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Traditional and Modern Theories of Fdi

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ABSTRACT : *The rapid emergence of TNCs from emerging economies, dubbed variously as Challengers, newcomers, latecomers, dragon multinationals, born global for their distinctive pattern of internationalization as compared to giant multinationals of developed and advanced industrial nations, have exposed the limitation of traditional FDI theories which have focused mainly on the FDI from developed countries. The emergence of these new species of TNCs possessing distinct set of abilities, showcasing distinct patter in internationalization calls for a more dynamic resource based view of the process of internationalization in an asset seeking or asset exploration perspective combining strands of strategic management, international entrepreneurship, networking theory to the already existing literature on firm internationalization. In this context, the paper presents key traditional theories on FDI, discuss the limitations of traditional literature in explaining the extent and pattern of internationalization of firms from peripheries and give a brief review of modern theories on FDI.*

KEYWORDS: *Dragon MNCs, FDI, Multinational Enterprises, Theories on FDI.*

I. INTRODUCTION

International Monetary Fund defines 'FDI' as an investment, which is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in management of the enterprise. In addition to equity participation, it also includes other non-equity forms of investment and control, such as, sub-contracting, management contract, turnkey agreement, franchising, licensing and product sharing. The striking feature of world FDI flows during recent years and particularly 2000 onwards has been the transformation in their geographic distribution. Continuing economic liberalization in developing countries, slowdown in developed countries due to global financial crisis of 2008 and the recent euro zone crisis have resulted in the increase in share of developing countries in global FDI flows. Developing countries on an average accounted for 37% of inflows and 18% of outflows up from 31% and 13% during last decade, mainly as a result of outward expansion by Asian TNCs. Multinational enterprises from developing countries are the visible manifestation of a sustained increase in OFDI from developing countries. The rise of MNEs from emerging economies dubbed as challengers or new comers and late comers (Mathews, 2002) is not sufficiently explained by traditional theories of FDI. This paper puts forth the traditional explanations underlying firms' internationalization, exposes their weaknesses in explaining internationalization behaviour of emerging market firms and presents a review of modern theories of FDI.

II. TRADITIONAL THEORETICAL UNDERPINNINGS

2.1.Industrial Organization Approach

This theory developed by Stephen Hymer (1960,1968 and 1970) and C.P.Kindelberger (1969) is one of the earliest explanations of investment flows in an oligopolistic market situations. It focuses on the means through which TNCs could mobilize its unique capabilities and transborder assets to overcome perceived operational and informational deficiencies with respect to domestic rivals. According to this theory, the possession of proprietary resources and unique capabilities such as differentiated products, proprietary technology, managerial skills, better access to capital and government imposed market distortions confer TNCs with competitive advantage over indigenous firms in the host country and help them offset the disadvantages of operating in a foreign country. In other words, TNCs derive competitive advantage from home country based market imperfections resulting from oligopolistic market situation.

2.2 Transaction Cost Approach

The transaction cost approach is pioneered by R.H.Coase and generalized by Williamson (1979). FDI is viewed as an organizational response to imperfections in intermediate goods, knowledge and capital markets faced by TNCs. The theory asserts that external market which is available to a TNC fails to provide an efficient environment in which firm can profit by using its technology, know how, brand name or production processes. The firm therefore produces an internal market via investment in multiple countries and thus creates the needed market to achieve its objectives. Firm creates hierarchies when either there is no market for intermediate

products needed by TNC or because external market for such products is inefficient. The transaction cost of intra firm transaction is negligible compared to their market cost.

2.3 Eclectic theory of International Production: The OLI Framework

The eclectic (OLI) paradigm of international production is pioneered by John H Dunning (1973, 1993). The paradigm asserts that, at any given moment of time, the extent and pattern of international production will be determined by the configuration of three sets of forces:

(i) The (net) competitive advantages which firms of one nationality possess over those of another nationality in supplying any particular market or set of markets. These advantages may arise either from the firm’s privileged ownership of, or access to, a set of income-generating assets, or from their ability to co-ordinate these assets with other assets across national boundaries in a way that benefits them relative to their competitors, or potential competitors.

(ii) The extent to which firms perceive it to be in their best interests to internalize the markets for the generation and/or the use of these assets; and by so doing add value to them.

(iii) The extent to which firms choose to locate these value-adding activities outside their national boundaries.

The theory therefore holds that FDI is the result of firms possessing ownership specific (income generating) advantages (O) that they want to exploit in foreign locations (L), which they cannot profitably do except through internalization (I). Dunning further refined the possession of proprietary resources and capabilities into asset-based ownership advantages, which are realized from structural market imperfections, and transaction-based ownership advantages, which are realized from transaction imperfections.

III. LIMITATION OF TRADITIONAL LITERATURE ON FDI

The traditional theories of FDI have focused mainly on the FDI from developed countries. These studies have primarily examined either why FDI occurs from a developed country to another developed country or from a developed country to less developed countries (LDCs) or newly industrialized economies (NIEs). The theories discussed so far essentially proposes that for FDI to occur, firms need to posses certain unique advantages or proprietary resources, so as to be able to overcome the disadvantages of operating in a foreign location and be able to compete with indigenous forms in host country. Makino et al (2002) proposed two distinctive and complementary perspectives of FDI: Asset Exploiting and Asset Seeking. Traditional theories of FDI explained FDI from asset exploiting perspective. In the asset exploitation perspective, FDI is viewed as the transfer of firm’s proprietary assets across borders. This perspective postulates that FDI would occur when firms posses proprietary resources and skills which give rise to a monopolistic (or competitive) advantage in a host country (Caves 1971, Hymer 1976).Building on the organizational learning perspective, Hedlund and Ridderstrale (1997) suggested that dominant theoretical perspectives in international business research adopted the exploitation rather than exploration (creation) perspective. They argue that due to neglect of aspects of asset exploration, the traditional theories of MNE have nor successfully explained how MNEs can create innovation through international expansion and activities. In asset exploration or asset seeking perspective, FDI is viewed as a means to acquire strategic assets (i.e. technology, marketing and management expertise) available in the host country.The rise of MNEs from emerging markets like India, China, Brazil, Turkey, Taiwan have challenged the asset exploiting perspective of FDI which fails to explain how do such firms that start small, lack key resources and are distant from major markets challenge established positions in the global economy and displace the incumbents, some of them highly advanced and fiercely competitive. In the past decade a host of new firms have arisen in the global economy while bearing little resemblance to the giant multinationals.

IV. NEW SPECIES OF FIRMS

4.1 Dragon Multinationals

The term “Dragon Multinationals” is coined by John A Mathews. Mathews (2002, 2006) used the term to describe firms that emerged from the peripheral areas of Asia – Pacific region. These are the firms that start from behind and overcome their inefficiencies to emerge as industry leaders, in sometimes astonishingly short periods of time, without any of advantages of the incumbent industry leaders. They rise up in a phase of catch up industrialization to emerge as challengers to the existing large MNEs. They do so without initial resources, without skills and knowledge, without proximity to major markets and without social capital that is to be found in the regions like Silicon Valley. Their accelerated internationalization can be attributed to the manner in which they leverage their way into new markets through partnerships and joint ventures. They are also known as latecomers because they arrived late on international stage but thereby drew advantages not available to their earlier counterparts.

4.2 Micro Multinationals

Micro Multinationals include small or medium sized firms which originate from advanced industrial countries but attack the world market with such vigor and with such clever strategies of integration that they are classified as “new comers” or as ‘born again multinationals” (Bell, Mc. Naughton and Young, 2001). Micro TNCs are not defined by their speed or pace of internationalization but by their tendency to adopt more advanced market servicing modes such as International Licensing agreements, international franchising, international joint ventures or foreign subsidiaries.

4.3. Born Globals

Born Globals are the firms which almost bypass internationalization as a “process” since they are started and operate from day one in global markets as global players, servicing their customers, wherever they are to be found. These firms are variously called “global start ups”, “born globals” or “international new ventures” (Oviatt and Mc Dougall, 1994).The discussion of new species of TNCs from the peripheries reveals the distinctive pattern of their internationalization as compared to giant multinationals of developed and advanced industrial nations. The Late comers and new comers do not start out in a cautious way, feeling their way through foreign markets, but tend to regard a highly integrated world as their market from the outset. Moreover, their advantage arise from their developing country context, which include flexibility, low overheads, cost effectiveness and business models that fit emerging market contexts (Buckley et al, 2007). These firms have an advantage in the use of networks and relationships, organizational structures, the leveraging of cultural ties or institutional affinity and other heterogeneous sources of potential advantages (UNCTAD 2006). The emergence of the new species of TNCs possessing distinct set of abilities, showcasing distinct patter in internationalization calls for a more dynamic resource based view of the process of internationalization in an asset seeking or asset exploration perspective combining strands of strategic management, international entrepreneurship, networking theory to the already existing literature on firm internationalization.

V. MODERN THEORIES OF FDI

5.1 Stage theory approach/ The Network Model

The stage model of internationalization explains the process of firm internationalization as a result of learning through gradual increases in international involvement. Johanson and Vahlne (1977,1990), Johanson and Weidersheim-Paul (1975) and the Network model (Johanson and Mattson, 1988) both explain international involvement as a sequential learning process based on increasing experiential knowledge. The core idea behind this model is that a pre requisite for international operations is the development of both objective and experiential knowledge and the development of capabilities based on it.

5.2 Linkage, Leverage and Learning: The LLL framework

The LLL framework of firm internationalization was developed by John A Mathews (2002, 2006). The framework recognized the fact that latecomers and newcomer MNEs do not depend for their international expansion on prior possession of resources but they utilize international expansion in order to tap resources that would otherwise be unavailable. The framework explained the rapid emergence of the latecomer firms in the 1990s in terms of prior Linkages developed in the global economy which firms Leverage through experiential Learning helping them to gain a foothold in interconnected global network.

5.3 Strategic Alliance Network Approach

Developed by Johanson and Mattson (1988), this approach also explains internationalization as learning process based on increasing experiential knowledge.

5.4 Leapfrogging Theory

The leapfrogging theory explains systematic and recursive behaviour used by late entrants to catch up with the competitive position of early movers while avoiding the risks of technological obsolescence and proprietary technology diffusion to rivals, as well as the extra burden of educating a changing market.

VI. CONCLUSION

Traditional theories of international production do not sufficiently explain the internationalization behaviour adopted by new species of firms’ originating from emerging economies. The rapid internationalization patterns, innovative strategies and organizational structures adopted by such firms to overcome their small size and inefficiencies arising from absence of key resource and firm specific advantages

(FSAs) call for the integration of existing literature with the concepts from strategic management literature, international entrepreneurship and the networking theory.

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