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An Overview Of Most Used Foreign Direct Investment Theories

Clement Oppong
Christian Service University College- Kumasi Ghana

ABSTRACT
Due to the importance attached to the flow of Foreign Direct Investment (FDI) as its roles toward global integration cannot be neglected, different theories have been forwarded to explain the reasons and movement of foreign capital across borders. Despite the existence of numerous FDI theories, there is no single theory which could serve as "one in all" theory, therefore this paper was theoretically purported to unveil those theories that are most always used to explain the movement of foreign direct investment.

Keywords: Foreign Direct Investment, Internalization, Multinational Corporations
JEL Classifications: F21, E60, F36

INTRODUCTION

Despite few doubts on the capabilities of FDI as its impacts on the recipient economies are not convincely established (Alfaro, 2013; Alfaro et al, 2004; Borensztein & Gregorio et al, 1998), different theoretical literatures exist to create public awareness of its (FDI) needs as one of the major forces behind globalization(Cotton & Vijaya,2001).There are many theories which double serve as significant steps toward the development of a systematic framework for emergence and attempt to explain the determinants of FDI (Demirhan & Masca, 2008).However, the ability of each to serve as 'one in all' theory to explain all kinds of FDI either at the outward or inward FDI at the firm, industry and country level has been accordingly questioned by various scholars (Agarwal,1980). Even though an individual firms can equally have a considerable number of motivations to undertake FDI (Jadhav, 2012).

Right after the World War II where globalization accordingly emerged, FDI really became the focal point and attraction. The unprecedented importance attached to the Multinational Corporation (MNCs) and Foreign Investment between 1950s and 1960s especially, FDI flows from the world's leading countries like United States to European countries actually gave the grounds for most researchers to look into the issue of MNCs (Nayak and Choudhury,2014). Corollary, several theories have been formulated to explain the global movement of capital as this paper briefly reviews most of the theories that are widely used to illuminate such international movement of capital.

To start with, theories of capital market and portfolio investments were initially used to explain the origination of FDI as direct investments were originally only international capital movement (Kindleberger, 1969). Before 1950s where FDI flows actually became global issue, FDI was already recognized as a subset embedded in portfolio investment. And as portfolio investment is rooted on the premise of differences in interest rates which suggests that capital tends to flow to areas or locations or regions where highest returns could be accrued, the fundamental differences that exist between portfolio and direct investment as the latter entails controls, has accordingly failed to be addressed (Nayak and Choudhury, 2014).Theoretically, interest rate explaining the rationale behind the flow of capital from one point to another has been criticized as it fails to explain controls that investors are entitled to. Rather, it basically stipulates that investors only consider lending monies abroad when interest rates are found to be higher in abroad as well as there is no risk or inherent barriers in the way of capital movement (Denisia, 2010).This according to Hymer (1976) does not spell out the logical possibility of that investor to exercise control over institutions into which he or she has committed his or her resources. As there were no reality bases in the earlier theories, several new theories have been formulated to give insights into the reasons for foreign direct investment even though each has its own peculiar shortcomings. As theories kept on unfolding, it therefore becomes difficult to completely talk about all theories that exist to explain the rationale behind any event. Notwithstanding few of these theories that almost always explain why FDI flow have been reviewed in the next section. Though, the attention is not on the international trade but as it plays essential roles in the flow of FDI, as there are number of theories that also exist to explain the emergence of trade between countries it is imperative to distinguish such theories of international trade from that of FDI. For instance; classical trade theory according to Ricardo (1817) and Smith (1776) suggests that, countries benefit if much resources are committed into the production of goods and services in which they have much advantage. Similarly, factor proportion theory as stated by Hecksher and Ohlin (1933) suggests that countries specialize in the production of goods and services that effectively utilize most of their resources. Lastly and probably the famous theory of international trade; production life cycle theory as developed by Vernon in 1966 dwelled on the belief that transnational companies manufacture innovative products basically for local consumption while surpluses are accordingly exported in order to serve the foreign markets. Though equally good as they (theories of international trade) explain reasons for international trade, other theories have brought into books the limitations of international trade theories under FDI preface. Selection of these theories include: gravity model, market imperfection theory, international production or eclectic theory of Dunning, internalization theory and exchange rate theory.

Gravity model of FDI

Originally, the originators of this model based their assumption on the Newton's rule of gravity as it applied the gravity model of international trade to FDI. The developers of this model opined that, in a two-country world, countries size(for instance;GDP,GDP per capita) is positively associated with FDI or trade between them and inversely associated with the physical distance between such countries. Logically, gravity model has been and continues to be a strong basis for several studies in international trade even though unlike the distance which has not been verified, the proposition on gravity model with respect to size and FDI association has been widely confirmed by data (Chakrabarti, 2001).

Market imperfections Theory

During his doctoral dissertation, Hymmer (1970) established FDI theory approach, one which was first regarded to explain international production in an imperfect market. Basically, the central idea of market imperfection theory of Hymer was that as firms are into the production of the same products and accordingly enjoy the same level of production factors accessibility in the host countries, foreign firms or investors seek available market opportunities as a possible means to capitalize on capabilities not shared by relative competitors in foreign countries. This suggests that foreign firms compete with domestic firms (Nayak and Choudhury, 2014). The reality of this theory suggests that firms gain unique competitive advantages and to varying degrees due to imperfections in markets firm are keen to take advantage of their market power in order to reap good profit through investing in abroad. However, theorists such as Robock and Simmond (1983) have criticized this theory by arguing that "possessing firm-specific advantages does not necessarily mean investment abroad as firms might very well exploit their advantages through exporting or licensing" as several factors (example- local government policy, local market conditions and size, the reaction of rival firms and riskiness of investment) as well influence the choice between FDI and licensing (Nayak and Choudhury, 2014). This theory accordingly fails to explain why foreign production is largely considered as the most favourable means of harnessing foreign firm's advantages as well as where and when FDI actually takes place (Morgan and Katsikeas,1997; Nayak and Choudhury, 2014). In an attempt to address these issues peculiar to market imperfection theory, Dunning (1980) and Fayerweather (1982) as well developed what is usually described in literature as international production or eclectic theory.

International production or Eclectic theory

Gradually, as countries are finding themselves to be intrinsically part of the global economy through interdependency of countries, the concept of global village and spaceship which reflects inherently the international status of the contemporary marketplace, international production or eclectic theory sees the contemporary marketplace otherwise. Even though, this theory does not refute the fact that contemporary marketplace has gain international status. It rather argued that the propensity of firms to commence foreign production strictly depends on peculiar attractive factors of home countries which are compared to inherent resource implications and advantages when relocating or establishing a subsidiary in a different country (Dunning, 1980; Fayerweather, 1982) as cited in Morgan and Katsikeas (1997). This theory clearly depicts that not only differences in countries' resources and firms' advantages play significant roles in instigating overseas investment activities, but also the actions of foreign governments actually determines the attractiveness and conditions of entry. To this, Dunning added by suggesting that firms engage in FDI if only the following conditions are fulfilled: a). the foreign firm will have ownership advantages "O". Thus, an advantage solely given to foreign investor with respect to its brand name and acquisition market share (Gastanaga,et al., 1998). b). location advantage "L". This condition plays an important role in determining which country really plays host to the firm's activities. c). Internalization advantage "I". Unlike the first two conditions, this advantage offered to the investor usually depends on the investor's own behavioural characteristics, and intentions which are less influence by host countries and can only be influenced through the provision of better and stable economic institutions, tax rates as well as a very functioning bureaucratic and justice system (Denisia, 2010; Nayak and Choudhury, 2014). Interestingly, Dunning (1980) stated that all these conditions ought to be satisfied before FDI actually occurs.

Internalization theory

A related aspect of Dunning's eclectic theory of FDI dwells on the notion of internalization. And due to its sensitivity, internalization has been extensively researched by different scholars such as Buckley (1982, 1988), Buckley and Casson (1976, 1985), Henmart (1982) and Hymer (1976). Commenting on this theory, Hymer identified two main drivers of FDI to be _ the removal of competition_ and the possesion of advantages in particular activities. Probably, it was based on these drivers that the notion of internalization was coined as it stipulates that firms aspire to enhance their internal markets as soon as the cost of business activities within the firm becomes minimal (Morgan and Katsikeas, 1997).

Buckley and Casson who were the founders of internalization theory extended the original notion of this theory from Hymer by stating that, companies organize their own internal activities in order to gain specific advantages (Buckley and Casson 1976, 1985). They (Buckley and Casson) further expressed their theory of internalization based on three specifications namely:

i. In imperfect market, firms or institutions maximize profit.
ii. Firms bypass intermediate products that are imperfect in market by creating internal markets.

iii. Proliferation of MNCs is as a result of internalization of markets across the world.

Again, according to Buckley and Casson (1976), internalization resulted from the existence of five main types of market imperfections:

i. Longer time is needed for the co-ordination of resources
ii. Firms need price discrimination to efficiently exploit market.
iii. Unstable bargaining emerges out of bilateral monopoly.
iv. Buyers find it difficult to estimate accurately the price of goods on sale
v. The involvement of government in international markets creates avenue for transfer pricing.

Hymer complemented this theory by stating that FDI is basically" a firm-level strategy decision rather than a capital market financial decision" (Hymer, 1976).

Exchange rate theory

The performance of countries' currencies has been since being a major driven force behind FDI inflow. Due to its (currency performance) driven ability, theorists have investigated into the extent at which the strength of host countries' currencies could serve as a motivating factor for FDI flows. For instance, based on the strength of countries' currencies, Aliber (1970) made the earliest attempt to explain countries' FDI. In his theory considering the discrepancies in the host and source countries' currencies, he noted that countries with weaker currencies are always almost likely to attract more FDI than their counterparts with stronger currencies irrespective of their regions. This assertion was probably meant to take advantage of the discrepancies in the countries market capitalization rates. Even though earlier theory of Aliber was on several occasions tested to proof its validity and reliability, notwithstanding, it remains the theory that has been seriously criticized. Despite the fact that his theory claimed to provide accurate explanation for direct investment mostly in advanced countries, according to Lall (1976), this theory of Aliber seem irrelevant especially in less advanced countries with highly imperfect capital market. Furthermore, the theory failed to provide insightful explanation for investment between developed countries that have parallel strength of currencies (Nayak and Choudhury, 2014). Also, the investment of less advanced or developed countries in the highly developed countries were virtually left in isolation (Nayak and Choudhury, 2014).

Commenting on the possibilities of exchange rate to determine FDI to countries, Cushman (1988) revealed that while real exchange rate boosted FDI made by US$ during the period of study, appreciation in foreign currency accordingly contrasted FDI flows in USA by a margin of 25%.

CONCLUSION

In summary, as it could be seen from the ongoing discussion of FDI theories, different theories exist to provide meaningful explanations as to where and when FDI will flow from and to. And since there is no single theory that could serve as "one in all" theory, several policy implications could be bestowed onto institutions' authorities and government officials. For instance, possible measures should be devised to attract maximum FDI into their respective institutions and countries at large taking into consideration the theories discussed above as they possess the equal ability to determine the location of foreign investments.

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