Outward FDI: Theories And Determinants

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ABSTRACT
Outward Foreign Direct Investment (OFDI) as overseas investment leads to long-term repatriation of the profits from host to home country. The theoretical framework of OFDI and the determinants of the same are important elements in the international economic environment. The present study aims to build a critical discussion on Outward FDI theories and the determinants of OFDI. Researchers and policymakers in the area of international investment will be benefitted from the theoretical research.

KEYWORDS: OFDI, Host Country, Home Country, Capital Flows.

1. INTRODUCTION

International Capital movements have been a historical trend in the spread of civilizations. As man progressed from primitive times to the ancient and medieval times, capital gained strength amid the economic and trading relations among the countries. With the advancement of public administration, economic affairs became a key issue in the welfare state system. Economics as a formal branch of study started to emerge in the 18th century in the western hemisphere, however, eastern history suggests the classical works were written much before the 18th century, that reflected on economic affairs and policies. Both eastern and western philosophers have focused on economic affairs, starting from Ibn Khaldun (eastern) to Adam Smith (western). A close reading of their work suggests similar patterns on several counts. With the advancement of economics as a disciple, in the 19th century, several schools of thought appeared including Scarcity Thought, Welfare State Thought, Growth and Development Thought, Chicago School, Austrian School *et cetera*. At the same time, globalization started to catch up with the world. This provided a new opportunity for the firms and fellows to study the requirement to achieve new levels of growth and development. In the book "The Moral Consequences of Economic Growth" David argues economic growth targets in the 20th century were compromised against ethical decision making (Friedman, 2006). The world became obsessed with growth and developing countries started to search for new sources of investment. Already in the globalized world free movement of "goods, services, people and ideas" was considered a punch line for the political economy of the countries. This gave a push to International Capital Movements and countries started developing their Foreign Direct Investment (FDI) Policies.

FDI is considered capital investment arising from one country and destined for another country. The literature on FDI has been accumulating since the 18th century and certain things have been standardized in the last 2-3 decades. Organization for Economic Co-operation and Development (OECD, 2009) defines FDI as "Foreign Direct Investment reflects the objective of establishing a lasting interest by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor". The lasting interest is considered to be 10% equity, thereby saying that if the cross-border investment is at least 10% in the equity share capital, the investment would be considered FDI, if below 10% it will be Portfolio Investment (PI).

2. CONCEPTUAL FRAMEWORK OF OFDI

FDI is a cross-border investment with a lasting managerial interest denoted by at least 10% investment in the equity capital of the host country firm. It is differentiated from the domestic investment in terms of origin, FDI originates from somewhere in the rest of the world, contrary to this, Domestic Investment originates in the economy itself. In order to pursue the higher objectives of growth for an economy, countries need foreign investment. However, foreign direct investment as a form of foreign investment is preferred by economies due to advantages such as knowledge transfer, managerial expertise transfer, etc. The spillover effects of OFDI have wide-ranging benefits for the economy in the form of exchange rate stability, technology advancement, infrastructure development, to name a few.

2.1 TYPES OF OFDI

OFDI is divided conceptually based on three parameters, motive, flow, and entry mode. Figure 1 presents all types of OFDI.

2.1.1 OFDI BY MOTIVE

The first parameter is Outward FDI based on firms' motives.

1. Resource Seeking OFDI

Host country natural resources are at the sight of firms, particularly in sectors such as mining, oil, natural gas, metals, etc. Developing countries are rich in natural resources and are ready to sell or lease the resources. This provides a great opportunity for OFDI to seek the use of such resources. Countries with low protectionism demonstrated more OFDI in comparison to countries with high protectionism.

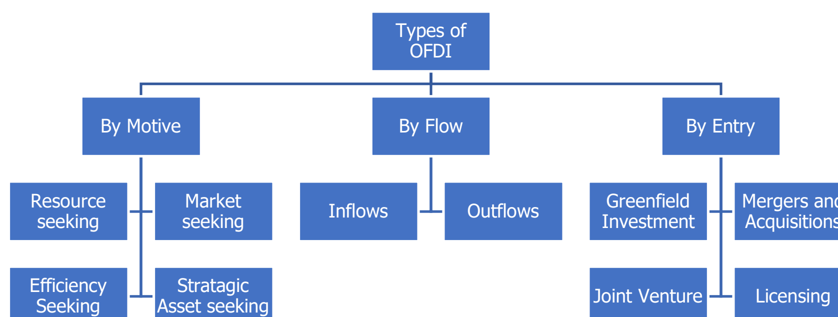

Figure 1. Types of OFDI.

Source: Rahman, 2016.

2. Market Seeking OFDI
   Firms are always in search of new markets to expand their consumer base and to achieve economies of scale. The size and growth of the host country market are important constraints in OFDI. Investing in such economies improves the strategic positioning as well as avoids import barriers (Bjorvatn *et al*., 2001). Market-seeking OFDI aims to minimize transport costs, transfer price, non-tariff barriers, etc. With market-seeking OFDI firms can also reduce the uncertainty due to exchange rate fluctuations (Gari and Josefsson, 2004).
3. Efficiency Seeking OFDI
   Efficiency is a key managerial objective and global firms are always looking for ways to inculcate it in their operations. Higher cost of production is a challenge to the firms and if given an opportunity to produce at a location where production cost is relatively low, it becomes a hot cake for the firms. MNCs and TNCs use OFDI as a means to reduce production costs including the low cost of auxiliary trade services. Efficiency seeking OFDI benefits through internal as well as external economies of scale for international firms.
4. Strategic Asset Seeking OFDI
   In the post-globalization stage, firms seek access to strategic assets across the globe. It can be a location, resource, technology, geopolitical region, etc. The tangibility of the asset is not a criterion for these firms. The focus of firms under strategic motive remains on skills and technology (Saeed, 2001). Sometimes, firms seek assets to counter competitors in the host country.

2.1.2 OFDI BY FLOW

OFDI can be studied by applying the Flow concept or the Stock concept. In the international investment environment, both OFDI stock and OFDI flows are reported by the respective countries. While Stock is the measurement of the OFDI at a point of time in the host economy, flow is OFDI for a specific period; in other words, OFDI stock is cumulative while OFDI flow is non-cumulative. For the Balance of Payments statement, OFDI flows are important as BOP is prepared for a specific time. FDI flows are further divided into Inflows and Outflows, the reporting country is the key to understanding and naming FDI Inflows and Outflows. A country that is reporting FDI, if it is receiving FDI during a period, it is termed as FDI Inflows. On contrary, what the reporting country is investing in the rest of the world, is Outward FDI to the rest of the world. Thus, the conceptual model to understand Outward FDI is the method of reporting the country as the stationary point. If not, then there will always be confusion. OFDI includes both stock and flow. However, from the point of view of the international economic environment, Outward FDI flows are much more relevant as they are non-cumulative. This avoids double-counting, as well as the historical performance in terms of FDI, becomes gloomy as per the stock concept. OFDI has become a new norm and a strong indicator for the economic might and integration of economies with the international economic environment.

2.1.3 OFDI BY ENTRY MODE

There are three most prominent forms of OFDI based on entry mode.

1. Greenfield Investments: Foreign Investment that creates new establishments. Such type of OFDI will result in the creation of new facilities and infrastructure development.
2. Merger and Acquisitions: Another mode of entry to the host country is investing in already established companies. This can be a merger where a specific percentage of equity is acquired or an acquisition wherein a majority stake is held by the foreign investor.
3. Joint Ventures: This type of mode of entry is a collaborative effort between the foreign company and the domestic company. The strategic importance of the host country firm is used by the foreign company to target the market and penetrate it. For the domestic company, this type of foreign direct investment is an opportunity to expand the business operations, if required, to achieve economies of scale.
4. Licensing: International licensing agreements are another mode of entry in the host country. It requires the involvement of a licensor (home country) and a licensee (host country). Knowledge resources are generated through licensing agreements such as technology, managerial expertise, trademarks, patents, etc.

2.2 THEORIES OF OUTWARD FDI FLOWS

Over the years, researchers have developed different theories explaining the underlying objective and dynamics of OFDI. Figure 2 presents theories of OFDI.

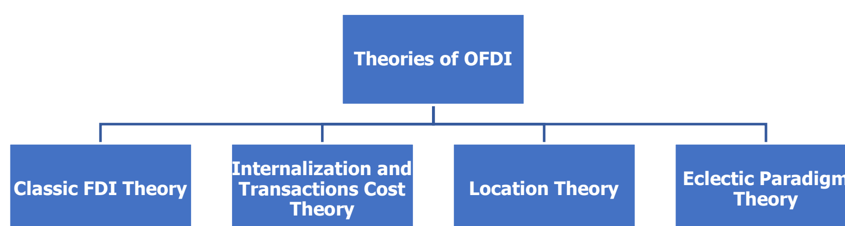

Figure 2. Theories of OFDI.
Source: Rahman, 2016

1. Classic Outward FDI Theory
   Hymer (1960) and Kindleberger (1969) introduced the classical theory of FDI. Their main focus was on the imperfect markets across the world and how they attract FDI. In terms of Outward FDI, it means that firms invest in foreign countries due to market imperfections. The market imperfections may be in terms of factors of production, goods and services markets, economies of scale, government restrictions, etc. The Outward FDI flows destination is identified by firms based on the competitive advantage.
2. Internalization and Transactions Cost Theory
   Firms that intend to invest through OFDI face the trade of external cost and burden of value chains. This gave a push to the Internalization and Transactions Cost theory propounded by Buckley and Casson (Buckley and Casson, 1976). They argued that companies face two choices, either go for exports or OFDI, the decision is critical as with OFDI, financial integration with the rest of the world takes place while in case of exporting it is connecting to value chains. Exporting focuses on transactions between two or more countries, on the other hand, when it comes to OFDI, the transactions become inter-corporate through the establishment of subsidiaries. Buckley (1976) maintains that due to the advantages of OFDI firms are able to internalize human capital, knowledge, managerial expertise, and patents. Focus on the cost of the transaction is yet another feature of a firm's overseas operations. Coase (1937) exclusively worked on the cost dynamics of international transactions and found out that to lower the cost of the transactions, firms do get involved in OFDI. However, he also identified that the underlying reason is the presence of imperfect markets. Imperfect markets incentivize firms to pursue production within their subsidiaries.
3. Location Theory
   In international capital movements, location is important due to the resources available and the level of global integration. This avoids any ambiguity related to value chains and supply chains. Location advantages motivate firms for OFDI and this was propounded by Vernon (1966). He identified that countries with infrastructure attract OFDI from similar countries lacking in infrastructure. Today this can be said for digitalization as well, more firms are looking for OFDI in countries that are digitalized. Countries have attempted to showcase their infrastructure development and location advantages at the global level to attract FDI in their countries, while OFDI is moving towards advanced economies, except where the consumer base is the target.
4. Eclectic Paradigm Theory
   Whatever was missing in the previous theories was accumulated in this theory propounded by Dunning (1977, 1988). He made a successful attempt to bend all the existing theories to develop a comprehensive theory of OFDI. The theory incorporates ownership advantages as the first criteria supported by the pieces of evidence provided by Hymer (1960), Kindleberger (1969), Griffin and Pustay (2001). OFDI flowing due to the location advantages is considered the second

pillar. And, the third pillar is the competitive advantage gained by the firms due to internalization of the cost supported by Griffin and Pustay (2001). This theory is also known as the OLI framework.

2.3 DETERMINANTS OF OFDI

The interesting question put to a study by research over the last decade suggests that OFDI is determined due to several macroeconomic variables, both country-specific and company-specific. Different countries have suggested different determinants of OFDI. However, in general, there are economic indicators that determine OFDI, irrespective of country or company. Apart from quantitative aspects, qualitative aspects also play an important role such as corruption (Hasan *et al*., 2017) reforms, etc. In this section, all the major determinants of OFDI are discussed.

1. Exports to the Host Country

   In terms of OFDI, the host country receives the direct investment and in turn, provides the market opportunities for the firm. The job of the host country is to provide safety and security of the funds invested and maintain a stable market. ODFI is originating from a country and that country will already be having exports relations with the host country. This provides an area of economic cooperation between the countries. Exporting allows to explore the host country market and companies can investigate the economic viability of the host country project or sector. This provides an incentive to indulge in OFDI in the host country. The companies are already aware of the value chains working in the host country, as they are exposed due to exporting in the host country. Researchers have provided empirical shreds of evidence regarding exports as one of the important determinants of OFDI (Zhang and Daly, 2011; Behera *et al*., 2020). There is also evidence for a causal relation between FDI and exports (Rahman and Grewal, 2017).
2. Imports from the Host Country

   Trade is considered to be two-way economic relation and therefore the opposite of exports is imports. Assuming that both countries have economic relations, it is clear that the host country will be importing goods and services to the OFDI originating country. Imports help the host country to build a sound relation with the OFDI originating country thus allowing the domestic firms to invest in the host country. The host country also looks towards the revealed competitive advantage to identify sectors and products in which it is less efficient and allow foreign firms to enter and share their efficiency. This provides an opportunity for the host country to achieve higher growth rates. Empirical pieces of evidence suggest that imports are important determinants of OFDI (Zhang and Daly, 2011; Roy and Narayanan, 2020; Lei and Tian, 2020). As part of the trade, regional blocs have used exports and imports to push for OFDI (Rahman, 2016a; Iqbal *et al*., 2019).
3. Host Country Gross Domestic Product

   The National Income of countries measured by GDP has become one of the litmus tests for the economic might of the countries. A country having higher GDP growth rates or GDP per capita is considered to be an investment destination for firms from the rest of the world. Absolute GDP is not considered a valid criterion as it is a stock concept and does highlight the changes in the time series of the economic indicators. It has been found that the higher the GDP rate of the country the higher is the FDI received (Buckley *et al*., 2007; Zhang and Daly, 2011). This is quite clearly demonstrated by the developing economies. Though they have a moderate infrastructure and less skilled population, firms involve in OFDI in these countries because of higher GDP rates. Empirical evidence is profound when it comes to the GDP rate and OFDI relationship (Chakrabarti, 2001; Feng, 2021). Though there may be disagreement pertaining to other economic variables for GDP it is clear throughout the global economy (Rahman and Rahman, 2018; Iqbal *et al*., 2018).
4. Host Country Official Annual Average Exchange Rate

   There are few studies that suggest the exchange rate be one of the determinants of OFDI. Statistically, it is the host country's official annual exchange rate against the home currency. Researchers have reported a positive correlation between exchange rate and OFDI meaning thereby that a blooming exchange rate results in increased OFDI to the host country. Currency exchange agreements between two countries under bilateral agreements have also suggested the same. After bilateral currency agreements, the OFDI between the countries has gone up (Zhang and Daly, 2011).
5. Host Country Annual Inflation

   When companies are examining the economies where they can invest, they do consider inflation. Galloping inflation is considered to be a bad indicator of the purchasing power and in such a scenario no country will be willing to invest. In the early 1990s, Zimbabwe faced this problem and the OFDI was affected by rest-of-the-world. Studies have used Consumer Price Inflation, for companies, it is the market inflation that affects the consumers, and to sell their products consumers' disposable income is an important determinant. A falling purchasing power of the consumer will pull the market and, in that case, OFDI will not bear the speculative results. Empirical shreds of evidence suggest inflation be an important determinant of OFDI (Zhang and Daly, 2011; Riaz and You, 2007; Iqbal and Rahman, 2018).
6. Home Country Technological Development

   It has been found that countries that are technologically developed in terms of spending on Research and Development indulge in more OFDI than other countries. Technological advancement provides economies of scale, efficiency, growth, cost internalization, and better-quality products. Less advanced countries look towards advanced countries for two reasons (Stoian, 2013). One, they also want to have access to advanced technology but for which they have to import technology which is sometimes a huge burden on the foreign exchange reserves. Two, they are looking for technology

transfer to their countries for long-term sustainable growth but this can only be achieved if the advanced countries invest in the home country (Dong *et al*., 2021).

7. Home Country Trade and Exchange Reforms

   Globalization and Liberalization are two key pillars of OFDI. Countries that were closed in the 1980s were criticized in the global economy due to their protectionist policies and thus OFDI seldom flowed to those countries. With the advent of globalization and liberalization, a country's global integration is seen as a positive indicator for investment. As the degree of liberalization improves in an economy, trade and exchange reforms do take place that is much global and fairer. This incentivizes for the rest-of-the-world firms to involve in OFDI. Evidence is provided by researchers (Stoain, 2013).

8. Home Country Competition Reforms

   Competition policies of the economies are important for the companies to compete with the domestic firms. If the domestic firms are given an extra edge in such a proportion that for the foreign firms it becomes impossible to compete, there is no motivation to invest. Thus, firms crucially evaluate the competition policy and look towards continuous and gradual reform in this regard. Countries that consider competition reforms from time to time along with building confidence with the parties are more prone to OFDI (Stoain, 2013).

3. CONCLUSION

OFDI is a concept of capital flow originating in an economy and flowing to the host country. OFDI is an important indicator for the firm's global integration and a source of foreign reserves for the originating country. OFDI theories suggest that there are different motives of the firms for OFDI. However, it cannot be denied that firms are always looking for a competitive advantage with OFDI. The literature on OFDI determinants suggests that both host country determinants and home country determinants play a significant role in OFDI flows. The growth prospects of countries, particularly the emerging economies and developing countries are heavily dependent on OFDI flows.

CONFLICT OF INTEREST

None.

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