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Theories of internationalization and foreign direct investment: how to explain FDI from emerging MNEs? [i]

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1. Introduction

The rise of multinational enterprises (MNEs) from emerging markets is topical, important and poses a number of questions and challenges that require considerable attention in the future from academia as well as business management. The recent takeovers of high-profile companies in developed or developing countries by emerging-market MNEs – such as Lenovo, Wanhua (China), Hindalco (India), etc. – as well as the greenfield or brownfield investments of emerging companies (such as Huawei, ZTE, Tata, etc.) show a new trend where new kind of firms become major players globally. According to the World Investment Report investments from emerging-markets reached a record level: based on UNCTAD data, developing Asia now invests abroad more than any other region (UNCTAD 2013).

Majority of traditional theories explaining the different motivations for foreign direct investment (FDI) were born after World War II, in the 1960s and 1970s, when investments were typically flowed from developed countries to other developed or developing regions. Consequently, the rapid growth of FDI from emerging and developing countries in recent years - often directed at developed regions - has been a subject to numerous studies trying to account for special features of emerging-country multinationals' (MNEs) behaviour that is not captured by traditional theories.

Although emerging MNEs' foreign direct investment is not a completely new phenomenon but has examined by scholars with a new momentum in the past one or two decades due to the 1) the unprecedented size of the phenomenon; 2) the fact that developing Asia accounts for more than a quarter of all outward FDI; 3) while this group of countries will be soon a net direct investor (UNCTAD, 2015). The phenomenon itself is indeed existing since Japan, then later the Four Asian Tigers (Hong Kong, Singapore, South Korea and Taiwan) are all experienced similar upward trend in terms of inward as well as outward FDI. These countries can be considered as predecessors of FDI from emerging countries today (such as BRICS - Brazil, Russia, India, China and South Africa). Consequently, we can differentiate between three waves of FDI (Andreosso-O'Callaghan, 2016, p. 15), 1) FDI from emerging Europe and the United States after the second World War; 2) FDI from Japan, then the Asian tigers from the 1960's, 1970's; and 3) FDI from BRICS countries after the turn of the Millennium.

2. A brief overview of traditional and new theories

The theoretical framework of FDI, as well as the concept of internationalization, has evolved a lot in the past century. To briefly summarize the traditional theories of FDI, the next chapter use - and expand - the typology of Andreosso-O'Callaghan (2016, pp 16-17), where different theories can be labelled as micro-, meso- or macro-economic levels. After these traditional theories the main findings of the Japanese School of FDI is also summarized briefly as it can be relevant in explaining, for example, Asian FDI. The chapter then continues with those new theorists that consider traditional economic factors insufficient in explaining MNEs' FDI decisions and, as a result, develop new theoretical attempts to explain FDI decisions of emerging MNEs.

2.1 Traditional theories

Macro level theories include theories such as the capital market theory, the dynamic macroeconomic FDI theory or the exchange rate theory, economic geography theory, gravity as well as institutional approach and investment development path theory.

Capital market theory is one of the oldest theories of FDI (1960s) which states that FDI is determined by interest rates. However, it has to be added that when this theory was formulated, the flow of FDI was quite limited and some parts of it were indeed determined by interest rate differences. According to the dynamic macroeconomic FDI theory, FDI is a long-term function of TNC strategies, where the timing of the investment depends on the changes in the macroeconomic environment. FDI theory based on exchange rates considers FDI as a tool of exchange rate risk reduction. The FDI theory based on economic geography explore the factors influencing the creation of international production clusters, where innovation is the major determinant of FDI. Gravity approach to FDI states that the closer two countries are - geographically, economically or culturally, ... - the higher will be the FDI flows between these countries. FDI theories based on institutional analysis explore the importance of the institutional framework on the FDI flows, where political stability is a key factor determining investments.

According to the investment development path (IDP) theory, that was originally introduced by Dunning in 1981 and refined later by himself and others (Dunning 1986, 1988, 1993, 1997; Dunning and Narula 1996; Durán and Úbeda 2001, 2005), FDI develops through a path that expresses a dynamic and intertemporal relationship between an economy's level of development, proxied by the Gross Domestic Product (GDP) or GDP per capita, and the country's net outward investment position, defined as the difference between outward direct investment stock and inward direct investment stock.

In the framework of the investment-development path theory, Dunning also differentiated between five stages of development:

- Stage 1. is characterized by low incoming FDI, but foreign companies are beginning to discover the advantages of the country. In this phase there are no outgoing FDI since there are no specific advantages owned by the domestic forms.
- Stage 2. is characterized by growing incoming FDI due to the advantages of the country (such as low labour costs), while the standards of living are rising which is drawing even more foreign companies to the country. Outgoing FDI is still rather low in this phase.
- In stage 3. incoming FDI is still strong, but their nature is changing due to rising wages. The outgoing FDI are taking off as domestic companies are getting stronger and develop their own competitive advantages.
- In stage 4. strong outgoing FDI seeks advantages - for example low labour costs - abroad.
- In stage 5. investment decisions are based mainly on the strategies of multinational companies and the flows of outgoing and incoming FDI come into an equilibrium.

At the meso-level we find Raymond Vernon's product life cycle (PCM) model (Vernon, 1966), which conceptualizes the role of the diverse stages of the product cycle in boosting the level of economic development among regional trading partners. Vernon's PCM theory was published

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at a time when there were the first traits of offshoring to developing (or lower wage) countries experienced by the United States. Vernon differentiated between four stages of development of a new product:

(1) domestic production - introduction phase,

(2) export - growth phase,

(3) export of capital - maturity phase and

(4) foreign production - decline phase.

While the product matures, the market expands, economies of scale set in that drives the prices down, justifying exports to other countries. When production costs - especially labour cost - became a major component of total costs, production is moving to lower labour-cost countries. According to this theory, companies decide to invest abroad considering beneficial ownership and transaction cost as well as local conditions. As a result, FDI can be seen mostly in the phases of maturity and decline.

At the micro level (actually, at a rather mixed micro-macro level), Dunning's eclectic paradigm, also known as OLI model, became the mainstream theoretical framework explaining FDI (Dunning, 1992, 1998). This paradigm states that firms will venture abroad when they possess firm-specific advantages, i.e. ownership (O) and internalization (I) advantages, and when they can utilize location (L) advantages to benefit from the attractions these locations are endowed with. The OLI paradigm has changed a lot since it has first presented, ownership advantages, for example, have been divided into asset-based and transaction-based categories. "The asset-based ownership advantage is the exclusive or privileged possession of country- specific and firm-specific intangible and tangible assets, which gives the owner some proprietary advantage in the value-adding process of a particular product"... while "the transaction-based ownership advantages reflect the ability of a corporation to coordinate, by administrative fiat, the separate but complementary activities better than other corporations of different ownership and the market" (Cuervo and Pheng, 2003, p.82). The transaction-based ownership advantage seems to be also very relevant for multinational companies from non-developed countries.

Different types of investment motivations attract different types of FDI which Dunning (1992, Dunning and Lundan 2008) divided into four categories: market-seeking, resource-seeking, efficiency-seeking and strategic asset-seeking. The factors attracting market-seeking multinationals usually include market size, as reflected in GDP per capita and market growth (GDP growth). The main aim of a resource-seeking MNEs is to acquire particular types of resources that are not available at home (such as natural resources, raw materials) or are available at a lower cost compared to the domestic market (such as unskilled labour). Investments aimed at seeking improved efficiency are determined by low labour costs, tax incentives and so on: localization advantages “comprise geographical and climate conditions, resource endowments, factor prices, transportation costs, as well as the degree of openness of a country and the presence of a business environment appropriate to ensure to a foreign firm a profitable activity” (Resmini, 2005, p 3). Finally, the companies interested in acquiring foreign (strategic) assets might be motivated by a common culture and language, as well as trade costs (Blonigen and Piger, 2014; Hijzen et al., 2008). It should be emphasised that some FDI decisions may be based on a complex mix of factors (Resmini, 2005, p. 3; Blonigen and Piger, 2014). Much of the theoretical discussion is based on FDI outflows from developed countries, for which market-seeking and efficiency-seeking FDI is most prominent (Buckley et al., 2007;

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Leitao and Faustino, 2010), while FDI from non-developed regions is motivated by an even more mixed composition of factors..

2.2 The Japanese School of FDI

In Asia, Japan was the first country that became outward investor. Its catching-up strategy can be traced back to the Meiji Restoration that allowed the country to became the „lead goose” in Asia. This historical process inspired the Japanese School of FDI. Although it has often been left out from other theoretical overviews of FDI related books or papers, this chapter plays special attention to this theory, as it can be especially relevant in explaining Asian FDI. In addition, interesting links can be found between the Japanese school’s main ideas and the aforementioned product life cycle and/or investment-development path theories.

In specific terms, the flying geese paradigm (FGP) is a view of Japanese scholars upon the technological development in Southeast Asia viewing Japan as a leading power. It was developed in the 1930s, but gained wider popularity in the 1960s after its author Kaname Akamatsu (1962) published his ideas in the Journal of Developing Economies. According to the theory, the „lead goose” Japan provides birth help to East Asian industrialisation through foreign direct investment. This catching-up experience emulated others and Japan's model was followed by the Four Asian Tigers, including South Korea and Taiwan, and later by China. Akamatsu stated that "these countries, advanced and less advanced, do not necessarily go forward at the same speed in their development of a wild-geese-flying pattern, nor do they always make gradual progress, but they are at times dormant and at other times make leaping advances" (Akamatsu 1962, p. 18). However, when building up the theory, Akamatsu didn't really explained the motivation or driving force behind a country's upgrade. Kojima (1960) made an attempt to do so and explained the driving force with the accumulation of capital, that is the Heckscher-Ohlin factor. In a later article he also mentioned "the Ricardian advantage by learning-by-doing and economies of scale" as potential driving force (Kumagai, 2008 p. 8).

At the turn of the Millennium, the FGP model was reformulated by Kojima (2000) and Ozawa (2001). In his article Kojima (2000) reviewed several empirical studies that tried to verify the FGP, while Ozawa (2001) analysed the relationship of FDI, competitiveness and economic development based on the ideas of Michael Porter. Ozawa identified three main phases of development as he analysed the waves of FDI inflow and outflow from a country. These phases are factor driven, investment driven, innovation driven phases of development.

- In the phase of economic growth the country is underdeveloped and targeted by foreign companies wanting to use its potential advantages (especially low labour costs). In this stage there is almost no outgoing FDI.
- In the second phase the country attracts market-seeking inward FDI and intermediate goods industries from developed countries. In this phase, new FDI is drawn by the growing internal markets and by the growing standards of living. This development generates outward FDI to less-developed countries in labour-intensive and resource-based industries.
- In the third phase of economic growth the competitiveness of the country is based on innovation, while the incoming and outgoing FDI are motivated by market factors and technological factors.

Nowadays, the FGP is generally used to "depict the sequential development of a group of countries, and the concept is sometimes thought to be obsolete" (Kumagai, 2008 p. 17).

2.3. New theoretical attempts

As mentioned above, although Asian FDI is not a new phenomenon, but what is different today is the scale and pace it has evolved since the early 2000s, in particular, since China launched its „go global" strategy (2000) and started to invest more and more globally. Nevertheless, traditional theories as well as economic factors seem to be insufficient in explaining FDI decisions of emerging (Asian as well as non-Asian) MNEs.

In the last decade international economics and business researchers acknowledged the importance of institutional factors in influencing the behaviour of MNEs (e.g., Tihanyi et al., 2012). According to North, institutions are the "rules of the game" which are "the humanly devised constraints that shape human interactions" (North, 1990, p 3). Institutions serve to reduce uncertainties related with transactions and minimize transaction costs (North, 1990). Similarly, Meyer and Nguyen (2005, p 67) argue that informal constraints are "much less transparent and, therefore, a source of uncertainty". In response to such observations, Dunning and Lundan (2008) extended OLI model with the institution-based location advantages which explain that institutions developed at home and host economies shape the geographical scope and organizational effectiveness of MNEs.

To catch the special features of emerging MNEs' behaviour, Mathews extended OLI paradigm with linking, leverage, learning framework (LLL) that explains rapid international expansion of companies from Asia Pacific (Mathews, 2006). Here *linking* means partnerships or joint ventures that latecomers form with foreign companies in order to minimize risks involved with internationalization as well as to acquire "resources that are otherwise not available" (Mathews, 2006, p 19). Latecomers when forming links with incumbents also analyse how the resources can be *leveraged*. They look for resources that can be easily imitated, transferred or substituted. Finally, repeated processes of linking and leveraging allow latecomers to *learn* and conduct international operations more effectively (Mathews, 2006, p 20).

Although emerging-market MNEs from various emerging countries differ in many respects but to some extent they share common characteristics. Barnard (2010), for example, writes about the lack of strong firm capabilities among MNEs from South Africa and Taiwan. Due to the geographical, cultural and institutional distance between the home and host countries, emerging companies - like all other MNEs - suffer from the 'liability of foreignness' (Kostova and Zaheer 1999; Hymer 1976), while they also suffer from - as Amendolagine and Rabellotti (2017) calls it - the 'liability of emergingness', which is related to their emerging market origin, reducing their legitimacy in advanced markets (Madhok and Kayhani 2012; Ramachandran and Pant 2010).

When it comes to the 'special' role of the home country, i.e. the role of the state, Kalotay and Sulstarova (2010) highlights that Russian MNEs' investments are also influenced by home country policies. Similarly, Anwar and Mughal (2014) argue that Russian outward FDI follows the eclectic paradigm to a certain extent, but home-country factors also play a significant role. Kalotay (2010) divides these home-country advantages into home-country-based competitive advantages, business-environment advantages, development-strategy advantages and state-involvement advantages. Peng (2012) reports that Chinese MNEs are characterized by three relatively unique aspects: (1) the significant role played by home country governments as an institutional force, (2) the absence of significantly superior technological and managerial resources, and (3) the rapid adoption of (often high-profile) acquisitions as a primary mode of entry.

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Surprisingly, with the exception of China, there is no specific going global strategy in the majority of emerging countries. While China's FDI expansion is driven by state-owned enterprises, Russian outward expansion is mainly driven by private companies (Skolkovo, 2009), while state support for Russian multinationals is quite weak due to the lack of developed policy instruments. By comparing the Chinese and Brazilian outward FDI strategies, Ricz and Szunomar (2019) concluded that Chinese outward FDI strategy has taken a much more aggressive stance to promote Chinese companies abroad, while its Brazilian counterpart was a rather a defensive one. Brazilian industrial policies were focusing on already existing dynamic comparative advantages, as they preferred to support industries, that were already highly competitive internationally, and did not promote further structural changes in the domestic economy. In contrast, the Chinese government has promoted and guided outward FDI with the main aim to acquire assets that were scarce in the country or considered to be crucial for the further development of the domestic economy.

The motivations of developed country MNEs are often different from those of emerging countries. For example, Hanemann (2013) points out commercial reasons behind most Chinese investments: the acquisition of rich-world brands and technology to increase competitiveness, money-saving by moving higher value-added activities in countries where regulatory frameworks are more developed. In the case of emerging MNEs, the primary drivers of internationalization are not only industry-driven processes, such as circumventing transportation costs, trade barriers, or intangible asset-seeking, as Dunning et al. (2008) or even Ramamurti and Singh (2009) demonstrated, but more firm specific characteristics (Feenstra 1998). For example, in the case of Indian MNEs, the most important characteristic in this regard is access and usage of modern technology (Ramamurti, 2012). Similarly, the main driver for other emerging MNEs to specialize in global value chains is to get access to state of the art technology which can help develop capacities in their home base.

Gubbi et al. (2010) find that Indian MNEs are fond of undertaking acquisitions overseas. Since 2002 a marked shift in corporate attitude towards global markets took place in Brazil, too, but “multi-latinas“ have emerged throughout Latin America (Casanova-Kassum, 2013). While some emerging-market MNEs focus on neighbouring regions others target the global market, including the countries of the developed world. According to Gubbi and Sular (2015) Turkish firms, for example, seem to be using the European countries to (1) present themselves as a European Union company, (2) make use of special features of these countries to expand their businesses within and to other countries and, (3) make use of the favourable tax treatment policies available to foreign investors.

Global value chains (GVCs) have increased the interdependencies between trade and FDI, while participation in GVCs has allowed emerging countries to specialize on the global market. Some of the emerging countries’ – especially China’s and India’s – development have already been GVC-driven in the past decades, consequently it might have influenced their outward FDI flows. Martínez-Galán and Fontoura (2018) made a study on OECD as well as emerging countries and found that a country′s degree of GVC participation has positively contributed to bilateral FDI transactions. Carill-Caccia and Pavlova (2018) also found that foreign takeovers, both in terms of number of projects and their value, are mostly driven by FDI supporting exports and to certain extent vertical FDI.

3. Driving forces and location choices behind the international expansion strategy of emerging MNEs: push and pull factors

Various factors determine the direction and intensity of MNEs' FDI flows. While there are important factors on the firm level such as - among others - size, performance or industry (Terpstra and Yu, 1988; Nachum and Zaheer, 2005), country level characteristics may play an even more important role when it comes to emerging MNEs (Schüler-Zhou et al., 2012), especially those with autocratic, authoritarian regimes. As highlighted by Dunning (1998), at the country level, both home and host country characteristics determine the location decisions of MNEs. As result, in this book we concentrate on exploring the country-level driving forces of OFDI that can be grouped into push and pull factors (or home country and host country determinants, respectively), to differentiate the factors that drive investment out of the home country, or attract investments into the host country.

Push factors - or home country factors - are those factors that drive (push) investment to other countries. Several types of push factors contribute to the internationalization of companies from developing countries. Masron and Shahbudin (2008) differentiated between institutional and structural push factors. Structural push factors - such as gross domestic product (GDP), export-orientedness, interest rates, stock returns or exchange rate volatility - are related to the home country's domestic economy and market. Institutional push factors are related to the distance between home and host countries - such as, for example, cultural proximity that can be measured by the size of the home country diaspora in the host country - or government policy, including pro-active and interventionist strategies to promote the international expansion of MNEs, specific incentives, taxes, country and industry recommendations or the role of actors, and their interplay (see also Peng, 2012; Voss et al., 2008; Luo et al., 2010, Schüler-Zhou et al., 2012).

Host country determinants - or pull factors - are those characteristics of the host country markets that attract FDI towards them. Pull factors - just like push factors - can be grouped into institutional and structural factors. Structural pull factors include access to markets, low factor cots and new opportunities for asset-seeking companies, such as acquiring already well-known brands, valuable know-how, knowledge as well as distribution networks and channels and company-level relations. Institutional factors include international and regional investment and trade agreements, host government policies (such as the creation of tax free zones, offering reduced tax, etc.), institutions such as government-related investment promotion agencies (IPAs) as well as institutional stability (IPR protection, product safety standards), privatization opportunities, the possibility to participate in the host country’s public procurement processes and the role of local home country diaspora (Makino, Lau, and Yeh, 2002; Buckley et al., 2007, Schüler-Zhou et al., 2012)

When analysing the impact of institutional characteristics - such as forms of privatization, capital market development, state of laws and country risk - on East Central European (ECE) countries, the studies show varying results. According to Bevan and Estrin (2004, p. 777), institutional aspects were not a significant factor in investment decisions of foreign firms. Carstensen and Toubal (2004) argue that these aspects could explain uneven distribution of FDI across CEE countries. Fabry and Zeghni (2010) point out that in transition countries, FDI agglomeration may rather be explained by institutional weaknesses - such as poor infrastructure, the lack of developed subcontractor networks and an unfavourable business environment - than by positive externalities resulting from linkages, such as spillovers, clusters and networks. Based on a study of 19 Latin American and 25 Eastern European countries in the period 1989-2004, Campos and Kinoshita (2008) found that structural reforms, especially financial reforms and privatization, had a strong positive impact on FDI inflows.

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The example of extra-EU foreign investors in ECE is presented in a study by Kawai (2006) who analysed motivations and location determinants of Japanese MNEs. The author found that by 2004 Japanese investment in ECE was low when compared with European counterparts and 90% of it was located in the Czech Republic, Hungary and Poland (Kawai, 2006, p 6). Japanese MNEs' investment in ECE was motivated by relatively low labour and land costs, well-educated labour force necessary in manufacturing sectors while access to rich EU markets have also played a role.

4. Instead of conclusion

The rise of emerging market multinationals is a new and dynamic process, while their approach towards host economies are relatively unique compared to more developed MNEs. In this chapter we have made an attempt to summarize the existing theories of internationalization and foreign direct investment, presenting the traditional theories, the Japanese School of FDI and some of the new theoretical avenues as well as the push and pull factors behind the international expansion strategy of multinationals.

Theories are indeed numerous, however, the majority of traditional theories doesn't really capture the motivations behind emerging countries' investments since these theories were designed to explain capital movements from developed countries to developing – or other developed – regions. New theories – or extended / re-invented old theories – often refer to those "specialties" the emerging countries possess, such as the essential function of home-country governments in promoting outward investment, the significance of institutions in influencing emerging MNEs' behaviour or the outstanding role devoted to learning from others' experiences.

Emerging countries share several common features but they also differ in many respects: their economic as well as political development are divergent so as their current political system (democracy, autocracy or something in between) or the mechanisms of economic coordination (market, bureaucratic, ethic or forced). Consequently, their motivations for and characteristics of outward investments often vary considerably. As a result, the scientific literature – including this volume - shall not undertake to write on the subject in a generalized manner but uses case studies and/or a comparative approach instead.

This volume will focus on emerging MNEs' strategies, operation and challenges in East Central Europe by discussing its anomalies to the traditional theories as well as to other types of MNEs in the ECE region. In order to contribute to the expanding literature on such topic, several yet open questions have to be answered. What are the driving forces behind the international expansion strategy of emerging MNEs? How important is the ECE region in their localization strategies? What are the global patterns and recent trends of inward FDI flows to the ECE region? What factors seem to determine FDI location in the ECE region: how do macroeconomic and institutional factors affect inward FDI from emerging as well as developed MNEs? What ECE countries and what types of sectors receive the majority of emerging companies' investments? How do emerging MNEs influence the host ECE region, do they generate, for example, locational advantages through their own activities? What policy measures could be implemented to attract FDI from emerging regions and to help the companies to accommodate to the ECE region?

All these questions shall be explored on the following pages.

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