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# Theories of Foreign Direct Investment- A Comparative Analysis

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***Abstract:*** **The theories of Foreign Direct Investment explain the utility of foreign investment in the developing country and that have various views to expand the business of local market in these countries. As we know that the Foreign Direct Investment internationalizes the local firms, brings foreign investment which leads to the development, further investment opportunities by the foreign companies and it improves growth rate also etc.**

**The purpose of this research paper is to know the roles of Foreign Direct Investment theories and identify the similarities and differences in that. Researcher has studied the some theories to get an ideas regarding investment at international level made by the developed countries. As per the first theory named 'Production Cycle Theory of Vernon' states that in the first stage, foreign companies establish their plants in local country, start operational activities for local people and exports surplus to the other countries. The second theory named 'The theory of Exchange Rates on Imperfect Markets' explains that exchange increases stimulated Foreign Direct Investment made by US, while a foreign currency appreciation has reduced American Foreign Direct Investment. The third theory named 'Internationalization Theory' describes that domestic company under its conditions internationalizes its marketing and other operation activities in the foreign market through Foreign Direct Investment and the last theory named 'Dunning's Electic Theory' covers some advantages like for e.g. Ownership, Location and Internationalization etc. which are derived by combining the country locations. The following are ownership advantages; Monopoly advantages in the form of privileged access to markets through ownership of natural limited resources, patents, trademarks, technology, knowledge broadly defined so as to contain all forms of innovation activities, Economics of large size such as economies of scale and scope, greater access to financial capital. 'Location' advantage includes; the economic benefit consists of quantitative and qualitative factors of production, cost of transport, telecommunications, market size etc. Political advantages; the common and specific government policies that affect Foreign Direct Investment flows and social advantages; includes distance between the home and home countries, cultural diversity, attitude towards strangers etc.**

***Keywords:*** **Foreign Direct Investment flows, 'Internationalization Theory', 'Dunning's Electic Theory'.**

## 1. INTRODUCTION

**Product life cycle theory of Vernon:**

This theory states that a firm allows the foreign direct investment for their products, when it initially introduces its product in the market and at that time it chooses the customer nearest to it and after some time when it reaches the maturity stage with the demands of foreign customers then it starts production in foreign countries, especially in low-cost countries, to serve the local market.

This theory can be used for trade and foreign direct investment by adding a time dimension; it can get monopolistic advantage only if it shifts from export to the foreign direct investment. Initially when a firm innovates any kind of product at the local level, it enjoys its monopolistic advantages and later on specializes and exports. Thus the firm retains its monopoly power in the foreign market also.

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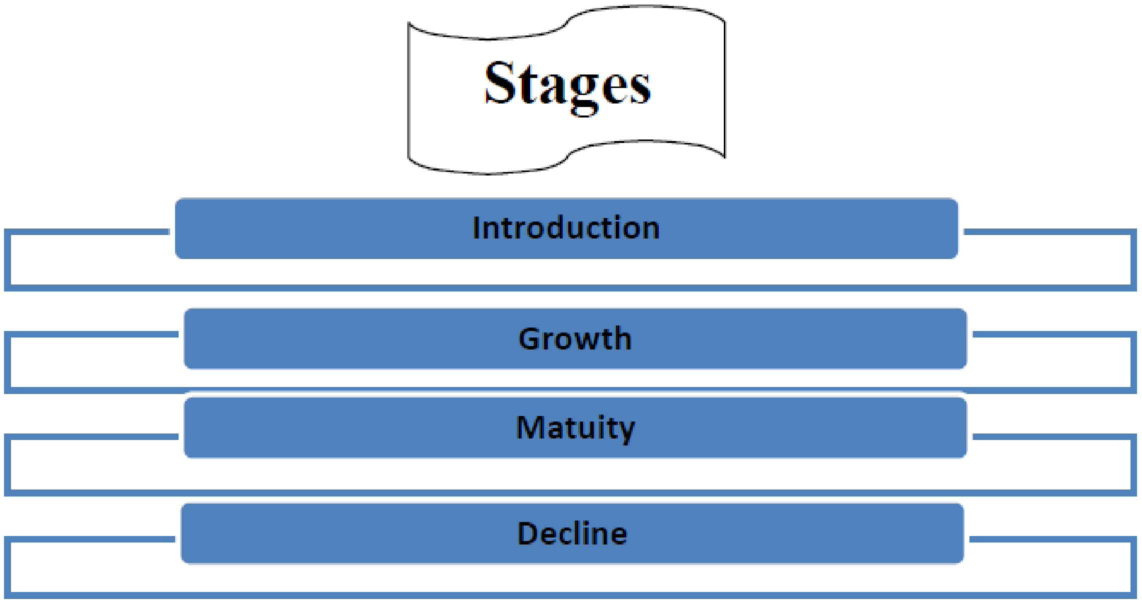
This theory comes out with two weaknesses, one that it is entirely ethnocentric because many new products are produced in advanced countries and two that this study had been carried out in the 60's.




**Stage 1: Introduction:**

A firm launches new product at local level to meet their customer requirements, needs, wants and desires etc. After this they move for foreign countries or similar level countries with similar needs, preferences and incomes to expand their business.

**Stage-2: Growth:**

If a firm getting good output and revenues by launching their launch new products in local market then they can has good opportunity to get growth for their business.

**Stage-3: Maturity:**

It is that stage in the theory which comes after reaching of product at growth stage. At this level product occupies a peak position with good growth and full satisfaction from their customers.

**Satge-4: Decline:**

It is last stage in the product life cycle theory at this level product starts to be decline after a period of time. It may have some reasons like outdated products, failure of products among competitor's products.

## 2. KNICKERBOCKER'S THEORY OF HORIZONTAL FDI

This theory is based on the reflection of strategic FDI flows among countries in the global market place and has considered similar kind of behavioral characteristics of FDI. Further, this theory also states that the action of a firm will be suffered by others for e.g. behavioral characteristics can be in the form of a price decrease by one firm with a view to improve its market position, others will decrease their price accordingly in order not to allow the firm to develop a competitive advantage at their expenses.

## 3. FDI AND PORTFOLIO INVESTMENT THEORY

This theory was developed by Stephen Hymer in the year 1976. Researcher has explained that earlier FDI theories did not clearly mention why firms were engaged in foreign operations, however he started his research work by analyzing the motivations behind foreign investment of US corporations in other countries.

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Further researcher has taken the views of 'Neoclassical theory' which is that foreign direct investment as a flow of capital across borders is based on perceived benefits from interest rates in other markets.

In this theory he has differentiated the terms Foreign Direct Investment and Portfolio Investment and identified the role of notion of control for foreign firms. These two terms are implied for the control of the operation also. He has concluded that the Foreign Direct Investment does control operations and confers a share of ownership and while Portfolio Investment does not control operation but enjoys share of ownership.

Researcher has also proved an assumption, that the Foreign Direct Investments are motivated by low cost in foreign countries because they have cheap labor cost, availability of raw material and opportunities for further growth but sometimes they also have to face foreign barriers like cultural, political and lingual barriers to take advantage of such investments.

There are the some suggestions given by the researcher:

First, firm invests in foreign countries to maximize their specific advantage in imperfect markets, where the flow of information is low and then such markets must allow foreign companies to get benefits from a competitive advantage in that local market.

Second, foreign firm must try to remove their conflicts, which arises in local country at the time of business transactions. According to him, multinationals take complete control of production of goods, which increases market power of that specific firm in imperfect market.

Multinational Corporation's face the distribution risk to choose their different markets and product locations and the risk related to these two are reduced by allowing the Foreign Direct Investment and Portfolio Investment in local country. A firm engages in direct investment, reduces competition, eliminates conflicts and becomes capable so that the foreign firm gets local advantages.

Findings are: researcher has analyzed the activities of the multinational enterprises, their impact on the economy and effectively studied multinationals from a different perspective.

## 4. ELECTIC PARADIGNS (JOHN H. DUNNING)

This theory was developed in year 1993, this is also called 'OLI-Model' and it is a further development of the theory of internationalization based on transaction cost theory. It says that business transactions can easily occur if transaction costs on free market are higher than the internal costs. Such process is called Internationalization.

**Researcher has added the three additional factors to the theory:**

**1. Ownership advantages (trademark, production technique, entrepreneurial skills and return to scale)-** This factor refers to the competitive advantages of enterprises engaging in foreign direct investment. The investing firms like to get advantage from their production of goods.

**2. Locational advantages (existence of raw materials, low wages and special taxes or tariffs)-** This factor refers to the alternative countries or regions that can undertake the value added activities of their multinational enterprises.

**3. Internationalization advantages (advantages by producing through a partnership arrangements such as licensing or joint venture)-** This factor refers to the greater net benefits of internationalizing cross-border transactions. A firm will prefer to engage in foreign production itself rather than license the right to do so.

**Researcher has classified the foreign direct investment in five different categories:**

1. Resource seeking investments.

2. Market seeking investments.

3. Efficiency seeking investments.

4. Strategic seeking investments.

5. Support investments.

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**The OLI Paradigm and Internationalization:**

Finance specific factors and the OLI Paradigm; 'X' indicates a connection between Foreign Direct Investment and Finance specific strategies.

| **Proactive financial strategies** | **Ownership advantage** | **Location advantage** | **Internationalization advantage** |
|---|---|---|---|
| 1. Gaining and maintaining a global cost and availability of capital. | | | |
| a. Competitive sourcing of capital globally. | **X** | **X** | |
| b. Strategic preparatory cross-listing. | **X** | | |
| c. Providing accounting and disclosure transparency. | **X** | | |
| d. Maintaining competitive commercial and financial banking relationships. | **X** | | |
| e. Maintaining a competitive credit rating. | **X** | **X** | **X** |
| | | | |
| 2. Negotiating financial subsidies and/or reduced taxation to increase free cash flow. | **X** | **X** | |
| 3. Reducing financial agency cost through FDI. | | | **X** |
| 4. Reducing operating and transaction exposure through FDI. | **X** | | |
| | | | |
| **Reactive financial strategies** | | | |
| 1. Exploiting undervalued or overvalued exchange rates. | | **X** | |
| 2. Exploiting undervalued or overvalued stock prices. | | **X** | |
| 3. Reacting to capital control that prevents the free movement of funds. | | **X** | |
| 4. Minimizing taxation. | | **X** | **X** |

***Source-*** Reprinted from 'International business review,vol.10, Lars Oxeaheim, Arthur Stonehill and Trand Randey, 'On the treatment of finance specific factors within the OLI Paradigm', pages 381-398, © 2001, with permission from Elsevier Science.

This table has explained about the various proactive and reactive financial strategies. The first financial strategy named 'Gaining and maintaining a global cost and availability of capital' is divided into sub categories; its first category 'Competitive sourcing of capital globally' has the advantages of ownership as well as location without the internationalization advantage but the other three categories their named 'Strategic preparatory cross-listing', 'Providing accounting and disclosure transparency' and 'Maintaining competitive commercial and financial banking relationships' have only the ownership advantage and the last strategy 'Maintaining a competitive credit rating' has all these three advantages.

Further this table has covered the some reactive financial strategies. The first three strategies are 'Exploiting undervalued or overvalued exchange rates', 'Exploiting undervalued or overvalued exchange rate' and 'Reacting to capital control that prevents the free movement of funds' have defined only the location advantages without any internationalization and ownership advantages but the last category 'Minimizing taxation' has location as well as internationalization advantages etc.

**John H. Dunning's Foreign Direct Investment table:**

| | | **Categories of advantages** | | |
|---|---|---|---|---|
| **Particular** | | **Ownership advantage** | **Internationalization advantage** | **Location advantages** |
| Form of market entry | Licensing | Yes | No | No |
| | Export | Yes | Yes | No |
| | FDI | Yes | Yes | Yes |

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This table explains that the first component 'Licensing' which is a form of market entry has ownership advantage but does not have internationalization as well as location advantage but the second component 'Export' has both ownership and internationalization advantage without location advantage and the third and last component 'FDI' has all these three advantages.

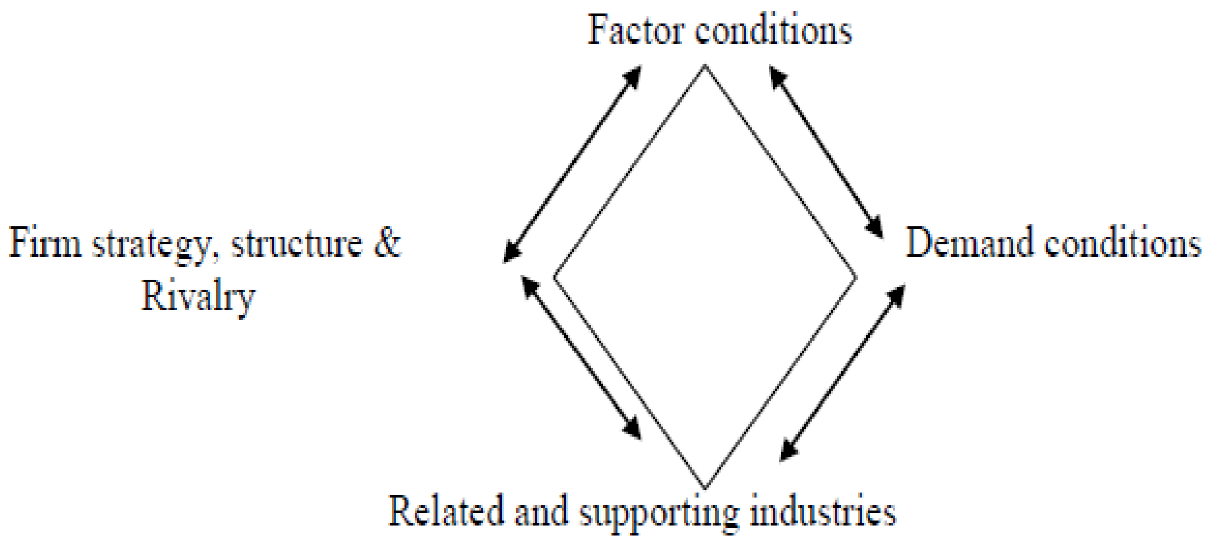
| **Trade and FDI Industries and** | **Patterns for Countries.** | **Location advantages** | |
|---|---|---|---|
| **Ownership advantages** | | **Strong** | **weak** |
| | **Strong** | Exports | Outward FDI |
| | **Weak** | Inward FDI | Imports |

This table explains that the component 'Exports' has a strong relationship with advantages of ownership as well as location, the next 'Outward FDI' has a weak relationship for location advantage but a strong relationship for ownership advantages. In case of 'Inward FDI' the reverse relationship prevails, it has a strong relationship for location advantages but weak for ownership advantages and the last component 'Imports' has a weak relationship for both these advantages.

## 5. MAC DOUGAL-KEMP HYPOTHESIS

This theory was developed by Mac Dougal (1958) and was later elaborated by Kemp (1964). FDI moves from capital abundant economy to capital scarce economy till the marginal production is equal in both countries. This leads to improvement in efficiency, in utilization of resources and in ultimate increase of welfare. According to this theory, foreign direct investment is a result of differences in capital abundance between economies.

**Porter's diamond of notional competitive advantage**




## 6. CONCLUSION

Hence there are various theories that expound the relationship that FDI and investment share and since these theories vary in parameters and findings there is a wide body of view-points available on the analysis of the two. However, the common deduction that can be traced is that for every economy investment is vital and FDI has a major role to play in the fulfillment of this vitality.

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