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A Study on the Analysis of Growth of FDI in India

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Abstract – Most theories of FDI have emerged during the post-war period, when the forces of globalization began to grow. The growing importance of MNC and FDI during the fifties and sixties gave an impetus to researchers to find theories able to explain the behavior of MNC's and the existence of international production. The early theories could only explain a limited share of the total FDI flows. These theories were also inadequate because they failed to bring out the fact that FDI is not only a capital flow but also constitutes a package including other components such as management and technology transfer.

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INTRODUCTION

During the sixties, researchers started to focus more explicitly on MNCs and their activities. Vernon (1966) applied the idea of the product-life-cycle to international trade in order to explain the existence of international production as well as trade. According to Vernon, as a product moves through the product-life-cycle, the characteristics of the product change. These changes imply that the optimal location for production of the product also changes over time. The product-life-cycle begins when innovations are transformed into actual products. Increasing competition eventually forces production to move from higher to lower income economies in order to reduce production costs. As the product and its production process become more standardized, the product moves into the mature stage of its life-cycle. Consequently production in high and average income economies declines as a result of ever fiercer competition. The demand for the product is then met through exports from low income, developing economies to the rest of the world.

Consequently, some of the approaches to develop a theory of FDI failed to incorporate the fundamental difference between portfolio and direct investment. An example is the "Capital Markets Approach" (Aliber, 1970). These approaches used the already existing theories for flows of portfolio investment to explain flows of FDI. FDI was treated as portfolio investment and accordingly it was considered that FDI should flow to locations where the financial return on investment was the highest.

Considering the large number of motives an individual firm can have to undertake FDI; it is not surprising that there exists no general theory that can comprehensively explain the existence of MNCs and FDI. As a result of this, the FDI literature is diverse and spans over several different disciplines including international economics, economic geography, international business as well as management. There exist several studies providing overviews of FDI theories, for example, Aggarwal (1980), Cantwell (1991), Meyer (1998) and Markusen (2002). Whereas this thesis primarily focuses on a developing economy, most of the theories described in this section can be applied to all types of economies.

Vernon's theory was a contribution since it could explain some of the outflows of FDI from the US during the fifties and sixties. It was also the first theory that treated trade and direct investment as two dynamic alternatives to serve demand in a foreign market. Unfortunately, the theory fails to explain the large flows of FDI between developed economies. The focus on innovations also makes the theory difficult to apply to outflows of FDI from industries which are not innovative.

FIRM-SPECIFIC ADVANTAGES AND THE "OLI" PARADIGM

Stephen Hymer came up with his theory of firm specific advantages approximately at the same time as Vernon's theory. Hymer's dissertation (1960) laid the foundation necessary for "eclectic paradigm" that has had a large impact on FDI theories. The theory of firm-specific advantages was the first theory treating international production explicitly, and the first focusing on the MNC itself.

According to Hymer, firms operating in a foreign location are at a disadvantage compared to the domestic firms. The domestic firms are assumed to have lower costs of operation since they are more familiar with local conditions such as legislation, business culture, language and so on. It therefore

becomes imperative for a foreign firm to have an offsetting, firm-specific advantage allowing it to compete with domestic firms. Firm-specific advantages include superior technology, brand name, managerial skills and scale economies. However, this approach could not explain the actual decisions about FDI. This void was filled by John Dunning, who further developed the idea of firm-specific advantages, resulting "OLI" paradigm of FDI, also known as the "eclectic theory" of FDI.

The "OLI" paradigm (Dunning, 1977) provides a strong framework for a discussion of the motives for FDI. It also allows for a discussion of the choice of an MNC between licensing, exports and FDI in order to serve a foreign market. This choice accordingly, is determined by Ownership advantages, Locational advantages and Internalization advantages, thus the acronym "OLI".

Ownership advantages are based on the concept of firm-specific advantages. To overcome the disadvantage of operating in a foreign country, a firm must possess an Ownership advantage. The Ownership advantage comes in the form of an asset reducing the firm's production cost and allows it to compete with domestic firms in the foreign economy despite the information disadvantage.

Ownership advantages come in the form of assets such as patents, management or technology and should have the characteristics of 'excludability' and 'transferability'. The foreign firm should be able to exclude competing firms from using the asset. Also to create proper conditions for FDI, the Ownership advantages should be transferable to a foreign country and possible to use simultaneously in more than one Location.

Locational advantages determine how attractive a location is for production. A strong Locational advantage reduces a firm's production costs in that location. Location advantages can never be transferred to another location but can be used by more than one firm simultaneously. For example, a supply of cheap labour can provide an advantage for several labour-intensive firms. If the home country provides the strongest advantage to the firm, then instead of FDI, production is located in the home country, and the output is exported in order to meet demand in the foreign economy.

The existence or non-existence of an Internalization advantage is important to determine how the MNC chooses to use its Ownership advantage and also choose between own production and licensing of production to an external firm. Existence of an Internalization advantage implies that the firm's most efficient alternative of using an Ownership advantage is through exports or FDI. If an internalization advantage is missing, it is more profitable for the firm to exploit its Ownership advantage through selling the right of its use to another firm through licensing. While possession of an Ownership advantage is a prerequisite for a firm to be able to serve demand in a foreign market, it is the existence of Locational and Internalization advantages that determines how the foreign market is served.

Box : "OLI" advantages and MNC channels for serving a foreign market

Channel of Serving Foreign Market	Ownership Advantage	Internalization Advantage	Locational Advantage of Foreign Country
FDI	Yes	Yes	Yes
Exports	Yes	Yes	No
Licensing	Yes	No	No

FDI only occurs when the MNC possesses both an Ownership and an Internalization advantage and the foreign country has a Locational advantage. For the case where the MNC lacks an Internalization advantage, production is licensed to local firms in the foreign market. If the MNC's home country has the strongest Locational advantage, the MNC uses exports to serve the foreign market. The "OLI" paradigm can, therefore, also be used as a framework for a discussion about the relationship between FDI and trade.

Dunning (1981, 1986) use the framework of the "OLI" paradigm as a base for the "Investment Development Path" (IDP) theory. The idea of the "IDP" theory is that there exists a U-shaped relationship between the level of an economy's development and the net outward flows of FDI. In the first low income stage, FDI inflows are small and outflows are zero or close to zero. Domestic firms have not yet acquired Ownership advantages and therefore have no prospects for investing abroad whereas Locational advantages are too weak to attract inward FDI inflows. Economies where significant improvement of the Locational advantages take place (for example, an improvement of the educational level), enter the second stage. Inflows of FDI increase substantially while outward FDI remains very small, resulting in an increasingly negative net outward FDI position. During the third stage, net outward flows are still negative but increasing. There are two possible causes for this. The first possibility is that outward investment is constant and inward investment is failing. Alternatively, the outflow of FDI are rising faster than the inflow due to eroded ownership advantages of the foreign investors or as a result of domestic firms developing advantages, generating outflow of FDI. During the fourth stage, the outward flow of FDI surpasses the inflow of FDI; implying domestic firms have developed strong ownership advantages. Empirical applications of the "IDP" theory include Barry et al. (2003), who

analyze inward and outward FDI flows for Ireland. They find that the growing inflows and subsequent outflows of FDI are consistent with the "IDP" theory.

FDI AND THE NEW TRADE THEORY

The new trade theory developed in response to the failure of classical trade theories of incorporating concepts observed in actual flows of international trade such as intra-industry trade. The new trade theories contributed by constructing general equilibrium trade models which could include increasing returns to scale, imperfect competition and product differentiation (Helpman and Krugman ,1985).

A weakness of the early contributions to the new trade theory was that they failed to incorporate MNCs and FDI. The dominant assumption in these theories was about the single plant national firms, which limited the usefulness of these models explaining FDI. However, during the eighties and nineties, James Markusen (1995) and other researchers modified the new trade models to allow for inclusion of MNCs and FDI. An important contribution of new trade theory models incorporating MNCs is that they can be used to analyse a firm's decision between FDI and exports. The decision between foreign production and exports revolves around the "proximity-concentration trade-off', where MNCs compare trade costs to the costs of producing at several locations. The advantage of producing in a single location to achieve scale economies is compared to the reduction in trade cost achieved when production takes place at several locations close to the local market. The "proximity-concentration trade-off' has resulted in the idea of two primary forms of FDI, horizontal and vertical. The distinction between these forms has been fundamental for modeling MNCs and FDI (Markusen 2002).

Horizontal FDI means that an MNC replicates the same activities in several different geographical locations, whereas vertical FDI implies that an MNC locates production stages according to factor costs.

Vertical and horizontal FDI have different motives. Horizontal FDI occurs when the motive of the MNC is primarily "market-seeking" and the firm wants to satisfy foreign market demand by local production. In this case there exists a foreign market with a demand that the MNC wants to serve by producing close to the market. A reason for this might be that it is necessary to adapt the product to the preferences of local customers. Higher trade costs in the form of tariffs tend to increase the incentive for horizontal FDI.

An MNC performing vertical FDI has primarily an "efficiency-seeking" motive, that is, the MNC exploits differences in factor costs between geographical locations. The MNC decomposes the production process geographically into separate stages according to factor intensity. For example, the labour-intensive stage of production should be located where labour costs are low. Similarly, a capital-intensive stage should be located where the cost of capital is low. Vertical FDI can be seen as a special version of the spatial product cycle model described in Andersson and Johansson (1984).

The focus on a horizontal / vertical distinction of FDI and MNCs has strongly dominated trade theory models incorporating FDI. Two of the earliest models of vertical and horizontal MNCs are given in Helpman (1984) and Markusen (1984), respectively. Helpman's model is a general equilibrium model based on differences in factor endowments, where vertical MNCs locate production according to factor intensities, whereas Markusen presents a horizontal model of MNCs, where FDI is driven by firm-level scale economies.

The nineties saw an increasing number of trade models incorporating international production and MNCs. Modeling efforts were still based on the distinction between horizontal and vertical FDI since these were believed to be the main forms of FDI. Markusen (2002) provides an overview of how new trade theory models have incorporated MNCs and foreign direct investment, with a focus on general equilibrium models.

Brainard (1993) presents a two-sector, two-country general equilibrium model, where firms choose between exports and foreign investment. The choice is determined by the trade-off between proximity to the market and scale economies at the plant level providing advantages to concentrating production in one country. According to him, national firms can coexist with MNCs in equilibrium. Brainard's (1997) study is an econometric study of MNCs using bilateral data for 27 economies with affiliate activity with the U.S. She finds that higher transport costs and foreign trade barriers result in an increase in FDI, providing support for a horizontal model of FDI. Markusen and Venables (1998) develop a two-country general equilibrium model where both national and multi-national firms arise endogenously. Simulation results imply MNCs become more important when countries are similar in size and relative endowments. The simulations also indicate that MNCs tend to arise when firm-level scale economies and tariff or transport costs are large relative to plant-level scale economies, confirming the results found by Brainard (1993).

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