THEORIES OF DETERMINANTSOF FOREIGN DIRECT INVESTMENT

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Abstract - The considerable growth of foreign direct investment (FDI) across countries in the world has been considered as a phenomenon which has attracted the attention of a number of researchers over recent decades. In the literature, there are a number of various theories explaining factors that motivate FDI to flow from a country to another. The paper aims to review and analyse theories of FDI determinants, namely market-power theory, product-life-cycle theory, oligopolistic-reaction theory, currency area theory, risk diversification theory, Kojima's theory, vertical FDI theory, horizontal FDI theory, internalisation theory and eclectic theory. Among the theories, the eclectic theory is considered as the most comprehensive theory explaining determinants of FDI of multinational firms.

Key words - Foreign direct investment (FDI); determinants of FDI; theories of FDI; international business; multinational firms.

1. Introduction

The substantial growth of foreign direct investment (FDI) has been considered as one of the remarkable developments in the global economy for the last two decades (Dunning and Lundan, 2008). According to the *Statistics Database of the United Nations Conference on Trade and Development* (henceforth UNCTADstat), the global stock of FDI increased twelvefold from US$2.2 trillion in 1990 to a high recordof approximately US$25 trillion in 2015 (see the figure below).

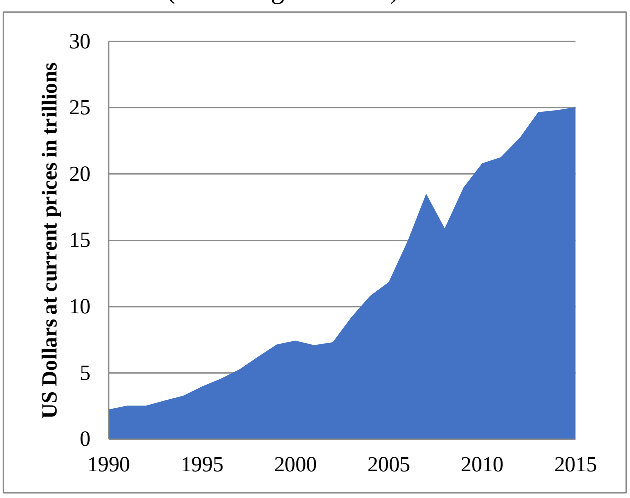

Figure 1. *Stock of global FDI 1990-2015*

The considerable growth of FDI across countries in the world leads to the emergence of various theories suggested by a number of researchers toshowdeterminants of FDI. This paper aims to analysecharacteristics of popular theories of FDI determinants in the literature in order to find a theory which may explain factors determining FDI in the most general way.

2. Solutions

In the literature, there are a number of theories of determinants of FDI. In the part of solutions, we review popular theories of FDI determinants to find the most comprehensive theory to explain determinants of FDI.Before the 1960s, most theorists explained overseas investment based on the assumption of perfect markets. However, Hymer (1976) and Kindleberger (1969) argued that in a perfectly competitive market, all firms compete equally and have no advantages over each other, soFDI has no reason for existence. In his doctoral thesis in 1960, later published in 1976, Hymer showed that firms operating in foreign markets often face a variety of disadvantages compared to indigenous firms, for example language differences or lack of customer tastes. Faced with these disadvantages, for a firm to engage in investment in foreign markets, it must possess specific ownership advantages such as knowledge or technology to balance the disadvantages of operation in a foreign country. Specific-ownership advantage is a source of market power to help a firm to expand its operation into foreign markets. This is a reason for foreign direct investment.

Despite pointing out the importance of the ownership advantage for FDI, Hymer (1976) and Kindleberger (1969) do not explain how multinational firms (MNFs) may benefit from such an advantage (Agarwal, 1980). This point is addressed in the theory of internalisation proposed by Buckley and Casson (1976) which will be discussed below. However, firstly, this study reviews some major theoretical approaches to the debate on the theory of FDI.

Apart from the theory of market power proposed by Hymer and by Kindleberger, Vernon (1966) used the concept of the product life cycleto explain FDI.Vernon suggested that the production of a commodity goes through three distinct stages, including the 'new', then the 'mature', and finally to the 'standardised' commodity. In the first stage when the product is new, it is firstly designed and manufactured in home developed markets whose infrastructure and market conditions can facilitate the innovation of new products. The second stage is when the product is maturing, the designs of new products become accepted and the production process is stabilised. At that time, demand would develop for the product in overseas markets where high-income customers welcome innovation and are willing to pay a high price for it. Therefore, firms should expand their sales by exporting their commodities to other developed countries whose consumers have similar purchasing power to that of the home country.

Finally, when the product is standardised in its production, technological inputs and market knowledge are not very important. At that time, firms search for lower-cost locations abroad, particularly in less developed countries, in order to obtain cost advantages. At this stage, the product is manufactured in the less developed countries to serve their domestic consumers and to export back to the home countries and other developed countries. The firm may thus be able to increase its market share.

However, the theory of a product life cycle is mainly restricted to industries characterised by a high level of innovation (Solomon, 1978). In addition, this theory addresses the position of US firms in the 1950s and 1960s when they were leaders in production innovation. Today new products are introduced at the same time in many different countries and production facilities can be located in many countries right from the beginning, because the technology and income gap between the US and other countries has narrowed since the 1970s (Moosa, 2002). Therefore, this theory is likely to be of lesser importance in the explanation of FDI activities of firms today (Clegg, 1987).

Closely related to the product-life-cycle theory suggested by Vernon is the oligopolistic-reaction theory proposed by Knickerbocker (1973) which considers FDI as the response of a mature firm in an oligopolistic market to its competitors' decision to carry out direct investment overseas.In an oligopolistic environment, firms follow each other into foreign markets as a defensive strategy, because the firm that takes the first step in a new market exploiting any business opportunity draws the attention of similar firms that may exploit the same opportunities. However, the theory is sometimes said to be limited in explaining FDI, because it can only explain why oligopolistic firms invest defensively to counter the FDI of the initiating firm, but cannot explain the investment made by the initial firm.

A theory of currency area explains FDI based on the role of fluctuations of the exchange rate. This theory gives two different explanations of the effect of the exchange-rate fluctuations on FDI. The first argues that the exchange rate is often volatile, thus firms seek FDI to avoid the volatility of the exchange rate (Cushman, 1985). A country with a high variation of its exchange rate may see an increase in inward FDI. In contrast, Benassy-Quere *et al.*(2001) argue that a host country with large fluctuations of the exchange rate may deter inward FDI because investors worry that these fluctuations may lead to uncertainty over the economic environment of that country.

Differentiating from the theory of currency area, Lessard (1976) put forward another theory based on risk diversification. FDI in this theory is explained as a way for firms to spread risk from solely producing domestically. However, Caves (1996) asserts that the diversification of MNFs is more likely to result from investments that are propelled by other motives.

Unlike the theorists above, Kojima (1977) argues that FDI is a means to exploit factor endowments in the host country. He states that the flow of FDI should target countries which can be assisted by the inputs of the investing firm in industries where the home country is disadvantaged. Using the case of Japan, he argues that Japanese firms tend to launch FDI in industries such as textiles, iron and steel, and assembly of motor vehicles and electronics which are less well-suited for manufacturing in Japan because of the lack of labourand resources, andstrict policies on pollution. Petrochilos (1989) criticises this theory in that it is mainly relevant to the Japanese context. Thus it does not provide a general explanation of FDI.However, to some extent, Kojima's theory seems to be within the notion of locational advantages in the eclectic theory which will be discussed below.

Closely related to Kojima's theory, Helpman (1984) proposes a theory of vertical FDI. This theory explains that vertical FDI is implemented by MNFs to exploit the differences in endowments (e.g. labour costs, tax rates) between the investing country and the host country in order to decrease production costs. Hence, FDI determinants in the theory of vertical FDI are likely to be consistent with those in Kojima's theory. Differentiating from the theory of vertical FDI, Markusen (1984) puts forward a theory of horizontal FDI. According to this theory, MNFs conduct FDI to serve the local market of the host country from local production in order to avoid transport costs. In this theory, the motivation for the horizontal FDI is the host country's market size and transport costs. These motives could be considered as locational factors in the eclectic theory.

Another theoretical approach to explain FDI is the theory of internalisation as suggested by Buckley and Casson (1976). Whereas Hymer (1976) and Kindleberger (1969) emphasise the importance of ownership advantages, Buckley and Casson stress internalisation advantages as an explanation of overseas investment of MNFs. The idea of internalisation theory originated from Coase (1937) who used the concept to explain the growth of multi-plant domestic firms. He argued that if transaction costs in external markets - for instance, contractual obligations or contract prices - were high, firms would internally conduct these transactions within the firm at a lower cost.

Applying Coase's internalisation approach to explain FDI, Buckley and Casson (1976) argue that firms prefer to exploit their ownership advantages such as knowledge or technology by transferring them within an internal structure (e.g. from its headquarters to subsidiaries). When the internalisation is undertaken across national borders, FDI occurs. According to Buckley and Casson (1976), the internalisation process helps investors to be able to ensure product quality as well as to keep their ownership-specific advantages within their internal firms. In addition, through the internalisation, MNFs may avoid time lags and high transaction costs.

In general, along with the theory of market power suggested by Hymer and Kindleberger, internalisation theory offers an insight into the operations of MNFs. However, it cannot fully explainthe aspects of FDI as a general theory (Dunning, 1988). Theories of market power and internalisation seem to be able to explain only why a firm seeks FDI (because it possesses one or some ownership-specific advantages) and how it can exploit ownership advantages (by internalisation), but cannot fully explain why the distribution of FDI varies across countries. In other words, the theories are likely to be unable to provide an 'explicit' explanation regarding the location of FDI. This is addressed by the eclectic theory suggested by Dunning (1988) which is presented below.

The eclectic theory combines ownership, internalisation advantages and locational advantages within a single paradigm in order to interpret the main influences on FDI. According to the eclectic theory, for a firm to engage in FDI activities, the decision problem needs to satisfy the three following conditions. Firstly, a firm must possess certain advantages that provide it with comparative advantages in the host market. These advantages largely take the form of intangible assets (e.g. knowledge or technology) that are exclusive or specific to the firm possessing them, which are called ownership-specific advantages. Secondly, assuming a firm possesses one or some ownership-specific advantages, it must be more efficient for the firm to internally exploit its specific ownership advantages overseas by itself, rather than to sell them to foreign firms through market transactions. This is called an internalisation advantage, which explains how a MNF can exploit the profitability from their ownership-specific advantages. Thirdly, the host country must possess location-specific advantages that help firms to be able to make profits when operating there. The locational advantages can explain the location of FDI.

3. Study Results

Among the popular theories of FDI above, the eclectic theory is widely accepted as a general theory of FDI because it synthesises different theories of FDI (Moosa, 2002). The eclectic theory encompasses ownership advantages in Hymer (1976) and Kinderberger (1969), the process of internalisation in Casson and Buckley (1976) and location-specific advantages including FDI determinants suggested in Kojima's theory, theory of currency area, and theories of vertical and horizontal FDI. Therefore, it can give a comprehensive explanation for many aspects of FDI activities. In terms of determinants of FDI, it can be seen that the 'original' factors determining FDI in the perspectives of ownership advantages and internalisation advantages are likely to be similar. They often are ownership-specific factors such as advanced technology or superior managerial systems, whereas locational advantages refer to factors relevant to the host countries' characteristics, for instance, market size or labour costs.

In particular, Dunning (1988) and Dunning and Lundan (2008) indicate that in order to engage in foreign direct investment, a firm has to meet the following conditions:

(1) It must possess net competitive or ownership specific (O) advantages vis-à-vis firms of other nationalities in serving particular markets. These ownership advantages largely take the form of intangible assets or of the advantages of common governance which are, at least for a period of time, exclusive or specific to the firm possessing them.

(2) Assuming condition (1) is satisfied, it must be more beneficial to the enterprise possessing these advantages to use them (or their output) itself rather than to sell or lease them to foreign firms: this it does through an extension of its existing value added chains or the adding of new ones. These advantages are called internalisation advantages (I).

(3) Assuming condition (1) and (2) are satisfied, it must be in the global interests of the enterprises to utilise these advantages in conjunction with at least some factor inputs (including natural resources) outside its home country, otherwise foreign markets would be served entirely by exports and domestic markets by domestic production. These advantages are termed the locational advantages (L) of countries.

In short, according to the eclectic theory, an enterprise has to satisfy simultaneously three conditions to engage into cross-border value-adding activities. First, ownership advantages (e.g. technology supremacy, superior knowledge and management skills, scale economies) enable the enterprise to have a competitive advantage over rival enterprises. Second, internalisation advantages mean that the competitive advantages are exploited internationally within the enterprise, rather than selling components in the market place. It is more profitable and efficient to carry out some transactions within an enterprise rather than between enterprises because the market is costly and inefficient for undertaking certain types of transactions (Krugman and Obstfeld, 1997). Finally, location advantages would be generated by trade barriers (e.g. tariffs, quotas or transport costs). Lower costs of local inputs are also considered as a location advantage which drives production from developed countries to developing ones.

Moosa (2002) illustrates an example explaining how the eclectic theory interprets FDI. He supposes that there is a demand for a specific commodity in which a specific enterprise has an ownership advantage. What happens depends on the internalisation and locational advantages, and the author shows the three possibilities as follows.

(1) If there are no internalisation gains, the firm will license its ownership advantage to another firm, particularly if locational factors favour expansion abroad.

(2) If there are internalisation gains and if locational factors favour home expansion, the firm expands at home and exports.

(3) If there are internalisation gains and if locational factors favour foreign expansion, FDI will take place and an MNC will emerge.

It is noted that the key point of the eclectic theory is that any one of the three above advantages would be important but not sufficient to make FDI occur. It is necessary to consider and analyse all three conditions. Dunning and Lundan (2008) believed that nearly all types of FDI can be interpreted by the three conditions in the electic theory.

4. Conclusion

The paper reviews and analysespopular theories of FDI determinants in the literature, namely market-power theory, product-life-cycle theory, oligopolistic-reaction theory, currency area theory, risk diversification theory, Kojima's theory, vertical FDI theory, horizontal FDI theory, internalisation theory and eclectic theory. In the theories above, the eclectic theory is considered as a comprehensive theory which can explaintypes of FDI determinants in the most general way. This theory ties together the three factors including ownership, internalisation and location to interpret nearly all factors motivating multinational enterprises to conduct FDI in the international market.

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