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EMERGENCE OF THE FOREIGN DIRECT INVESTMENT THEORY: REVIEW

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ABSTRACT

Foreign Direct Investment as transmitted to host countries by multinational corporations has generated lots of books, articles and papers which have examined the motivation for and the impact of this phenomenon. The aim of this paper is to provide a selected review on the Foreign Direct Investment theory. It starts with the contributions of Hymer and ends up with the recent developments. Overall literature on this field shows that this very important form of international resource transfer stays in the middle of international trade theory and the theory of industrial organization.

I- Introduction

The development of the foreign direct investment in the last fort to forty-five years has provided us plethora of theoretical explanations regarding the motives and causes of foreign direct investment. Since the early 1980's government attitudes about foreign direct investment in many developing countries as well as Turkey have changed decisively. Investment barriers have given way to active promotion. Therefore foreign direct investment is considered as an engine for growth and most counties have actively competed for foreign direct investment.

On this context Turkey, as a developing country attracted very little foreign direct investment comparing to the tremendous amounts of foreign capital flows. All factors directly or indirectly affecting Turkey's attractiveness as a destination for FDI should be analyzed carefully but before any empirical work, the theoretical literature has to be investigated. The aim of this study is to provide a selected literature review on the foreign direct investment theory. The paper will help the interested reader by providing the existing works on this area of study.

II- Plan of the Study

Since this is a review article on foreign direct investment theory , there will be no empirical work. The emergence of the foreign direct investment theory

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beginning from the works of Hymer to Kojima's Macroeconomic Model of FDI will be analysed with a special emphasis on the differences. Prior to the 1960's there was no established theory of the Multinational Enterprise or of Foreign Direct Investment; but most of the work on this subject heavily influenced by the Coates work of 1937. The Plan of the study will be as follows;

- 1- Contributions of Hymer
- 2- The Product Cycle
- 3- Follow Up Developments
- 4- Financial Theories of FDI
 - i- Risk Diversification Hypothesis
 - ii- Macro Financial and Exchange Rate Theories
 - iii- Exchange Rate Models
- 5- Late Theories of FDI
 - i - Internalization of Theory of FDI
 - ii- Eclectic Paradigm of International Production
 - iii- Macroeconomic Model of FDI

1- Contributions of Hymer

The first contribution was made by Stephan Hymer in his unpublished Ph.D thesis. Hymer's work is best known for its application of an industrial organizational approach to the theory of foreign production. His argument run as follows; for firms to own and control foreign value adding facilities they must possess some kind of innovatory, cost, financial or marketing advantages which is sufficient to outweigh the disadvantages they faced in competing with indigenous firms in the country of production which he assumed to be exclusive to the firm owning them, implying some kind of market failure. In extending his analyses to explain the cross border activity of firms, Hymer argued that such firms had to possess some kind of proprietary or monopolistic advantage, but these advantages may arise from the firms ability to organize transactions more efficiently than markets.

Although Hymer's work show a clear awareness of the market failure, he always seemed to compare the welfare implications of resource allocation by MNE's with those of Pareto optimality offered by perfect markets. In consequence, Hymer overlooked the fact that increased profits from the superior efficiency of foreign firms is not necessarily a social loss if the prices of the final products are not higher than they would otherwise be (Teece, 1985).

2- The Product Cycle

The Product Cycle Model was introduced in 1966 by Raymond Vernon where Vernon used a microeconomic concept –the product cycle- to help explain a macroeconomic phenomena –the activities of US MNEs in the post war period.

The product cycle was the first dynamic interpretation of the determinants of, and relation between international trade and foreign production. It also introduced new variables such as demand stimuli, technology leads and lags, information and communication costs which have proved to be useful tools in the study of foreign production and exchange.

This approach to explain foreign production was essentially an extension of the neo-classical theory of the spatial distribution of factor endowments to embrace intermediate products, together with an acknowledgement that strategic factors, arising from an oligopolistic market structure in which MNEs were observed to compete. Vernon argued that the competitive advantages of the US firms, particularly their capacity to innovate new products and processes was determined by the structure and pattern of US factor endowments and markets. Without explicitly bringing market imperfections into his analyses, Vernon switched his unit of analyses to the location of firm's production. Initially the product was produced for the home market in the home country close to both its innovatory activities and markets, at a larger stage, the product was exported to other countries which has the similar demand patterns and supply capabilities.

As the product gets standardized or matured, the competitive advantages of producing firms changes from the uniqueness of their product to their ability to minimize the cost of value adding activities and/or their market expertise. The pressure for the firms increases as imitators start making inroads into the market. At the same time, as price becomes more price elastic, the attraction of siting value added activities in a foreign, rather than in a domestic location increase.

3- Follow up Developments

The most significant work to understand the emerging role of MNEs in the world economy in the late 1960's and early 1970' came from Multinational Enterprise Project of the Harvard Business School under the direction of Raymond Vernon. Since 1970's most economist tried to refine and test the contributions of Hymer and Vernon.

Stephan Magee (1977) investigated the incentives of firms to internalize the market for technology. He came up the concept of the Industry Technology Cycle which built upon Vernon's hypothesis that the comparative advantages of firms was likely to change over the life of the product. Magee argued that, firms were unlikely to sell their rights of new technology for two reasons (Magee, 1976, pp. 22-24) :

- Due to the information inadequacy, the buying firm was unlikely to pay the selling firm a price that would yield at least as much economic rent as it could earn by using the technology by itself.
- Fear that the licensee might use technology to the disadvantage of licensor or even become a competitor to it.

As the technology matured, lost its uniqueness, the need to internalize its use evaporated and then the firm may switch its modality from FDI to licensing.

Perhaps of greater significance for the development of FDI theory this time were the findings of a group of Vernon's students at Harvard Business School. These researchers found out that it was not just locational variables that determine the spatial distribution of the economic activity of the firms but their strategic response to these variables and to the anticipated behaviour of their competitors.

Knickerbocker (1973) argued that, as risk minimizers, oligopolists wishing to avoid destructive competition, would follow each other into new foreign markets to safeguard their own commercial interests.

Graham (1975) hypothesized that an MNE which found its home market invaded by a foreign MNE would retaliate by penetrating the invaders home territory.

In his pioneering work Aharoni identified the kind of enterprise most likely to become an MNE and some unique properties of FDI. He concluded that, high information, search negotiating and learning costs are the characteristics of these type of MNEs.

To summarize, by the mid 1970s the two streams of thoughts which tried to explain MNE activity pioneered by Hymer and Vernon were beginning to converge although their focuses of interest remained very different. The industrial organizational approach which was concerned with identifying the main ownership specific advantages of MNE's was beginning to recognize that the way in which assets were created, acquired and organized was an advantage at its own right.

At the same time trade/location approach had also begun to acknowledge the role of market imperfections, not only in affecting the ownership of firms but also of the way in which firms choose to organize their cross border activities.

4-Financial Theories of FDI

Approaches developed by financial economists brought further insight to the understanding of the FDI theory. Three major ones are stated below;

i- Risk Diversification Hypothesis

Risk Diversification Hypothesis was first put forward by Lessard (1977). He argued that MNE offered individual or institutional equity investors, a superior vehicle for geographically diversifying their investment portfolios than did the international equity market. Rugman and Lessard further argued that firms' decision on the location of FDI would be a function of both the firms' perception of the uncertainties involved and the geographical distribution of its existing assets.

ii- Macro Financial and Exchange Rate Theories

Aliber considering the failure of the financial markets, concerned with the underlying reason of MNEs to finance their foreign assets in their domestic currencies. He explained this in terms of the ability of firms from countries with strong currencies to borrow or raise capital in domestic or foreign markets more cheaply than firms from countries with weak currencies, which in turn enabled them to capitalize their expected income streams at rates of interest. Aliber's theory is more regarded as an extension of portfolio capital theory rather than the FDI but it is complementary to other explanations of FDI.

iii- Exchange Rate Models

The role of exchange rate influencing the location of MNE activity is acknowledged by many economists. Relationship between exchange rate and the location of MNE activity is systematically explored after 1985. While Frost and Stein (1989) presented a model in which currency movements affect the geography of MNE's by altering relative wealth across countries. Culem (1988) have argued that, rather than reflecting relative wealth, exchange rate movements show the changes in relative real labour costs and that determines FDI.

5- Late Theories of FDI

In the mid 1970's there were three new attempts to explain MNE activity which were attracted wide spread attention in the literature: The Internalization Theory of the FDI, the Eclectic Paradigm of International Production, and Macroeconomic Theory of FDI.

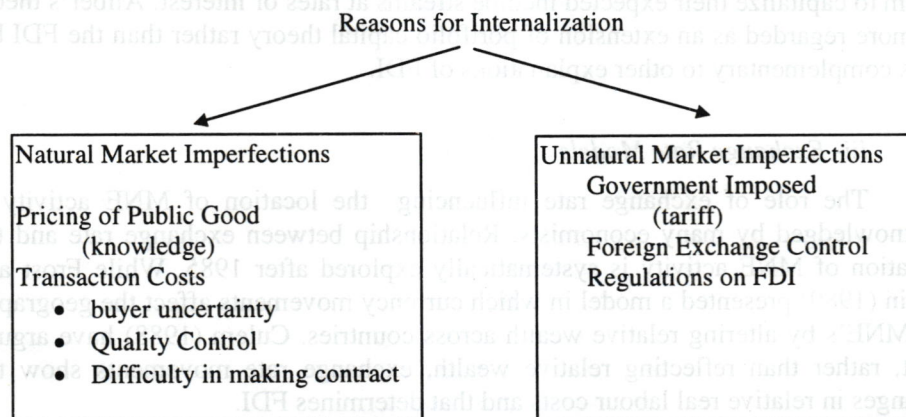
i- The Internalization Theory of the FDI

Internalization is about imperfections in intermediate product markets. Intermediate products flow between activities within the production sector. Market imperfections generate transaction costs and these costs are often minimized for the sector as a whole by bringing independent activities under common ownership and control. (Casson, 1986). Therefore primary concern of the internalization theory is identifying the situations in which the markets for intermediate products are likely to be internalized. As it is seen in Figure I, market imperfections can be classified within two groups; natural market imperfections and unnatural market imperfections. The former one covers the problems of pricing of public goods and transaction costs. Whereas the latter one deals with the external impositions to the markets which can not be included in natural workings of the markets.

The internalization of tangible intermediate product flows between upstream and downstream production can explain vertical integration between mining and manufacturing, agriculture, food processing so on. The internalization of tangible flows of "know how" leads to a combination of horizontal and vertical integration within the innovation process; R&D and production are vertically integrated while

“public good” nature of know how leads to horizontal integration. Internalization also can be applied to marketing and distribution. Therefore internalization generates both a vertical link between production and distribution and horizontal link between the various distribution facilities that use of common source of supply.

Figure 1 :



Source: Alan M Rugman, Donald J. Lecraw, Lawrence D. Booth, 1985

The shortcoming of the internalization theory acknowledged by its protagonists Buckley (1992) and Casson (1986); it is not sufficient to explain the level and structure of a firm to produce in another country. Therefore, location specific variables and internalization variables need to be integrated to make a more profound theory of FDI.

ii -Eclectic Paradigm of International Production

The eclectic paradigm was developed by John Dunning in the mid 1970's. It provides a consolidation of the literature on FDI that draws on the industrial organization, trade/location theory and market imperfections. Dunning specifies a set of three conditions that are required if a firm is engaged in FDI (Dunning 1988a, 1988b).

1) Ownership Specific Advantages: The firm must possess net ownership advantages comparing to the firms of other nationalities in serving particular markets. These ownership specific advantages largely take the form of the possession of intangible assets which are at least for a period of time exclusive or specific to the firm possessing them.

2) Internalization Advantages: Assuming condition (1) is satisfied, it must be more beneficial for the enterprise possessing these advantages to use them by itself rather to sell them or to lease them to foreign firms. They may reflect either

the greater organizational efficiency of hierarchies or their ability to exercise monopoly power over the assets under their governance.

3) *Location Advantages*: Assuming conditions (1) and (2) are satisfied, it must be profitable to the enterprise to locate abroad, that is to utilize these advantages in conjunction with at least some factor inputs outside its home country.

A fourth statement also be needed in order for foreign production to occur. Given the configuration of the Ownership, Location and Internalization (OLI) advantages facing a particular firm, it should believe that foreign production is consistent with its long term management strategy.

Figure 2 :
Necessary Conditions Required for FDI in Eclectic Paradigm

<p>(1) Ownership Specific Advantages</p> <ul style="list-style-type: none"> • Firm specific knowledge advantages • Management, marketing, financial skills • Risk diversification
<p>(2) Internalization Advantages</p> <ul style="list-style-type: none"> • To enforce property rights and overcome other transaction costs • To reduce buyer uncertainty • Vertical integration <ul style="list-style-type: none"> ◊ control of resources ◊ control of markets • To overcome governments regulations
<p>(3) Location Specific Advantages</p> <ul style="list-style-type: none"> • Country specific resources • National production functions • Governments controls and regulations • Political risk, cultural values

Up this point, FDI theory tries to explain the firms' specific behavior in undertaking a particular activity in a particular country. Moving from partial to general equilibrium perspective question at hand changes to which activities of firms are best undertaken in particular countries. This would be the distinction between micro and macro explanations foreign production.

iii - Macroeconomic Model of FDI

Kojima's theory of FDI (1978, 1982) is an extension of the neo-classical theory of trade to embrace cross-border transactions of intermediate products especially technology and management skills. Multinational enterprise is considered as an instrument by which the comparative trading advantage of nation states maybe better advantaged.

Kojima's prescription that a home country should invest abroad in sectors which require (but internationally mobile) intermediate products which it is comparatively well suited to supply, but which need to be combined with non transferable inputs in which the host country is relatively well endowed. Coming from the other side, inbound FDI should import intermediate products that require resources and capabilities in which the recipient country is disadvantaged, but the use of which requires resources and capabilities in which it has a comparative advantage. In this case FDI act both as a catalyst to trade and as an arbitrager for improving the international allocation of economic activity.

Kojima makes a distinction between the US and Japanese FDI in a way that the former is mainly conducted within an oligopolistic market structure and not trade oriented and in the long term has disadvantages both for the home and host countries. The latter is primarily trade oriented and responds to the principle of comparative advantage. The shortcoming of macroeconomic theory of FDI is the same with all neo-classical trade theories which fail to explain much of modern trade which does not take into account of market failure.

Recent contributions to the literature on the determinants of foreign direct investment have increasingly distinguished between the initial act of FDI and sequential investment. Kogut (1983) persuasively argued that although the possession of superior intangible assets may give rise to the initial act of foreign production, once established abroad, the advantages of multinationality gained from the spreading of environmental risks and the common governance of diversified activities in dispersed locations, become more significant.

III- Conclusion

As it can be seen from the above selected theoretical literature review, one must digest the works of Hymer and Vernon before proceed to deeper understanding of the emergence of FDI theory.

Two streams of FDI theory may explain the international production phenomenon: The industrial organization/microeconomic and macroeconomic approach. The former focuses on the internal attributes of investors and their rivalries with one another. The latter emphasizes why net investment among pairs or groups of nations tend to flow in certain patterns. Irrelevant to the stream of thoughts, the cost and benefits of FDI especially for the countries which are desperately taking incentives to attract, should be analyzed carefully. It is crucial for both the public and private sectors to have a complete understanding of the determinants of this phenomena .

Investigator who are interested at this field must always keep in mind that the theory of MNE activity stands at the intersection between a macroeconomic theory of international trade and a microeconomic theory of the firm.

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