A selective review of foreign direct investment theories

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Abstract: Several theories have been put forward by the researchers to explain foreign direct investment. However, no single theory fits the different types of direct investment or the investment made by a particular multinational corporation or country in any region. This paper traces the evolution of the theories of foreign direct investment (FDI) during the past few decades. An attempt is also made to explain the growth phenomenon of Third World multinational companies. The applicability of the theory differs with the type and origin of investment. Nevertheless, all these theories are unanimous in their view that a firm moves abroad to reap the benefits of the advantages in the form of location, firm-specific or internationalization of markets.

JEL classification: F21, F23, F36

Keywords: Foreign direct investment, internalization, MNCs, motivation, trade

Contents

Introduction

After the Second World War, when the forces of globalization emerged, expansion of foreign direct investment (FDI) really took off. The growing importance of multinational corporations (MNCs) and foreign investment during the 1950s and 1960s, particularly FDI flows from the United States of America to European countries, provided the impetus for many researchers to examine the issue of MNCs and the existence of international production.[1] As a corollary, many theories were formulated to explain the international movement of capital. It is in this context that an attempt is made in this paper to examine various theories that explain FDI.

Initially, the theories of capital market and portfolio investments were used to describe the initiation of FDI. Originally, direct investment was an international capital movement only (Kindleberger, 1969). In fact, prior to 1950, FDI was regarded as a subset of portfolio investment. Accordingly, it was asserted that the most important reason for capital flows lay in the differences in interest rates. This approach stated that when there were no uncertainties or risks, capital tended to flow to the regions where it gained the highest return. However, this context failed to incorporate the fundamental difference between portfolio and direct investment. Direct investment entails control. Thus, the important theoretical shortcoming of the interest rate theory is that it does not explain control. If interest rates are higher abroad, an investor will consider lending money abroad, but there is no logical necessity for that investor to control the enterprise to which he or she lends to the money (Hymer, 1976).

The formulation of a proper explanation of FDI was attempted in the 1960s. Further, with the increasing role of MNCs, academicians attempted to integrate their activities with the theories of FDI (Rayome and Baker, 1995). Since then, these theories have highlighted different factors governing the international movement of capital. Some theories have considered market imperfections as the reason for FDI flows while others have considered oligopolistic and monopolistic advantages. There are also FDI theories that relate FDI to international trade. In the following sections an attempt is made to examine these theories.

[1] As FDI is primarily routed through multinational corporations, the terms FDI and MNCs are used interchangeably in this paper.

The objectives of this attempt are threefold: (a) first, to gain an understanding of the basic motivation for firms to go abroad; (b) to highlight the weaknesses of these theories;[2] and (c) to review the theories that provide explanations for FDI flows from developing countries.

Although literature reviews on FDI theories have been conducted from time to time, surveys of literature explaining the outflow of FDI from the so-called “Third World” are sparse. This paper attempts to bridge this gap. In section 1, theories of FDI based on the assumption of perfect competition are described. Section 2 examines the different theories against the backdrop of imperfect competition. Currency-based theories of FDI are reviewed in section 3. Section 4 examines the theories that have linked FDI with international trade and section 5 deals with the linkages between RIA and FDI. Section 6 considers theories that explain the outflow of FDI from developing countries. Section 7 concludes the paper.

1. Theories of FDI based on perfect competition

The early works of FDI theory can be traced in the work by MacDougall (1958) who established his model based on the assumptions of perfectly competitive market. His theory was further elaborated by Kemp (1964). Assuming a two-country model and prices of capital being equal to its marginal productivity, MacDougall and Kemp both stated that when there was free movement of capital from an investing country to a host country, the marginal productivity of capital tended to be equalized between the two countries. They found that after investment, the output of the investing country fell without any decrease in the national income of the country. This is because in the long term the investing country gets higher income from its investment abroad.

Theories explaining international investment in a similar way can be found in the works by Simpson (1962), Frankel (1965), Pearce and Rowan (1966) and Caves (1971). However, the fact is that in a world characterized by perfect competition, FDI would not have existed (Kindleberger, 1969). In fact, some form of distortion must be there to enable the realization of direct investment. Hymer (1976), who was the first to point this out in 1960, developed his theory based on an imperfect market setup. Others followed suit. This is discussed in the next section.

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[2] Several previous reviewers did not consider this aspect.

Furthermore it is pertinent to note that during the interwar period of the twentieth century an important development was Britain's loss of its status as the major creditor, and the United States emerged as the major economic and financial power. In the post-Second World War period, there was significant FDI growth fuelled by: (a) the improvement in transport and communications, which facilitated exercising control from a distance; and (b) the need of Europe and Japan for United States capital to finance their reconstruction activities. However, by 1960, host countries started to recover and there was a slowdown in FDI outflow from the United States; at the same time, other countries initiated FDI in the United States. The 1980s witnessed two important developments. First, the United States became a net recipient of FDI. Second was the emergence of Japan as a major home country for FDI flows to the United States as well as Europe. The 1990s saw the decline in the importance of Japan as a source of FDI. Moreover, merger and acquisition became an important force behind FDI. Since 2000 there has been an increasing flow of FDI from the developing countries, not only to other developing countries but also to the developed world. It is against this changing scenario that FDI theories have evolved over time.

2. Theories of FDI based on imperfect markets

2.1. Industrial organization approach

Hymer was one of the pioneers who established a systematic approach towards the study of FDI. In his 1960 doctoral dissertation, Hymer (1976)[3] developed the FDI theory approach of industrial organization. His theory, which was one of the first works to explain international