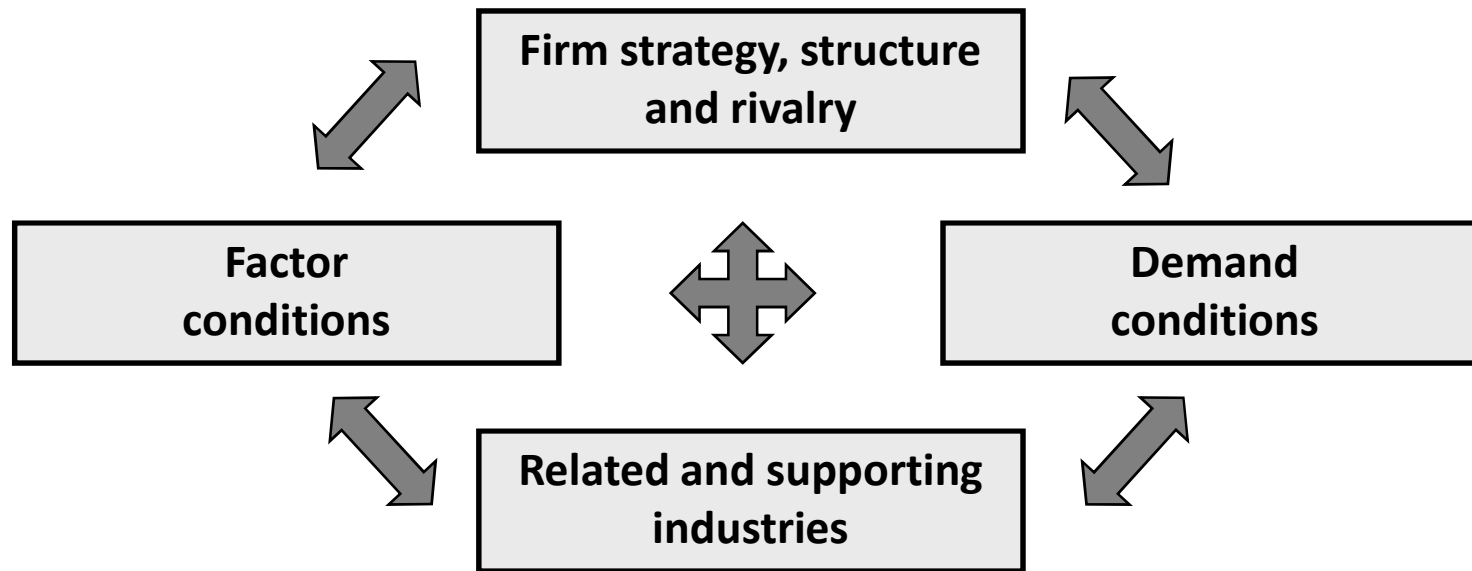


A synthesis of trade theories: Porter's diamond

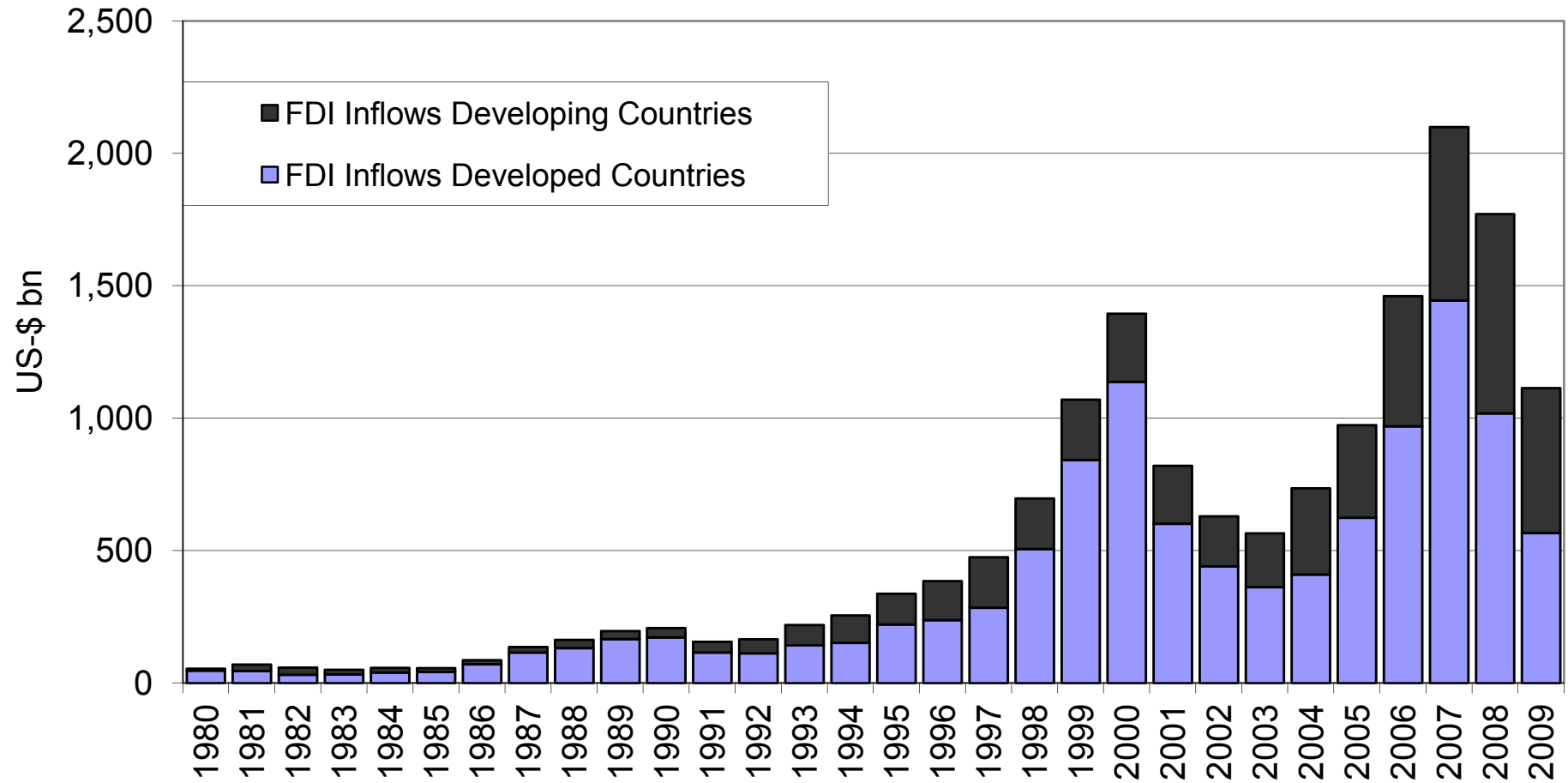


- Four attributes shape the environment of firms
- National competitive advantage
- Success → where “the diamond” is more favorable
- “The diamond” is a mutually reinforcing system

A synthesis of trade theories: Porter's diamond (cont.)

- Two additional variables: chance and government
- Factors: hierarchies (basic and advanced)
- Demand: sophisticated and demanding consumers put pressure on firms
- Industries: spillover effects (clusters)
- Firms: different management ideologies; and how vigorous rivalry is
- Porter: countries should export products from industries where all 4 components are favorable, and import in those areas where components are not favorable

Trends in FDI



Data source: UNCTAD 10

- FDI occurs when a firm invests in a foreign country (MNEs)
- FDI takes on two main forms: greenfield investment (new operation) or acquisition/merger
- We can refer to flows and stocks; outflows and inflows
- Sustained growth of FDI from the 1990s and on
- Both in developed and developing nations, but especially in the latter more recently
- Shift towards services
- Increasing internationalization (outsourcing/offshoring)

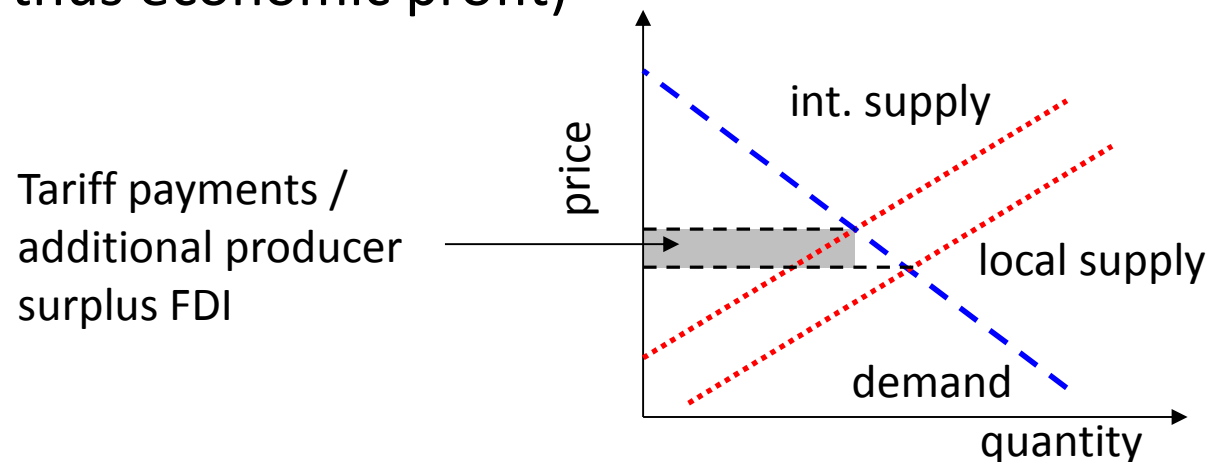
Selected theories of FDI

- Country specific explanations of FDI
 - Trade policy approach
 - Capital market approach
 - Location theory approach
- Product specific explanations of FDI
 - Industrial-organization in monopoly
 - Industrial-organization in oligopoly
- Company specific explanations of FDI
 - Transaction cost approach
 - Behavioristic approach

Integration of single explanations into one 'eclectic' approach [Dunning]

Country specific explanations of FDI I

- Trade policy approach [Hirsch, Johnson]
 - FDI as means to surmount natural and artificial trade barriers
 - FDI will take place in case increased fixed cost of new investment is overcompensated by savings in transport cost and tariff payments of substituted exports to the target market.
 - Basic idea: transform tariff payments into producer surplus (and thus economic profit)



Country specific explanations of FDI II

- Capital market approaches [Aliber]
 - Mobility of factor capital: capital flows from industrial countries (relatively rich in capital) to developing countries (portfolio investment and FDI)
 - Equilibrium: equal returns on capital worldwide
 - But: additional risks for international investments:
 - Foreign exchange rate
 - Political, economic, and social risks
 - International risks also cause additional information and transaction cost
 - Therefore: returns on capital in different countries will not converge entirely (→ risk and diversification reasoning)

Country specific explanations of FDI III

- Location theory approaches [Tesch]
 - Location factors as a reason for FDI
 - Macro location factors (country)
 - Micro location factors (industry)
 - General rule of location decisions: compare *location specific* cost and earnings
 - Empirical studies: market related location factors of prime importance

Product specific explanations of FDI I

- Market equilibrium, enterprise behavior, and market structure are mutually interdependent
- Monopoly [Hymer]:
 - FDI can
 - reduce competition in target market (e.g. by acquisitions)
 - be a means to use monopolistic advantages
 - Products (technology, quality, and marketing)
 - Large scale economies and organizational advantages
 - Financial and diversification advantages
 - Monopolistic advantages need to overcompensate the liability of foreignness (also “barriers to international operations” and “cost of doing business abroad”) in order to make FDI profitable

Product specific explanations of FDI II

- Oligopoly: mutual interdependence of competitors
- Prices in oligopoly compared to prices in perfect competition may be:
 - lower (→ cut-throat competition)
 - equal (→ contestable markets)
 - higher (→ trusts and cooperation)
- Relevant international competitive strategies:
 - Follow-the-leader [Knickerbocker] (→ advantages of FDI like economies of scale and know-how transfer force competitors to also internationalize)
 - Cross-Investment [Graham] (→ FDI as a defense of foreign competitor's market entry to home market)

Company specific explanations of FDI I

- Exchange of goods and services cause transaction cost [Coase]:
 - Ex ante transaction cost
 - Ex post transaction cost
- Transaction cost advantages are the reason why firms are involved in exchange processes [Williamson, Teece]
- High transaction cost of firms in case of:
 - High uncertainty
 - Low degree of standardization
 - Low frequency of transaction

Company specific explanations of FDI II

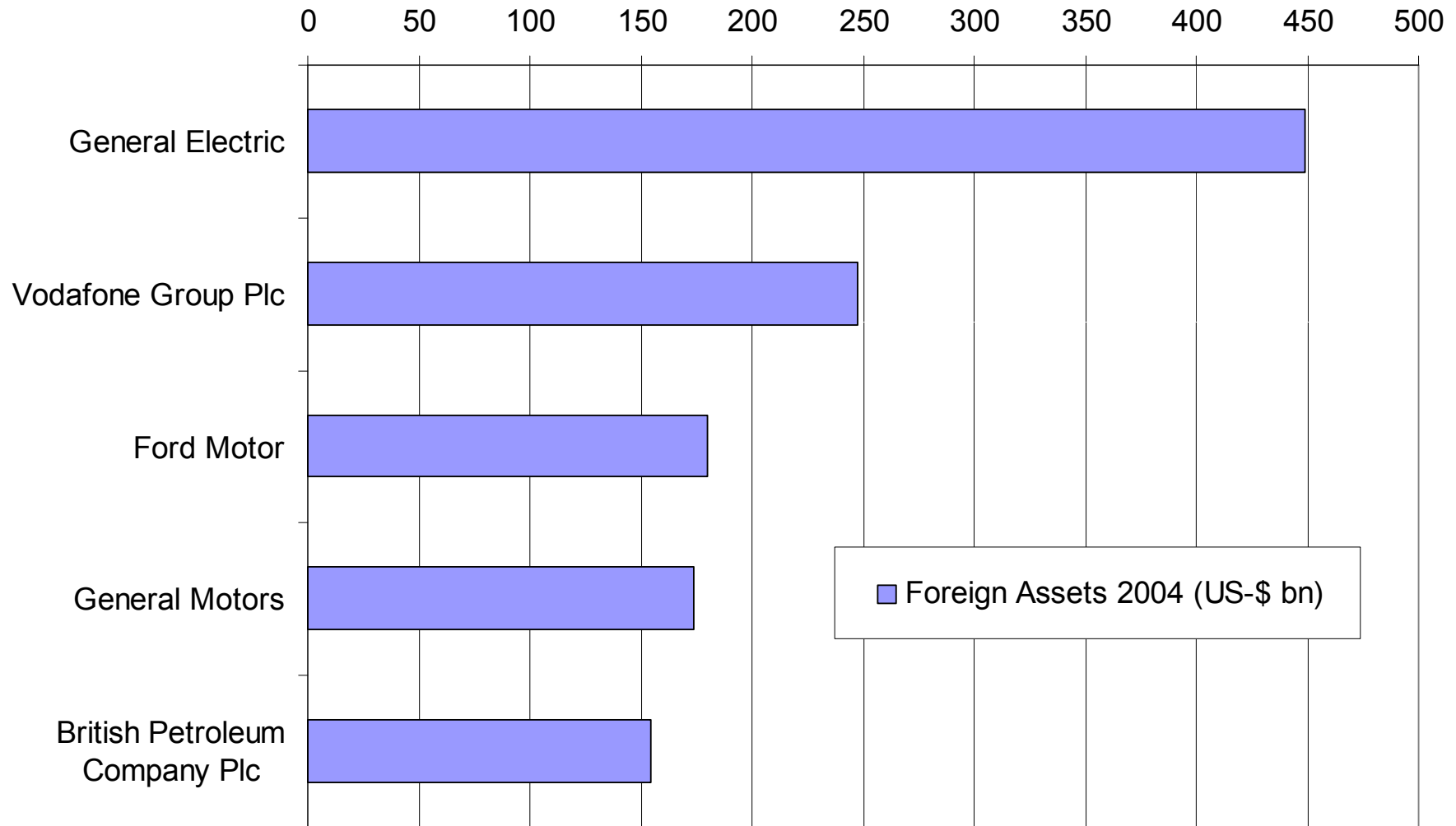
- Behavioristic approaches [Ahorni] : bounded rationality as a basis
- FDI is a result of a group decision (and not a rational decision)
- Phases of the decision for FDI:
 - Decision to look abroad (internal and external stimuli)
 - Investigation process (satisfying instead of optimizing evaluation)
 - Decision to invest (negotiation process)
 - Reviews and negotiations (learning effects)

Integration of single explanations – the eclectic view

- According to the eclectic (“summarizing”) theory of the multinational approach [Dunning], FDI will be successful, if it has three characteristics:
 - Ownership advantage
 - Internalization advantage
 - Location advantage
- Mode of market entry can be explained:

	Ownership Adv.	Internalization Adv.	Location Adv.
FDI	yes	yes	yes
Cooperation	yes	no	
Exports	yes	yes	no

Top 5 Multinationals (ranked by foreign assets)



Data source: UNCTAD 06

Summary of Unit 2

- Concepts
 - Division of labor
 - Absolute advantage
 - Comparative advantage
 - Ricardo's theory
 - Other international trade theories
 - Porter's diamond
 - FDI theories