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A SURVEY OF FOREIGN DIRECT  
INVESTMENT THEORY

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# A SURVEY OF FOREIGN DIRECT INVESTMENT THEORY

by Thomas N. Gladwin and Ian H. Giddy<sup>1</sup>

## I. INTRODUCTION

In contrast with much of international economic theory, the theory of foreign direct investment (FDI) is just emerging from infancy. As is characteristic of economic theories in their early, indeterminate stages, a number of explanations of the FDI phenomenon have recently been offered. This paper provides a survey of the major theoretical interpretations of direct business investment abroad by national firms. A primary aim is to summarize the answers that these theories provide in regard to a number of important questions that have been raised concerning the nature of FDI. In order to answer these questions, the paper surveys the basic conceptual frameworks currently in existence, drawing primarily on the theoretical contributions of international economics, industrial organization, and growth of the business enterprise.

The subsequent discussion concerns itself first with the rationale for FDI and its ability to survive and expand, and second, with the industrial and geographical patterns of direct investment flows. Major attention is given to two dominant contributions: the monopolistic advantage and product life

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<sup>1</sup>Ph.D. candidates at the University of Michigan, Graduate School of Business Administration. The comments of Dr. Gunter Dufey are gratefully acknowledged.

cycle theories. Three additional explanations of FDI which use behavioral, capital market imperfection, and imperialism approaches, respectively, are discussed. A final synthesis integrates the material and attempts to answer the major questions required of a satisfactory comprehensive theory.

## II. FOREIGN DIRECT INVESTMENT DEFINED

Traditionally, FDI has been viewed as an international flow of capital, differing from other types of international capital movement such as portfolio investment<sup>2</sup> because it is accompanied by varying degrees of control, technology, and management. Yet the capital movement interpretation has been found to be incomplete: new FDI may or may not be accompanied by a flow of financial capital (i.e., movement of funds through the foreign exchange market), or real capital (i.e., machinery, etc.). FDI may take place through borrowing abroad in local or multinational markets, through the reinvestment of local profits, or through the exchange of tangible property for ownership of a foreign subsidiary. Thus, FDI represents not so much an international capital movement as capital formation undertaken abroad.<sup>3</sup>

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<sup>2</sup>In portfolio investment the private investor does not exercise any managerial control. The foreign investor either holds foreign bonds or other nonequity securities which do not confer ownership rights, or he holds stock shares in a foreign company in an amount too small to give him managerial control.

<sup>3</sup>Charles P. Kindleberger, International Economics, 5th ed., (Homewood, Illinois: Richard D. Irwin, 1973), p. 246.

The nature of modern FDI differs both conceptually and behaviorally from a mere long-term capital flow. Broadly viewed, FDI pertains to the formation (or acquisition) and ownership of productive capabilities abroad by a foreign enterprise. However the essence of FDI is control in a managerial sense. Managerial control is extended to cover business activities abroad; the locus of decision making power resides in the source country business enterprise. In addition, while strictly financial resources are not necessarily involved, FDI always embraces a transfer of some economic resources or factor inputs. This international transfer will often consist of a complementary package of inputs. Technology, management skills, production processes, entrepreneurship, funds, and other factor inputs may or may not be embodied in the package. The package is often made up of indivisible inputs, whose parts are not easily effectively separated or disassociated from the foreign firm using them.<sup>4</sup>

This broader vision of the nature of FDI is adopted for use in this paper. Thus, FDI is seen as much more than mere international capital movement. The key features are extension of managerial control and transfer of a complementary package of factor inputs. It must be stressed that control and transfer

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<sup>4</sup>The presumption of package indivisibility is a current controversy. See A. E. Safarian, "Perspectives On Foreign Direct Investment From the Viewpoint of A Capital Receiving Country," The Journal of Finance, 28, May 1973, pp. 425-426.

of resources are not two unrelated, independent concepts but are mutually dependent. Control is necessary to:

(i) effectively channel and administer the continuous flow of the complex resource package, and (ii) assure obtainment of a maximum share of benefits from the application of these resources in the foreign environment. Although not all FDI is undertaken by multinational enterprises (MNEs) (i.e., some governmental and mixed governmental-private FDI does exist), they are by far the major conduits. As viewed in this paper, FDI represents one of the primary instruments by which MNEs implement their international strategy.

### III. HISTORICAL OVERVIEW OF FDI

International corporate activity resulting in overseas investment is hardly new. The antecedents of modern FDI can be traced back to the Middle Ages, the Renaissance, and the Age of Exploration when the great banking houses and trading companies maintained branches in foreign countries.<sup>5</sup> During the age of empire building, large commercial colonial enterprises invested extensively in the underdeveloped areas of Asia, Africa, and the Americas, including the U.S. During the latter half of

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<sup>5</sup>For discussion of the historical predecessors of the modern-day multinational enterprises see: Arvind V. Phatak, Evolution of World Enterprises (New York: American Management Association Inc., 1971), Chapter 1; Endel J. Kolde, International Business Enterprise, 2nd ed. (Englewood Cliffs: Prentice-Hall, Inc., 1973), Chapter 9; and Richard D. Robinson, International Business Policy (New York: Holt, Rinehart and Winston, 1964), Chapter 1.

the nineteenth century, business investment, motivated by the need to secure sources of raw materials for the developing industrial revolution, began to replace this colonial investment. It was during these late 1800s and early 1900s that today's large MNEs such as Unilever, Singer, Standard Oil, Nestle, Kodak, and Shell began going global.<sup>6</sup> Direct investment, however, represented only a small portion of the total international investment of this period; portfolio investment constituted the dominant form of investment in foreign countries.<sup>7</sup>

The analysis of this paper is largely centered on the post-World War II period, the era of international corporate activity. The industrial composition of FDI shifted from primary to secondary level production activities. Manufacturing investment, rather than mining and smelting, agriculture, public utilities, etc., became the dominant form. FDI increasingly took place between the highly industrialized nations. The share of FDI going to the advanced nations dramatically increased, while the share to the less-developed countries fell. During this period, FDI rose at about ten percent a year, while world trade and real GNP's grew at rates of only 7% and 4-5%,

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<sup>6</sup>The best work on the early history of the multinational enterprise (from the colonial period to 1914) is: Mira Wilkins, The Emergence of Multinational Enterprise: American Business Abroad From the Colonial Era to 1914 (Cambridge, Mass.: Harvard University Press, 1970).

<sup>7</sup>For a historical look at international capital movements see: John H. Dunning, Studies In International Investment (London: George Allen and Unwin, 1970), Chap. 1.

respectively. In addition, the sources of investment shifted: the proportion of U.S.-based FDI declined and a counter thrust of European and Japanese origin has been emerging.<sup>8</sup> For an excellent survey of FDI facts, statistics and history see Chapter 1, "Concepts and Dimensions," in the recent United Nations study: Multinational Corporations in World Development.<sup>9</sup>

#### IV. REQUIREMENTS OF FDI THEORY

A comprehensive theory of FDI should not only provide a satisfactory explanation of the rationale for FDI (i.e., why and how), but also must be capable of explaining the observed patterns (i.e., what and where) of FDI in the world economy. These explanatory requirements can be translated into a set of questions as follows:

- A. Why do firms wish to expand abroad?
- B. Why do they choose to expand abroad by means of FDI rather than through alternative strategies such as exporting and licensing?
- C. What advantages do foreign investors have over local firms that enable them to overcome the inherent disadvantages of being a foreigner in an unfamiliar environment?

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<sup>8</sup>For a recent survey of European investment in the U.S. see: H. E. Ekblom, "European Direct Investments in the United States," Harvard Business Review, 51, July-August 1973, pp. 16-26, 146-150.

<sup>9</sup>United Nations, Department of Economic and Social Affairs, Multinational Corporations in World Development (New York: United Nations, 1973) ST/ECA/190.



- D. Why do a few countries tend to be mainly the source of, and many others the recipient of, FDI?
- E. Why does FDI take place in some industries and not in others (and why do some firms but not others in a given industry invest abroad)?
- F. Why does cross-hauling take place (why does FDI occur in both directions between certain countries, even in the same industry)?

These questions about the rationale for and patterns of FDI are not answered fully by any one of the theories described below; however, they should be kept in mind as each major explanation of FDI is explored. In essence, these questions provide the reader with a set of measures with which to judge the explanatory power or capability of the various theories. Each of the theories which follow necessarily attempts to abstract from the complexity of the real world a simplified and generalized model of the FDI phenomenon. However, to the extent that they help to organize disciplined thinking about FDI and about policies relating to it, they are well worthy of analysis.

## V. THE MAJOR APPROACHES

It is appropriate to prelude an exploration of the two major approaches to FDI theory with a brief review of the classical theory of international investment. This theory,

as propounded by Ricardo, Hume, Mill, Iversen, and others, postulated that interest rate differences between countries are the causes of international capital movements.<sup>10</sup> Everything else being equal, the larger the differential between expected marginal profit or interest rates, the larger will be the movement of long-term capital. The classical capital abundance hypothesis predicted the direction of movement: in the absence of market imperfections or intervention, the flow of funds will be from countries with relatively low expected rates of return on new capital investment (i.e., as reflected in interest rates), to countries with relatively high expected rates of return. Capital thus flows from capital-abundant nations (with low marginal returns to capital) to nations with a shortage of capital (and higher marginal returns to capital).

This flow has the effect of raising the return to capital in the capital-abundant nations and lowering it in capital-short nations. Capital continues to flow in the same direction until returns to capital are eventually equalized in all nations. At the level of the firm, international investment--just as domestic investment--is a function of the relationship between return on investment and the cost of investible funds. The

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<sup>10</sup>For a comprehensive review of the classical theory of international investment see: Carl Iversen, Aspects of the Theory of International Capital Movements (London: Oxford University Press, 1935).

enterprise will invest abroad as long as the marginal rate of return, adjusted for risk differences, is greater abroad than at home.

The above theory provides a good explanation of international movements of financial capital, both short-term and long-term, when account is taken of devaluation risk and other risks. Moreover, it accords reasonably well with the form of foreign investment that dominated the pre-World War II period: that is, portfolio investment, chiefly bonds. But modern-day investment abroad is primarily of the direct form, for which classical capital flow theory is a rather inadequate explanation. As previously mentioned, FDI frequently does not involve an international capital movement. Even when it does, capital flow theory explains only how firms decide where to obtain capital to finance their investments; it says nothing about the acquisition, control and management of real assets by foreigners. FDI often takes place simultaneously in two directions, a phenomenon impossible under the assumptions of the classical theory. Nor can the geographical distribution of FDI be satisfactorily explained by yield differences between host and source nations. Finally, if the movement of capital is all that matters, why shouldn't this take place directly through the efficient international capital markets which are specifically organized for this function; why introduce the mediation of the firm, whose skills and expertise usually lie in the areas of production and marketing?

A. The Monopolistic Advantage Theory

The classical capital-flow theory serves as a useful reminder that the ultimate objective of firms' foreign investments is the attainment of higher marginal profit--a fact sometimes ignored by modern writers on the subject. The theory, however, is based on the assumptions of a perfectly competitive world of economic theory. The theory to be described in this section does not depend on these assumptions--in fact, it contends that the existence of direct investment abroad is dependent on imperfections in the markets for factors of production (capital, technology, management skills, patents, etc.) and for the firm's products.

The Foreign Investor's Monopolistic Advantage. The shortcomings of classical theory and the fact that what firms take abroad with them when acquiring control of foreign productive facilities is not so much capital as some special advantage such as technological know-how, patents, entrepreneurial skills, or the ability to manage men and assets in a productive and profitable manner necessitated a bold departure from the classical model. This was provided by the so-called monopolistic advantage theory of foreign direct investment, which appeared in its initial form in an unpublished 1960 doctoral dissertation at MIT by Stephen H. Hymer, "The International Operations of National Firms: A Study of Direct Investment".<sup>11</sup>

<sup>11</sup>Hymer's theory has been propounded and extended by Charles P. Kindleberger in American Business Abroad: Six Lectures On Direct Investment (New Haven, Conn.: Yale University Press, 1969), see especially Chapter 1: "The Theory of Direct Investment," pp. 1-36.

A business firm investing abroad, according to this theory, inevitably faces two disadvantages. First, it carries a stigma and political risk by reason of its being controlled by foreigners. Second, the foreign investor incurs certain distance costs--costs associated with unfamiliarity with the local environment and communications problems as well as physical distance. Other things being equal, therefore, host-country firms possess an inherent advantage over potential foreign competitors. In the hypothetical case of a perfectly competitive market for factors of production, host-country firms would be able to purchase any technology, patent, or other advantage possessed by foreign firms; and because of the local firms' inherent cost advantage foreign investors would never be able to compete profitably. But foreign investment does exist; so foreign investors must, if they are to succeed, possess some special or monopolistic advantage that cannot be purchased by their actual or potential local competitors. The term monopolistic advantage is intended to suggest that the firm has some degree of monopoly control over its special asset. The advantage is unlikely to be just access to less expensive financial capital. If this were the overriding advantage of the foreign firm it could exploit it by making purely financial (portfolio) investments. There would be no need to expose the firm to the risks, costs, and headaches of owning fixed assets abroad. FDI, therefore, belongs more to the theory of imperfect competition than to

the theory of capital movements.

What are the special advantages possessed by international firms? Often such firms control patents or technological skills not available to local competitors. Other advantages include marketing skills, or management know-how that is inseparable from the production process. The advantages are usually thought of as being embodied in knowledge, information, or technique, but could well be those associated with firm size, economies of scale and vertical integration, or access to large amounts of capital<sup>12</sup> in the sense that lenders will provide funds only if the assets are owned and managed by a corporation that is firmly believed to have the ability to run the project safely and profitably.

Whatever the special advantage actually is, it must fulfill an essential condition in order to be exploited profitably abroad. This condition is that it must be able to be applied abroad without too much change, i.e., it must be transferable abroad at little or no incremental cost to the firm. Examples of such unique assets are technological developments and management know-how. These advantages may have cost the firm a great deal to develop; however, the firm regards these as sunk costs and therefore wishes to make profitable use of its underemployed resources.

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<sup>12</sup>Ibid., pp. 14-27, (Kindleberger draws a distinction between market imperfections in goods markets and those in factor markets).

Why Foreign Investment? The discussion that follows is focused chiefly on manufacturing investment abroad; FDI in the extraction of raw materials will be treated later.

The motivation to exploit abroad special advantages that have been successfully employed at home arises when firms encounter limits to increasing sales of their traditional products in domestic markets. In order to grow, firms must undertake product diversification at home or horizontal expansion to sell the same or a similar line of goods abroad. With few exceptions, firms do not engage in product diversification across national boundaries. When firms have skills or advantages whose opportunity costs are low as compared to the return attainable via foreign investment, they tend to expand abroad.<sup>13</sup>

There are, however, at least three ways of expanding abroad: exporting; licensing a technology, brand name, or patent to foreign producers; or foreign investment. Under what conditions will foreign investment be chosen?

Licensing is feasible only when the firm's unique advantage can be transferred reasonably intact to a foreign firm. This is not the case when the advantage is one of a continual input of new technology from the parent company. Licensing tends to prevail when the advantage is a specific

<sup>13</sup>Richard E. Caves, "International Corporations: The Industrial Economics of Foreign Investment," Economica, 38, February 1971, pp. 5-6.

patent or technique, when the distance costs to the firm are relatively high, and, of course, when no other form of market entry is legally feasible. The restrictions on inward foreign investment that have been in force in Japan are an example of the latter.

Production abroad will be preferred over exporting, according to international trade theory, for reasons of comparative advantage and transfer costs. These traditional reasons, however, may be dominated by a marketing consideration: it is frequently asserted that local sales are helped by local production.<sup>14</sup> With on-the-spot production, better service can be provided to the firm's customers and the product can be more easily adapted to local market conditions.

What Characterizes Firms That Invest Abroad? To summarize, direct investment abroad is a feasible and likely choice when a domestic firm has some unique, monopolistic advantage, and (i) the advantage can be transferred abroad within the firm at little or no additional cost, (ii) it is a continuing, changing advantage and/or is in some other way inseparable from the firm's ongoing operations, and (iii) the profit from the unique advantage is closely tied to local production or marketing techniques. These are the fundamental conditions for successful--that is, profitable--investment abroad, according

<sup>14</sup> See: Jack N. Behrman, Some Patterns in the Rise of the Multi-national Enterprise, Research Paper No. 18, Graduate School of Business, University of North Carolina, Chapel Hill, N.C., 1969, p. 3.



to the monopolistic advantage theory. Taken together these conditions point to a particular characteristic of industries in which FDI occurs--product differentiation. This means that the firm's products are functionally similar to major competitors' products, but are held by the market to be differentiated from one another either by physical variations or subjective differences created by advertising or brand names. Marketing skill advantages inherent in product differentiation are often transferable abroad and are tied to the firm's operations by means of an ability to constantly change the product and/or its promotion. It is for this reason that industries with considerable foreign investments tend to have high expenditures for new product research and development and advertising.<sup>15</sup> Knowledge about how to serve a market (and differentiate a product) is, moreover, most effectively applied when the firm operates in or close to the market itself. This is less true of advantages in the form of patents or managerial skills. Casual evidence supports the contention that manufacturing investments abroad will be undertaken in industries where product differentiation prevails such as in automobiles, other consumer durables,

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<sup>15</sup>William H. Gruber, Dileep Mehta, and Raymond Vernon, "The R & D Factor in International Trade and International Investment of United States Industries," Journal of Political Economy, 75, February 1967, pp. 20-37; and Thomas Horst, "Firm and Industry Determinants of the Decision to Invest Abroad: An Empirical Study," Review of Economics and Statistics, 54, August 1972, pp. 285-266.

and chemicals.<sup>16</sup>

FDI and Oligopoly, Given these characteristics of FDI and of the industries in which it takes place, one is able to discuss the way in which decisions to invest abroad in manufacturing operations are reached, and on the timing of such investments. These aspects of FDI are best explained by reference to the less-than-perfect competition that exists in many product differentiation industries. Industries that manufacture abroad, this theory contends, are characterized by product differentiation, but also by oligopoly. That is, they are industries in which there are only a few sellers who market products that are close substitutes for one another, and who recognize their mutual interdependence.<sup>17</sup> Firms in an oligopoly react to one another's actions in a direct and personal manner.

The existence of a few, mutually interdependent firms is indeed typical of industries with considerable foreign investment. In such an oligopolistic industry, a time comes when the local market has been fully exploited. Product differentiation advantages do not readily lend themselves to application in other industries, so diversification is not feasible.

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<sup>16</sup> See: Raymond Vernon, Sovereignty at Bay: The Multinational Spread of U.S. Enterprises (New York: Basic Books, 1971), Chap. 1.

<sup>17</sup> See: Frederick T. Knickerbocker, Oligopolistic Reaction and Multinational Enterprise (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1973).

As indicated earlier, the incentive is to obtain returns on the firm's sunk costs of producing marketing and technological know-how by investing to produce the same product lines abroad as at home.

But each firm recognizes that if one firm goes abroad, that leader will dominate the foreign market and its profits may rise to an above-average level for the industry. If any one firm is allowed to dominate not only will its rivals suffer an opportunity loss, but in addition their cost of equity capital may rise in comparison to this firm as investors shift funds into the stock of this foreign investor with its now higher earnings expectations. To minimize this risk, one firm's intention to invest abroad will be matched by similar actions in the remaining companies in the industry. This is reflected in the oft-heard contention of business executives that foreign investment is undertaken defensively to protect their firm's market share. Each firm, in fact, wants to protect its share of the returns that can be gained abroad on special marketing or business capabilities that were previously developed at home. It is for this reason that FDI tends to be characterized by oligopolistic industries, and that the foreign investments of large U.S. firms in the same industry have tended to bunch together in time and place--notably in the sixties.

Foreign investment in the oil and mining industries is also characterized by oligopoly, but its existence is explained somewhat differently. Such investments form part of a vertical integration strategy--the common ownership and integration of oil wells, oil refineries, and petroleum-product marketing outlets, for example. Vertical direct investments have been analyzed in terms of economies of scale; efficiency and economy may result from coordinating decisions at various stages of production within one firm. Of firms with vertical investment in raw materials sources, it is argued that "their advantage over other firms with equal technology, managerial skill, access to capital, and so on, is that they coordinate mining operations with transport and marketing."<sup>18</sup> No doubt this is true in some cases, but the major motive for vertical investments abroad in raw materials industries is a defensive one. Large international firms find it both necessary and advantageous to control the sources of raw material supply to production processes in the home country whenever the supply of raw materials is limited and controlled by a few governments. This creates uncertainties regarding possible supply cut-offs and the possibility of input prices being raised. The strategy has the effect of erecting barriers to the entry of new competitors in the industry and thus protecting existing firms' oligopolistic positions. In the petroleum industry, for

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<sup>18</sup> Charles P. Kindleberger, American Business Abroad..., op. cit., p. 20.

example, new rivals are effectively discouraged by the long-term concessions granted on known resources, and the extra costs of finding and developing new resources.

The monopolistic advantage theory of direct investment is a powerful one. It is also intuitively appealing because it agrees with the apparent facts of international business which are the large size and small number per industry of multinational firms and the absence of significant foreign direct investment in highly competitive industries such as agriculture, retailing, and textiles. It should perhaps be noted that the theory is based on observations of American MNC's. There is little reason to believe, however, that the conclusions drawn lose their validity when the FDI carries a Japanese or European label. In each case the ability of the firm to engage in FDI depends on some unique or monopolistic advantage not available to host-country firms.<sup>19</sup>

There remain, however, a few unanswered questions. Why, for example, have firms exploited their monopolistic advantages only in recent years? Why do some firms within an industry invest abroad and not others?<sup>20</sup> And what is the explanation

<sup>19</sup> Lawrence G. Franko, "Multinational Corporations in the 1970's: Will They Matter?," in Pierre Uri (ed), Trade and Investment Policies for the Seventies: New Challenges for the Atlantic Area and Japan, (New York: Praeger Publishing, 1971), p. 186.

<sup>20</sup> Elsewhere it has been suggested that the major explanatory factor for such within-industry differences is firm size--large firms can bear the costs of information as well as the risks of foreign cases more easily. See Thomas Horst, "Firm and Industry...", op. cit., p. 261.

for the host-country pattern of FDI; for example, why has about 65% of U.S. investment gone to the more developed countries and, in particular, to Canada? Finally, the theory does not explain well the evolution over time of production location and direct investment patterns; this theme is best handled by the other major theory of FDI, the product life cycle model.

#### B. Product Life Cycle Theory

Introduction. Recently, a dynamic theory emphasizing national comparative advantage in new product generation, subsequent product evolution, and global diffusion of technology has emerged to explain patterns of international trade and investment.<sup>21</sup> At center stage is the role of the multinational enterprise; its international involvement is viewed as following sequential stages in the life cycle of the product or process it innovates.

In contrast to the classical theory of trade, this approach assumes that information and technology are tightly controlled and not freely transferable between countries, that scale economies in R & D and production exist, and that products

<sup>21</sup>The trade theory approach has recently been explored by Harry Johnson and Raymond Vernon, in particular. See the following: Harry G. Johnson, Comparative Cost and Commercial Policy Theory For a Developing World Economy (Wicksell Lectures 1968, Stockholm: Almquist and Wiksell, 1968); Raymond Vernon, "International Investment and International Trade in the Product Cycle," Quarterly Journal of Economics, 80, May 1966, pp. 190-207; Raymond Vernon, Sovereignty at Bay: The Multinational Spread of U.S. Enterprises, (New York: Basic Books, 1971), Chap. 3; Louis T. Wells, Jr. (ed.), The Product Life Cycle and International Trade (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1972).

undergo predictable changes in their marketing and production characteristics over time.<sup>22</sup> It must be pointed out that the focus of this theory is largely on U.S.-based manufacturing direct investment.

Rationale: Innovational Advantage and Product Life Cycle.

The model claims that as a product moves through the stage of its life cycle [from new product to mature product to standardized product] it is associated with an international trade and investment cycle as well. The life cycle of an internationally marketed product is viewed as following a common pattern in terms of location of production, direction of trade, and market structure. Overwhelming evidence has been found in support of this model.<sup>23</sup>

As living standards rise, the value of human labor time also rises and this creates incentives for the development of

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<sup>22</sup>For a full listing of the assumptions underlying the product life cycle concept see: Louis T. Wells, Jr., "International Trade: The Product Life Cycle Approach," in Wells, op. cit. pp. 19-21.

<sup>23</sup>See the following: James W. Vaupel and Joan P. Curhan, The Making of Multinational Enterprise (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1969); Raymond Vernon, Sovereignty at Bay... (op. cit.); the collection of eight studies in Louis T. Wells Jr., (op. cit.); and Mira Wilkins, The Emergence of Multinational Enterprise (Cambridge, Mass.: Harvard University Press, 1970).

both high-income consumer goods and labor-saving producer goods.<sup>24</sup>

It has been observed that the innovation of new products and processes is more likely to occur close to a market in which there is a strong demand.<sup>25</sup> Because the flow of information between nations is restricted (e.g., by geographic distance, communication costs, and cultural, linguistic, political, and legal differences) not all opportunities for new product innovation are equally well known to all prospective producers everywhere.<sup>26</sup>

Differences in the availability and cost of acquiring information about foreign markets and industrial systems tends to confer an advantage to those producers who are physically and culturally closest to a prospective market. Added to the

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<sup>24</sup>One should note that a bit of circular reasoning is employed here: rising living standards lead to new market demands, which provide incentives for the innovation of products or processes to meet these demands, which when produced serve to raise living standards, which of course lead us once again to the same demand - incentive - innovation - production cycle. The source of innovation theoretically should not be the result of innovation.

<sup>25</sup>For discussions of the role of demand in new product development and causes of innovation see: James R. Bright, Research Development and Technological Innovation (Homewood, Ill.: Richard D. Irwin, Inc. 1964); Staffan B. Linder, An Essay on Trade and Transformation (New York: John Wiley and Son, 1961); R. R. Nelson (ed.), The Rate and Direction of Inventive Activity (Princeton: Princeton University Press, 1962); and Jacob Schmookler, Invention and Economic Growth (Cambridge: Harvard University Press, 1966).

<sup>26</sup>For a fuller exploration of the variety and impact of barriers to trade and information see: Harry G. Johnson, op. cit., pp. 28-31.



observation that nations are on similar growth paths (i.e., rising incomes and labor costs), this implies that an innovational advantage, a source of comparative advantage, is possessed by producers in the richest and largest nations who are innovating goods and processes that will be in demand abroad in years to come.

Initially, innovations are typically produced in the country for whose market they are designed, even though this may not represent the lowest cost location. What accounts for this indifference to cost considerations during the new product stage? A number of characteristics associated with the uncertainty of new product development and introduction seem to provide the answer. During this stage there is a crucial need for quick and effective communication between producers, customers, and suppliers so that market information can be quickly translated into product changes. In addition, the demand for the product is likely to be relatively inelastic due to product differentiation and the initial monopoly position of the innovation. For these reasons, the cost of production is not a major factor at this stage with the result that the location of initial production is usually in the country of innovation.

Following product introduction, a process of maturation sets in involving a transition from product differentiation to product standardization. Specifications become more

standardized, production runs become larger and more stable, and economies of scale through mass output allow for a lowering of average cost. Many of the production and marketing uncertainties are lessened and the technology or product can more easily be imitated, making for increased competition as more firms enter the market. During this period of technological standardization some unsolicited orders come in from abroad. A modest export business usually blossoms as income levels and labor costs rise in foreign nations. These exports constitute technological-gap trade,<sup>27</sup> enabling the original producer to extend his exploitation of his eroding monopoly advantage in the face of increasing competition at home.

As time goes by, demand in foreign markets rapidly develops, barriers to entry fall as the product or process technology becomes increasingly standardized, and wider possibilities for technological diffusion and imitation become available. In certain advanced-country markets demand grows sufficiently large to support a local production facility of economic size. In general, the length of time until foreign production begins is dependent on the economies of scale, tariffs, transportation costs, income elasticity of

<sup>27</sup> A major source dealing with the role of technology in trade is Raymond Vernon (ed.), The Technology Factor in International Trade (New York: National Bureau of Economic Research, 1970). For the original work on technological-gap trade see Michael V. Posner, "International Trade and Technical Change," Oxford Economic Papers, 13, October 1961, pp. 323-344 and G. C. Hufbauer, Synthetic Materials and the Theory of International Trade (Cambridge: Harvard University Press, 1966).

demand for the product, and the income level and size of the foreign market. The time is shorter where economies of scale are reached at low volumes, tariffs and transportation are high, income elasticity of demand is low and income level and size of the foreign market is large.<sup>28</sup>

The transfer of production from the country of innovation to foreign locations may occur in alternative ways: through imitation of the innovation by indigenous firms, through a direct investment by the innovating firm in a manufacturing plant, or through licensing by the innovating firm of the productive knowledge to a domestic firm.<sup>29</sup>

The most powerful motive that induces the innovating leader to invest abroad at this time is the perceived threat to his established export market position, either by local imitators or rival multinational competitors, or by an anticipated increase in local tariff levels. As the original innovator sees it, exporting will soon cease to be a viable option and his choice at this point is either to invest or to give up the overseas market. The motive is thus defensive or preemptive in nature, reflecting the attempt to hang on to a market already built up through exports.

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<sup>28</sup>Wells, "International Trade...", op. cit., p. 13.

<sup>29</sup>Harry G. Johnson discusses these three methods of production transfer and a possible fourth alternative when the product or technical knowledge loses its commercial value in Johnson, op. cit., pp. 34-38.

The innovator is also attempting to retain, extend, and exploit what remains of his eroding monopolistic advantage. The foreign firm is able to retain part of its innovational lead in the local market particularly if barriers to entry are strong, implying that the cost to indigenous competitors of entering the market is high. It was observed in the monopolistic advantage theory that the foreign investor must overcome the many incremental distance costs which a local firm does not face. With the gradual diminution of the initial product or process-specific innovational advantage, one must question how the foreigner is able to effectively compete. The answer probably lies in the investor's special ability to maintain a continual innovational lead. It may also be related to the possession of other managerial, marketing, and financial skills which serve to supplement the innovational advantage in offsetting the costs of being foreign.

As potential or actual competition in the product increases globally, prices and profit margins are forced down, making low production costs increasingly important. As concern about production cost becomes critical, the location of production will shift again to lower labor cost nations, usually in the less-developed nations. This is the so-called standardized product stage where the basis for the original lead is almost completely eroded. At this point the original innovator will either abandon the product, attempt to create new

oligopoly advantages, or attempt to find the location with the lowest total factor cost from which to export back to the more developed markets.<sup>30</sup>

Explaining Patterns of FDI. The model presented above is, of course, a generalization and a deliberate simplification of reality. Nonetheless, considerable evidence suggests that the development of U.S. foreign direct manufacturing investment does come about in this manner.<sup>31</sup> The theory's description of a trial-and-error path leading through exports to FDI does correspond well with the observed pattern of penetration in foreign markets. The emphasis on technology, behavior over time, innovational advantage, economies of scale, defensive motives, and uncertainty in influencing trade and investment patterns contribute much to our understanding of the FDI phenomenon.

The product life cycle approach provides a rather good explanation for the industrial patterns in manufacturing investment which have occurred. Much U.S.-based horizontal FDI has occurred in the electrical, chemical, transportation equipment, and machine product industries; all research-intensive and science-based industries. Strong links between

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<sup>30</sup>Vernon, Sovereignty at Bay... op. cit., pp. 76-77.

<sup>31</sup>See sources in footnote 3 and Seev Hirsch, Location of Industry and International Competitiveness (Oxford: The Clarendon Press, 1967); Robert B. Stobaugh, Jr., "The Product Life Cycle, U.S. Exports and International Investment," D.B.A. Thesis, Harvard Business School, June 1968; and Robert B. Stobaugh, et al., "U.S. Multinational Enterprises and the U.S. Economy," in The Multinational Corporation (Washington: U.S. Department of Commerce, 1972).

R & D effort, export performance, and foreign expansion have been pinpointed.<sup>32</sup>

The reasoning behind the model also compares reasonably well with the facts of the 1950s and 1960s with regard to the geographical patterns of FDI in the manufacturing sector. During this period, the U.S. was conclusively a leader in new product development of goods designed to meet labor-saving or high-income needs.<sup>33</sup> Much of the world's FDI originated from the U.S., reflecting the innovational lead, and went largely to Canada and Western Europe where demand existed for technologically advanced manufacturing and consumer goods.

Of course, innovation is not confined to or monopolized by the large countries. Enterprises innovate in response to environmental conditions in their home markets. In Europe, for example, the innovative stress has rested on raw material or capital conservation. Although the trade theory model presented above was directed only to innovation induced by the rising value of human time, one would expect that any kind of cost-lowering innovation may set a trade and investment product cycle in motion. Some of the rapidly growing European and Japanese investment abroad may, perhaps, reflect a carrying of distinctive innovations across national borders. In any case, the trade theory model suffers from an inability to

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<sup>32</sup>William H. Gruber, Dileep Mehta, and Raymond Vernon, op. cit.

<sup>33</sup>See the following O.E.C.D. studies: Gaps in Technology: An Analytical Report (Paris: OECD, 1969); and The Conditions for Success in Technological Innovation (Paris: OECD, 1971).

fully explain non-U.S. foreign manufacturing investment abroad (especially in the U.S.), and fails the crucial explanatory test of FDI cross-hauling. Finally, as its principle proponent has noted, the model may be losing some of its relevance in explaining current patterns of FDI as produced by large multinational firms with a global habit of mind and global scanning capacities.<sup>34</sup> Large multinationals are increasingly shedding a home country orientation and are basing investment decisions on a conception of the firm as a global entity. The growing practice of developing complex world sourcing and logistical networks, especially in such industries as transport equipment and electronics, has given new importance to cost advantages. Less-developed host countries are increasingly engaged in the production of fairly sophisticated products with the traditional stages of the product cycle being eliminated or shortened. In other words, an increased multinational orientation on the part of large MNEs combined with better communications and transportation facilities have served in some cases to shorten the early stage of the international investment cycle to virtually zero.

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<sup>34</sup>Vernon concludes his examination of the model with a brief section entitled "Toward Another Model," in Sovereignty at Bay..., op. cit., pp. 107-112.

## VI. SUBSIDIARY CONTRIBUTIONS TO FDI THEORY

Three additional contributions to an understanding of business investment abroad are the behavioral approach, capital market imperfections theories, and the modern-imperialist view. The first and last of these do not purport to substitute for the direct investment theories delineated above; rather, they try to explain the same phenomena from different perspectives.

### A. The Behavioral Approach

A useful starting point for an explanation of foreign investment in terms of organizational behavior and subjective preferences is the idea of corporate growth as a motivating force in large firms.

In the view of J. K. Galbraith, once the corporation has satisfied its profit constraint the organizational goal becomes corporate growth as measured by sales.<sup>35</sup> Expansion of the firm means more responsible jobs and hence more promotion and more compensation for executives. But what factors influence firms' decisions to expand by means of foreign investment?

One writer who deals with the initial foreign investment decision argues that rational economic behavior in firms is

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<sup>35</sup> John Kenneth Galbraith, The New Industrial State (Boston: Houghton-Mifflin Company, 1967), pp. 171-178.



subject to a constraint analogous to the physical law of inertia: a body at rest will remain immobile unless disturbed by an external force.<sup>36</sup> Corporate inertia and information costs will keep a firm in familiar, nearby markets unless a sufficiently great external stimulus overcomes the subjective impediments to going abroad. This idea is supported by the evidence that a large proportion of U.S. FDI has occurred in Canada. Another theory which claims that foreign investment decisions cannot be explained by economic rationality alone is contained in a rather fascinating book by Yair Aharoni called The Foreign Investment Decision Process.<sup>37</sup>

The author describes the first foreign investment decision as "to a large extent a trip to the unknown."<sup>38</sup>

The uncertainty, the ignorance, and the lack of precedent associated with investments in a foreign country must be overcome by some powerful initiating force that will induce the firm to investigate an FDI proposal. External inducements to foreign investments include the so-called bandwagon effect, in which a company takes an action because others are doing

<sup>36</sup> See: J. David Richardson, "On Going Abroad: The Firm's Initial Foreign Investment Decision," Quarterly Review of Economics and Statistics, 11, Winter 1971, pp. 7-22.

<sup>37</sup> Yair Aharoni, The Foreign Investment Decision Process (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1966).

<sup>38</sup> Ibid., p. 42.

so, or because of strong competition from abroad in the home market. But once the investigation is undertaken, if it is not checked, an individual in the organization usually develops a vested interest in the proposed investment: he then seeks information to support his case for approval. The firm's commitment may also develop from the strong interest of a high-ranking executive. The creation of an international division, deriving its raison d'etre from international operations, creates forces that impel the corporation toward increasing foreign involvement. The foreign investment decision is not made: it evolves as a complex social process. Aharoni, too, replaces the profit maximization assumption with the concept of "satisficing"; the firm has a multiple goal structure and, subject to some specified satisfactory level of achievement, will select investment projects that are "good enough."

The behavioral perspective with its emphasis on subjective preference, perceived risk, satisficing, information and commitment adds a great deal to our understanding of FDI. It is clear that the motivations for, and resulting patterns of, FDI lie in behavioral variables as well as in the economic ones which we have explored above. The existence of external stimuli and initiating forces does help to explain how firms arrive at the decision to go abroad and the considerations of information availability, cultural and political familiarity,

and short physical distance do help to explain the observed patterns of FDI geographical expansion.

B. Capital Market Imperfection Theories

The second of the subsidiary theoretical contributions to foreign direct investment theory asserts that the main source of a foreign investor's advantage over local firms is the confidence investors in securities markets have in the investing country's currency compared to that of the host country.<sup>39</sup> The market participants--i.e., those who invest in the securities of firms--prefer to hold assets denominated in selected currencies, those that are not exposed to the risk of depreciation.

The exchange-rate theory is perhaps best explained by means of a hypothetical example. Say firm A, a U.S.-based MNE, wishes to build a plant in Colombia. Firm B, a local Colombian firm, is considering the same investment. The stream of future earnings from the investment will be the

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<sup>39</sup>A theory of FDI based on capital market imperfections was first suggested by Robert Aliber in "A Theory of Direct Foreign Investment", in C. P. Kindleberger (ed.), The International Corporation (Cambridge, Mass.: M.I.T. Press, 1970), pp. 17-34; the theory was reviewed and extended in Robert Aliber, "The Multinational Enterprise in a Multiple Currency World," in John H. Dunning, (ed.), The Multinational Enterprise (New York: Praeger Publishing, 1971), pp. 49-56. A second such theory of FDI, with the theme that direct investment results from imperfections in stock markets, is that of Giorgio Ragazzi, "Theories of the Determinants of Foreign Direct Investment," IMF Staff Papers, 20 July 1973, pp. 471-498.

same whoever builds the plant, except that firm A, as a foreigner to Colombia, is likely to incur extra distance costs. How can A overcome this disadvantage? The oligopolistic theory claimed the foreign investor owned some factor, managerial or other, that was not available to host-country firms. This view, however, asserts that firm A will have a lower cost of capital than firm B; that is to say, investors will be content with a lower rate of return on their investment in A than in B. Why? Because investors prefer to hold dollar-denominated equities to equities denominated in Colombian pesos (or any other weak currency). U.S. firms are identified with dollar equities, and Colombian firms with peso equities. Since investors will pay more for the dollar-denominated equities of American firms, the U.S. firm is able to pay a higher price for earning assets in a foreign country than is the local firm. Exchange-rate risk provides firms with an advantage that is "inherent in the financial system rather than in the behavior of individual firms."<sup>40</sup>

This thesis is intriguing in that it suggests that the world market of investors may attach a different exchange-risk premium to equities denominated in different currencies and thus evaluate investment opportunities differently, but it cannot be regarded as a complete theory of FDI. There is little evidence of any relationship between the flow of FDI to particular countries and the strength of their currencies.

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<sup>40</sup> Robert Aliber, The International Money Game (New York: Basic Books, 1973), p. 187.

For example, it does not explain how U.S. FDI has been able to continue at a high rate in spite of the weakness of the dollar during the past few years, and cannot explain the phenomenon of cross-hauling.

A recent theory that takes as its basis imperfections in capital markets claims that heavy European portfolio investment in the U.S., and corresponding heavy U.S. direct investment in Europe, is the result of Europe's less efficient capital markets. Narrow, inefficient stock markets in Europe induce European investors to put their money in the highly developed New York stock market, in American company stock. American companies investing in Europe, however, do not have to risk investing in European stocks--they find it much less risky to undertake direct investment. This way they incur only the usual business risk, without the added risk of stock market fluctuations caused by inefficient markets. This version of the capital market imperfections theme also provides a useful insight into one reason for foreign direct investment; yet all it really says is that firms who list their stocks in efficient stock markets are better able to make industrial investments than firms which do not. In other words, American firms have some additional advantage arising from their highly developed capital markets.

To conclude this section, these theories should be regarded as variants, rather than substitutes for, the monopolistic

competition theory discussed above. In this view, capital market imperfections from exchange-rate bias or narrow stock markets might be considered as only some of the many possible sources of a firm's monopolistic advantage.<sup>41</sup>

C. The Modern-Imperialist View

FDI is viewed by some as a means by which one economy (advanced capitalist governments and oligopolistic enterprises pursuing coordinated policies) exerts political and economic control over another in order to secure sources of raw materials, markets for outputs, and outlets for investment. The firms engaged in FDI are regarded as instruments through which the home nation, via direct or indirect domination and exploitation of other areas, asserts its power in the world.

Under the traditional Marxist-Leninist theories, imperialism is seen as a necessary outgrowth of chronic underconsumption, an inherent feature of mature capitalism. The theory supposes that a closed capitalist economy must suffer from chronic insufficiency of effective demand and from a basic inability to generate enough profitable opportunities to absorb the investment funds created by private corporations. Thus, the basic imbalance can only be corrected by the opening of foreign

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<sup>41</sup>This has been suggested by John H. Dunning in "Comment on the Chapter by Professor Aliber," in Dunning (ed.), The Multinational Enterprise, op. cit., p. 58.

markets; FDI becomes a necessary outlet for "surplus capital."<sup>42</sup>

Modern imperialist theory sees control as the central FDI motivation. Control is sought by an enterprise and/or its government to assure the secure provision of essential imported raw materials and food, markets for its manufactured exports, and spheres for the investment of its capital.<sup>43</sup>

To achieve these objectives the home government and its foreign investors collaborate in an intimate, symbiotic fashion. The government works "hand-in-glove" with its MNEs: the firm becomes an instrument of home nation foreign economic and political policy, while in return the investor's efforts are supplemented by their bringing state power (diplomatic, financial, and military) to bear.<sup>44</sup>

Under this modern view, the MNE is an alien agent, extending imperialistic domination and fostering a pattern of international division of labor which perpetuates politico-economic dependencia.<sup>45</sup> FDI is the driving force of a sophisticated

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<sup>42</sup>For the classic statement see V. I. Lenin, Imperialism: The Highest Stage of Capitalism (New York: International Publishers, 1939).

<sup>43</sup>The modern imperialist view of FDI is concisely presented by Richard D. Wolff, "Modern Imperialism: The View From the Metropolis," American Economic Review (Papers and Proceedings), 60, May 1970, pp. 225-230.

<sup>44</sup>For a discussion of the methods of modern imperialist economic expansion see Harry Magdoff, The Age of Imperialism: The Economics of U.S. Foreign Policy (New York: Monthly Review Press, 1969).

<sup>45</sup>See: Osvaldo Sunkel, "Big Business and 'Dependencia': a Latin American View," Foreign Affairs, 50, April, 1972, pp. 517-531; and Stephen Hymer, "Is the Multinational Corporation Doomed?", Innovation, No. 28, February, 1972, pp. 10-17.

global system of dominance which progressively is creating a so-called new imperial system. High level division-making and control are centered in a few nations (the metropolises) and the rest of the world (the colonies) are "peacefully" converted into complementary appendages, confined forever to lower levels of activity and income.

This vision pictures FDI as a straightforward extension from the days of colonialism, dollar diplomacy, and the banana republic. Yet the imperialist theory has been criticized on many grounds. The underconsumptionist concept of the capitalist process has been shown to be a fallacy, uncorroborated by empirical evidence. Others have pointed out that the U.S. is relatively self sufficient in raw materials and not as dependent as most other nations on external sources of supply.<sup>46</sup> Still others have observed that the symbiotic collaboration thesis is grossly at variance with the actual facts.<sup>47</sup> The close connections between the

<sup>46</sup> Considerations about relative independence and self sufficiency of the large capitalist economies have led some analysts to conclude that FDI in the raw materials sector cannot or should not be considered to be a vital national interest. See Kenneth N. Waltz, "The Myth of National Interdependence," in Charles P. Kindleberger, (ed.), The International Corporation, (Cambridge, Mass.: MIT Press, 1970); S. M. Miller, Roy Bennett and Cyril Alapatt, "Does the U.S. Economy Require Imperialism?", Social Policy, 1, September-October 1970; and Karl W. Deutsch and Alexander Eckstein, "National Industrialization and the Declining Share of the International Economic Sector, 1890-1959," World Politics, 13 January 1961.

<sup>47</sup> This view has been presented by Raymond Vernon in "The Multinational Enterprise: Power Versus Sovereignty," Foreign Affairs, 49, July 1971, pp. 736-751.



home state and its enterprises are breaking down, as the multinationals increasingly become autonomous, independent transnational actors in the world economy.

As seen above in the other models of FDI, oligopolistic corporations do strive to establish and expand effective control, usually to reduce risk or to maintain options for future expansion. In addition, the global interpenetration and centralization of economic power caused by FDI has visibly revealed the subtle relations of subordination which seem to be associated with the evolving structure of the international economic system. Even though the days of sending gun boats and marines to protect property abroad are probably gone, mutual support and cooperation by the home government and direct investor certainly continues to exist and is more than coincidental. A foreign investor requires a freedom to operate and access to foreign markets, both implying a desire for a safe and open world. It will naturally bring its influence to bear on its home government to create and preserve an open, integrated international system that facilitates foreign economic expansion.<sup>48</sup> Governments in return may utilize FDI as one of their policy instruments in attempting to attain such a system.

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<sup>48</sup>This is the conclusion of Theodore H. Moran in "Foreign Expansion as an "Institutional Necessity" For U.S. Corporate Capitalism: The Search for a Radical Model," World Politics, 25, April 1973, pp. 369-386.

## VII. A FINAL SYNTHESIS

As the preceding discussion confirms, the theory of FDI is in a relatively indeterminate and untested state. The various theories explored above have taken different perspectives or emphasized different factors, and as was suggested earlier, no one theory provides a complete explanation of the phenomenon. To answer the central questions required of a generalized theory of FDI one must necessarily construct a synthesis. This section is an attempt to provide some answers to eight pertinent questions about the rationale for, and patterns of, FDI.

### A. Why Do Firms Go Abroad?

The motives for going abroad usually reflect a desire for continued growth and exploitation of a particular monopolistic economic advantage. The initiating forces which cause a firm to develop foreign interests may be internal (e.g., the strong drive of a high ranking executive) or external to it (e.g., the bandwagon effect, the fear of losing an established export market, a struggle to defend an oligopoly position, etc.). The triggering stimulus must be powerful enough to overcome the investor's natural preference for home country operations. A strong stimulus of this kind was shown to be the reaction of firms in an oligopolistic industry to an intended or actual investment abroad by a rival firm. Investment abroad in the extraction of raw

materials is undertaken in part to achieve economies of vertical integration, but chiefly in order to secure sources of supply where limited resources cause natural oligopolies.

B. Why FDI Rather Than Exporting or Licensing?

Why does the firm choose to exploit the foreign market through FDI with its additional costs and complexities, rather than through alternative strategies of involvement, such as exporting or licensing? In many cases the firm chooses FDI defensively by default: because of a perceived threat, continued exporting is seen as no longer possible. This, of course, is simply a variant of the basic underlying reason, that of choosing the most profitable way of servicing the market. When the firm's advantage can be applied abroad at little cost, and there is some complementarity between local production and local sales, direct investment is superior to exporting since firms are able to obtain higher profits from their monopolistic advantage by means of investment near the market. Except where "distance costs" are relatively high, licensing is seldom preferred because of the difficulty of separating the firm's technical advantages from its own operations.

C. What Is the Source of the Foreign Investor's Advantage?

How are foreign firms able to overcome the various distance costs related to locational and political factors, to which local firms are not subject? Recall that in a world of perfect competition for goods and factors, host country firms could

purchase any advantage possessed by potential foreign competitors; hence, FDI could not exist. But as has been argued above, market imperfections allow foreign investors to have monopolistic control over some knowledge or other advantages that cannot easily be purchased by local firms. As products and technologies mature, however, the barriers to market entry by rivals are whittled away, and foreign investment can survive only if the parent firm provides its subsidiary abroad with new technologies, new products, or the economies of multinational coordination. The advantages may be technological, managerial, or product-related, although there is reason to believe that marketing advantages in product differentiation industries are particularly suited to foreign investment. Advantage may even arise from a capital market bias that gives U.S. firms a lower cost of capital than foreign ones. The pressures of high labor costs and the opportunities of large markets tend to induce the development of technological and product innovations in the richer, larger countries.

D. Why Does FDI Emanate From Relatively Few Source Nations?

FDI will tend to originate from those nations whose income level and industrial development allow local firms to develop a monopolistic advantage that can be exploited abroad. The incentive for and ability of firms to invest abroad is derived from the nation's environmental characteristics. Firms in the relatively large and rich nations are surrounded by a market

for producer and consumer goods that is in some respects a forerunner of what will later be found in other nations. Market characteristics thus confer an innovational or learning advantage to entrepreneurs in these nations. A host of other factors--sociological, institutional, and political--will also create sources of advantage. For example, the preponderance of U.S.-based FDI might be tentatively explained by the relatively large size of U.S. firms (economies of scale and/or experience), by the large military industrial emphasis on technological research and development (technology gap advantage), or by the extensive investment in management education (managerial capabilities and expertise).

E. Why Does FDI Flow Largely to the Advanced Nations?

Why has so much of the investment gone to the highly developed countries? Why has so much of U.S.-based FDI gone to Canada? With regard to manufacturing, FDI appears to follow markets. Producers of high-income consumer goods and labor saving manufacturing goods generally establish plants abroad in high-income markets with similar demand structures. FDI in raw materials, by necessity, must go to where the natural resources are located. In addition to these factors of market size (or characteristics) and raw material availability, certain behavioral factors are also important in explaining the geographical patterns which have emerged. FDI will be higher in those areas where the so-called inertial

resistance of the investor (with regard to that area) is low. FDI will occur more frequently when the cultural, political, and locational ties between the source and host nations are close. Investors will also have a lower aversion to risk and experience stronger initiating forces to look abroad when the areas of potential investment are well-known.

F. Why Does Cross-Hauling Take Place?

How can one explain the coexistence of FDI by firms of different countries in each other's home market, often in the same industry? The answer lies in the market segmentation that occurs in oligopolistic industries characterized by product differentiation. Proctor and Gamble, with its investments in the United Kingdom, and the British firm Unilever with investments in the U.S., are in the same, oligopolistic industry. They are able to compete in each other's backyard not, as some have suggested, because of mutual acceptance, but because each controls somewhat different marketing and product-related advantages. The broad consumer package goods market is segmented into portions dominated by different firms. While a tacit understanding of mutual dependence is a recognized facet of oligopoly, this factor alone is not sufficient to explain why two such companies dominate portions of each other's market, rather than simply gaining a larger market share at home.

G. Why Does FDI Exist in Some Industries and Not In Others?

As we have observed above, horizontal manufacturing investment is possible when an enterprise possesses a unique advantage that differentiates it, or its product, from competitors. Generally, FDI will be greater in those industries where deviations from perfect competition are greater. Thus, we find that manufacturing FDI takes place largely within those industries with oligopolistic market structures and access to monopolistic advantages through heavy R & D expenditures, economies of scale, or differentiated products. Vertical FDI in the raw materials industries depends on the extent of barriers to entry on the level of imperfections within the individual industries. For example, the higher incidence of foreign investment in the aluminum industry than in the steel industry reflects the greater imperfections of competition in aluminum.

H. Why Do Some Firms in an Industry Invest Abroad, While Others Do Not?

The answer here appears to rest on the variable of firm size. The cost economies of large plant size, the relatively high fixed costs of securing information necessary to undertake FDI, the economies of multinational experience, etc., all seem to favor the large firm in FDI. This establishes a minimum or threshold firm size below which firms choose licensing or exporting as a less costly means of servicing foreign markets.

Above the threshold, relative rather than absolute size is important. Firms that already dominate the market at home, for fear of antitrust action or simply because of the increasing difficulty of gaining a still larger market share, are induced to seek foreign markets. In behavioral terms, it may be that the initiating forces for foreign expansion impinge more often and with greater intensity on large firms than small ones.

#### VIII. CONCLUSION

In all likelihood, the reader has by now reached the conclusion, not without justification, that foreign direct investment theory is a hodge-podge of hypotheses and inferences. However the lack of consensus concerning particular aspects of a theory does not excuse one from reaching tentative conclusions. FDI may be regarded as the strategy of corporations to exploit abroad and defend unique advantages which are repeatedly challenged and eroded. The large markets and developed technologies of the richer countries are conducive to the development of such advantages. Large firms that market differentiated products in oligopolistic industries control advantages that are particularly well suited to foreign direct investment. Finally, the behavioral characteristics of mutual reaction in oligopolistic markets and a resistance to the uncertainty of business ventures overseas provide an explanation of the timing and geographical orientation of decisions to invest abroad.