

INTERNATIONAL INVESTMENT THEORIES



Why Does FDI Occur?

You might be tempted to assert that average rates of return are higher in foreign markets. Yet Canada and the United Kingdom are both major sources of FDI in the United States and important destinations for FDI from the United States. Average rates of return in Canada and the United Kingdom cannot be simultaneously below that of the United States (which would justify inward U.S. FDI) and above that of the United States (which would justify outward U.S. FDI).



FOCUS: FIRMS + COMPETITIVE ADVANTAGE



Caterpillar built factories in Asia, Europe, Australia, South America, and North America to exploit proprietary technologies and its brand name.

Ownership Advantage Theory

A firm owning a valuable asset that creates a competitive advantage domestically can use that advantage to penetrate foreign markets through FDI. The asset could be, for example, a superior technology, a well-known brand name, or economies of scale.

Good Start But...

The **ownership advantage theory** only partly explains why FDI occurs. It does not explain why a firm would choose to enter a foreign market via FDI rather than exploit its ownership advantages internationally through other means, such as exporting its products, franchising a brand name, or licensing technology to foreign firms.

Internalization Theory

FDI is more likely to occur—that is, international production will be internalized within the firm—when the costs of negotiating, monitoring, and enforcing a contract with a second firm are high.



Transaction Costs

The costs of entering into a transaction, that is, those connected to negotiating, monitoring, and enforcing a contract. A firm must decide whether it is better to own and operate its own factory overseas or to contract with a foreign firm to do this through a franchise, licensing, or supply agreement.

Good Start But...

Although **internalization theory** addresses why firms choose FDI as the mode for entering international markets, the theory ignores the question of why production, by either the company or a contractor, should be located abroad. In other words, is there a location advantage to producing abroad?

01

Ownership

The firm must own some unique competitive advantage that overcomes the disadvantages of competing with foreign firms on their home turfs.

02

Location

Undertaking the business activity must be more profitable in a foreign location than undertaking it in a domestic location.

03

Internalization

The firm must benefit more from controlling the foreign business activity than from hiring an independent local company to provide the service.

Eclectic Theory

FDI occurs because of location advantages, ownership advantages, and internalization advantages.