Theories of foreign direct investment (fdi)

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This assignment tries to discuss various theories concerning foreign direct investment and give the statement as to whether the theories provide a successful explanation of the main determinants of such activity

In real sense the main theories of FDI does not provide successful explanation of the main determinants for such activity, as explained by Dunning and Lundan (2008: 81) Multinational Enterprises and Global Economy 2nd Edition.

Definition of foreign direct investment

According to Graham and Spaulding (website information) direct foreign investment in its classical definition is defined as the company from one country making physical investment into building a factory to another country. Foreign direct investment (FDI) plays an extraordinary and growing role in global business. It can provides a firm with new markets and marketing channels, cheaper production facilities, access to knew technology, products, skills and financing. For a host country or the foreign firm which receives the investment, it can provide a strong impetus to

economic development. The direct investment in building, machinery and equipment is in contrast with making a portfolio investment, which is considered an indirect investment. In recent years, given rapid growth and change in global investment patterns, the definition has been broadened to include the acquisition of lasting management interest in a company or enterprise outside the investing firm's home country. As such, it may take many forms, such as a direct acquisition of a foreign firm, construction of a facility, or investment in a joint venture or strategy alliance with a local firm with attendant input of technology, growing, licensing of

Ewe-Ghee Lim (web information) The paper tells about two aspects of direct foreign investment (FDI): its correlation with economic growth and its determinants. The first part focuses on positive spillovers from FDI while the second deals with the determinants of FDI. The paper finds that while substantial support exists for positive spillovers from FDI, there is no consensus on causality. On determinants, the paper finds that market size, infrastructure quality, political/economic stability, and free trade zones are important for FDI, while results are mixed regarding the importance of fiscal incentives, the business/investment climate, labour costs, and openness.

Dunning (1993: 3), explain that there is less disagreement about

FDI THEORIES globalisation as a process of towards the widening of the extent and form of cross-border transactions; and the deepening of the economic interdependence between the actions of globalising entities located in other countries.

The FDI theories explain the reason why FDI occurs and the determinants of FDI. The theories have traditionally emphasises market imperfection

(Hymer, 1960; Kindlebeger, 1969) and firm specific advantages or ownership advantages derived from the ownership of intangible assets such as technologies, management skills, and organisational capabilities (Caves, 1971). Hymer's market imperfections theories suggested that a firm may have certain advantage that may be generated from the fields of technology, management or marketing

A. L Calvet (1981: 43-59) Journal of International Business Study (hhtp://teaching. ust. hk/ Accessed on 07. 11. 2009. He assert that Kindleberger provided the first comprehensive survey of the various theories of foreign direct investment along with the lines expressed by Hymer. He approached the question of direct investment from the standpoint of the perfectly competitive model of neoclassical economics by asserting that in a world of pure competition direct investment could not exist. Kindleberger (1969, p13) Indeed, when all markets operate efficiently, when there are no external economies of production or marketing, when information is costless and there are no barriers to trade or competition, International trade is the only possible form of international involvement. Logically, it follows that is the departures from the model of perfect competition that must provide the rationale for foreign direct investment. The first deviation had been noted by Hymer (1960/1976), who postulated that local firms have better information about the economic environment in their country than do foreign companies. According to his argument, two conditions have to be fulfilled to explain the existence of direct investment: (1) foreign firms must possess a

countervailing advantage over the local firms to make such investment viable, and (2) the market for the sale of this advantage must be imperfect. It was, thus, a natural step for Kindleberger later to suggest that market imperfections were the reason for the existence of foreign direct investment. Specifically, he came up with the following taxonomy: Imperfections in goods markets, imperfections in factors market, scale economies and government imposed disruptions. This classification may be called the market paradigm; To encompass new developments in the field of determinants of foreign investment, a somewhat different taxonomy from that of Kindleberger was proposed to distinguish among four classes: (1) market disequilibrium hypotheses, (2) government-impose distortions, (3) market structure imperfections, and (4) market failure imperfections. The common feature found in all the hypotheses in group (1) will be the transitory nature of foreign direct investment. FDI is an equilibrating force among segmented markets which eventually comes to an end when equilibrium is re-established; that is when rates of return are equalized among countries. The unifying characteristic in group (2) will be the role played by either host or home governments in providing the incentive to invest abroad. Group (3) will include theories in which the behaviour of firms deviates from that assumed under perfect competition, through their ability to influence market prices. Finally, in group (4) will be classified theories which depart from the technical assumptions behind the model of perfect markets; that is, the assumptions about production techniques and commodity properties. This last category will deal basically with those phenomena which lead to market failure or, cases where " the decentralizing efficiency of that regime of

signals, rules and build in sanctions which defines a price market system” will fail. (Bator 1958, p. 352)

Market disequilibrium hypotheses: The notion of a perfect economy and perfect competition requires the assumption that prices everywhere are adjusted to bring supply and demand into equilibrium. It may well be that because of segmentation in world markets rates of return are not equalized internationally. In a disequilibrium context flows of FDI would take place until markets return to stability. Instances of disequilibrium conditions that provide incentives to invest abroad are those which apply to factor markets and foreign exchange markets.

Ragazzi (1973: 491) State that Currency overvaluation is perhaps the most salient example of these disequilibrium hypotheses. A currency may be defined as overvalued when at the prevailing rate of exchange production costs for tradable goods in the country are, on the average, higher than in other countries. Such an occurrence creates opportunities for profit-making by holding assets in undervalued currencies with the expectation that, once the equilibrium in the foreign exchange market is re-established, capital gains will be realized. In meantime, there is an incentive to locate production of internationally traded commodities in countries with undervalued currencies and to purchase income producing assets with overvalued money. The important point is that, once exchange rates return to equilibrium, the flow of FDI should stop. Even more foreign investors should sell their foreign assets, pocket the capital gains, and return to domestic operations.

Foreign direct investment may be attracted toward areas where the average rates of profit are higher. This is basically the capital markets disequilibrium hypotheses. It implies that, for a given level of risk, rates of return on assets are not equalized internationally by portfolio capital flows, due to inefficiencies in securities markets-such as, thinness or luck of disclosure.

" According to Piggott and Cook (1999: 260-261) International Business Economics: A European Perspective 2nd Edition

It is difficult to fit into one neat theory because of the problem of definition; secondly any theory of FDI is almost inevitably a theory of MNCs. as well, and thus inseparable from the theory of the firm. Thirdly, the nature of FDI makes it a multidimensional subject within the sphere of economics as well as an interdisciplinary one. It involves the theory of the firm, distribution theory, capital theory, trade theory and international finance as well as the discipline of sociology and politics. It is therefore not possible to identify any single theory of FDI due to many explanations of FDI. Also not easy to classify these explanations into distinct and neat groups, due to substantial overlapping between some of the explanations.

They grouped the theories into three categories.

1). Traditional theories

2). Modern theories and

3). Radical theories

Traditional theories are based on neo-classical economic and explain FDI in terms of location-specific advantages.

Morden theories emphasise the fact that product and factor markets are imperfect both domestically and internationally and that considerable transactional costs are involved in market solutions. Also they acknowledge that managerial and organisational functions play an important role in undertaking FDI.

The radical theories, these take a more critical view of Multinational National Corporation (MNCs).

Let 1st examine the ownership, Location and Internalisation advantages, sometimes referred as paradigm of OLI.

To explain the activity of MNCs there is three different types of advantages which is important.

1). Ownership-specific advantages (OSA)

These refer to certain types of knowledge and privileges which a firm possesses and are not available to its competitor.

These arise due to the imperfections in commodity and factor market.

Imperfections in commodity markets include product differentiation, collusion, and special marketing skills, and in factor markets appear in the form of special managerial skills, differences in access to capital market, and technology protected by patents. Imperfect market may also arise from the

existence of internal or external economies of scale or from government policies regarding taxes, interest rates and exchange rates.

The market imperfection gives rise to certain ownership-specific advantages, grouped under the following headings:

Technical advantages-include holding production secrets such as patents, or unavailable technology or management-organisational techniques.

Industrial organisation-relates to the advantages arising from operating in an oligopolistic market such as those associated with joint R&D and economies of scale.

Financial and monetary advantages-includes preferential access to capital markets so as to obtain cheaper capital.

Access to raw materials-if a firm gains privileged access to raw materials or minerals then this becomes an ownership-specific advantage

2). Location-specific advantages (LSA)-This refer to certain advantages which the firm has because it locates its production activities in a particular area:

a) . Access to raw materials or minerals this normally represents an LSA. This advantage, however, applies to all the firms established in the locality and is not sufficient to explain FDI in itself pg 261

b). Imperfections in international labour markets-these create real wage-cost differentials which provide an incentive for the MNC to shift production to

locations where labour costs are low. Example electronics component firms using South East Asian locations for assembly production.

c). Trade barriers-These provide an incentive for MNCs to set up production in Europe to avoid CET. Similarly, high Canadian tariff barriers have been used in the past to attract US direct investment.

c). Government policies-such as taxation and interest rate policies can influence the location of FDI.

Internalisation-specific advantages (ISA) occur when international market imperfections make market solution too costly. This means the market is too costly or inefficient to undertake certain types of transactions, so whenever transactions can be organised and carried out more cheaply within the firm than thorough the market they will be internalised and undertaken by the firm itself.

The benefits of internalisation are as follows:-

a). the advantages of vertical integration cover such things as exploitation of market power through price discrimination and avoidance of government intervention by devices such as transfer pricing.

b). the importance of intermediate products for research-intensive activity: the firm appropriates the returns on its investment in the production of new technology by internalising technology.

c). the internalisation is not entirely costless. It creates communication, co-ordination and control problems. There is also the cost of acquiring local knowledge."

FDI theories

1). Traditional theory

Capital arbitrage theory

The theory states that. Direct investment flows from countries where profitability is low to countries where profitability is high. It means therefore that capital is mobile both nationally and internationally. But sometimes implication is that countries with abundant capital should export and countries with less capital should import. If there was a link between the long-term interest rate and return on capital, portfolio investment and FDI should be moving in the same direction.

International trade theory-the country will specialise in production of, and export those commodities which make intensive use of the country's relatively abundant factor.

2). Modern theory

Product-cycle theory –

New products appear first in the most advanced economy in respond to demand conditions.

The maturing product stage is described by standardisation of the product, increased economies of scale, high demand and low price

The standardised product stage is reached when the commodity is sold entirely on price basis.

The internalisation theories of FDI

The theory explain that why the cross-border transactions of intermediate products are organised by hierarchies rather than determined by market forces.

The theory of appropriability. The theory explains why there is a strong presence of high-technology industries among MNCs

3). The electric theory of FDI

The theory tries to offer a general framework for determining the extent and pattern of both foreign-owned production undertaken by a country’s own enterprises, and that of domestic production owned or controlled by foreign firm. Dunning and Lundan(2008)

Robock and Simmonds (1989: 48) International Business and Multinational Enterprises 4th Ed

Assert that, the electric theory of international production enlarges the theoretical framework by including both home-country and host-country characteristics as international explanatory factors. It argues that the extent, form, and patterns of international production are determined by the

configuration of three sets of advantages as perceived by the enterprises. First Ownership (O) advantage 2nd Location (L) and 3rd Internalization (I) advantage in order for the firm to transfer its ownership advantages across national boundary

Diamond Porter Theory

Daniels, Radebaugh and Sullivan (2009: 287) 12th Edition. International Business: Environment and Operations: Pearson International Edition

This is the theory which shows four conditions which is important for competitive superiority: demand conditions; factor conditions; related and supporting conditions and the firm strategy, structure and rivalry.

Demand conditions whereby the company start up production at near the observed market for example an Italian ceramic tile industry after World War II: At that time there were post-war housing boom and consumers wanted cool floors because the climate was hot.

Another factor is factor conditions which recall natural advantage within absolute advantage theory and the factor-proportions theory

Conclusion