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international Business Strategy

Lecture Two

Foreign Entry Theories

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Introduction of Lecture Two

In topic one we explored several definitions and triggers of competition within the context of international business. In this topic we will focus on what foreign investment is, then shift our attention to the theories that explain foreign investment.

Learning Outcomes

- Describe the current pattern of foreign investment in the world
- Describe the theories that explain why foreign investment occurs
- Explain why and how the government intervenes in foreign investment.



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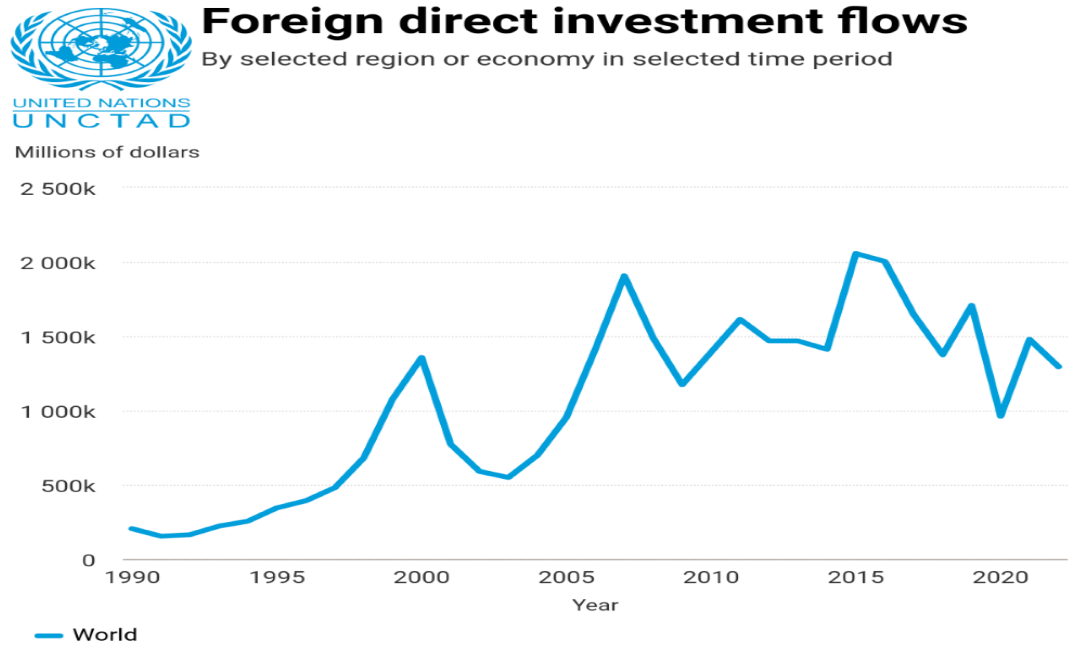
Introduction and Recent Trends of Foreign Direct Investment

Foreign investment or what is commonly referred to as foreign direct investment (FDI) represent the purchase of physical assets or a significant amount of the ownership of a

company in another country to gain a measure of management control (Wild, Wild and Han, 2010 p222). This definition is supported by the World Bank (n.d) which talks of FDI as the net inflows of investment intended to acquire a lasting management interest i a firm located in a country other than where the investor is located. The World Bank threshold which has been adopted by many countries is ownership of at least 10%. While there is varying threshold that different countries give to what constitutes foreign direct investment, what is clear is that the intention of this strategy is for the investing firm to get some **degree of control** in a foreign company.

Although this form of investment has not been steady, the Covid-19 Pandemic in 2020 led to a serious decline across the globe. The pandemic saw the investment hit the lowest amount since 2005 as can be seen in **graph 1**. When the world was recovering from the impact of the pandemic, the war between Russia and Ukraine has further compounded the possibility of a steady rise.

Graph 1: FDI Flows Trend




Source: UNCTAD World Investment Report 2022

Source: World Investment Report 2023

Some notable developments according to UNCTAD (2024) in as far as FDI is concerned, there was decline in FDI flow to global south by 9% in 2023, Asia witnessing the biggest

decline of 12% while Africa largely remaining nearly unchanged with 1% decrease. China and India saw a 6% and 47% decline respectively in the same period, however both countries saw an increase in greenfield projects UNCTAD (2024). The same report paints a picture of slight optimism though with a caution of continued geopolitical tensions and rise of countries that could be burdened by high levels of debts.

 What is the current state of FDI inflows and outflows in your country?

Explanations for Foreign Direct Investment (Theories of FDI)

In the foregoing section we have looked at the current trend of foreign direct investment, in this section we now look at “why does FDI occur?” A theory is basically an idea trying to explain a situation, phenomenon or an action; therefore, we will be trying to explain firms engages in FDI. The theories offer varying perspectives or explanations.

1. International Product Life Cycle

This theory was proposed by Raymond Vernon in the mid-1960s. It proposes that a firm will start by exporting its product but later will undertake FDI as the product moves through its life cycle (Wild, Wild and Han 2010 P. 185). Though the theory was developed for United States’ Economy it can easily be generalized and apply in other markets. The theory suggest that a product will go through three main stages:

Stage 1- New product: here the product is new in the market and the product is consumed where it is manufactured, and according to Vernon in an industrialized country

Stage 2- Maturing Product: Consumers in the home markets and foreign markets are fully aware of the products and its benefits.

Stage 3- Standardized Product: In this stage new entrants have joined the industry and have put pressure on the firm to reduce its price. As a result, the firm is pushed to look for ways to cut costs to compete in a price-sensitive market. The result is locating its production facilities in developing countries while supplying its demand worldwide. This may at times cause the closure of production in its domestic markets. Thus, where it started with exporting it may end up importing.

In this theory, the firm initially starts by manufacturing the product for its domestic market in **stage 1**, but as the outside market becomes aware of the product's existence in **stage 2** the firm is pushed to export its products. When the exports start accounting for a bigger percentage of its sales, they begin to locate production facilities in foreign countries

where demand is high. Eventually, in **stage 3**, the firm may end up producing entirely from developing economies to satisfy world demand including its home market where it once produced from.

Though the theory seemed to explain trade then- when the United States was the dominating power in world trade, it has been termed weak in explaining today flows (Wild, Wild and Han, 2010).

2. Internalization (Market Imperfections)

The theory states that when an imperfection in the market exists (*breakdown in the efficient operation of an industry*) and makes a transaction less efficient than could be, a firm could undertake FDI to internalize the transaction and thereby remove the imperfection (Wild, Wild and Han 2010). In an ideal situation, which is very rare, prices are supposed to be as low as possible and this would depict a perfect market. But markets are characterized by breakdowns or imperfections. In international business, the common imperfection highlighted is the trade barriers. Where trade barriers exist in a country with huge potential, a firm may try to circumvent this by directly investing in that country, thereby avoiding the imports levies.

3. Eclectic Theory

The theory was developed by John Dunning. The theory combines three types of advantages Wild, Wild and Han (2010) as follows;

- *Ownership advantage (O)*- where the firm has some special assets such as intellectual property, strong and recognizable brand name, and technical know-how among others.
- *Location advantage (L)*- this denotes the benefits that accrues to a firm by locating in a specific country, this could include presence of natural resources such as soil, oil, and forest.
- *Internalization advantage (I)* - this is in reference to overcoming market imperfections as discussed in theory two.

The theory postulates that firms will undertake FDI when the three advantages make a location/country/economy attractive for investment.

4. Market Power Theory

The theory is based on the needs of firms in an industry to seek power. It states that a firm will try to establish dominance relative to its rivals in an industry by undertaking

foreign investments (Wild, Wild and Han, 2010). Possible scenarios include either backward integration where the firm engages in production of its own raw materials or forward integration where it moves closer to its customers. All these are geared towards getting a grip on the cost of its inputs and/or the final price of its products.

Conclusions

None of the theories can firmly and whole explain the phenomenon of FDI. For a long time, Dunning's theory has been used in explaining foreign investment (Denisa, 2010).

Quick Review

1. How does Market Power explain FDI?
2. Under the international product life cycle, what happen in each stage?
3. What are the examples of market imperfections in eclectic theory?
4. What are the three advantages that must occur for foreign direct investment to occur as stated by Eclectic theory?

Government Intervention in Foreign Direct Investment

Any nation's government is interested in foreign direct investment and international trade. It is due to these interests, that the government will use available methods or tools to either encourage or discourage FDI. In this section we will focus more on why and how the government intervenes.

Why Governments Intervene in FDI

There are myriads of reasons as to why the government of the day may be interested in foreign direct investment coming into its territory. Here are some obvious reasons;

1. **National security:** There are some sectors that are crucial for maintaining the security of a country and for that reason the government may not allow foreign investment in such sectors to safeguard its territorial integrity. Communication and security installations are obvious examples where government may want to maintain control.
2. **Balance of Payments:** This is the accounting of inflows versus the outflows in a country. The government may be encouraging FDI to increase capital inflows, thereby trying to balance an initial negative payment scenario common in many countries.

3. **Encouraging domestic industries:** The government may be restricting FDI into the country in its bids to protect local industries from foreign competition. Here they may erect barriers to entry by foreign businesses.
4. **Discourage job exportation:** In other circumstances the government may discourage local firms from engaging in FDI outside their country in fear that they could be exporting jobs to those countries.
5. **Infrastructure development:** Governments may at times encourage FDI into their country to leap developments that those firms will create as they set production facilities in the country. Some of these developments may include roads, water and telecommunications.
6. **Economic Development:** There are economic activities that will result from foreign firms setting up in a country. There will be local raw materials that will be used, and locals will be employed. This will no doubt make the country's economy vibrant and have a significant impact on its Gross Domestic Product (GDP).
7. **Managing political relations:** At times, the government may encourage or discourage FDI from certain countries to assert its sovereignty. This happens when there is tension between two countries or when they are trying to mediate the relationship.
8. **Preservation of cultural heritage:** Government is concerned in preserving and maintaining cultural heritage, to do this they may have to manage ownership in some sensitive areas where culture is perpetuated. Media industry is one common example where the government may be interested in controlling so as to protect the native culture.

How Government Intervene in FDI

As indicated earlier, governments have at their disposal tools or methods they can result in either encouraging or discouraging FDI in or outside their country. In this final section we look at such tools.

1. **Financial Incentives:** Here the government may use incentives such as tax breaks, lower taxes or waivers to companies that set base in their territory. Normally, this tends to raise a country in the ranks of doing business by reducing the cost of doing business in such a country. On the flip side, when such incentives are withdrawn or reduced, it may discourage foreign investment.
2. **Legal framework:** By enacting friendly laws, the government can make their country a good environment for foreign investment. This is usually done by removing restrictions or strict requirements that undermine foreign investment. On the other

hand, if the government wants to discourage foreign investment, they will erect laws that will act as barriers to foreign firms' entry.

3. **Development of infrastructures:** When the government invests in necessary infrastructure for businesses such as roads, railway, telecommunications, and airports this is likely to result in sustained interest from foreign investors. This is the case since the cost of operation and indeed of doing business in a country where the infrastructures are developed is much lower compared to where firms must develop them. In Kenya, for instance the government invested in sea cables and road networks from 2010, this did saw an increase in the firms that set their base in the country.
4. **Investment in human development:** In instances where the government invests in human capital development through such a thing as education, the result is a population that is knowledgeable, skilled and with qualifications. This becomes an attraction for foreign investors. Countries such as Singapore and Malaysia are leaping from such an investment are currently becoming a hub of foreign investment as a result.

Reflections

1. What is your government poster regarding foreign direct investment?
2. Do you think the existing laws are pro FDI or anti FDI?

Topic Recap

In this topic we have looked at what FDI constitutes, where we emphasized that *management control* in a foreign country's firm is the bottom line. We further looked at the theories that try to explain why firms engage in FDI. Finally, we looked at why and how the governments intervene in FDI. In the next topic we will be looking at how you can analyze foreign markets.

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