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FOREIGN DIRECT INVESTMENTS - FDI

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Abstract

The Foreign Direct Investments (FDI) are international investments aimed at the acquisition of durable participations (control, on an equal basis or on a minority basis) in a foreign firm (M&A) or at creating a foreign branch (Greenfield investments) implying a certain degree of involvement of the investor in the direction and management of the created or acquired firm. FDI are tools for productive internalisation.

The productive internalisation is one of the main aspect of the globalisation process. The most important instrument of the this process are the Foreign Direct Investments (FDI).

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It is widely agreed that multinational companies (MNCs) engage in FDI when three sets of determining factors simultaneously emerge: notably the presence of: i) ownership-specific competitive advantages, ii) location advantages in the host countries and iii) better trade benefits in intra-firm as against arm's-length relationship between investor and recipient (internalisation advantage). This

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theoretical approach, introduced by Dunning (1977), is known as the OLI (*Ownership, Location, Internalisation*) framework.

Ownership advantages pertain to products or production processes which other firms do not have access to, such as patents, or intangible elements, such as reputation for quality or brand names. Location advantages pertain to the host country's quality of business environment, such as low factor prices or customer access, together with relatively low trade barriers or transport costs making FDI more profitable than exporting. Finally, internalisation advantages derive from the firm's interest in maintaining its knowledge assets internal. This may happen for several reasons. For instance, markets for assets or production inputs (technology, knowledge, management) may involve significant transaction costs or time-lags.

Starting from the OLI theoretical framework, the "new FDI theory" mainly refers to the ownership and location advantage, including MNC's in general equilibrium models. It should be stressed that, while the OLI framework is rather a normative theory, derived from the observation of the MNC's behaviour in the localisation decision planning, the "new FDI theory" seems to be heuristically more adequate to an analysis in a theoretical model framework.

In early literature (Helpman E. [1984], Helpman E. and Krugman P. [1985]) the presence of MNCs in a foreign country was explained in terms of differences in relative factor endowments among countries. Transport costs being null, the location of MNCs abroad is determined by the differences in endowments. The main shortcoming of this approach is that it seems suitable to explain "vertical" FDI (when firms locate different stages of production in different countries by taking advantage of differences in factor costs), but it cannot explain "horizontal" FDI (when firms locate similar types of production activities). The latter phenomenon has been observed among industrialised countries during the past few years. Thus, it seems that this approach cannot fully explain recent FDI trends.

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This conclusion leads us to a more recent literature, whose starting point (Brainard S.L. [1993]) is that multinational activities are driven by trade-offs between “proximity” and “concentration” advantages, rather than by differences in factor endowments.

The proximity advantage stems from firm-level economies of scale, whereby any type of “knowledge capital” (like R&D activity) is transferable to the affiliates and allows MNCs to be closer to the foreign market. The concentration advantage derives from traditional plant-level economies of scale, which make it more profitable to concentrate production in one location and supply foreign markets by exports. Whenever the proximity advantage outweighs the concentration advantage, FDI flows arise. It is more likely to happen the higher are intangible assets relative to the fixed costs of opening up an affiliate, and the higher are transport costs.

This model seems more suitable to explain horizontal FDI flows (i.e. FDI among industrialised countries). Markusen in several different works contributes to the theory endogenising multinational firms in general-equilibrium trade models and offering predictions about the relationship between affiliate production and parent-country and host-country characteristics. In particular, the knowledge-capital approach to the multinational enterprise identifies motives for both horizontal and vertical multinational activity and predicts how affiliate should be related to variables such as country sizes and relative-endowment differences.

Vertical multinationals dominate when countries are very different in relative factor endowments; horizontal multinationals dominate when countries are similar in size and in relative endowments and trade costs are moderate to high. Investment liberalisation can lead to an increase in the volume of trade and produces a strong tendency toward factor-price equalisation: direct investment can be a complement to trade in both a volume of trade sense and in a welfare sense.

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Recent trends[2]. In 2008 and early 2009, global FDI flows declined following a period of uninterrupted growth from 2003 to 2007. Meanwhile, the share of developing and transition economies in global FDI flows surged to 43% in 2008. In 2008, FDI inflows to developed countries shrank by 29% compared with the previous year, while FDI inflows into developing countries were less affected than those into developed countries. FDI inflows into developing countries therefore increased in 2008 at 17%.
Outflows of FDI from developed countries as a group declined in 2008, FDI outflows from developing countries rose by 3% in 2008,. Asian economies, especially China, continued to dominate as FDI sources. Thus in the first half of 2009, developing countries seemed better able to weather the global financial crisis, as their financial systems were less closely interlinked with the hard-hit banking systems of the United States and Europe.

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[2] Free on line databank on FDI is available at http://stats.unctad.org/FDI/ReportFolders/reportFolders.aspx

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