Chapter-I

Concept and Historical Background of Foreign Direct Investment
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There is a growing recognition of the importance of the private sector and of Foreign Direct Investment (FDI) in the development process of the underdeveloped countries. A considerable number of developing countries as well as the countries in transition have become more receptive to FDI and are exploring ways for increasing inflows. Several considerations lie behind these perceptions. The first is an increasing preference for investment in equity form over commercial bank borrowing, which have proved to be unpredictable, onerous and inflexible in its servicing obligations, and obtainable for many countries. Foreign investment provides not only an initial capital inflow but the subsequent outflow of profits is also determined by the performance of the investment.

Let us now illustrate the main distinguishing features of foreign direct investment. First, unlike portfolio investment, direct investment implies the investing unit (usually a business enterprise) and purchases the power to exert some kind of control over the decision making process of the invested-in unit (again usually a business enterprise). This immediately suggests that other than money, capital is (or may be) involved in
international direct investment. This might simply be informal managerial or technical guidance; on the other hand it could incorporate the dissemination of valuable knowledge and/or entrepreneurship, in the form of research and development, production technology, marketing skills, managerial expertise, and so on. Where such knowledge is not separately obtainable (e.g. by licensing agreements) and is an important determinant of a company’s competitiveness, this may be crucial component of direct investment to the host company and country as the capital per se. It initiates not only an income-generating effect but a ‘technological generating’ effects that reflects directly in the superior knowledge of the investing country.

The special features of direct investment is that for the investing company, it buys a power of control over decision-making in a foreign enterprise. The extent of the decision-making power will carry according to its equity participation, particularly in relation to that of other investors. Secondly, it is usually accompanied by the transference of other factor inputs, or the output of such inputs, in the form of knowledge and ideas. In some ways, the multi-national corporation is better conceived as a vehicle for the dissemination of other factor inputs and services than a mere provider of finance. If we look from the viewpoint of the investing country portfolio capital, it is mainly supplied by individuals and institutions to different foreign individuals and institutions through the mechanism of the capital market. But on the other hand, direct investment, except where the purchase or part-purchase of an existing enterprise is involved, may be accomplished

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2 Ibid.
without any change in ownership at all. Essentially, it represents the vertical\textsuperscript{3} or horizontal\textsuperscript{4} geographical extension of a firm's activities and thus be viewed in light of its overall objectives.

In general, foreign direct investment is more likely to promote world economic growth than portfolio investment. This is because it tends to be concentrated in the dynamic and technologically advanced sectors, where the knowledge content of the investing firms is superior to that of local competitors. The distribution of the gains resulting from the investment between the host and investing country will depend \textit{inter alia} on the extent of competition and Government policy in the host country. Britain, in the nineteenth century, largely invested in those overseas outlets that yielded a safe return, but with little capital growth Further with outside trade and distribution and certain resource industries US firms today invest either to exploit certain economic advantages which is not possessed by competitors (or potential competitors) or where the pattern of market growth is likely to follow that of the US.\textsuperscript{5} These investments in general yielded high profits and a considerable capital appreciation.

\textsuperscript{3} A situation where the activities of a firm extend over more than one successive stage in the production process of transforming raw materials into final goods. Vertical integration can be partitioned into two types: backward integration, where a firm extends itself into a previous stage of the production process and forward integration, where a firm moves into a succeeding stage of activity. Motives commonly adduced for such integration are reduction in working capital requirement, elimination of prohibitory transaction costs, greater price competitiveness as a consequence of avoiding successive profit mark-ups and in the case of forward integration into retail outlets, the acquisition of secure markets.

\textsuperscript{4} Horizontal integration is said to take place when two firms at the same stage of the production process merge to form a single business organisation. For detail see Richard E. Caves, \textit{Multinational enterprise and economic analysis}, (Cambridge, 1982).

History of FDI

If we look into the growth and expansion of the theory of foreign direct investment, it is evident that the last two decades have been experiencing the emergence of numerous literature about the activities of corporations which are well spread outside of their national boundaries. To have a comprehensive knowledge about the historicity of the growth of FDI, we have further divided the period into four phases as classified vis-à-vis discussed below.

First Phase: (1870-1914)

The first half of the nineteenth century studies throw light on the earlier scholars those have considerably underestimated the role of Multi National Enterprises (MNEs) both as an entrepreneur as well as the transfer of intangible assets in the forty years i.e. prior to First World War. By the first decade of the twentieth century at least 14 billion US dollar had been invested in enterprises or branch plants. Either a single or a group of non-resident investors owned all these enterprises. Foreign direct investment during this period was both as a channel for the transfer of resources between different countries and as a means of controlling the use of these resources and complementary local inputs. It is also a known fact that several economies and some sectors, particularly capital-intensive primary product and technology-intensive manufacturing sectors, were dominated either

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7 Ibid.
by affiliates of MNEs or by foreign entrepreneurs, who both financed these activities and organised the supply of technology and management for them.

The territorial expansion of FDI was probably wider than it has mostly been for the last 35 years. Eastern Europe and China, for example, were attractive to western businessmen in the years preceding the First World War, and there were few controls exerted on investment flows, or on the scope of the activities of foreign capitalists.⁸ The first three-quarters of the nineteenth century mainly comprised expatriate investment or raised finance in the home country by corporations or individual entrepreneurs who come ahead to purchase a controlling equity investment in a foreign company. The next forty years saw the infancy and adolescence of the type of activity, which mainly resembles the present day pattern viz. the setting up of the foreign branches by enterprises that were already operating in their home countries.

The latter thrust began around the middle of the nineteenth century and gathered pace after 1875. By 1914 it had become firmly established as a vehicle of international economic involvement. On this aspect the eminent scholar Dunning mentioned that the United Kingdom was by far and away, the largest foreign capital stakeholder in 1914 with the United States some way behind.⁹ However, at that time, the US direct investments were more directed to growth sectors and a much larger proportions represented the activities of affiliates of MNEs. Such country specific differences were reflected in the structure of endowments, institutional mechanisms and existing international economic development. Europe had accumulated a pool of marketable

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⁸ Ibid.
⁹ Ibid.
venture capital, entrepreneurship and management expertise and was already a major portfolio capital exporter. But the USA with none of this background was building a strong comparative advantage in corporate technology -- management skills, which were often best exploited within the enterprises generating them. In 1914, the German and France capital stakes were about the same; and that there were also some Russian, Canadian and Japanese investments.

It has been seen that about three-fifth of the foreign capital stake in 1914 was directed to today's developing countries; but taking a contemporary definition of such countries to include all areas outside Europe and USA, the figure would be something more. About 55 per cent of total capital stake was accounted for by the primary products sector, 20 per cent by rail roads, 15 per cent by manufacturing activities, 10 per cent by trade and distribution and balance by public utilities, banking and the like. The manufacturing investments, which largely oriented towards local markets, were mainly concentrated in Europe, the USA, the UK Dominions and Russia; while apart from iron ore, coal and bauxite, almost all mineral investment were located in the British empire or in developing countries.

Special significance in this era was the raw material and agricultural investment. This period was the heyday of plantations, e.g. rubber, tea, coffee and cocoa; of cattle raising and meat processing, e.g. in the USA and Argentina; and of the emergence of the vertically integrated MNE in tropical fruits, sugar and tobacco. Apart from some

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10 This refers to the capital invested in a business where the owner accepts the risk that the company may go bankrupt.
transnational railroad activity in Europe and Latin America, it was in the agricultural sector that the international organisation first made its impact felt. Especially in economies whose prosperity depended mainly on a single cash crop, the production and marketing of that commodities were controlled by a few foreign companies, like (Cuba, Sugar), (Costa Rica, Banana), (Ceylon, Tea) and (Liberia, Rubber).\textsuperscript{11}

\textbf{Second Phase: (1918-1938)}

The First World War and the years followed thereafter saw several changes in the level, form and structure of international production. The war itself caused several European belligerents to sell some of their pre-war investments. Subsequent political upheaval and changes in boundary further reduced the intra-continental European corporate activity and eliminated it altogether from Russia. Only the USA remained fairly unscathed by these events. But the USA along with other countries subsequently suffered from the collapse of international capital markets in the late 1920s and early 1930s. Because her foreign investments largely took the form of branch plant activities by MNEs, and were directed to sectors supplying products with an above income elasticity of demand. In such a situation the US share of the world capital stock rose from 18.5 per cent in 1914 to 27.7 per cent in 1938.

Hence the international capital stake rose quite substantially in the inter-war years.\textsuperscript{12} There were also some changes in its geographical distribution. Inspite of some sizable West European investments in Central Europe, the US continued to attract more

\begin{footnotesize}
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\item[\textsuperscript{11}] Peter Buckley, n. 1, p. 6.
\item[\textsuperscript{12}] Ibid, p. 8.
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than two-thirds of the US direct investment stake. The role of intra-European and US participation in Europe declined in the 1920s and recovered somewhat in 1930s. There was also a lot of new MNE participation in the developing world in the inter-war years. This included new oil investments in the Mexican gulf, the Dutch East Indies in the Middle East, copper and iron ore in Africa, bauxite in Dutch and British Guyana, nitrate in Chile, precious metal in South Africa and most noteworthy of all, non-ferrous metal in South America.

Though a number of new subsidiaries set up by MNEs continued to rise throughout the period, it was only in the 1930s that the value of direct capital stake exceeds its pre-war figure. During this period, investments by continental European firms were mainly directed to other parts of Europe and the USA, while the US firms were strongly oriented to South America, Canada and the larger European countries. The first four Japanese manufacturing firms existing in 1970 and affiliates of the largest Japanese MNEs were set up between 1920 and 1938.

**Third Phase: (1939-1960)**

It has been seen that the inter-war years experienced deceleration in the expansion of international business. The thirty-five years since the end of the Second World War has experienced almost uninterrupted growth. The period may be conveniently divided into two phases. The first phase could be up to around 1960, in which the USA dominated the international investment scene. During this phase the increase in both the capital stake and the number of new manufacturing subsidiaries accounted for about two-

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13 Ibid. p. 10.
thirds of its operation. The third phase spanning the following two decades witnessed the increasingly important role of European, Japanese and some third world countries as international direct investors. Between 1960 and 1978, of the $38 billion increase in the world direct capital stake, the USA accounted for 48 per cent and West Germany and Japan for 18 per cent. Between 1971 and 1978 the respective ratios were 46 per cent and 22 per cent.\textsuperscript{14}

The effect of the Second World War was similar to that of the first in that each of the main European belligerents was forced to divest many of its foreign assets. However, unlike the First World War, the Second World War generated major technological advances while its aftermath produced an international economic and political climate, which was particularly favourable to foreign business activities. By 1960, for example, the French and the Dutch capital involvement had more than matched its pre-war level.

As a percentage of both the world output and trade, the international direct investment stake increased modestly between 1930 and 1960. During this period there was a continuation of the pre-war trend for the MNEs to favour the developed countries for new venture activity. In 1914, something like two-thirds of the capital stake was directed to developing countries, by 1938 this had fallen to 55 per cent, and by 1960 it was nearer 40 per cent. Partly this reflected another major structural change.

Although this period saw the start of enforced divestment or nationalisation of some primary product investments and the setting up of international producers’ cartel,

\textsuperscript{14} Ibid, p. 11.
the power of host country economics could not be revealed fully until the 1960s. Apart from state owned oil, MNEs European firms were not very active in raw material exploration. The major capital exporters in the 1950s viz., the Netherlands, France and Switzerland preferred to invest in manufacturing, trade and service activities i.e., including finance and insurance.

In the inter-war years, UK MNEs directed their attention mainly towards Commonwealth countries. Indeed, such countries increased their share of the total capital stake from around one-half in the 1930s to over 70 per cent in 1960. In the early post-war period South Africa and Australia followed by Canada attracted the bulk of new UK direct investment.

Unfortunately for this as for other periods, there are no comprehensive statistics on the entry or exit of MNEs. It is, therefore, not possible to estimate how much of the growth of the international capital stake was accounted for by firms existing at the beginning of the period and how much by new entrants. However, from available facts two things seem perfectly clear. First, over that part of the last century for which they had been operating as MNEs, something like 800 enterprises had set up affiliates in at least 10 countries. Second, of the total number of MNEs in 1973, nearly one-half operated only in one country and 70 per cent in other three countries.\textsuperscript{16}

\textsuperscript{15} Ibid, p. 11.
\textsuperscript{16} Ibid, p. 12.
Fourth Stage: (1960 – 78)

The rate of growth of the international capital stake reached its peak in the late 1960s, decelerated in the early and mid-1970s, but picked up again in the last few years of the decade. But the continued fall in the UK and US share and the increase in the share of the West German, Japanese and Swiss is the most striking feature of this period. This is also confirmed by an examination of the growth of 483 of the world’s largest industrial enterprises conducted by scholars like Dunning and Pearce.\(^\text{17}\) Between 1962 and 1977 the number of those MNEs of US origin declined from 292 to 240. But those of Japanese origin increased from 29 to 64. And in case of developing countries it increased from 2 to 18. In terms of investments flows, the West German’ share in 1979 and 1980 was scarcely less than that of the UK. Though the Japanese contribution was about 60 per cent of the UK it was on an increasing trend.

A change in the geographical distribution of the capital stake was also evident. According to an estimate by the United Nations UNCTC, 1981, $293 billion invested by the seven leading home countries in 1978. Out of the $293 billion, 26.5 per cent was in developing countries, a figure slightly higher than that in 1971, but below than the 1960 level. Most of the forced divestment in natural resources and public utilities occurred in the decade ending in 1975 and these were mostly located in developing countries. On the other hand, the 1970s saw a major surge in Japanese investment abroad. Unlike the US and UK it was concentrated in developing countries. In 1978, the developing countries accounted for 56.5 per cent of all Japanese cumulative investment compare with 27.4 per

\(^{17}\) Ibid, p. 13.
cent of US and 19.8 per cent of UK investments.\(^\text{18}\) moreover, the decline in extractive investments has been largely counteracted by the growth of manufacturing and service industries; for example, the share of the total US capital stock in these two sectors located in developing countries increased from 21 per cent in 1971 to 16 per cent in 1978.

A look within developed host counties reflects that the last twenty years experienced a marked shift of interest by MNEs to Western Europe and the USA. In 1960 about 32 per cent of the foreign capital stock of developed market economies was located in Western Europe or the US. But by 1970 this percentage again increased to 38 per cent and to 47 per cent by 1978. This reallocation of activity has been particularly marked in the case of UK investors. In 1978, Western Europe accounted for 31 per cent of the UK direct capital stake (excluding oil) compared to 13 per cent in 1962. The share to the developing countries, however, fell from 37 per cent to 20 per cent. Japanese investment has also grown rather, more rapidly in other industrialised countries.

However, the US, West German and Swedish MNEs continued to dominate the high-technology and information-intensive industries, while those of UK and Japanese origin are more represented in consumer good sectors. In Japan's case, however, her investments up to the mid-1970s were in the traditional industries\(^\text{19}\) in which she once had a comparative trading advantage like textiles. In the case of the UK, her strength appears to lie in branded goods like processed foods and cigarettes, where consistency of quality was an important competitive advantage.

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\(^{19}\) Ibid.
It is of prime importance to mention three other features of recent direct trends in MNE. The first is the growth in two-way investment by countries. For example, not only has the USA’s share of the outward capital stake fallen but her share of the inward capital stake has also risen. In 1960, the USA’s outward/inward capital stake ratio was 4.0 and it was 5.7 in 1970. But by 1980 it had fallen to 3.3. By contrast, the West German ratio has risen from 0.40 in 1960 to 0.809 in 1970 and 1.09 in 1978, and the Canadian ratio from 0.19 to 0.23 and 0.31. Moreover, in the later part of 1970s, several developing countries, e.g., Hong Kong, Singapore, Brazil, Korea and India, also began to export capital on some scale.

A shift away from traditional import-substituting and resource-based FDI to that designed to promote an integrated structure of production of MNEs has proved to be the second trend. The rationale for this has been discussed in the theoretical part of the study.

Thirdly, the last twenty years has seen an increase not only in the importance of joint ventures and non-equity resource flows but of liquidations and voluntary divestments by US’ MNEs. Between 1951 and 1975 the ratio of divestments to new investments rose from 23 in 1968-69 to 0.56 in 1974-75. These divestments have been of two kinds, both underlining the dynamic character of MNE involvement. The first was in low or mature technology sectors in which entry barriers are falling; the second is in response to the move towards global or regional rationalisation.

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20 Peter J. Buckley, n. 1, p. 16.
21 Peter J. Buckley, n.1, p. 16.
Other developments of the late 1970s were also worth mentioning. These included the opening up of regions such as parts of Eastern Europe and China. Both the areas were previously closed to international business owing to their allegiance to the central planning. The growth of MNE activity in different services sectors, i.e., banking, insurance, advertising and tourism and the increasing use of cross-border arrangements through multilateral agreements are also among the development indices.

Transition Economies

Before discussing the other aspects of FDI it is pertinent to have some ideas on the transition economy. How it differs from other form of economies is a matter to look in light of the present study. A comparison on the transition economy and other groups of economy has been attempted in the study in terms of a series of indicators, which can be placed together under the label institutional and that clarifies the basic difference between the transition economy and the other form of enterprises.

Enterprise size

Enterprise size is the first parameter that essentially throws light on the nature of the enterprise. The average number of workers employed in a firm speaks volumes of its activity. In a study undertaken by Sergei P. Aukutsionek, it well defined that the transition economy performs without a well thought market system.²²

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Form of Ownership

There has been sufficient basis for the argument in favour of ownership form, which plays a predominant role in defining the scope of a transition economy. Over the years of the reform, the proportion of state enterprises in the command administrative economy has diminished sharply. In a study in the second quarter of 1992, it was found that 74 per cent enterprise agreed and 94 per cent enterprise disagreed regarding the ownership size in dictating an economy and its business operation.

Freedom to make business decisions

It was expected that negative assessments of the government would be given primarily by those enterprises facing a lack of market freedom. Some data presented by the Russian Economic Barometer, however, confirmed this hypothesis and also allowed others to presume that the opposite tendency is possible. In 1992-95 on average 76 per cent of disagreeing enterprises were completely or basically free to set prices for their output. These average figures, however, concealed big fluctuations in individual years. At the start of the reform, in the second and third quarters of 1992, the agreeing enterprises were 6 percentage points more free than disagreeing. In 1993, on the contrary, the latter were 11 points. And from 1994 the difference between the two groups in respect of this indicator has been reduced to practically nothing. Similar results were obtained from measuring the degree of independence of decisions on the volume and structure of output produced. The average proportion of completely and basically free enterprises in 1993-95 in the agreeing group was slightly smaller than in the disagreeing group (89 per cent compared with 92 per cent). And as for decisions about the size and composition of the

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workforce, the figures for the two groups were found to be the same. On average in 1994-95, around 90 per cent of enterprises in both categories were completely or relatively free. \(^{23}\)

**Composition of the board of directors**

In this case the differences between the two groups proved to be very marked and symptomatic. At agreeing enterprises the board of directors less frequently includes representatives of the Property Fund but more often includes representatives of other enterprises, and much, more often includes representatives of banks which hold shares in the enterprise and other shareholders. \(^{24}\) Thus the more outside investor's enterprises have, the more often their directors support the government's economic policy.

**Business Objectives:**

Lastly, notable differences between the two groups of enterprises appear in their business motivation. The biggest divergence is registered in the parting of two motives i.e. profit and maintaining employment. On an average over a year and a half, profit was indicated as a motive by 35 per cent of respondents in the agreeing group and 26 per cent in the opponents group. For employment the proportions were reversed as 26 per cent and 34 per cent respectively. In other words, the government's economic policy enjoys more support from those enterprises whose behaviour is determined to a greater extent by market motives and forces.

\(^{23}\) Ibid, pp. 293-296.
\(^{24}\) Ibid, p. 329.
Other aspects of transition economy apart from the above institutions also required to be studied. Among others the characteristics of a transition economy could be categorised as follows. The presence of the following features primarily focuses light on its nature. Utilisation of productive capacity, utilisation of labour, stocks of finished productions, barter turnover and the prevailing financial situation could be as important as the institutional factors to determine the nature of an economy.

**Motives of FDI**

Foreign direct investment represents the territorial expansion of business activities. In principal it is undertaken to advance the interests of the investing institution. Obviously a question arises that why FDI is preferred to portfolio investment or to other of resource allocation. Why direct investment is preferable to other ways of exploiting a market, e.g., by export or licensing agreement? What is the cost of FDI in terms of forgone investment opportunities at home? To answer these questions it is imperative to know that a firm has a certain amount of capital available for investment and that it wishes to secure the highest rate of return on that investment. In this case the firm will invest abroad rather than invest in domestic company as long as the income it expects to earn will be greater. This will be possible only when the investing company possesses some advantages over its foreign competitor and sufficient to compensate for the disadvantage of operating a subsidiary at a distance. These advantages as described by scholar Kindleberger that take various forms and include superior technology, access to markets entrepreneurial expensive and experience, economics of integration and so on.²⁵

A firm would like to exploit these benefits rather than share them with potential competitors, and this encourages them to undertake direct rather than portfolio investment. The more significant the advantages, the greater the likelihood of monopoly profits being earned, and the more a firm is encouraged to engage in direct, rather than portfolio investment. Apart from this factor the case of capital nobility and Government policy are the two most important factory influencing the level and structure of domestic investment and it in form indirectly affect the direction of foreign investment.

**FDI in the context of developing and transition economies**

FDI constitutes a resource flow, which is particularly useful for the economic development of the developing countries, especially for their industrial development. It provides a unique combination of long-term finance, technology, training, know-how, managerial expertise and marketing experience. Moreover, the balance of payment situation improves in the form of profit remittances, as it is function of the commercial success of the foreign venture rather than occurring as fined interest payments, as in the case of borrowing. Developing countries seem increasingly to recognise these advantages, and in recent years these have witnessed a rapid, though erratic, growth of direct investment to them.

It is important to emphasise that the choice for an entrepreneur, who wants to establish a venture abroad, is world-wide and that in a majority of cases especially for smaller cases, less experienced decision does not go in favour of location in the third world. Developing countries therefore have to compete with other host countries in attracting foreign direct investment. Measures taken as incentive for attracting the
investment into the less developed countries can never be the substitute for the fundamentals, i.e., investment climate, political security and profit opportunities. But to compete with other developing countries for foreign direct investment, developing countries can offer a number of genuine comparative advantages. These are natural resources, low-cost labour, local and export markets, a relatively less powerful focus on social and environmental objectives, and lower taxes.  

These advantages, however, are sometimes overweighed by negative factors of an economic, political or even psychological character. Lack of supportive infrastructure, skilled labour, incohesive development policy, political risk and uncertainties surrounding the decision-making process also play a predominant role in outweighing the advantages. On balance, developing countries which have successfully attracted direct investment are mainly those with a dynamic and outward looking economic stance sustained by appropriate financial and economic policies, a disciplined labour force and at time of transaction, a good international credit standing.

Such a propitious general economic environment is particularly attractive if it is accompanied by clear and stable investment conditions, and the ability to generate a large range of productive investment project. Stability of investment conditions, non-discrimination (national treatment), freedom of capital movements and satisfactory, arrangements for the settlement and of investment disputes are feature of investment security to which foreign investments attach particular importance.  

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27 Grant L. Reuber, n. 5, p. 27.
By its very nature foreign investment involves some foreign control over the host country's internal economic activity. This remains the cause of some of the tension over FDI. Each developing country is, of course, free in its sovereign decision to accept or to reject any economic activities. It is important, however, that those developing countries, which have chosen to use FDI as an instrument of development, could create and maintain mutually beneficial investment conditions. These conditions have to meet the need both to secure adequate benefits to the host countries and take account of the legitimate interests of foreign investors.

**Why firms invest abroad**

The forces making for direct investment abroad are many and various. Basically, the investing firm is interested in the contribution, which such a capital outlay will make to the prosperity of the whole organisation. It would seem reasonable to assume that the firm will invest abroad as long as the marginal rate of return is greater than that could be earned elsewhere (allowing for any differences in risk). It is, however, increasingly unusual for this to be the case. As there are so many ways in which the establishment of a foreign enterprise can and does affect the profitability of the investing company. Exports may be increased or raw material procured more easily and cheaply; there may be a valuable feedback of technical knowledge; markets may be preserved against competitors, and so on.

The fact that the international business venture has become such a potent force in recent years may be due as much to the growing importance of these factors, as

28 Ibid.
to the profits earned on the capital invested. Thus, in 1965, about two-fifths of the total US capital invested abroad was concentrated in resource industries e.g., petroleum and mineral extraction compared with a third before the war. No less than one-quarter of American imports are currently derived from US productive facilities overseas (30 per cent in the case of imports from Canada and Latin America. As the US exhausts more of her indigenous raw materials, the urgency of the need ‘international investment in the middle and Far East and it the modern counterpart of the ‘colonial-type’ investments of the nineteenth century.

A no less important reason for the migration of business operations abroad has been the desire to expand horizontally or laterally, either to overcome import restrictions of one kind or another or to open up new markets. Not only may it be cheaper for a firm to manufacture in a foreign country than to export to it. Fear of competition has also been a powerful inducement.

Empirical evidence on this subject is mostly impressionistic. According to one survey, over four-fifths of US firms with manufacturing subsidiaries in Canada claimed that their exports had been either raised or unaffected as a result of local production. There is reasonable, though by no means conclusive, evidence that US direct investment abroad has stimulated rather than curtailed exports of US goods and services. Whatever the truth, the desire to penetrate new markets or to protect existing ones is one of the most commonly stated factors influencing foreign investment. In recent years it has been favourable for this latter type of overseas investment, particularly in the case of the US. In between 1950 and 1965 the rate of return earned on manufacturing capital at home and
the rate of growth in manufacturing output was generally well below that in most other
developed industrial countries.

This prospect of higher profits and market growth has also prompted British
investment overseas and followed by German and French as well. Looking at the
geographical distribution of direct overseas investment since the war, it is observed that
between 1952 and 1956 Canada was the main attraction. Then, when the Canadian boom
burst, attention was switched to Australia, and since the formation of the EEC the
continent of Europe has been the most favoured.\(^{29}\) Most of this investment has been
undertaken for both defensive and aggressive reasons. Unlike US overseas investment,
other investing countries were rarely producing higher returns. For the period 1960-64
the net profits to net assets ratio of UK firms in the major industrial areas worked out at
8.0 per cent, compared with 7.2 per cent at home. Nevertheless, it has often led to very
valuable indirect benefits, such as a feedback of technical knowledge and to increased
exports.

The increasingly significant role of the multi-national enterprise is strikingly
illustrated by the fact that, between 1946 and 1967, the investments of US companies in
foreign subsidiaries and affiliates increased at twice the rate of the domestic assets of US
corporations.

The income of UK companies abroad rose from under a third in 1950 to over two-
fifths in 1966. To the extent that direct investment finances its own growth out of re-

invested profits, and the more advanced less developed countries develop their own economies and markets with aid of official capital, private investment will gradually assume the predominant role, as it is doing in many South American states.

Modern economic conditions favour the growth of the multinational company, and today most European companies of any size have to look beyond their national boundaries for growth. This has been accelerated by changing international demand and supply conditions. On the demand side, as incomes have expanded and communications have improved, international tastes have become more and more standardised. On the supply side, developments in capital intensive technology and the increasing cost of research and development programmes have reinforced the need for companies to seek new markets to spread costs economically. In part, these needs have been met by exports, but, increasingly, conditions have favoured the replacement these by the establishment of local producing facilities. Besides transport costs, others include tariff barriers and the formation of regional economic blocs, the importance of adapting to local markets, after-sales servicing and so on. There has been a growing impetus of companies to invest abroad and this has been enhanced by the concentrated structure of competition, which exist between international firms. At a national level, no country can afford to adopt an entirely isolationist policy. Small countries invest abroad to secure the markets to enable them to compete with large countries. Large innovating countries, e.g. US, invest to protect existing markets and as a way of promoting new outlets.

The form of entrepreneurial investment varies according to the local situation and policy of the parent company. In some cases complete ownership is considered desirable but in the other joint participation with local firms also proved to be beneficial. In almost
every instance, however, technical and managerial expertise is exported with capital, and disseminated into the economy of the host country. The influence of the international corporation as a pioneer of new product, new technique and new skills is now spreading across national boundaries with a renewed vigour. At some point of time knowledge is transmitted through licensing arrangements, which usually involves no financial investment and here management plays an important and so also equity control. Local manufacturing is preferred to exports partly on the basis of cost, partly on the basis of offering servicing facilities and adaptations to local market needs.

Attitude of lending countries

In recent years, both lending and borrowing countries have restricted the international flow of capital. Up to 1960, the US actively encouraged overseas investment, but since that date, balance-of-payments difficulties have forced a reappraisal of the effects of such investment and there has been some pressure to reduce the outflow of capital. For similar reasons, the UK has controlled overseas investments for most of the post-war period, although the scope and intensity of control have varied with the balance-of-payments position.

In addition, there are other longer-term considerations that have led some countries to question the desirability of foreign investment. It has been argued that though the private rate of return on overseas investment is higher than that at home, it has its own drawbacks. The loss of tax revenues, the possible deterioration of the terms of trade, the retardation of growth at home and other drawbacks may outweigh any benefit in the form of higher profits and external economies that are arising from investment.
To what extent this is true is difficult to say; although recent studies on the costs and benefits of foreign investment seems to suggest that there has been a little or no misallocation of resource. Nevertheless, both the US and most European countries have treated foreign investment, particularly security investment as somewhat of a luxury in the post-war period. The quantity varied very closely with the balance-of-payment and the likely effects of such investment may foster country’s economic growth and stability.\(^{30}\)

**Views of borrowing countries**

Borrowing countries have also regarded the inflow of foreign capital with mixed feelings. Increasing attention is now being given to analysing the repercussions of such investment and, through a variety of policy measures, to align its magnitude and composition to national resource allocation and growth. In the past, the most substantial benefit of foreign investment has been its stimulus to economic development. Direct investment is particularly welcomed as it brings to the recipient country all the elements necessary to create new production units: improved technology, new products and marketing methods, patents and trade-mark right, managerial expertise and entrepreneurial initiative. By example, and contact with other firms, these benefits percolate to the rest of the economy.

Capital also brings with it access to research activities of the parent company: some years ago, it was estimated that more than a quarter of US research and

\(^{30}\) Charles P. Kindleberger, n. 6, p. 390.
development was made available to the UK economy through the media of Americans subsidiaries (Dunning 1958). Clearly, the impact of such investment will depend on the direction of investment and its industrial spread. However, the package of investment is attracted to growth industries. There are other benefits to the host country, such as the additional supply of capital provided and the taxation levied on the income it creates.

Set against the benefits is the costs of foreign investment, particularly direct investment. These fall broadly into two group. The first one is the servicing of the debt and the second one is the fear that national economic, strategic or cultural objectives may in some way be interfered with. The latter applies particularly where foreign enterprise controls key sectors of an economy.\(^{31}\) As with the investing country, the balance of advantage will depend on many factors, such as the type and ownership of capital invested; its character and its industrial distribution. Thus, investment made by foreign firms for the exploitation of natural resources would prove less beneficial to the host country as it tends to export the benefit to the investing country. Since, the indirect benefits of entrepreneurial investment trends to increase, minimum foreign equity stake consistent with the acquisition of these benefits may be thought preferable to a 100 per cent control. In certain circumstances, foreign investment may adversely affect domestic savings and caused deterioration in the host country's terms of trade.

The host country would always try to maximise the profits and minimise the costs of FDI. In order to reach at this goal, it could be said that the host country would consider integrate and regulate the capital flow not only into a particular project but in the light of

\(^{31}\) Ibid, p. 401.
its expected contribution to the national development programme as a whole.\textsuperscript{32} This requires a discriminatory policy designed to attract capital into particular sectors of the economy where it will have the maximum catalytic effect of mobilising national resources, while restricting the inflow elsewhere, e.g., into luxury industries. To minimise and stabilise the cost of foreign borrowing while obtaining the maximum technological advantages, it is essential to draw distinctions between various types and forms of foreign capital.

Recent developments in the theory of FDI have centred on the theory if international capital markets and the theory of the international firm go hand in hand together. These theories are reviewed in the next chapter. The next chapter considers how the theories may be integrated with each other and how it fits with trade theory, to explain FDI. It is shown how different authors have combined different aspects of these theories, as a result, the relations between alternative theories of FDI are seen in a clearer light.