An Analysis of Foreign Direct Investment Theories

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Abstract

This paper seeks to analyze the theories of Foreign Direct Investments (FDI) over the past few decades. An attempt has also been made to define international growth as a result of these investments. All of these ideas agree with the idea that a company invests in foreign markets in order to reap the benefits of localization, firm-specific or foreign exchange.

Keywords: Foreign Direct Investment (FDI), Product Life Cycle Theory (PLC), OLI, Investment Development Path Theory (IDP), Multinational Corporations (MNCs), Imperfect Markets, Eclectic Paradigm

1. Introduction

According to UNCTAD (2012), private cash flows include foreign direct investment (FDI), foreign portfolio (FPI) investments, and other investments such as international bank flows and loans. The increase in the flow of international currencies has resulted in global financial exchange rather than globalization. Therefore, it has become increasingly necessary to understand the basic concepts that help to explain this growth and the flow of funds, especially from an investor perspective. We are very focused on FDI as it has been a major source of revenue, especially in developing countries. This paper therefore presents the FDI theoretical view. The first section provides a summary of FDI definitions. The second section discusses the historical background and origins of the FDI ideas, and the third section provides the division of FDI ideas. The fourth phase presents the FDI theories of the macro-economy, followed by microeconomic. The final section of this article provides a summary of the research findings.

2. Definitions of Foreign Direct Investment

Foreign Direct Investment is defined as the international investment of a single entity, in the activities of a separate business entity, with the aim of establishing a lasting interest (International Monetary Fund (IMF), 1993). According to the International Trade Organization (1996), foreign direct investment (FDI) occurs when a single investor based in one country (home country) acquires assets in another country (host country) for the purpose of managing those assets. Management size is what separates FDI from portfolio investments in foreign stocks, bonds and other financial instruments. Alternatively, FDI can be considered to own 10% or more of the common shares or business voting stocks generally considered to reflect the 'significant influence' of the investor (IMF, 2000). However this varies from country to country and can even be determined by their policies, some of which limit the shareholding of foreign companies in local companies. According to the World Bank (2004), Foreign Direct Investment is a foreign investment that establishes a permanent or effective interest rate control over a business. In its publication Benchmark Definition

of FDI, OECD (2008), defined FDI as a total investment income generated to obtain permanent administrative interest (10% or more of voting stock) in a company that conducts business in any other economy, except the home country of the investor. It is also emphasized that the 10% threshold generally referred to is recommended to ensure statistical uniformity internationally.

In order for the investment to qualify as FDI, emphasis is placed on the fact that the investor must meet the commonly held 10% voting allocation threshold, which is especially recommended to ensure universal statistical equity (UNCTAD, 2009). Lipsey, Feenstra, Hahn and Hatsopoulos (1999) have previously noted that this "permanent interest" implies the existence of a long-term relationship between a direct investor and a firm, and a significant level of influence in the management of the firm. .

3. History and Origins of FDI Ideas

The origin of FDI is not fully understood. Although there are many schools of thought that have been used to explain this phenomenon, there is still no consensus on any higher or standard FDI theory. FDI theory dates back to the work of Smith (1776) [as quoted by Smith, 1937] and Ricardo (1817), and was related to international production specialties. In Smith's theory of total profit, he explained that trade between two nations would be possible if one country could produce and export goods using a given amount of money and labor, in addition to its nearest rival (total profit). However, Smith's theory did not explain how trade came about between countries where one country was not in the production business. It was then that Ricardo's work (1817) emerged, to define FDI using comparative profit theory. Ricardo was passionate about international affairs as he had a view that workers and money went home but not across borders. His theory, however, was flawed because it was based on the assumptions of two countries, two products and the flow of material, but it did not justify the movement of international currencies. This is therefore in stark contrast to the view that, in a world symbolized complete competition, FDI will not exist anyway (Kindleberger, 1969). According to Denisia (2010), if markets were efficient, they would have no barriers to trade or competition; international trade can be the only way to participate in global markets. It was at this point that when Hymer (1976) published his 1960 thesis, he laid the groundwork for some authors to come up with sound ideas for FDI. In his interviews, he found that FDI was motivated by the need to reduce or eliminate international competition between firms, and the desire of the Multi-National Corporations (MNCs) to increase their profits achieved through special benefits. Mundell (1957) came up with a model of 2 areas of international currency flows where cash flows were considered to replace international trade, which led to price equity between countries. However, Mundell's model looks at a much shorter time, kind of an international investment portfolio than FDI, and therefore could not define international production with FDI. Most of the previous ideas were based mainly on the U.S. and Europe. Therefore, it is also necessary to consider FDI perspectives on two economic perspectives: macroeconomic and microeconomic perceptions in FDI.

4. Distinguishing FDI theories

According to Denisia (2010), the major economic perception in FDI is that FDI itself is a form of cross-border cash flow, between foreign and domestic countries, and is included in the balance of statement of international payments, the volatility of interest into cash flows and shares the proceeds of the investment. Microeconomic vision on the other hand is related to investment

incentives across national borders, as evidenced by the investor's perspective. This follows Shin (1998) who critically analyzed existing FDI theories and quoted various scholars who categorize FDI theories in the same way. Petrochilos (1983) categorized the FDI decisions of a large economy based on the volatility that determines an investment decision (as stated in Shin, 1998, p.186), and imitates the business investment behavior, under the importance of the market size of the host country as measured by GDP, growth in market size, prices, interest rates, profitability and investor protection against costs and other such factors. According to him, microeconomic determinants, based on industrial organization theory (factory theory), are more concerned with strong and industrial factors that could give MNCs certain benefits over domestic firms. Caves (1971) provide examples of these factors including product classification, technology, product life cycle and factory size as measured by its sales or the value of its assets. Another scholar who distinguish FDI theories along the macro and micro economic views was Gray (1981). According to him, macroeconomic FDI theories emphasize country-specific factors, and are more aligned to trade and international economics, whereas microeconomic FDI theories are firm-specific, relate to ownership and internalisation benefits and lean towards an industrial economics, market imperfections bias.

5. Macroeconomic FDI Theories

Lipsey (2004) describes the macroeconomic view as seeing FDI as a particular form of the flow of capital across national borders, from home countries to host countries, measured in balance-of-payments statistics. These flows give rise to a particular form of stocks of capital in host countries, namely the value of homecountry investment in entities, typically corporations, controlled by a home-country owner, or in which a home-country owner holds a certain share of voting rights. Lipsey (2004) further explains that the variables of interest are the flow of financial capital, the value of the stock of capital that is accumulated by the investing firms, and the flows of income from the investments. Macro-level determinants that impact on a host country's ability to attract FDI include market size, economic growth rate, GDP, infrastructure, natural resources, institutional factors such as the political stability of the country, amongst others. The various theories are discussed below.

5.1 Capital Market Theory

This theory, also sometimes referred to as the "currency area theory", is considered one of the earliest theories which explained FDI. Based on the work of Aliber (1970; 1971), it postulated that foreign investment in general arose as a result of capital market imperfections. FDI specifically was the result of differences between source and host country currencies (Nayak & Choudhury, 2014). According to Aliber (1970; 1971), weaker currencies have a higher FDI-attraction ability and are better able to take advantage of differences in the market capitalisation rate, compared to stronger country currencies. Aliber (1970; 1971) further adds that source country MNCs based in hard currency areas can borrow at a lower interest rate than host country firms because portfolio investors overlook the foreign aspect of source country MNCs. This gives source country firms the borrowing advantage because they can access cheaper sources of capital for their overseas affiliates and subsidiaries than what local firms would access the same funds for.

5.2 Location-based Approach to FDI Theories

Although FDI location is influenced by firm behaviour (a microeconomic element) insofar as the motives of its location, that is whether it is resource seeking, market seeking, efficiency seeking or strategic asset seeking; the overarching decision is in fact taken on the basis of economic geography, which is a macroeconomic decision as it takes cognisance of country-level characteristics (Popovici & Calin, 2014). According to them, the theory explained the success of FDI among countries based on the national wealth of a country, such as its natural resources endowment, availability of labour, local market size, infrastructure and government policy regarding these national resources. An off-shoot of this location-based theory is the gravity approach to FDI wherein it was assumed that FDI flows between two countries is highest if those two countries are similar, geographically, economically and culturally. Gravity variables such as size, level of development, distance, common language and additional institutional aspects such as shareholder protection and trade openness were regarded as important determinants of FDI flows (Popovici & Calin, 2014). This is however a very basic approach to the economics of FDI, because FDI flows are more complicated than just being about commonalities between nations. Being close together geographically may reduce transportation costs, but not necessarily the cost of labour, for example. Also, sharing the same culture may not necessarily result in increased profitability or trade between the two countries.

5.3 Institutional FDI Fitness Theory

Developed by Wilhems and Witter (1998), the term FDI Fitness focuses on a country's ability to attract, absorb and retain FDI. It is this country ability to adapt, or to fit to the internal and external expectations of its investors, which gives countries the upper-hand in harnessing FDI inflows. The theory itself attempts to explain the uneven distribution of FDI flows between countries. Wilhem's institutional FDI fitness theory rests on four fundamental pillars – government, market, educational and socio-cultural fitness. At the base of the pyramid are socio-cultural factors which according to Wilhelms and Witter (1998), are the oldest and most complex of all institutions. Above that is education, which the authors affirm to being necessary in ensuring an attractive environment for FDI as educated human capital enhances R&D, creativity and information processing ability. The actual level of education does not seem to matter much for FDI as the requirements are dependent on the various skills needs of projects to be undertaken. However what is certain is that basic education may impact on the productivity and efficiency of FDI operations, making formative education such as the ability to speak, hear, understand, interpret and implement instructions key for attracting FDI.

6. Microeconomic FDI Theory

Lipsey (2004) also states that the microeconomic concept examines FDI motives from an investor perspective, which can be likened to taking a solid or industry-level perspective in making a decision. Therefore this small check examines the effects on the investor, domestic and host countries, the performance of international companies or controlled by this investment, rather than the flow size or the number of stocks of investment or investment position. These results come from their trading, hiring, production, and cash flow and stock exchanges, measured by cash flows and stock balance payments, although some of the cash flow proxies are part of the current account (Lipsey, 2004). According to Das (n.d.), FDI microeconomic theories try to clarify why MNCs choose to acquire subordinate companies where they operate, and why they specifically want to

enter those areas. Many of these FDI ideas for a small economy are all based on the existence of incomplete markets. In view of the farm-specific advantage, developed by Hymer (1976), the MNC's decision to invest in other countries depends on its potential benefits, such as access to immature goods, economy, labor access, low transaction costs, intangible assets in the form of brands and patents, among others. It is actually a company-level decision, rather than a financial market decision (Das, n.d.). Hymer's theory that laid the groundwork for the definition of international production was also supported by scholars such as Kindleberger (1969) in his partial market model, Knickerbocker's (1973) oligopolistic reaction theory of following a market leader, the theory of internalization of Buckley and Casson (1976) in the international context, and Dunning's eclectic paradigm (1974). These theories are based on the same basic principle - the existence of imperfect markets, which also contribute to strong morals. As a result, apart from Dunning's eclectic theory, no other attention will be given to them, as calculated in Dunning's OLI paradigm.

6.1 The Eclectic Paradigm

This is probably the most well-known FDI theory. On his way to winning the internationally acclaimed Nobel Prize, Dunning (1980) incorporated the various ideas discussed above - international trade, incomplete markets (governance only) and internal ideas; and he completed this with local theory, also mentioned earlier. According to Dunning (2001), in order for a company to engage in direct foreign investment, it must simultaneously meet three conditions.

(1) The company should have the full ownership advantage over other firms operating in certain markets. These patents are specific and special to the company, in the form of both tangible and intangible assets such as trademarks, patents, information and technology, which can lead to a reduction in the production costs of the firm, making it more competitive with foreign firms. These benefits were further emphasized by Hymer (1976) and Kindleberger (1969) in their perceptions of market imperfections regarding corporate and monopolistic benefits, respectively.

(2) It should be more profitable for a company with these patents to use them (international), rather than sell or lease foreign firms on licenses or management contracts (outsourced). Boddewyn (1985) describes this condition as a state of internal inclusion.

(3) Finally, assuming that the previous conditions are met by both, it should be profitable for the firm to utilize these benefits productively, in conjunction with other additional inputs such as natural resources and human economy, outside of their own country. If that does not happen, foreign markets will then be supplied for export, as well as domestic markets for domestic production.

Specific factors should be considered by investment firms, in terms of the economic and institutional FDI theory discussed under FDI's macroeconomic concepts. Boddewyn (1985) emphasizes that the more state-owned enterprises enjoy the benefits of patents, the more incentives we have to import them; and the more profit they have to exploit outside their home country, the greater the chances of FDI involvement and foreign production. Because of the correlation of the three conditions, it is important that they occur simultaneously, otherwise FDI cannot occur.

The context and application of the Ownership, Location and Internal Performance (OLI) paradigm varies from solid to solid, and that is why the theory cannot be considered separately for the ideas that confirm the importance of the elements of the host world. Although Eclectic Theory was strongly tested by Dunning himself, it still has some limitations that critics have highlighted over the years. Boddewyn (1985) praised Dunning's theory for explaining the first FDI decision of MNCs, yet lamented the lack of explanation for subsequent FDI increases, which may require changes only in some but not all aspects of OLI. In addition to this, Shin (1998) doubts the theory's effectiveness in LDCs that often do not have the same company-specific benefits as high-content content. Another criticism of eclectic theory is that it incorporates so many variables that it ceases to function in a practical way as it does not define FDI at factory, industry and national levels. This is based on the premise that Dunning has attempted to integrate a number of coherent theories of market imperfection, which in or of themselves are already complex (Nayak & Choudhury, 2014).

To address these issues, Dunning (1981) then came up with the Investment Development Cycle or Path (IDP) theory, in which he suggested a link between the country's level of economic development and its investment positions. The IDP has four stages that follow a pattern similar to the product life cycle theory (1) introduction, (2) growth, (3) maturity and (4) decline; no FDI specific benefits arise as a result of government intervention, which attracts FDI entry; domestic firms enjoy ownership benefits as wages rise, leading to FDI exits; countries end up being foreign investors in the fourth phase. The basic assumption here is that due to the volatile interactions between the country’s GDP and its economic policies, these have the potential to affect both domestic and foreign corporate ownership benefits (Nayak & Choudhury, 2014). Despite these challenges, Dunning's eclectic theory remains a well-known FDI theory.

Another criticism of Dunning's OLI paradigm was raised by Forssbaeck and Oxelheim (2008) when they questioned the low role given to financial features in the FDI decision. In response, Dunning (1993) acknowledged that there is a “financial asset” in the knowledge of firms and access to foreign exchange sources, but points out that this is simply a product based on size, efficiency and knowledge of MNCs, and not independent profits. Forssbaeck and Oxelheim (2008) argue that a strong financial strategy enables a company to lower its costs and increase revenue; so by lowering the discount factor for any investment, the company's chances of joining FDI increase due to financial gain. Until now, they think the company will engage in FDI where, among other things, it is able to achieve competitively priced equity, when it separates its stocks from a larger, more liquid stock market, while enjoying strong investment rates, and where it is able to negotiate reduced taxes and / or attract subsidies. Forssbaeck and Oxelheim (2008) scrutinized their views using sample 1379 for the purchase of European non-financial companies. In their series of experiments, they examined the effect of financial inconsistencies on Dunning's OLI model, and found that it has the potential to define dynamic financial variables, thus concluding that financial factors are equally important in defining FDI using the OLI model.

Conclusion

After examining the major theories available at FDI, it is clear that there is no single higher theory that elaborates FDI. However, as it is necessary to conduct research from a specific theater background, it is hoped that the above classification and FDI theoretical analysis provides an adequate basis for selecting the most appropriate theoretical framework for future learning work.

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