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foreign direct investment[1]

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Conceptual Overview

According to the OECD, foreign direct investment (FDI) is the development of a lasting interest by a resident enterprise in one country through direct investment in another enterprise in another country. FDI is seen as a long-term relationship between the investor and the enterprise with significant influence on the management of the enterprise.

The International Monetary Fund (IMF) distinguishes between FDI and foreign portfolio investment. Direct investment is viewed as a method of securing influence on overseas operation and tends to be associated with a lasting commercial relationship. Investors would provide other resources such as knowledge, management techniques, technology, and marketing strategy. Portfolio investors, on the other hand, have less influence and control over the decision-making processes within an enterprise with potentially important implications for future business processes and monetary flows (International Monetary Fund, 2010).

These definitions arise from the perspective that countries have a strategic interest in keeping accounting records of all monetary transactions between each other bilaterally and between them and the rest of the world.

The estimated global flow of FDI for 2012 is 1.4 US$ trillion. The economic crisis triggered a slowdown in FDI in 2009 and 2010 (Figure 1). However, investment in 2011 rose to 1.5 US$ trillion, equivalent to 2.5% increase on the precrisis average. In the first two quarters of 2012, transition and developing countries attracted over 50% of global FDI for the first time (Figure 2). China remained the largest recipient country in the same period, followed by the United States.

The theoretical issues involved in the study of FDI today are the same ones that are encountered in the study of transnational capital. Multinational enterprises (MNEs) or transnational corporations (TNCs) are the main drivers of FDI flows. Dunning and Lundan (2008) treat the two terms as practically synonymous. The awareness of the importance of transnational capital is reflected in the United Nation's establishment of the Program on TNCs, which evolved into the division on investment, technology, and enterprise development at the United Nations Conference on Trade and Development (UNCTAD).

FDI Theory Development

FDI is a strategic option for firms that undertake it and for the states that seek to attract and regulate it. Lagging behind the practice of FDI is the belated development of a theoretical framework that satisfactorily integrates economic structure and agency. Managerial players are free to make and implement strategic choices, albeit within the limits of their structural circumstances. The extent to which these players perceive these circumstances and are capable of analyzing them can be uneven and incomplete. The lateness of this development is mainly due to a paradigmatic indifference to FDI.

Although a critical reading of classical studies opens conceptual spaces for a discussion of FDI as a strategic option, international factor mobility is redundant in standard neoclassical international trade theories with no trade costs. Within the neoclassical paradigm, factor price equalization does not stimulate international factor mobility.

Indeed, trade and factor mobility substitute each other in Heckscher–Ohlin–Samuelson trade models. Between two states of equilibrium, factor price equalization should be restored as effectively by either trade or factor mobility interchangeably. The weakness of these models became evident when it was observed that FDI and international trade do grow together, although at different rates, with FDI growing faster than trade in certain periods. In the early 1990s, FDI worldwide was growing at a faster rate than world production, capital formation, and trade. In 2011, although FDI was slower in recovering from the crisis than global industrial output and trade, UNCTAD expected it to reach its precrisis peak in 2013 (UNCTAD *et al.*, 2011).

It is such observations that encourage the development of new theoretical perspectives to

Wiley Encyclopedia of Management, edited by Professor Sir Cary L Cooper.
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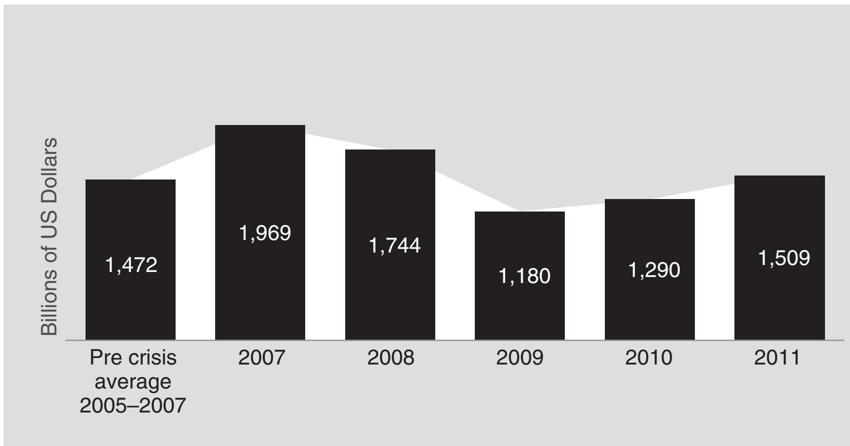

Figure 1 Foreign direct investment global flows. *Source*: UNCTAD.

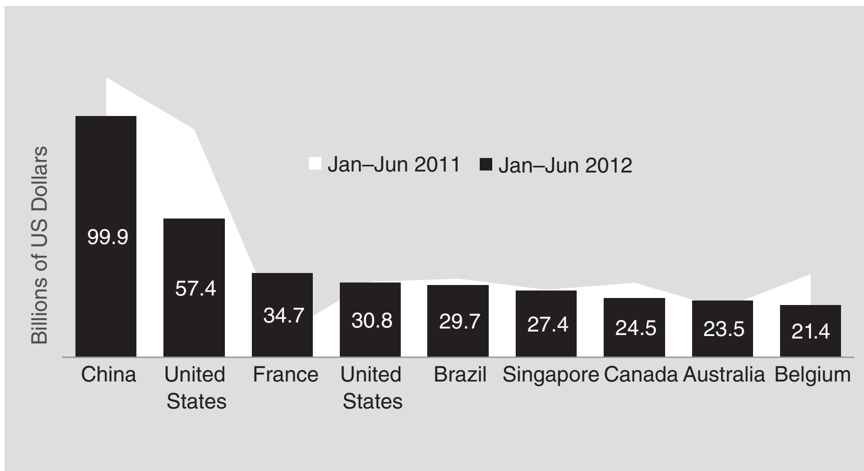

Figure 2 Foreign direct investment inflows – top 10 host countries. *Source*: UNCTAD.

account for FDI. Indeed, the practice of FDI in the last quarter of the twentieth century has been growing rapidly. While world FDI inflows stood at $US 57 billion in 1982, they rose to $US 201 billion in 1990, $US 1969 billion in 2007, and $US 1122 billion in 2010.

Trapped in the neoclassical paradigm of international trade and financial investment theory, mainstream academic scholarship came late to the recognition of the strategic character of FDI. Three groundbreaking intellectual perspectives spurred by Coase, Hymer, and Penrose provided the initial tremors causing the paradigm to begin to shift. In classic Kuhnian manner, however, the institutionalized paradigm continues to defend itself.

The first event is Coase's bid to construct a theory based on the concept of transaction costs and to predict whether a given economic task would be performed within or without the firm on the market. From the traditional assumption of the efficiency of markets it follows that, all

things being equal, contracting out is always cheaper than employing labor to perform a given task. The firm emerges when the transaction costs of procuring a good or service is higher than that produced directly without recourse to the market. The limit to this strategy is determined by decreasing returns to the entrepreneur function such as the cost of management's resource allocation errors. The ratio of internal to external contractual relations (between the firm and the suppliers of outsourced inputs), an index of the firm's size, is the result of the calculation of the most economic balance between the two under given conditions (Coase, 1937).

The next big leap forward comes with the approach of Hymer (1960). Distinguishing between portfolio investment and direct investment, Hymer sought to explain foreign direct investment as the strategy of firms seeking to achieve one or more of the following:

- Retain control of production with a view to realize economic rents
- Eliminate competition
- Access technology
- Access capital markets.

Hymer's relatively new economic perspective consisted in identifying the MNE as the mechanism for international production, rather than international trade. He articulated FDI as the extension of industrial organization (IO) theory to the international level. Hymer's approach introduced an understanding of why the international corporations move around products, business know-how, and technology among its units across different countries, keeping control and rights over its international assets. Hymer's perspective is framed by the political economy of underdevelopment Hymer (1968). When he was developing his critique of the MNE as an institution, FDI was perceived in some developing countries as a form of neocolonialism. The perspective today has changed as governments everywhere compete to attract FDI. Policies promoting the ELIFFIT model (export-led industrialization fueled by foreign investment and technology) have become the norm rather than the exception (Sklair, 1994).

A third seminal voice is that of Penrose (1959, 1987). In Hymer's perspective, an extension of Coase's transaction cost approach, FDI (a subset of "foreign operations") requires a firm to "internalize" an operation in another country. This explains why in certain circumstances a firm opts for FDI rather than, say, licensing the production of its goods in another country. Penrose's concept of intrafirm knowledge generation makes it easier to understand why a firm chooses to "make or buy."

Until a theory of the transnational enterprise and FDI emerges that is capable of bridging the epistemological gap that separates its territory from that of international strategic management (ISM), Dunning's OLI framework will be taken to be the extant theory of transnational enterprise. The framework involves:

- Ownership (advantages in terms of market power arising from a firm's ownership of a good or asset than nobody else has)
- Location (advantages of producing in another country rather than exporting to it and/or the advantage of lower factor costs in another country)
- Internalization (advantage of FDI over outsourcing from abroad)

The general oligopolistic equilibrium (GOLE) model solves a theoretical problem, namely that decreasing trade costs (say, as happens in the case of increasing economic integration, such as in the European Union) do not in fact result in diminishing FDI, indeed the opposite can and does happen through, for example, mergers and acquisitions (Neary, 2008). This brings us back to a point raised earlier on in this entry, namely the fruitfulness of engaging with the relationship between FDI and oligopoly (see, e.g., Ferret, 2008). Although an assessment of the contribution of game theory to the understanding of FDI and rent seeking TNCs goes beyond the aim of this article, its impact on teaching and research in this field is undeniable.

The corpus of literature on ISM evolved from the field of IO. Very schematically expressed, Bain's seminal work on IO influenced the development of the field of business policy, which led to the development of ISM (Porter, 1981; Porter, 1990, see also Stonehouse and Snowdon, 2007; interview of Porter with an introduction, 2007), thus justifying Buckley's

characterization of ISM as the "*grandchild*" of IO (Buckley, 1996: 12).

The field of ISM, however, rejected what it regarded as IO's structural determinism, on the grounds that the industrial structure, conduct, and performance continuum practically squeezed strategy out of the causal chain, thereby making it redundant and suggesting that performance could be directly deduced from structure.

From this follows ISM's prioritization of the performance of individual firms over macroeconomic parameters. It is this agency orientation of ISM, its concern to escape the causal straightjacket of structure of the tradition whence it emerged, which leads ISM to posit the strategic decision as the decisive causal moment of the firm's bid for competitive advantage over its rivals.

Endnotes

[1] Original article by Mario Vella. Adapted and updated by Tanya Sammut-Bonnici.

See also *comparative advantage*; *competitive advantage*; *foreign market entry analysis*; *globalization*; *global strategy*; *international strategy*

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