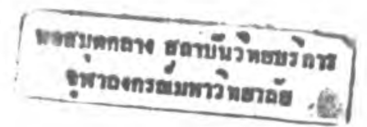

CHAPTER 2

THEORITICAL BACKGROUND OF FDI

As a background, the foreign direct investment (FDI) has many theories and fields such as product life cycle theory, industrial organization theory, ownership-specific theory, internalization theory, location theory, currency theory, the eclectic theory, market inefficiency theory, monopolistic advantage theory, oligopolistic competition theory, portfolio theory and the multinational theory etc., hence the propensity of literature of FDI already studied will be selected to related with the determinants in this thesis. This chapter examines the former two on the basis of both theoritical literature and empirical evidence. This chapter will review some principle theories of motives and determinants of FDI briefly as follows:

2.1 Froot and Stein Theory

Reasonably, corperations will access in the foreign market when they can see the stability of exchange rate in order to assure a reasonable level of margin. Thus, volatility of the exchange rate is the key point to determine the factor affecting and direction on FDI. The liquidity-based model explaining the effect of exchange-rate changes on FDI inflows rests on changes in the value of the host country's currency, and may

reflect possible misalignments of currencies. However, there is an additional role for the exchange rate. Exchange rate volatility may impede FDI because, to a certain extent, it increases uncertainty, thus decreasing a firm's willingness to undertake long-term commitments to expand capacity. Firms enter a foreign market only after the path of exchange rates is suitably stable so as to assure a reasonable level of profit. Volatility of the exchange rate may therefore serve to inhibit FDI. Some literature exists on the relationship between FDI and exchange-rate movements. The response of FDI to exchange-rate movements may take numerous forms. Firms may expand or contract existing production operations, enter or exit foreign markets, change the location of their facilities, reinvest or repatriate earning or consolidate markets, power through mergers and acquisition. As mentioned earlier, Froot and Stein (1991) provided a simple theoretical model and some preliminary empirical estimates that suggest a role for exchange rates in explaining FDI inflows to the United States. The basic idea is that, if domestic firms are cash constrained, a depreciation of the host country currency will give foreign enterprises the ability to outbid domestic firms because of the increase in the real value of foreign firm's capital that has been brought about as a result of the depreciation. Froot and Stein found a negative relationship between FDI inflows and exchange rate change; for

example, a one per cent change in the exchange rate leads to about a .07 per cent change in FDI inflows. This negative relationship is also found at the industry level. The coefficient of the trend variable is positive and statistically significant, implying that, although exchange rate depreciation leads to higher FDI inflows to the United States, the upward trend in the share of assets owned by foreigners (the value of which tripled over the last decade) remains unexplained.[1]

2.2 Internalization Theory

Organizations have to search for their advantages by internalization in their operation to foreign countries to reduce capital in business activities and increase the capacity in marketing connect efficiently. The foreign investor must discover the advantages through the process of direct investment in the foreign countries which makes corperations gain some benifits, for instance the marketing captital may be decrease and they enable to avoid government interruption policies, such as tariff imposition, quota setting and etc. They are able to supervise sources of production and prices of raw material used and make credit to the customer in foreign countries. The price strategy will be employed to

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[1] Froot, Kenneth A, and Jeremy C.Stein(1991). "Exchange rates and foreign direct investment: an imperfect capital markets approach", *Quarterly Journal of Economics*, vol. 106, No.4 (November), pp. 1191-1217.

set the differant price in each countries and creates the certainty in the future martket of firms.[2]

2.3 Location Theory

Location theory explains the existence of FDI by the location specific factor differential. The essence of the theory is that host country must possess some locational specific advantages over the home country of the foreign investor in order to attract him to locate his subsidiaries there to fully exploit those locational advantages.

Making a decision to invest directly in some foreign countries, investors must have motivative factors which is created by receiving location specific advantages of corperations. Compared with their own country investment, it assists investor to reduce capitail in business activities.These advantages depend upon the sources of material and the quality and price of resources in those countries. Transportation expenses, level of government interruption in production and controlling import, host country infrastructures, cultural gap, growth rate of

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[2] Casson Mark, *The Multinational Enterprise: Theory and Applications*, The Camelot Press Ltd., Southampton, 1989, pp. 114-117.

investment in host countries determine how much investor receive benifit from these advantages.[3]

2.4 The Eclectic Theory of FDI

By synthesizing the existing theories of FDI, John H. Dunning developed the eclectic theory of foreign direct investment, which is based on the OLI paradigm: Ownership-specific advantages, Locational advantages and Internalization advantages. Hence, in essence the eclectic theory summarizes all the specific theories already discussed.

As a result, there are three complete conditions, it can be assure that firms will engage in foreign value-adding activities. Firstly, the corporations have to possess ownership-specific advantages, for instance, superior technology, managerial and marketing skill, etc. In addition, they are those who can take advantage of investment opportunities abroad also. Secondly, firms have to acquire the internalization advantages, they have to take advantages from internalizing the efficient use of resources, rather than selling products on external markets. Thirdly, the conjunction of ownership and internalization must obviously appears in the country where the FDI take place. These advantages are named locational advantages.

[3] ibid. pp. 12-14, 86-88.

The nature of OLI advantages happening to a country's enterprises reflects its level of development, market size, domestic market, and government policies.[4]

2.5 The Multinational Enterprise Theory

This theory has three major motives which concerned are as follows:

1. market oriented foreign direct investment
2. raw material based investment
3. cost reducing investment

The first type, market oriented investment, is naturally oriented towards countries with large home markets, often in response to rapid market growth and/or the threat or tariff imposition. Much of this type of investment takes place in the advanced industrialised countries or in the large rapidly growing less developed countries (Brazil, Mexico, Argentina), and some in the newly industrialising countries (Malaysia, Korea).

The second type, raw material or extractive investment, has traditionally been the source of much satisfaction between host and source countries. Linked very closely with colonial patterns, the

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[4] John H. Dunning, *Explaining Changing Patterns of International Production: In Defense of the Eclectic Theory*, Oxford Bulletin of Economics and Statistics 41 4 (1979):275.

historical factors which have led to extraction technology reposing in advanced countries and the raw materials in colonised, less developed countries have increased tension. Recent attempts of host countries to gain control by nationalisation, expropriation and indigenisation have led to massive restructuring of operations and the search for new forms of institutional arrangements.

The final type of motive is cost reduction (raw material control can be considered a subset of this motive but it raises many other issues both strategic elements and risk reduction elements are likely to be also important). In many industries, labour is a major element of cost and one which can be reduced by the act of relocation. The search for cheap labour has led to multinationals reorganising their operations so that the labour intensive stages can be relocated.[5]

In generalization, eventhough there are several theories to clearify the FDI phenomenon, at present there is no gerneral theory of FDI. Some theories can explain only the phenomenon only in the short run but some can provide only partial analysis. In the next section, the empirical evidence of FDI determinants will be discussed.

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[5] Casson Mark, *The Multinational Enterprise: Theory and Applications*, Southampton, The Camelot Press Ltd., 1989, pp. 114-117.

2.6 Empirical Study of FDI Determinants

We will discuss the empirical studies to examine the validity of those theories mentioned. According to a number of empirical works on the determinants of FDI in developing countries, macroeconomic variables that often induce or attract inward foreign direct investment. In this study, we focus on examining the macroeconomic aspects of FDI in ASEAN, therefore, the literature review in this section will emphasize only on the previous studies fo the determinants of inwards FDI in ASEAN.

Sibunruang made an attempt to distinguish between the motive of foreigner to invest abroad and the conditions in the host country attracting them there. She asked MNEs located in Thailand to rank motives for making overseas investment, and then asked firms why they chose Thailand as a host country specifically. Motives for making overseas investment ranked most important were market expansion, low wages in host countries, and investment incentives. As for reasons for choosing Thailand, the result showed that FDI was attracted to Thailand due to availability of cheaper labor and raw materials, Thai Government incentives and adequate local demand.[6]

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[6] Atchaka Sibunruang, *Foreign Investment and Manufactured Exports in Thailand*, Ph.D. dissertation, University of Sussex, United Kingdom, 1984.

Traiwannakij examined the determinants of foreign direct investment in Thailand during 1960-1989 by the quantitative method by taking into account both demand and supply side hypothesis. In his study, he applied the optimal control approach within the hypothesis of maximizing the present value of the firm's profit to derive the factors influencing the net foreign direct investment inflow. Applying the ordinary least squares (OLS) method, he found that the investment control policy, the exchange control policy, the price of non-agricultural products, the price of imported capital goods, the price of imported raw materials, and government subsidization policies are the major factors determining the net foreign direct investment inflow.[7]

In an empirical study on the location of overseas production by Irving B. Kravis and Robert E. Lipsey tested two opposing hypothesis. One is the "market scanning hypothesis", which suggests that TNCs use their superior knowledge to locate their activities in countries where they have market or cost advantages. The other hypothesis is to view these firms as "market makers". Their large size, managerial and commercial strength and superior financial and capital resources permit them to

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[7] Surachai Traiwannakij, *Foreign Direct Investment in Thailand*, Ph.D. dissertation, Faculty of Economics, Insbruck University, 1992.

develop new markets for their products. They examined an array of forces both external and internal to the firm to identify the determinants of the location of production by United States TNCs. They found that the size of the host country's market appeared to explain the rankings of countries where FDI by United States firms is likely to take place. Factors such as labour costs, productivity and capital costs also tended to influence the decision of United States firms to locate their production abroad. They also found that a high propensity to trade and a high degree of openness of an economy were important in the decision to locate affiliates in foreign countries.[8]

After studying the theories of foreign direct investment, it can be concluded that the exchange rate and the variation of exchange rate related with Froot & Stein theory, while GNP, change in GNP, domestic investment, degree of openness, government expenditure, and labor cost related with multinational theory and eclectic theory. For internalization and location theory, they are the parts of eclectic theory.

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[8] Kravis, Irving B. and Robert E. Lipsey, *The location of overseas production and production for export by U.S. multinational firms,* Journal of International Economics, 1982, vol. 12, pp.201-223