoral Dissertation, Hymer identified two major determinants of FDI. One was the removal of competition. The other was the advantages which some firms possess in a particular activity (Hymer, 1976).

Buckley and Casson, who founded the theory demonstrates that transnational companies are organizing their internal activities so as to develop specific advantages, which then to be exploited. Internalisation theory is considered very important also by Dunning, who uses it in the eclectic theory, but also argues that this explains only part of FDI flows.

Hennart (1982) develops the idea of internalization by developing models between the two types of integration: vertical and horizontal.

Hymer is the author of the concept of firm-specific advantages and demonstrates that FDI take place only if the benefits of exploiting firm-specific advantages outweigh the relative costs of the operations abroad. According to Hymer (1976) the MNE appears due to the market imperfections that led to a divergence from perfect competition in the final product market. Hymer has discussed the problem of information costs for foreign firms respected to local firms, different treatment of governments, currency risk (Eden and Miller, 2004). The result meant the same conclusion: transnational companies face some adjustment costs when the investments are made abroad. Hymer recognized that FDI is a firm-level strategy decision rather than a capital-market financial decision.

4. The Eclectic Paradigm of Dunning

The eclectic theory developed by professor Dunning is a mix of three different theories of direct foreign investments (O-L-I):

1) “O” from Ownership advantages:

This refer to intangible assets, which are, at least for a while exclusive possesses of the company and may be transferred within transnational companies at low costs, leading either to higher incomes or reduced costs.

But TNCs operations performed in different countries face some additional costs. Thereby to successfully enter a foreign market, a company must have certain characteristics that would triumph over operating costs on a foreign market. These advantages are the property competences or the specific benefits of the company. The firm has a monopoly over its own specific advantages and using them abroad leads to higher marginal profitability or lower marginal cost than other competitors. (Dunning, 1973, 1980, 1988).

There are three types of specific advantages[9]:

a) Monopoly advantages in the form of privileged access to markets through ownership of natural limited resources, patents, trademarks;

b) Technology, knowledge broadly defined so as to contain all forms of innovation activities

c) Economies of large size such as economies of learning, economies of scale and scope, greater access to financial capital;

2) “L” from Location:

When the first condition is fulfilled, it must be more advantageous for the company that owns them to use them itself rather than sell them or rent them to foreign firms.

Location advantages of different countries are de key factors to determining who will become host countries for the activities of the transnational corporations.

The specific advantages of each country can be divided into three categories[10]:

a) The economic benefits consist of quantitative and qualitative factors of production, costs of transport, telecommunications, market size etc.

b) Political advantages: common and specific government policies that affect FDI flows

c) Social advantages: includes distance between the home and home countries, cultural diversity, attitude towards strangers etc.

3) “I” from Internalisation:

Supposing the first two conditions are met, it must be profitable for the company the use of these advantages, in collaboration with at least some factors outside the country of origin (Dunning, 1973, 1980, 1988).

This third characteristic of the eclectic paradigm OLI offers a framework for assessing different ways in which the company will exploit its powers from the sale of goods and services to various agreements that might be signed between the companies. As cross-border market Internalisation benefits is higher the more the firm will want to engage in foreign production rather than offering this right under license, franchise.

Eclectic paradigm OLI shows that OLI parameters are different from company to company and depend on context and reflect the economic, political, social characteristics of the host country. Therefore the objectives and strategies of the firms, the

[9] http://www.investmentsandincome.com/investments/oli-paradigm.html)
[10] http://www.investmentsandincome.com/investments/oli-paradigm.html

magnitude and pattern of production will depend on the challenges and opportunities offered by different types of countries.[11]

Conclusions

All the empirical results reveal that for FDI there is not a unified theoretical explanation, and it seems at this point very unlikely that such a unified theory will emerge.

Neoclassical trade theory failed to explain the existence of Multi National Corporations. Explanations in terms of differences in rates of return between countries could explain portfolio investments, but foreign direct investments (FDI). It was not until Hymer presented his work, in 1960, of foreign direct investments and multinational enterprises that a satisfying explanation was at hand.

After all these different attempts to explain why FDI take place and the pioneering work by Hymer (1976), the conceptual framework used until very recently was the one proposed by Dunning (1977), the OLI paradigm.

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