TOPIC 1B: DETERMINANTS AND THEORIES OF FOREIGN DIRECT INVESTMENT (FDI)

1. FDI is a feature of a broader economic phenomenon referred to as internationalization.
2. Internationalization relates to the organization of economic activities in an international perspective and may be defined as the phenomenon of creating and sustaining linkages by economic actors in one country with economic actors in other countries throughout the world.
3. These linkages can be manifold, but it is convenient to group them into three categories: (I) international trade; (II) non-equity agreement; and (III) FDI.
4. In the international trade mode, the relationship between a firm and another economic entity is limited to selling or buying of goods or services. The firm may export its output to entities in foreign markets. The company may also import its inputs from a foreign entity.
5. The attractiveness of the trade mode lies in the limited responsibility between a firm and a foreign entity. The foreign entity needs only to pay the bill for the delivery of the goods or services. Or, in the case of input provision, the firm is able to order from another firm next time if the foreign entities deliveries are not satisfactory.
6. A non-equity agreement is a mode of going international in which a firm has no or limited equity involvement in the foreign entity.
7. The most commonly known types are licensing and franchising in which a firm sells technical and/or managerial knowledge about particular activities to foreign firms.
8. Various strategy considerations may be at the basis of a non-equity agreement.
9. A firm may want to sell its goods and services but may not have sufficient production capacity at home or may not have the financial resources to invest in new capacity. It may also judge investing in the foreign market too risky. Another possibility is that trade and investment barriers block other modes of internationalization.
10. By licensing knowledge regarding the production of certain goods or services to a foreign entity, the firm is able to avoid the need for capacity increases or the perceived investment risks. In general, the foreign entity producing the good or service with the firm’s consent pays a fee for using this knowledge (e.g., a licence fee).
11. FDI is commonly regarded as a far-reaching form of internationalization. In essence, it is similar to the non-equity agreement mode. The primary distinctive feature of FDI is control over the management of another firm abroad. In most cases, the equity involvement is a majority share.
12. FDI may be motivated by strategy considerations similar to those for non-equity agreements. Selling in the foreign market may be attractive, but natural or political barriers may block access to this market via trade.
13. In addition, reasons for preferring the control feature determine the choice of the FDI mode. A firm may want to exert full or extensive control over the foreign operations, such as the distribution and sales of its goods or services in the foreign market. Similarly, a firm may want to secure the input provision for is production process.
14. As indicated previously, a firm may choose from two ways of FDI. It may either create a local production facility by setting up a new facility (greenfield investment), or it can take over an existing facility (merger or acquisition/takeover investment). This choice is again based on various strategy considerations.
An advantage of a greenfield investment may be that new production capacity may be created, which is fully consistent with corporate structure’s needs.

In the case of a merger or an acquisition, the firm may be able to strengthen its existing ownership advantages by combining them with attractive assets of a foreign entity.

Two important decisions thus need to be made by a firm that wants to internationalize.

The first one is the decision where to produce: production in the home country versus production in the host country.

The second decision relates to the extent of control needed over the economic activity in the host country.

International trade: production location is in home country for output, in host country for input; extent of control in host country is none.

Non-equity agreement: production location is in host country; extent of control in host country is none or limited.

FDI: production location is in host country; extent of control in host country is substantial/full.

Many strategy considerations and assessments of (potential) market revenues and (future) production and transaction costs are at the basis of these decisions.

Changes in the firm’s environment may necessitate a switch from one mode to another.

It is often assumed that FDI ultimately replaces production in and export from the country.

However, this need not be the case as FDI can be trade creating rather than trade destroying (i.e., FDI and international trade can be complementary activities). This occurs when the transfer of production to the host economy allows both countries to specialize in goods and services in which they enjoy comparative advantages.

The first attempts to explain in theoretical terms why FDI takes place emerged in the 1960s, just as FDI flows began to increase in volume. Before this rise in interest, FDI was treated as part of neoclassical capital theory, but that posed two problems.

FDI is more than just the transfer of capital, since just as importantly it involves the transfer of technology, organizational, and management skills.

Second, the resources are transferred within the firm rather than between two independent parties in the marketplace, as is the case with merely financial capital.

A more elaborate theoretical framework thus is needed to account for FDI.

I. Theories assuming perfect markets:
   Ia. Differential rates of return: Until the 1960s, FDI was largely assumed to exist as a result of international differences in rates of return on investment, with capital moving across countries in search of higher rates of return. FDI was consequently treated in the same way as FPI. This assumption was not supported by the facts.
   Ib. Portfolio diversification: The search for an alternative explanation of FDI soon shifted to portfolio diversification theory. It was asserted that MNEs do not consider just the rate of return on investment but also the risk involved. Since the returns to be earned in different foreign markets are unlikely to be correlated, the international diversification of an MNE’s investment portfolio would reduce an overall risk to the investor. Again, no strong empirical support was found for this hypothesis.
   Ic. Market size: The market size hypothesis, which has its roots in neoclassical investment theory, focuses on the role of both the absolute size of the host-country’s market and its growth rate. The hypothesis states that the larger the market, the more efficient the
utilization of investors’ resources is and, consequently, the greater the potential to lower production costs through the exploitation of scale economies. There is adequate empirical support for this hypothesis.

32. II. Theories assuming imperfect markets:

IIa. Market structure/industrial organization: The market structure/industrial organization theory is based on the idea that, due to market imperfections, some firms enjoy advantages/market power vis-à-vis competitors. These advantages (including brand name, managerial skills, organizational know-how, patents, superior technology, and the like) allow such firms to obtain rents in foreign markets that more than compensate for the inevitable initial disadvantages (e.g., inadequate market knowledge) to be experienced when competing with local firms within the unfamiliar environment. Firms thus invest abroad to capitalize on such advantages. While there is some empirical support for this hypothesis, it is not clear why firms need to engage in FDI to capitalize on their advantages when cheaper forms of expansion (e.g., exporting) would allow them to compete equally successfully in international markets.

IIb. Internalization: The theory states that the operations of firms, particularly large ones, take the form not only producing goods and services, but also activities such as distribution, financial management, human resource management, logistics, marketing, research development, and the like. These activities are interdependent and are connected through intermediate products, taking the form of either material products or knowledge or expertise. Since markets for intermediate products are difficult to organize, such activities can be handled more efficiently within the firm, by an internal hierarchy rather than an external market. The creation of an internal market brings these activities under the direct ownership and control of the firm. The internalization of markets across borders results in MNEs. International production is not just the transfer of capital but the extension of control over foreign subsidiaries. Management replaces the market in allocating resources. The primary incentives to internalize activities are to avoid the disadvantages (or capitalize on the advantages) of imperfections in external mechanisms of resource allocation. From a strategic viewpoint, firms must possess superior resources but they must also have the motivation and ability to profit from possession of these advantages.

IIc. Appropriability: This theory is similar to its internalization counterpart. Appropriability refers to the desire to keep (retain for itself) the ideas that originate within the firm. Such ideas are often based on a firm’s unique information and technology. The result is that such appropriability becomes particularly important in industries where new product development takes place on a continuing basis. Appropriability provides an incentive to choose direct investment as the mode of choice.

IId. Product life-cycle: The theories outlined above do not indicate when and where the specific advantages of FDI would be exploited. This is the purpose of the product- life-cycle theory. According to this theory, a product has a life-cycle that has three principal stages. Stage one: Product development process. The nature of the product the firm is making is not standardized. The lack of standardization means that there is uncertainty surrounding the product. Consequently, close communication between producers, suppliers, distributors, and customers is of utmost importance. This leads to a location decision that results in the product being situated near to its markets. Stage two: Maturing product. As demand for the product increases it moves through the product cycle to a greater degree of standardization.
This means that the need for the product to be situated near to its markets declines, which allows for economies of scale. This typically coincides with increase in demand for the product in other countries and a decision needs to be made whether, in order to take advantage of economies of scale and be closer to new customers, to set up production abroad. This decision depends on the degree of competition abroad, whether firms in the foreign country have patented the product, and if there is a high level of tariffs. If the firm decides to set up a plant abroad and if labor costs there are lower, then this will lead to the foreign location being the most cost-efficient plant. This could even mean that the home country is having products exported back to it from the foreign plant. The investment may also precipitate further investment into the country by the firm’s rival as they try to avoid a loss of their market share. Stage three: Standardized product. This is an extension of the maturing product stage, where the standardization of the product has reached its zenith, and a final framework of the product has been found. The international market is now well established and sales are determined by price competition. The low cost of production in developing countries may provide an incentive for firms to reduce costs further and set up in these areas. This argument may also apply to underdeveloped regions of developing countries, so that in principle the multinational firm could set-up anywhere in the world. The product life-cycle theory looks at the dynamic process of FDI in terms of why, when, and where it occurs. However, it is difficult to reconcile with the fact that FDI flows have primarily been between developed countries.

IIe. Uppsala internationalization model and psychic distance: The product life-cycle theory identified income and cost levels of would-be host countries as the key to affecting firms’ ability to expand internationally. However, work conducted by a group of Scandinavian researchers at Uppsala University questioned the explanatory power of the product cycle theory by emphasizing the limited knowledge of the individual investing firm as the most significant determinant. In examining the increasing outward involvement of Swedish firms, the researchers identified a four-stage sequence leading to international production. Firms begin by serving the domestic market, and then foreign markets are penetrated through exports. After some time, sales outlets are established abroad until finally foreign production facilities are set up. The researchers argued that this stepwise, evolutionary development is based on the gradual acquisition of knowledge of the foreign market, and use of foreign sources of intelligence. It is this process of incremental, experiential learning that justifies and determines successively greater levels of commitment to foreign markets. The researchers also observed that the typical FDI pattern of the Swedish firms was that they first set up foreign production facilities in one of the closest Nordic countries, such as Norway. Later on, they established subsidiaries in countries such as Germany, Holland, and the UK. And only then, if successful, they would venture into “psychically distant” markets. Although the concept of “psychic distance” can be traced to the mid-1950s, its use in this context was operationalized in terms of uncertainty about would-be host markets due to differences in culture, language, and levels of education and economic development. Still, this pattern does not seem to be universally followed and it is increasingly common to see firm that are” born global.”

IIIf. Eclectic approach: Dissatisfied with fragmentation of previous explanations of FDI, Dunning’s search for a generalized framework capable of integrating the existing hypotheses resulted in the eclectic theory, later renamed paradigm, of international production.
Dunning’s framework states that firms engage in FDI if conditions of ownership, location, and internalization (OLI) are satisfied. Ownership advantages (e.g., brand name) may give a firm competitive advantage vis-a-vis rivals. However, this approach distinguishes between asset-based advantages, which arise from propriety ownership of specific assets, and transaction-based advantages, which can only be gained if internalized. If the possession of ownership advantages offers internalization incentives across countries, and if there are additional location-specific factors which favor overseas production over production at home (e.g., access to natural endowments, lower factor costs, and the like), then the three conditions of FDI are satisfied.

33. Other theoretical considerations
I. Level and variability of exchange rate (weak exchange selectively positive influence, variability negative influence).
II. Socio-political instability (negative influence).
III. Export orientation, openness to trade, and tariff jumping (desire to avoid tariffs; positive influences)
IV. Wage costs and labor skills (low costs, coupled with adequate skills, selectively positive influence).
V. Government incentives (could be either way): Governments have rarely held a neutral position toward FDI. Some governments, perceiving the net benefits to be negative, have sought to restrict inward investment through the establishment of various protectionist barriers, which have ranged from slow processing of authorizations for FDI to its outright prohibition. Other governments, on the other hand, have offered incentives in order to attract MNEs. Since the mid-1980s, there has been a drastic shift in policy toward the latter approach, with many countries that had traditionally opted for widespread controls on FDI engaging in radical reforms of their investment regimes aimed at facilitating and promoting inward investment through incentives. These incentives include, in addition to more liberal operating conditions, fiscal benefits, such as tax concessions, and financial benefits, such as grants and subsidized loans. Some governments also provide less transparent benefits, such as public sector investment on specific infrastructure likely to raise the expected returns from a given investment project (selectively positive influence; however, no tangible impact when incentives are offered, or are perceived to be offered, for continuing comparative disadvantages of the home country).