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Comparing Foreign Direct Investments and Exports as Methods of Foreign Market Penetration

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Table of Contents

1. Introduction	4
2. International business operations	5
2.1. Multinational Enterprises	6
2.2. Foreign Direct Investment Forms	7
3. FDI vs Exports: Theoretical Approach	9
3.1. The Host Country's Characteristics	11
3.1.1. Market Size, Position and Competition	11
3.1.2. Market Potentials and Comparative Advantages	13
3.1.3. Taxes and Performance Requirements	15
3.1.4. Tariffs, Economic Integration and Transportation costs	17
3.2. Firm's Characteristics	19
3.2.1. Productivity Level, Firm Size and Specific Advantages	19
3.2.2. Firm's Unobserved Characteristics	22
3.2.3. Services vs Goods	24
3.3. Spillovers	24
3.4. Risk Diversification	26
4. FDI vs Exports: Empirical Economic Approach	27
4.1. The Host Country	29
4.2. Trade Restrictions	31
4.3. The Firm	32
4.4. Services vs Goods	32
4.5. Spillovers	34
5. Conclusion	34
6. References	37
7. Appendix	40



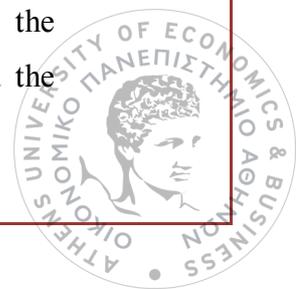
1. Introduction

Over the last few decades, a rising proportion of modern day businesses attempts to broaden the sales of goods and services across borders, to foreign customers, in order to remain competitive. Political, economic and technological barriers rapidly disappearing are factors that promote global trade. Entry mode selection is a very critical strategic decision and when deciding whether and how to serve foreign markets and participate in the international economy, firms can choose from a menu of options, with the most discussed being trading and producing goods and services abroad.

The question we are concerned with in this paper is in which situations a firm should undertake exports, and in which to engage in foreign direct investments (FDIs) and serve foreign demand locally. The decision between trade and FDI is ever more important, because of the economic austerity, and is being paid a lot of attention from a vast literature in international business studies, both at national and international level, making it really intriguing and mind-opening for a student, in particular, to find and present more aggregate data on this subject.

The method a business chooses to penetrate into new markets is dependent on a number of parameters, related to the destination market's attributes, such as the investment and economic environment, the size and the potentials the market can provide to a company that locates in its borders. Additionally, firm's characteristics, such as the level of productivity, the intangible assets available and the overall business strategy, can affect the company's choice. We also examine companies' optimal entry modes into foreign markets as a function of the possibility of externalities created from a FDI involvement and the role risk diversification plays.

The remainder of this dissertation is structured in four parts. The first contribution is to present, in the next section, the theoretical background on international business activities and analyze the forms it takes, focusing on the FDI's classifications. Secondly, in section 3, to analyze the economic theory that focuses on the comparison between FDI and exporting as modes to reach global markets and of course address some of the adverse determining parameters and consequences of each decision. Continuing, globalization acquires a higher profile when it is measured by actual trade flows, so in section 4, we employ our empirical analysis, by exploring how the international trade and investment have evolved through economic history and the



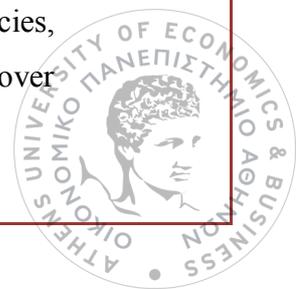
global economic trends of, trying to see how close the reality is to the theory discussed. Finally, in section 5, we sum up by reviewing both the theoretical and the empirical results for the issue of foreign market entry mode, from the perspective of an investor or a businessman interested in international trade.

2. International business operations

“The idea to produce abroad”, as Accolley (2003:5) has referred, “goes back a long way. As a matter of fact, several activities similar to nowadays’ FDI took place in the remote past. During the third millennium before Christ, Sumerian merchants established in Iraq, realized the necessity of having representatives based abroad to receive, to stock and to sell their commodities.” FDI acquired an important role in the global economy, especially, after the Second World War and since the 1960s, the phenomenon of transnational corporations and FDI has rapidly begun to gain importance (Denisia, 2010).

FDI, in its classic definition, relates to investments in fixed assets (buildings, equipment, etc.) in a country by foreign investors (Kottaridi, 2013). These investments can either happen by establishing a new production facility or by acquiring a minimum share of an already existing company, as we will analyze later on (Accolley, 2003). According to Moosa (2002:1) “FDI is the process whereby residents of one country (the source country) acquire ownership of assets for the purpose of controlling, partially or totally, the production, distribution and other activities of a firm in another country (the host country).” FDI is also defined as “the existence of a long-term relationship between the direct investor and the enterprise, and a significant degree of influence by the direct investor, the investor’s purpose being to have an effective voice in the management of the enterprise” (Accolley, 2003:5). FDI is only one of the forms globalization of economic agents takes.

A further category of international business is international investments which include FDI. Besides FDI, international investments also include foreign portfolio equity investments, which are either overseas lending or acquiring shares in listed companies or in short-term bank deposits in foreign currency. The distinctive feature with FDI is control (Milliou, 2015). The element of control implies that some degree of discretionary decision-making by the investor is present in management policies, methods and strategies, and gives direct investors an informational advantage over



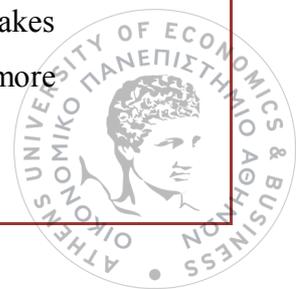
foreign portfolio investors and over domestic savers, improving a firm's competitive position and maximizing the returns on its assets and skills. The greater ownership a MNE obtains in the foreign venture, the higher operational control is given. In addition, FDI has, as cited above, long-term nature and it is not easily liquidated. The purpose of FDI is to expand the sales or reduce production costs. On the contrary, portfolio investments, which are considered an indirect investment, are short-term in nature and there is no commitment for their duration. They are simple movements of financial capital and the aim is to exploit differences in capital returns (Hajidimitriou, 1997).

Another form, and one of the most known forms of international business operations, is exports which is considered the most immediately efficient and rapid way of penetrating a foreign market. Exports can either be direct or indirect. In direct exports, a department of the company, sales usually, undertakes market research abroad and coordination of the development process of the exports, without the intervention of third parties and without the installation of production units or other functions being necessary. While, indirect exports incur with the contribution of external consultants, the intermediaries. These intermediaries may either be international companies, who undertake mediation, export traders, or middlemen who get paid on commission (Thanopoulos, 2006).

An additional form of international business expansion is selling the right to use proprietary resources of a company to foreign firms in the form of licensing or franchising. The licensing refers to concession royalty agreement for the production, which is usually registered through a patent, to the franchisor (licensor) by the franchisee (licensee), in exchange for a specific fee. A more specific form of licensing, franchising, has greatly expanded in the last twenty years. In franchising agreements, the use of the name is granted, but at the same time the buyer is supplied with additional inflows such as marketing and quality control (Kottaridi, 2013). These certainly take place under the strict enforcement of rules and regulations by the franchisor.

2.1. Multinational Enterprises

Bodies of FDI are the multinationals. This means that an enterprise which makes FDI is automatically converted to a multinational (Kottaridi, 2013). To be more



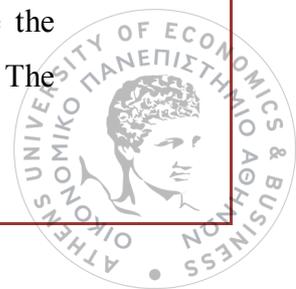
specific, a company that does not have FDI cannot be considered as a multinational enterprise (MNE) (Milliou, 2015). In other words, conducting some other forms of international business activities, as the term traditionally referred only to the cross-border activity of importing and exporting, is not enough for a company to be characterized as a MNE (Moosa, 2002). In general, MNEs are defined as businesses that own and control production facilities (subsidiaries) in more than one country and the ownership of all or part of the share capital of at least one subsidiary company is abroad. As mentioned above, this means that the parent company should not affect the process and decision-making criteria of the subsidiary, to determine the conduct of the subsidiary on a number of issues (choice of technology, resources raw materials, etc.). It is generally accepted in the literature, that the possession of a 25% of the share capital of the subsidiary is required (not necessary and sufficient) to exercise effective control (Milliou, 2015).

The MNE is defined and analyzed in three levels: economic, organizational and strategic. Regarding the first level, an enterprise is classified as a multinational depending on the size, geographical spread and range of activities abroad. Usually, about 20% of a company's activities should come from its subsidiaries. On the organizational level, we refer to the structure of the organization, decision-making and in general the ability of the enterprise to act as a single body with common goals. Finally, the strategic level relates to the organizational level because the group of companies belonging to the multinational (parent and subsidiaries) should be subject to a common strategy to achieve their goals (Kottaridi, 2013).

2.2. Foreign Direct Investment Forms

Although a strategy like FDI includes a high level of risk, it remains one of the most prevalent investment activities. The change in investment patterns worldwide required the extension of the definition to include generally the acquisition of lasting management interest rights in a company outside the investing firm's home country. Thus, the FDI can now take the form of investments in existing companies, joint ventures, strategic technological content agreements, copyrights etc. (Kottaridi, 2013). FDI can be realized in one of the following formats:

a. Subsidiary of exclusive ownership (wholly-owned subsidiary): In this case the firm establishes a new business in a foreign country and is the sole shareholder. The

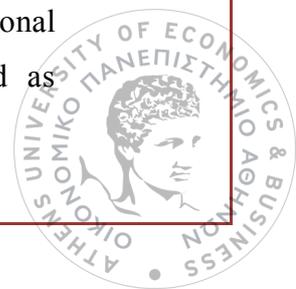


subsidiary may be an entirely new entity (greenfield strategy) or a local firm which was acquired by the foreign investor (acquisition strategy) (Milliou, 2015). A greenfield project entails building a subsidiary from bottom up to enable foreign sale and production. Real estate is purchased locally and employees are hired and trained using the investor's management, technology, know-how and capital (Meyer and Estrin, 2001).

b. Joint ventures: This is a collaboration of one or more foreign enterprises with one or more local businesses to create a new one (merger), or the acquisition of a local company. The partners contribute capital, staff, technology and expertise. Usually, they contribute in the productive factor in which they outweigh the other partners (Hajidimitriou, 1997). Depending on the contribution in the capital of the company, we can have JV majority (>50%), JV minority (<50%) and JV tied vote (=50%). Joint ventures are mainly created for two reasons: a) when the businessman wants to buy local knowledge and wants to exploit the existing marketing or an industrial unit and b) when a rapid market entry is necessary. Many times consortia are liquidated and the investor acquires full ownership (Hisrich, 2009).

c. Partial redemption (partial acquisition): It refers to the acquisition of a part of the share capital (stocks) of a local firm, in an amount sufficient to confer control. This partial redemption may be reciprocal and that involves the exchange of shareholdings between the two companies. Meyer and Estrin (2001:576) suggest that "the new affiliate joins the investing company as a going concern that normally possesses production facilities, sales force and market share."

Based on its role in the parent company's global production strategy MNEs tend to focus in one of the three ways FDI can be implemented: horizontal FDI, vertical FDI, and export-platform FDI. Horizontal FDI occurs when roughly same goods are produced both in the source and host country or the similar operations applied to plants in home and host countries. Vertical FDI is characterized by fragmenting stages of production geographically. In this case, a firm could locate part of the production process in a developing country for the main purpose of taking advantage of cheaper inputs and wages (resource-seeking and efficiency-seeking). Finally, it's the export-platform FDI, which takes place when a firm uses a host country as an export base. The firm could locate a part or a whole operation in a host country and then export its products to third markets, which could be either regional or international market (Agarwal and Ramaswami, 1992). Furthermore, FDI can be classified as



Inward FDI and Outward FDI, depending on the direction of flow of money. Inward FDI occurs when foreign capital is invested in local resources. On the other hand, Outward FDI, also referred to as "direct investment abroad", includes assets and liabilities transferred between resident direct investors and their direct investment enterprises (Sharma, 2012).

The separation of the FDI in horizontal and vertical is useful for investigating the motives and criteria under which an investment takes place. Thus, it has been observed that the vertical investment is made on the basis of the criterion of minimum cost. In the case of labor-intensive enterprises, therefore, the cheap labor cost is the most important criterion for the decision to withdraw the FDI. On the other hand, horizontal investments are made in order to avoid tariffs and generally when the product is manufactured in one country, it is more profitable than to export it (Salavopoulos, 2006). The dominant mode of FDI varies not only across time, but also across host countries with different development levels (Milliou and Pavlou, 2014). Denisia (2010:1) suggests that "to understand foreign direct investment we must first understand the basic motivations that cause a firm to invest abroad rather than export or outsource production to national firms."

A useful classification of firms' motives to engage in FDI is distinguishing between four groups of enterprises: "Resource seekers, who set up shop in other countries in order to make use of resources such as primary commodities, cheap labor and technology. Market seekers, who want to be near their customers in order to best fulfil their special wishes, or because the foreign government has put trade restrictions. Efficiency seekers, who want to benefit from economies of scale and risk spreading or from differences in factor proportions, culture, and institutional organization and so on between countries, and finally, strategic asset seekers, who resort to mergers and acquisitions in order to safeguard their long-term competitiveness" (Visser, 2006:346).

3. FDI vs Exports: Theoretical Approach

The choice of appropriate mode of penetration into new and foreign markets is, as we can understand by now, a key strategic decision for a company that wants to expand its activities internationally. Many and diverse motivations are known to drive investment decisions. For example, in the 1960s and 1970s investment was often

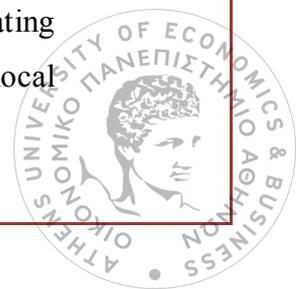


undertaken to bypass barriers to market entry, while more recently, trade and market barriers have been lowered and hence more and more companies have started to operate deliberately on international markets (Pain and Wakelin, 1997).

As noted above, firms can service foreign buyers through a variety of channels. In this context, the choice between exports and FDI has received the most attention in the economics literature (Saggi, 2000). These modes of market access have different relative costs, some of which are sunk (such as entry costs) while others vary with sales (such as transportation costs and tariffs). Firms, usually, choose the mode that yields the highest profits (Head and Ries, 1999). Nevertheless, the decision will depend on numerous other determinants, such as on the nature of the firm's intangible assets (like technologies, managerial skills, etc., also known as "knowledge capital"), on economies or diseconomies of scale, barriers to trade, and other government regulations. Additionally, important aspects are factor prices at home and in host countries, as well as the need to adapt the product to differences among markets (adaptation costs) and in the characteristics demanded (Blomstrom, Lipsey and Kulchycky, 1988).

Studies like Head and Ries's (2004), who carried out a regression model with firm-level data to search the relationship between exports and FDI, assume that FDI and exports are alternative modes through which to reach foreign markets. Even so, most of the theory that we will analyze, like Blonigen's (1999), have shown that trade and foreign investment might also be complements rather than substitutes and have a positive relationship, coexist and correlate. FDI and exports are complements in the sense that the marginal profitability of exporting is increasing in FDI. Furthermore, manufacturing a downstream product in a foreign country may induce trade in upstream products (Head and Ries, 2004).

In addition, according to Belderbos and Sleuwaegen (1998) who analyzed data of Japanese electronics firms to examine whether trade barriers give rise to foreign manufacturing, once a certain threshold is reached, exports could result in FDI in the destination market, aiming to exploit certain advantages intrinsic to the host country as well as trying to satisfy in a better way the specific requirements of that market. In the same way, local manufacturing would be a mean of consolidating and enlarging exportation markets by enhancing that country's demand for the firm's products and therefore decreasing variable costs (e.g. by avoiding transport costs) or by facilitating marketing and design specifically geared to the market, and therefore creating local



goodwill and customer loyalty. “Goodwill and consumer loyalty may then generate spillovers to other exportable products manufactured by the firm, such that multi-product firms experience less overall export substitution” (Belderbos and Sleuwaegen, 1998:602).

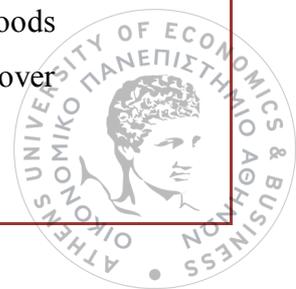
Pacheco-López (2005), finally, also supports that there is a bi-directional causal relationship between the two modes of internationalization we discuss, in the sense that exports stimulate FDI and FDI promotes exports. She analyzed the relationship FDI and exports have had in Mexico since the late 1980s, using Granger causality tests. The conclusion of this analysis is that exports are referred to be used initially in the globalization process of an enterprise, and after trading enough to learn what is important about the economic, social, political and ruling conditions of their trading partners they may establish a subsidiary in the host country. The role of the FDIs in expanding exports in the host countries derives from the additional capital, new technology, better management and marketing strategies that they can bring with them from the interaction with the new business environment.

3.1. The Host Country’s Characteristics

3.1.1. Market Size, Position and Competition

An essential parameter that should be taken into account for the company’s decision is the characteristics of the foreign market in which a company is interested in expanding its sales through exports or FDI, also known as the host country. Eicher and Kang (2004) have tried to bring together the characteristics of the host market that mostly affect the decision of the location of a MNE and one key decisive factor that they mention is the market size. Market size is not referred to the size of the country but to the number of the consumers, the firm is interested in, in the host country. The effect of the market size is positive on both strategies, however larger on the probability of investing abroad (Oberhofer and Pfaffermayr, 2007).

When the market is large, Eicher and Kang (2004) found that the enterprise should optimally use trade or FDI threats to acquire the local firm and become a monopoly supplier, while intermediate-sized countries may be served predominantly through trade, even if the tariffs are high. “In small markets, with little demand and low goods prices, trade becomes unlikely in the face of tariffs because a firm is unable to recover



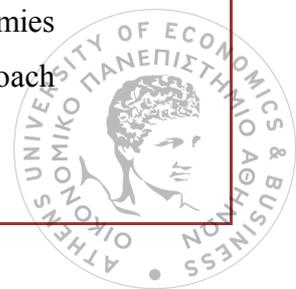
the marginal production costs. In such small markets, FDI is only possible if fixed costs are extremely low or competition (and hence the MNE's cost advantage) is significant.”(p.3) Eicher and Kang (2004) came to these conclusions after conducting a three stage entry game between a local company and its MNE rival, where the MNE had to decide whether, and how, to penetrate the market of the local firm. The reactions of the local firm are found to be critical in the decisive process.

According to Head and Ries (2004), the effects associated with an increase in the size of the foreign market are three. “First, it will increase the number of firms pursuing replication and decrease the number of exporters. Second, it will also increase the foreign production levels of the firms that choose to be multinationals even in small markets. Finally, it will increase the export levels of firms who continue to export. FDI increases as the foreign market expands, but the total effect on exports is ambiguous.” (p.418) Also, the larger the market size, the more likely we are to see dispersed locations of FDI (Motta and Norman, 1996).

High fixed investment costs increase the threshold market size for FDI, which cannot be offset unless trade barriers are sufficiently low to allow for the MNE's export penetration (Eicher and Kang, 2004). According to Rob and Vettas (2003), who explored the choice between FDI and exports to entry a foreign market where demand is uncertain and stochastically growing, the disadvantage of FDI is that it is irreversible and, hence, entails the risk of creating under-utilized capacity in case the market turns out to be smaller than expected.

Another important factor is the geographical position of the host country which is critical in whether it gives the possibility to expand in neighboring markets (possibly attract export-platform FDI) and the geographical proximity to potential markets, which increases knowledge of the business environment of foreign markets and is closely related to trade costs (Fosfuri and Motta, 1999). The infrastructure and transport level of the country affects significantly operating and transport costs and therefore must also be taken into account for the firm's choice.

Proper distribution networks are very important for easy and fast channeling consumer products. The creation of new networks means additional cost (Salavopoulos, 2006). Companies face a proximity-concentration trade-off which analyses the location decision of MNEs by a trade-off between proximity to customers and concentration of production stages to achieve scale economies (Oberhofer and Pfaffermayr, 2007). The proximity-concentration trade-off approach



also predicts that the profitability of FDI is increasing in the level of trade costs relative to fixed investment costs, (Bjorvatn and Erckel, 2001)

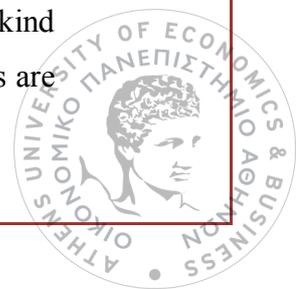
Further up, Oberhofer and Pfaffermayr's paper (2007) investigates, in a two host-country setting, the decision of a firm between FDI and exports as a function of market size and distance. They have shown that "distant markets, which imply high transportation costs, may be served by subsidiaries abroad, while markets nearby by exports. Large and distant markets are served via FDI, while small and nearby markets tend to be served by exports." Locations with similar factor costs are more likely to attract the same type of activities. Possible differences can be met in average wage costs across regions because of differences in the skill composition and the quality of expertise of the human resources available in the country.

In other words, the low average wage in a market may reflect a scarcity of skilled labor (Salavopoulos, 2006). Generally, labor costs, including the contributions for insurance, entrepreneurs pay for the employees in each country, are very important for the "either/or" decision, especially for labor-intensive businesses not so much for capital-intensive companies (Salavopoulos, 2006). Higher wages in the destination country can stimulate exports regardless of the level of FDI in the host country by making the exporter more competitive relative to domestic firms in that country (Head and Ries, 2004).

When we consider the case of high competition in a market, FDI becomes the predominant entry mode, which allows the MNEs to exploit the full benefits of its ownership advantage. Our results indicate that entry decisions can be conveniently grouped by the degree of competition (or product differentiation). High degrees of competition reduce the likelihood that MNEs coexist with local firms, as the low cost producer is poised to remain the monopoly supplier. Sufficiently weak competition allows for coexistence and rich strategic entry mode interaction between local firms and MNEs (Eicher and Kang, 2004).

3.1.2. Market Potentials and Comparative Advantages

Market concentration is a very substantial parameter because it gives information about the market power of the companies. According to Fosfuri and Motta (1999), who developed a two-country model to identify whether MNEs must have some kind of advantages in order to be able to stand against local firms, foreign investments are



preferred to remove "oligopolistic conflicts", which happen in sectors concentrated internationally or to increase market power by reducing competition. Interestingly though, the market concentration factor tends to influence more the decision to export, because a firm faces losses from not locating all production in a single location (Oberhofer and Pfaffermayr, 2007). Helpman, Melitz and Yeaple (2004:3) have identified "a new "home market bias," whereby the number of firms that locate their headquarters in a particular country rises disproportionately with the country's size, while small markets are disproportionately served by affiliates of multinational companies and by exporters from other countries."

In case of demand uncertainty and irreversibility (in the sense that there is no re-sale market for the used capacity), MNE is lead to, under certain conditions, a complementary use of both exporting and FDI (Rob and Vettas, 2003). For insufficient market demand, depressed price levels render it less likely that the company can overcome trade barriers. Instead, FDI can subsist in those markets due to the MNE's advantage in production cost over the local firm. In this case, foreign production under lower variable costs is used to satisfy proven demand and exports are used to explore uncertain demand (Eicher and Kang, 2004).

Countries that have relatively lower market potential can be expected to have a lower likelihood of attracting foreign firms. However, firms that are larger and that have a regional or worldwide presence may be interested in entering these markets for achieving their growth and profit objectives. Note, for example, that developing countries such as Brazil and India, even though not as attractive as the developed countries, may still have sufficient potential and strategic importance to warrant consideration. An additional benefit offered by these target markets is the opportunity for higher returns (in excess of the risks taken) due to the presence of greater market imperfections (Agarwal and Ramaswami. 1992).

Other significant characteristics of the host market that determine a firm's choice of market access is of course the political and economic stability, proved by good macroeconomic indicators, which are key decisive factors and important for all kinds of investment decisions and improve or impede the image of the host country. Similarly, the investment environment of the host country and investment incentives that it provides, such as the tax concessions, which we will bring up again later on, or any other favorable legislative framework can format a friendly environment for investors and attract FDI investments rather than exports (Salavopoulos, 2006).



Last but not least, markets and industries characterized by privatization initiatives increase the chances and opportunities for the participation of foreign investors. With attractive conditions and without excessive interference, acquisitions or shareholdings in large companies and organizations are enabled under state control. In many cases, previously monopolistic key economic sectors, such as telecommunications, banking and energy, open new horizons for foreign investments. Traditional trade theories emphasize the role of comparative advantages and strategic assets of countries, such as the possession of technological and managerial skills, physical capital, innovative behavior and marketing capabilities, in determining cross-industry patterns of trade (Salavopoulos, 2006). Financial variables are also identified as playing a key role in a company's foreign market entry decision and make one configuration preferable to others (Blonigen, 1999).

While one might expect that identical initial conditions would imply a common mode choice, this does not necessarily occur. This is Head and Ries's (2004) conclusion, referring also that differences in the choice of market access mode can arise from what is called the 'market-crowding' effect. When more firms produce locally overseas, the prospective profits for the next firm decline. "To understand the market-crowding effect, consider an initial situation where all firms export (home centralization). A fall in plant-level fixed costs then makes it more profitable for at least some firms to engage in FDI while maintaining their home plants to serve the home market." (p.415) Firms begin to switch to FDI and will continue to do so as long as the additional benefits of overseas production associated with avoiding trade costs exceed the fixed costs of operating a second plant.

3.1.3. Taxes and Performance Requirements

Interpreting the corporate income tax as part of the cost of FDI, as mentioned before, and burdensome for the firms, myriad tax incentives are offered from the host countries to appeal firms engaged in FDI (Head and Ries, 2004). However, these incentives are often tied to performance requirements, such as domestic content restrictions, which often specify local employment and training levels. These performance requirements act as a coordination device (especially in the presence of spillovers) of firms on actions that maximize the total rents from FDI. The maximized rents generated by the multinational activity are then extracted by the



firms through a competitively set of tax subsidies. This increase results from interactions between firm choices and the rents generated by other firms and the host jurisdiction. Since this allows firms to extract even more from jurisdictions through tax subsidies, they can find this external coordination beneficial.

In this context, Davies and Ellis (2001) have run a model of two discrete firms and two jurisdictions, in which the jurisdictions offer competing packages of tax subsidies and performance requirements to the MNEs, attracting them to choose them as the location for their mobile investment. What they found is that jurisdictions often undercut one another, which can lead towards a “race to the bottom” and large tax subsidies can be offered, sometimes setting the taxes lower than the host would like, transferring more gains from FDI to the firms. Alternatively, competition can be understood as a form of Bertrand competition in which each jurisdiction competes the other by offering marginally more attractive taxes to the firms. For given performance requirements, this drives taxes down until the losing jurisdiction no longer prefers to offer a lower tax (i.e. a higher bid) and win with certainty.

Thus, generous tax packages will be offered at the same time as performance requirements are imposed. While from the perspective of any individual firm performance requirements may not be viewed as beneficial, it may still be the case that from the joint perspective of all the firms and the municipality performance requirements may be highly desirable. Davies and Ellis’s study refers, that if firms find these requirements burdensome, they will encourage competition which will eliminate their imposition.

Another important issue is the one of double taxation, which occurs when a MNE faces taxes in the host and the home countries. Consequently, countries that want to attract foreign investments are forced to have different ways of addressing this double taxation issue. Two of the standard treatments that home countries use to deal with this problem are that they can offer the MNE a credit or a deduction of foreign tax payment. Conclusively, we have to mention that although higher taxes generally discourage FDI, the effects of taxes on FDI can vary substantially by the type of taxes, the measurement of FDI activity, and finally the tax treatment in the host and parent countries (Blonigen, 2005). In some cases, subsidies from the host countries may differ across firms, meaning that the jurisdiction may even choose to offer one firm a subsidy while taxing another.



3.1.4. Tariffs, Economic Integration and Transportation costs

Trade policy, generally, induces tariff-jumping FDI and tariff-jumping FDI reduces overall efficiency in the industry and leads to higher user prices in the local market. Clearly, an exporting enterprise is better off as tariffs are lowered if it chooses trade over FDI because, relative to FDI, exporting involves lower sunk costs but higher per-unit costs. Moving from prohibitive to positive tariffs, an MNE might find it profitable to forgo FDI with high fixed costs and export instead (Eicher and Kang, 2004). In this case, where tariffs are lowered and trade creation induces firms to switch to trade rather than choose FDI, Helpman, Melitz and Yeaple (2004) find that, prices may rise in the host country. They develop a model of international trade, using data on exports versus FDI sales of U.S. firms in 38 countries and 52 industries and estimate the effects of trade frictions, firm size and economies of scale, on the decision of the company to export or invest.

Political pressures may give rise to endogenous tariffs that influence company's entry modes. An endogenous tariff maximizes a government's political support, increases in the marginal cost of the local firm and decreases in the level of competition between firms. An altruistic government chooses a tariff to maximize aggregate support from its constituents. The literature on endogenous tariff formation has also included government preferences over contributions/bribes, which may be especially relevant for transition economies. If the government is, however, significantly more interested in consumer surplus than firm profits, it will lower the tariff even for monopolistic industries, in order to encourage competition from the MNE. Trade barriers also exist to protect the local firm's welfare at the expense of MNE profits. Hence, the MNE will pursue free international trade while the local firm will seek high protection from its government (Eicher and Kang, 2004).

There are political support approaches where policy makers weigh political support from local firms and consumers. The endogenous tariff renders governments more likely to impose tariffs in sectors that feature relatively inefficient (efficient) local firms (MNEs). Tariffs also increase in the competition intensity of an industry, except in very large markets in which governments put strong emphasis on firm profits. Rapidly expanding markets also provide less of an incentive for governments to impose tariffs. MNEs would relocate to lower production cost and geographically speaking the relocation would take place near large markets that have high fixed costs

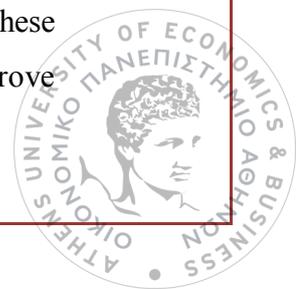


and low tariffs. Tariffs are unambiguously profit-reducing for an MNE. The tariff itself can be seen as a policy variable, as shown by voluminous endogenous protection literature (Helpman, Melitz and Yeaple, 2004).

Markusen's (1995) survey of MNEs' entry decisions finds that FDI increases relative to trade entry when tariffs and transport costs are high, depending on market size. The additional observation for this proposition is that firms are most likely to choose to serve the foreign market via FDI if the plant-level fixed costs are low, because FDI eliminates variable transport costs, but involves higher fixed costs. The fixed costs of FDI are the duplication of costs in establishing domestic production facilities and are assumed to be greater than those of exporting (Greenaway and Kneller, 2007).

The FDI may also be driven by the intention of reducing the probability of future protectionist measures, the so-called "quid pro quo" FDI (meaning: exchanging something for something in Latin). Clearly FDI leads to more extensive personal interaction with foreigners and exposure to new ways of doing things than does trade (Saggi, 2000). Investment decisions have been substantially influenced by trade policy restrictions. A well-known example is the one of the Japanese firms that invested in Europe and reduced imports from Japan in the second half of the 1980s. The main reasons were that the EU adopted a much stricter anti-dumping stance, the discriminatory action against trade from non-EU countries as well as the perception of increased marketing opportunities that emerged at the time (Belderbos and Sleuwaegen, 1998). Foreign markets, generally, are served more by exports relative to FDI sales when trade frictions are lower or economies of scale are higher (Helpman, Melitz and Yeaple, 2004).

Whereas increased market size is likely to lead to dispersed FDI, economic integration is more likely to lead to concentrated FDI, supplying the majority of the countries, participating in the agreement, through intra-regional exporting. Economic integration reduces costs for producers and increases trade between the countries taking part in the agreement, by raising external barriers or creating a free trade area encourage the outside firms to set up production facilities inside the free trade area and export to the other country in the bloc. When the investing country is not an EU member, firms investing overseas might prefer an EU country over other potential host countries because it offers free access to the whole EU markets. Therefore, these international trade agreements (free-trade blocs) lower trade barriers and improve



market accessibility. Low trade barriers favor international trade over other entry options on the part of the MNC (Eicher and Kang, 2004).

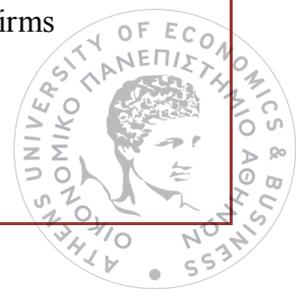
Other motivations behind FDI are, for instance, that transport costs for products with high weight/value ratios may render local production more profitable because certain products need to be produced close to the consumers (such as dairy products), because local production makes it easier to adjust to local product standards, or because local production yields better information about local competitors. Transportation costs might be correlated with the physical distance variable, in the sense that establishing a business in a host country that is far away includes more fixed sunk costs than exporting, as Fosfuri and Motta (1999) have referred in their paper, and realized that proximity to the EU is an important aspect in the decision to export or invest.

3.2. Firm's Characteristics

3.2.1. Productivity Level, Firm Size and Specific Advantages

Recently developed theoretical models, like Helpman, Melitz and Yeaple's (2004), link the heterogeneous productivity level of firms with their involvement in the international trade. Every industry is populated by heterogeneous firms, which differ in productivity levels that are captured by differences in marginal costs of production. Firm heterogeneity (dispersion) in productivity plays an important role in explaining the structure of international commerce and leads to self-selection. Of those firms that serve foreign markets, only the most productive find it profitable to engage in FDI, while firms with medium efficiency levels find it profitable to serve foreign markets through exporting and the least efficient enterprises operate only in the domestic market (Greenaway and Kneller, 2007).

Helpman et al. (2004), who developed a multi-country and multi-industry model to interpret the "export of FDI" choice of heterogeneous firms, emphasize that this happens because only the most productive firms are able to afford the additional facility duplicating fixed costs, that are higher in FDI strategy than in exports, and gain through less variable costs (proximity-concentration trade-off). The productivity level of all multinational firms must therefore be greater than that of all exporting firms (Oberhofer and Pfaffermayr, 2007).

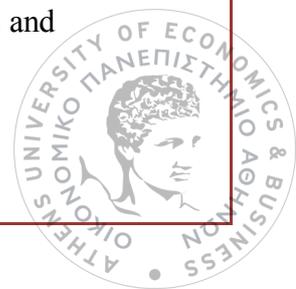


Profits associated with FDI are lower than those for exporting owing to the fixed costs of establishing a foreign plant, but as productivity increases, FDI profits rise more rapidly than exporting profits do (Head and Ries, 2004). These productivity levels, however, do not fully determine the composition of trade, as they have to be combined with information about the degree of dispersion of productivity levels across firms within every industry in order to forecast trade flows. Industries in which productivity levels vary highly across firms are characterized by a larger volume of FDI sales relative to exports (Helpman, Melitz and Yeaple, 2004). Helpman et al. (2004) predict FDI will be more common relative to exports, the greater the dispersion of productivity levels within an industry.

Industries in which firm size is highly dispersed are associated with relatively more FDI than exports (Greenaway and Kneller, 2007). Therefore, we observe that firm size measures exhibit a consistent ordering: firms that export are smaller on average than firms that invest abroad, since large firms may be able to exploit scale economies and may also have grown large because they are relatively efficient. The firm size positively affects the export and FDI decision, as previous studies have found and the impact of the firm size is larger than that of productivity (Head and Ries, 2004).

Highly connected with the size and productivity of the firm is another variable of special interest, the number of employees in a company. This variable is a proxy for size and therefore a proxy for fixed costs of a company. There is a positive influence of wages on the propensity to export (Head and Ries, 1999). Companies with more employees produce and sell more and so they have more liquid funds to pay additional fixed costs for doing a FDI (Oberhofer and Pfaffermayer, 2007).

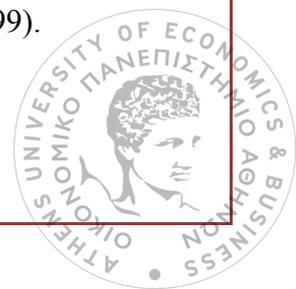
The use of market shares as a revealed measure of firm specific capabilities allows for direct measurement of firms' competitiveness at the product level where investment decisions are taken (Blonigen, 1999). For instance, a firm's market share in Japan has a positive and significant effect on the decision to invest in the EU. "Minor players in the Japanese market are not as likely to invest as firms which hold more than 5 percent of the Japanese market and the likelihood of investment increases the more market shares rise above 5 percent" (Belderbos and Sleuwaegen, 1998:615). Multi-product firms where there is a strong incentive for spatial separation or where the two products have very different comparative advantages would be cases where we would expect low propensities for firms to switch entirely from exporting to FDI (Head and Ries, 2004).



A firm which decides to establish a subsidiary abroad suffers many disadvantages and inherent difficulties with respect to local firms. Possible examples of such difficulties are that local companies will always be better informed about local economic and social environment, and the host market demand (the so called “information” costs), as well as of the host country's laws and regulations. Furthermore, the scarce familiarity with the different culture (such as trust and psychic distance and language difficulties), possible discrimination from consumers having preferences for domestic goods, and governments which assign public procurement to favor local firms make the idea to export more plausible. Fosfuri and Motta (1999), that identified these difficulties, showed that firm-specific advantages are not a necessary condition for investing abroad, because an organization might choose FDI to benefit from technological spillovers, to which we will refer again later on with more details.

In contrast to this conclusion, Accolley (2003) supports that for FDI to take place, MNEs must possess particular advantages over domestic firms in the host country that warrant for such an investment to be viable, despite the difficulties. Starting from this pioneering contribution, we get the essence of the well-known Dunning's OLI (ownership-location-internalization) or “eclectic” paradigm which entails that for a firm to be beneficial to internalize within FDI, rather than exports, should own specific ownership, location and internalization advantages.

“Ownership specific advantages mainly concern technological knowledge, including management and marketing knowledge that creates scale economies on the level of the firm but not of the plant. Location specific advantages are those advantages that explain the comparative advantage analyzed by traditional trade theory, including artificial advantages stemming from trade restrictions, subsidies and low taxes”. Finally, internalization advantages influence how a firm chooses to operate in a foreign country, trading off the savings in transactions, hold-up and monitoring costs of a wholly-owned subsidiary, against the advantages of other entry modes such as exports (Visser, 2006:345). However, firm-specific advantages may differ widely across individual products, firm-wide proxies for intangible assets such as R&D intensity, even though firm-specific assets have a public goods aspect to them in the sense that they can be used across multiple plants for a single firm-level investment. Thus, it may make sense for the firm to locate production in a variety of markets rather than have one production plant that exports to many markets (Blonigen, 1999).



The number of the MNE's successful and profitable operations is based, mainly, on the use of the specific competitive advantages they have, such as offering differentiated products or technological superiority. Further examples of competitive advantages can be the ability to convert scientific knowledge into new profitable goods, economies of scale and the existence of specialized personnel. Exploiting these comparative advantages, the organizations apply their international trade strategies mainly driven by their subsidiaries (Roumeliotis, 1999). Size and multinational experience reflect a firm's asset power, while its ability to develop differentiated products reflects its skills (Agarwal and Ramaswami, 1992).

Blonigen's (1999) study of disaggregated product-level data on Japanese automobile parts and other final consumer goods with either exports or FDIs in the United States (U.S.) during the late 1970s through the early 1990s also suggests that for lower levels of sales, firms will export to avoid the higher fixed costs associated with foreign production (e.g., building a new plant). On the other hand, they will switch to foreign production for higher level of sales because exports naturally incur higher costs per unit than foreign production because of greater transportation costs and possible tariffs.

For concluding remarks we must mention that MNEs tend to be important in industries and firms with 4 characteristics: high levels of R&D relative to sales, a large share of professional and technical workers in their workforces, products that are new and/or technically complex, and high levels of product differentiation and advertising relative to sales. All these characteristics seem to increase the consumers' willingness to pay for goods and services (Fosfuri and Motta, 1999).

3.2.2. Firm's Unobserved Characteristics

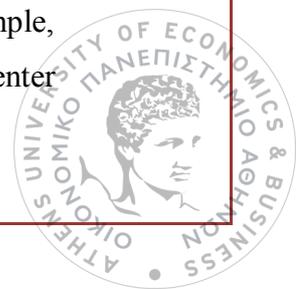
Firm's unobserved characteristics, along with the firm's status on internationalization in the previous year, are further major determinants of the "export or FDI" decision. Todo's (2009) paper, which has tried to quantitatively examine the determinants of the choice between FDI and exports using data from Japanese firms, suggests that the selection process of internationalized firms may be inefficient. In other words, he found that "firms which are unproductive but are currently serving foreign markets through export or FDI are most likely to continue to serve foreign



markets in the future, while firms which are productive but have no experience in foreign markets have a small chance to enter foreign markets.”(p.17)

A further determinant of the either/or choice we are comparing, that Todo (2009) brought into the light, is stickiness of the export and FDI status of each firm, which is connected with the company's status on internationalization in the year before. The stickiness of the export and FDI status may be generated by the importance of initial costs in this particular decision. This means that “if the average domestic firm happens to become an exporter or an FDI firm, without any change in other observed firm characteristics, the firm can remain serving foreign markets with a probability of more than 90 percent.” (p.16) It has been found that a firm's current investment is strongly affected by its own past behaviour and experience in exporting and FDI (Saggi, 2000). Past behavior, therefore, can be one of the reasons that firms are more likely to be MNEs the older they are, as the results of Oberhofer and Pfaffermayer (2007) show.

Together with the previous observations, empirical estimation results show that a firm's current investment is strongly affected by the investments undertaken by its rivals (Saggi, 2000). Indeed, the preceding research highlights the interdependence of decision making between multinational firms. For example, when two firms are exporting to a foreign market, a switch from exports to FDI by one creates an incentive for FDI on the other firm's part, who finds itself at a competitive disadvantage (the competitive incentive for FDI) (Saggi, 2000). Belderbos and Sleuwaegen (1998) find, for example, that Japanese firms that are members of electronics keiretsu export more to Europe if the keiretsu leader has invested there (Head and Ries, 2004) meaning that if a company like Coca Cola entered a country and advertised heavily the demand for cola drinks might increase enough to open the market to local or other foreign producers (Blomstrom, Lipsey and Kulchycky, 1988). To end this section, we refer to an important gap in the empirical literature, that Agarwal and Ramaswami (1992) realized, and it is the issue of how the interrelationships among the determinant factors influence firms' entry choices. Changes and different combinations of the basic determinants, both of the firm's and the market's, can shift relative benefits in one direction or the other. The importance of this interrelationship derives from the fact that they may explain firm behaviors that cannot be captured by the independent effects these factors cause. “For example, firms that have lower levels of ownership advantages are expected to either not enter



foreign markets or use the low-risk entry mode which is exporting. However, many such firms have been observed to enter foreign countries, especially those that have high market potential.” (p.2)

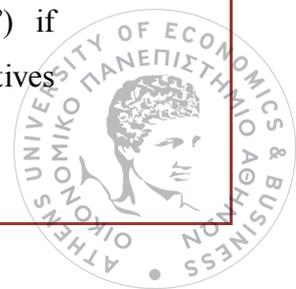
3.2.3. Services vs goods

In addition to all the factors influencing the firm’s choice to serve foreign buyers, we must also distinguish the influence these factors have whether we deal with a product or a service. In order to be competitive in foreign markets, the service provider must have a physical presence in those markets. Indeed, whereas with manufactured goods, FDI often follows trade, in services it is more often the other way around (Saggi, 2000).Fillat-Castejón, Francois and Woerz (2008), who examined export and FDI in services during 1994 to 2004, point out that goods producing firms and services delivering ones may have the same determinants for FDI, but they differ on how important these determinants are for the two sectors. “Government regulations, policies, cultural distance and the tradability of services (influenced by technological progress as well as by economic policy and regulatory measures) are the prime factors influencing FDI in services. In contrast, market size, barriers to trade and cost differentials in production are the main determinants for FDI in goods.” (p.1)

3.3. Spillovers

Firms might be induced to choose FDI to acquire new advantages and assets, rather than exploit existing ones. One of the most highly touted benefits of investing abroad is that it creates spillovers. In the presence of possible externalities, as we have mentioned above, a firm might be attracted to invest abroad even when the establishment of a subsidiary might seem less profitable than exports, in the absence of exporting costs (such as transportation costs) and lower production costs in the host country or even when none of the traditional reasons for choosing FDI exists..

Fosfuri and Motta (1999) in their study refer that FDI may generate positive welfare effects, specifically for lower quality enterprises, through technological knowledge spillovers from firms with high quality or more advanced technology, transmitted to their less advanced workforces (also called as “technology sourcing FDI”) if they establish their production where the superior quality firms are located. Incentives



for technology sourcing FDI are larger if the technology acquired through spillovers is easily transferable between plants. If the mobility of spillovers is low, the low-tech firm may have an incentive to relocate its entire production to the high-tech location.

The benefits from local externalities might improve the technology, the product, and therefore the quality level of the less advanced investing firm, which can then incorporate the improvement obtained in all the markets where it sells. This situation will, then, increase the competitive position of the MNE, earning profits which outweigh the possible losses from running the foreign venture. The potential spillover benefits, although, are realized only if the firms have the ability and motivation to invest in absorbing foreign technologies and skills (Blomstrom and Kokko, 2003).

These spillovers also include worker training which benefits future employers, technology transfer, improved efficiency of local input providers, and a host of other mechanisms. For example, this has often been the case for Korean firms and for Japanese firms that have invested in the U.S. Furthermore, Irish firms in the food industry have transferred technology acquired abroad and adopted in their foreign plants back to Ireland (Visser, 2006). When there are multiple firms, such as in the case of the market-crowding effect that is referred above, the effects of one firm may interact and reinforce the spillovers caused by others and for these reasons, the level of new technologies of a country attracts especially high technology sectors such as information technology, telecommunications and energy (Salavopoulos, 2006).

On the other hand, Bjorvatn and Erckel's study (2001) focuses mainly on the strategy of the high-tech firm, as far as the spillovers that incur in a FDI are concerned. They find that firms endowed with superior quality might find it profitable not to make FDI in order to avoid dissipation of their competitive advantages in favor of host country firms. Therefore, technological leaders might choose to export to internationalize in order to minimize spillovers that reduce their proximity gains. Even so, the existence of spillovers does not necessarily discourage technological leaders from foreign investment. Instead, spillovers can even promote FDI by the technological leader, strategically employed to deter investment in the less advanced rival's home market. Bjorvatn and Erckel develop scenarios with respect to the spillovers of two competing firms that differ almost only in the degree of technology and refer that the suggested way for a high quality enterprise to reduce spillovers is to optimally choose the technology with which to enter the market, ranging from state-of-the-art to low-tech.



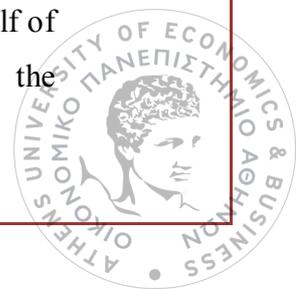
Spillovers, as this study further refers, have to exceed a certain threshold before technology sourcing FDI becomes profitable for a high-tech firm. Below this threshold, spillovers generally discourage FDI since the firm chooses exports in order to prevent its technology from being copied by the rival firm. But once spillovers exceed this threshold, high quality firms can consider of penetrating a market with a FDI.

Yet another confirmation of the strong role FDI plays in transmitting technology internationally comes from the inter-industry distribution of FDI. There is a positive relationship between MNE expansion and R&D investment and this can be confirmed from the fact that MNEs are concentrated in industries that exhibit a high ratio of R&D relative to sales and a large share of technical and professional workers (Markusen, 1995). In fact, MNEs rely heavily on intangible assets, such as superior technology, to successfully compete with local firms who are better acquainted with the host country environment (Saggi, 2000). There is evidence that firms that are lacking R&D intensity (or innovation) relative to their industry competitors are the ones more likely to engage in FDI (Blonigen, 1999).

To conclude this section we have to mention that externalities from foreign investments can also take the form of the firm's specific advantages, "namely advantages in terms of more skilled management, of manufacturing techniques (know-how), of commercialization (abilities in distribution and marketing), and related to the quality of the product (brand name, reputation for quality and reliability)" (Fosfuri and Motta, 1999:1).

3.4. Risk Diversification

According to Fosfuri and Motta (1999:1), further reason for choosing FDI over exports is "to diversify risk, in case that a firm decides to invest in a sector whose expected profits are not positively correlated to the main sector of activity. Risk spreading is even higher when investing in another country, where exogenous shocks are likely to be non-correlated with home country shocks." In addition, companies that use both exports and FDI for their international activity, Belderbos and Sleuwaegen (1998) have observed that, possibly do it to hedge against exchange rate risk. Especially for the Japanese firms that they studied in detail, in the second half of the 1980s, the period of the big expansion of the Japanese firms in the EU, the



Japanese Yen had been appreciated against the European Currency Unit. This situation made manufacturing in the EU even more attractive for the Japanese entrepreneurs.

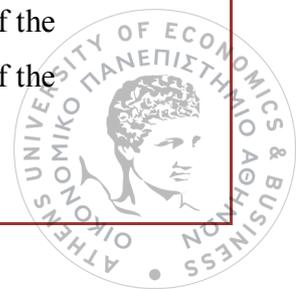
Normative decision theory refers that the decision of a company for market penetration mode should be taken after weighing the risks and returns that each one may result. A firm is expected to compare the trade-offs between exporting and FDI and then choose the entry mode that offers the highest risk-adjusted return. Managers evaluate market potential and investment risks (connected with location advantages), and costs of writing and enforcing contracts, risk of deterioration in the quality of services, and risk of dissipation of knowledge (connected with internalization advantages) in a given host country.

The exporting mode is a low resource (investment) and consequently low risk/return alternative. On the contrary, FDI mode, while providing a firm with operational control, lacks in providing marketing control that may be essential for market seeking firms and, due to the assumption of responsibility for decision making and higher commitment of resources, risks are expected to be higher. (Agarwal and Ramaswami, 1992)

4. FDI vs Exports: Empirical Economic Approach

As discussed in the theoretical section, companies might use the best strategy for each foreign market and it might be exports in some cases, FDI in others, or, quite often, a combination of both strategies. Referring to the relationship between these two methods, and whether they are substitutes or complements, World Trade Report (2015) of World Trade Organization (WTO) has found “a positive and statistically significant link between trade and FDI flows using a dataset covering 141 countries over a 10-year period (2004-13).” (p.135) Additionally, Blonigen (1999) provides evidence that exports of Japanese intermediate goods and sales of affiliates are complements whereas exports and sales of final goods are substitutes. Head and Ries (2004) also states that foreign markets are served through a combination of both modes and that countries that receive high levels of exports also host large amounts of FDI.

The features that we have mentioned are broadly consistent with several facts of the international trade and investment empirical literature. One of the stylized facts of the

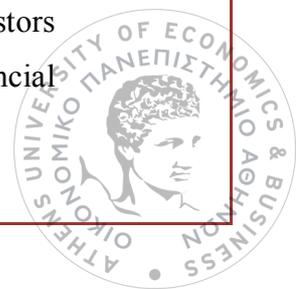


last few decades is that international trade has been growing at a very fast pace. Driven by favorable policies, technological innovation and business models bringing down the costs of cross-border transactions, international trade in goods and services “added about 20 trillion US\$ during the last 25 years, going from about 4 trillion US\$ in 1990 to about 24 trillion US\$ in 2014.” (p. 5) Over the last three years, exports are affected by the recession and surely decreased in most parts of the world. Nevertheless, at least part of the trade slowdown is expected to be temporary and to follow a cyclical trend, returning to high trade growth rates by the time global economy recovers.

The increase in world trade has been really noticeable between 2004 and 2014 and caused mostly because developing countries export a higher share to other developing countries than in the past. The destination of exports has taken a turn with a comparable fall in exports from the developed country to the developing countries. More specifically, developing countries, like East Asian, Southern African and North American, exported an increasing share of world trade by value, particularly in manufactured goods. However, developed countries account for about half the value of global trade in goods and about two-thirds of trade in services (Key Statistics and Trends in International Trade, 2015).

On the other hand, the expansion of MNEs in the globalized economy is rapidly accelerated over the last decades, with the value of sales of FDI exceeding the value of world exports of goods and non-factor services by over one-quarter, by the year 1993, and with two-thirds of the world trade being carried out by MNEs by the year 2006. (Visser, 2006). Nowadays, AIM’s Investment Report (2015:10) refers that “the number of MNEs headquartered in 15 members of the Organization for Economic Cooperation and Development (OECD) rose from 7,300 at the end of the 1960s (with some 27,000 foreign affiliates) to, world-wide, 65,000 around the turn of the century (with around 850,000 foreign affiliates) to, again worldwide, at least 100,000 at the end of 2010, controlling a minimum number of 900,000 foreign affiliates spread across the globe, selling of 10.000 bn. dollars (1,7 times the amount of global exports) and employing more than 75 million employees.”

In the FDI world, the year 2014 saw an interruption in the recovery of global inflows, as we can observe in Figure 1, mostly because of the geopolitical tensions, persistent vulnerabilities of the global economy and policy uncertainty for investors after they had fallen to an all-time low in 2009 as a result of the western financial



crisis, and then began to recover. Nevertheless, given the expected growth of the world economy in 2015, world FDI inflows can be expected to recover and rise (AIM Investment Report, 2015). More specifically, the share of MNEs intending to increase FDI expenditures over the next three years (2015–2017) rose from 24 to 32 per cent. (UNCTAD, World Investment Report (WIR), 2015).

4.1. The Host Country

An important observation on the choice of the market is that a large volume of trade is conducted between relatively similar economies. This happens because the foreign markets need to be nearby, small markets with low tariffs for a company to export there, while the distant, large market with high tariffs to be served through FDI (Head and Ries, 2004). The key determinants of investment decisions, called by AIM (2015), are the locational and economic ones. More specifically, the size and growth of the market, the price of the infrastructure and the technology resources are at the top of the list of the business of today.

These factors determine to a large extent the locational choices of firms seeking to invest, as they determine whether or not a given investment location contributes to the international competitiveness of a firm and, hence, ultimately its profitability. While the economic determinants are not everything, everything is nothing if the economic determinants are not in place – even if the regulatory framework is exemplary (AIM 2015). Interestingly, unlike what we saw in the theoretical section about markets with low average wages, studies have shown that, not only they do not reflect a scarcity of skilled labor, but on the contrary, the new EU member states have highly skilled human capital with low wages (Oberhofer and Pfaffermayr, 2007).

Global trade liberalization, nevertheless, has reduced the impact of market size and allowed smaller countries to compete for investments while in the past were only directed to major markets (Blomström and Kokko, 2003). In fact, historically, developed economies are usually preferred because they have a larger market size than developing or transition economies and therefore larger target group with a satisfying level of spending power, “promising” the firm profitability (Fosfuri and Motta, 1999). Likewise, Belderbos and Sleuwaegen (1998), in their research, found that the firms were more likely to invest in the European Union member countries (EU) if the European market was relatively large.



Today, while developed countries still account for the largest share of FDI flows and have the great majority of the largest and therefore most productive MNEs headquartered there, data of UNCTAD's WIR (2015) shows that there is growing attractiveness towards developing nations, especially in the emerging markets around the world, with nine of the twenty largest investor companies being from developing or transition economies. Interestingly, while developed countries experienced a sharp decrease in both in- and outward FDI, in 2012, developing countries were less affected by this decline.

4.2. Trade Restrictions

Conventional tariff barriers, as Belderbos and Sleuwaegen's (1998) analysis has showed, are associated with significantly more manufacturing investments. The Japanese electronics industry is responsible for a large part of Japan's FDI and "it can be calculated that for firms with a market share in the 5 to 10 percent bracket, an antidumping action increases the probability of investment by 50 percent points, while a 10 percent tariff increases the probability of investment by 19 percent points." (p.615) The main idea behind Belderbos and Sleuwaegen's results has been that unlike European and American firms' experience, Japanese FDI in Europe has been tariff-jumping FDI, which is an effort to avoid the increase in export barriers, such as antidumping measures, since the mid-1980s, and not a managerial decision based on search for lower production costs or demand-enhancing effects of FDI. Japanese firms increased trade from Japan, forcing the EU antidumping legislations to become stricter and stricter.

Nowadays, although traditional trade barriers, such as tariffs, have come down, and innovations in transportation and communications technology have shrunk the costs, the distance between nations and, consequently, trade and production costs remain high, particularly in developing countries. "High trade costs appear to disproportionately affect small and medium-sized enterprises (SMEs), time-sensitive products and goods produced in global value chains. SMEs suffer more from administrative burdens than large enterprises, particularly in developing countries. For instance, exports by SMEs are more sensitive to delays at the border than exports by large firms." (WTO, 2015:134)



Investment policy measures continue to be geared predominantly towards investment liberalization and facilitation, with frequent successes towards freer movements of goods. In 2014, in particular, more than 80 per cent of investment policy measures aimed to improve entry conditions and reduce restrictions. A focus was in sector-specific liberalization (e.g. in infrastructure and services) and new investment restrictions related mostly to strategic industries (such as transport, energy and defense).

Economic integration is also very important, as countries continue their search for reform of the international investment agreements (IIAs) regime. In 2014 only, thirty-one new IIAs were concluded, creating a multilateral framework for reducing trade costs (WTO, 2015). In 2013, economic integration can also be noticed on the data from intra EU transactions (trade between EU Member States) that accounted for the majority of the EU's total international transactions in services (Eurostat, 2015).

Other recent evidence suggests that regional economic integration can provide an important stimulus not only to trade, but also to FDI within the region concerned. For example, Brenton et al. (1998) found that the EC Single Market programme led to a significant increase in investment by EU firms in other EU countries in the late 1980s. Trade liberalization, globally, through World Trade Organization (WTO), or regionally, in the form of EU, NAFTA (North American Free Trade Agreement) and other regional agreements has led to increasing market integration and reduced the importance of market size as a determinant of investment location (Blomstrom and Kokko, 2003). Pacheco-López (2005:4) mentions that “NAFTA’s investment provisions contribute to a less discriminatory investment environment among its members, but they also reflect the protectionist demands of several powerful industries. In essence, NAFTA guarantees favorable conditions for investors within the region.” Finally, Motta and Norman (1996), who tried to analyze the comparative importance of economic integration based on a three country model, observe that much FDI is between countries in regional trading blocs.

The situation globally, and in Europe in particular, is of serious concern, mostly because of the political and economic situation, such as the adoption of austerity policies and sovereign debt concerns. Therefore, uncertainty prevails along with a number of risks forcing a big proportion of enterprises to maintain their investment levels relatively constant over the short and medium term. “Indeed, many countries have implemented greater numbers of policies that regulate or restrict investment,



bringing the share of such measures to a recent high, although investment liberalization and promotion remained the dominant feature of national investment policies” (World Investment Prospects, 2013:3). For example, tariff liberalization has been quite marginal until 2005. Even so, the last decade, more and more policies are created in order to keep tariffs low, affecting trade worldwide (WTO, 2015).

Finally, MNEs, in order to surpass high or double taxation issues, build their corporate structures through the most tax-efficient manner possible, within the constraints of their business and operational needs, and employ a range of tax avoidance levers, enabled by tax rate differentials between jurisdictions, legislative mismatches, and tax treaties. The structure of the investment may enable opportunities to avoid tax on subsequent investment income (WIR, 2015).

4.3. The Firm

In line with the theoretical predictions, export intensity is found to be higher for firms with a higher R&D intensity, a higher direct and indirect marketing intensity, and a relatively high capital to labor cost ratio and human capital intensity, while FDI for enhancing marketing efforts and demand for a firm’s products. Export intensity of Swedish firms, in particular, has been analyzed and reaffirms a positive relationship with R&D intensity, labor skill, and economies of scale in the industry (Belderbos and Sleuwaegen, 1998).

Further empirical work supports the prediction that firms that engage in FDI tend to be more productive than firms that supply foreign markets through exports. Head and Ries (2004) consider a sample of 1,070 Japanese manufacturers and find that, within industries, firms that engage in both FDI and exporting on average have greater domestic sales and higher productivity than firms that export and do not conduct FDI. Todo (2009), on the other hand, found that, in the case of Japan, unproductive firms, or so called zombies, remain in the market because of additional credit from large Japanese banks to avoid bankruptcy so that entries of new firms are discouraged and that productive firms are more likely to exit.

4.4. Services vs Goods



International trade largely relates to physical goods, because, although increasing, trade in services accounts for a much lower share (Figure 2). World exports of services are mainly dominated by transportation, travel and other business services and have strongly increased over the last decade, providing some support to the downward performance of global trade. Developing countries have increased their share of trade in services in all sectors. Developed countries remain exporters in all sectors but developing countries are becoming large suppliers to international markets with regard to construction services, travel and transportation as well as computer and information services. The most important products within the group for exports are pharmaceutical products and organic chemicals. Nevertheless, in the context of the global economic crisis, trade of goods has fallen excessively. (Key Statistics and Trends in International Trade, 2015).

Between 2008 and 2013, the most dynamic services trade sectors in developing countries were computer and information services. Other fast-growing services trade sectors for developing countries were insurance services, followed by travel services and financial services. Communication services, however, have not yet recovered their pre-crisis level. Meanwhile, transition countries posted their highest increase in computer and information services, insurance services and, last but not least, construction (United Nations, 2015).

Nonetheless, “the shift towards services FDI over the past 10 years has continued, in response to increasing liberalization in the sector, the increasing tradability of services, and the growth of global value chains in which services play an important role.” (WIR, 2015:2) According to data of Eurostat, FDI is expanding more rapidly for services than for goods, and is increasing at a more rapid pace than conventional trade in services. Over 70 per cent of world FDI outflows between 2010 and 2012 were related to services activities, more than twice the share of manufacturing, at 26 per cent. The primary sector represented less than 10 per cent of the total. Many industries such as autos, chemicals, pharmaceuticals, and electronics, are usually dominated by MNEs.

As long as FDI spending intentions by sector are concerned, firms in the financial and business services industries report the highest prospects for FDI expansion in 2015 (Figure 3), while a higher share of corporations are active in the high-tech, telecommunications, pharmaceuticals and other manufacturing industries expect FDI to increase for 2016 and 2017. However, there are some differences in the expected



benefits and risks of investment in the services sector compared to other sectors of the economy. These differences require the appropriate measures taken to formulate efficient policies (Salavopoulos, 2006).

4.5. Spillovers

To conclude, while convincing evidence of the dominance of FDI as a channel of international technology transfer (spillovers) is hard to find, according to Saggi (2000) several facts hint in that direction. For example, evidence available show that Japanese firms' acquisition FDI in the US was motivated by accessing firm-specific assets, and not necessarily in order to globalize their own firm-specific assets (Blonigen, 1998). In addition, in 1995, over eighty percent of global royalty payments for international transfer of technology were made from subsidiaries to their parent firms.

Furthermore, externalities from FDI have been identified in many developing and formerly communist countries, such as China and the CEEC (Central and Eastern European Countries,) that have recently altered their operations. As a result, firms from industrialized countries have gained access to hitherto closed markets and information for the first time. But at the same time, they lack in prior experience in operating in these new environments and because of the complexity surrounding the FDI decision, firms seeking to invest in these markets can learn valuable lessons from the successes and failures of others. Therefore, Saggi (2000) points out that informational externalities amongst investors, both private and public, play an important role in determining investment decisions and experience of one firm, even if it is the rival firm, may impart lessons to others.

5. Conclusion

In this paper, theoretical and empirical literature analysis has revealed the factors that affect firms who want to serve foreign consumers, choosing between FDI and exporting. We notice that the majority of the studies investigating the relationship of the two methods of market penetration find it to be complementary, while other papers find it to be substitutive. Nevertheless, the economic history facts show that international investment and trade have mainly positive effects towards one another.



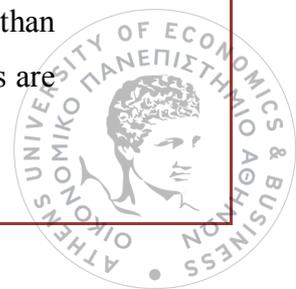
Company's decision is diversified by the destination country's features. Therefore, production via foreign affiliates is most likely to be preferred when the economy is characterized by high trade and transportation costs, minimal plant-level scale economies, and high tariffs. FDI is also chosen over exporting if the benefits associated with avoiding transportation costs exceed the fixed costs of establishing a second plant abroad, because FDI is shown to decline in fixed costs, depending on the degree of competition. Also, further advantages of FDI is that it creates lower marginal cost than exports and allows companies to cope with protectionist measures by circumventing trade barriers, such as tariffs.

Furthermore, trade entry is shown to be chosen in countries that are located close to the firm's production location, or to avoid governmental pressure that local production may suffer. Additionally, home-country's comparative advantages should be positively related to exports but negatively related to FDI, while the issue of taxation that MNEs face abroad, if the host country does not offer tax incentives, also strengthens the alternative of exporting. In addition, the share of firms that export in an industry is larger the smaller the foreign market size is.

We have observed that the choice of multinational firms depends, mostly, on the trade-off between the gains from locating near consumers and avoiding transport costs, and the losses from not locating all production in a single location. If proximity advantages outweigh concentration advantages, the company will decide to have a local presence in the foreign market.

Firm's characteristics, both tangible and intangible, are additional indicators that determine the volume of FDI sales relative to the volume of exports. It is shown that there is a relationship between the heterogeneity level of a firm and its type of involvement in the international commerce. The most productive firms engage in FDI, firms with medium efficiency levels will become exporters, and the least productive firms do not serve the foreign market at all. However, if the foreign country is small and offers some cost advantage, the least productive firms locate abroad whereas more productive ones produce at home. In this case, low productivity enterprises have a greater incentive to pay the FDI sunk costs because they use more intensively the factor whose overseas price is low.

Further interesting remarks are that trade is a decreasing function with firm size and that firm-specific assets may lead a firm to locate production abroad rather than export. MNEs are important in industries in which intangible, firm-specific assets are



important. Firms with intangible assets, such that their use does not diminish in other plants, are more likely to have multiple plants, *ceteris paribus*.

Even if exporting is the more traditional channel for companies to globalize, most importantly in the manufacturing and primary sector, most cross-border trade in services has been dominated by FDI, especially in developing countries.

Together with the previous observations, firm's unobserved characteristics give another point of view to the dilemma we investigate, by raising questions on the stiff selection process businesses follow to choose the one international activity method over the other. Interdependence between the adverse parameters and between the company's decision with its competitors', or the stickiness of the firm on its past market access behavior, and possible unobvious reasons may differentiate the final choice and should be taken into account too.

To conclude, we have shown that FDI can provide a firm with access to new skills and involves explicit trade in technology and for that reason companies with high level of technology may not find spillovers profitable and avoid FDI strategy, while for lower quality enterprises spillovers act as an advantage of the FDI strategy. In addition to all that, FDI can act as a method to diversify risk by investing in different economies, which is a very critical element of successful business management.

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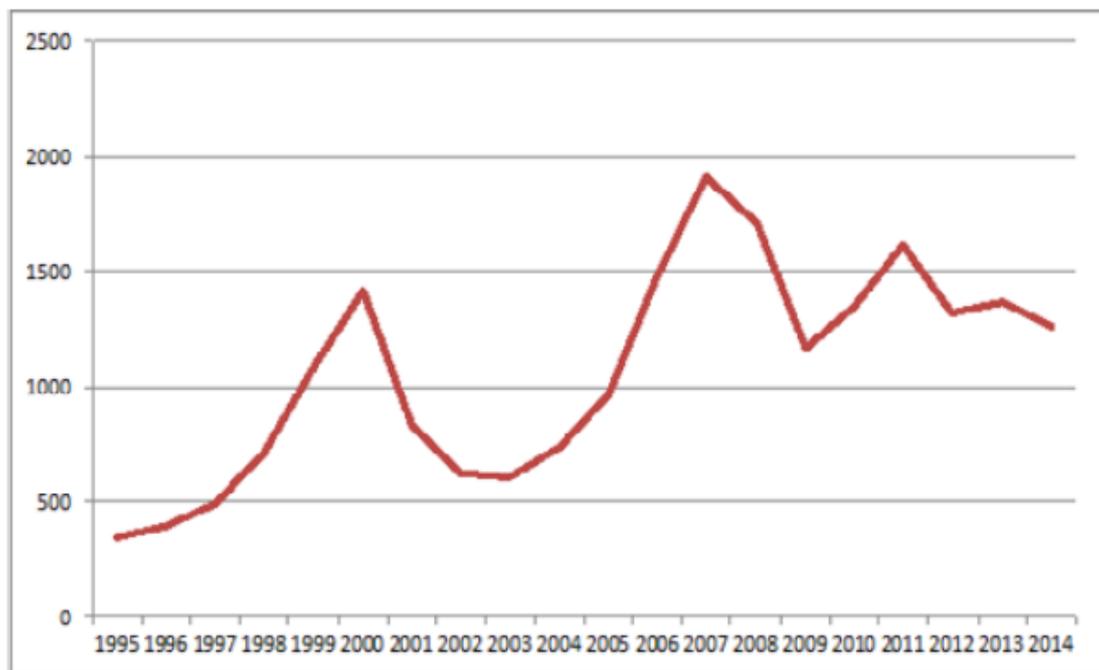
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7. Appendix

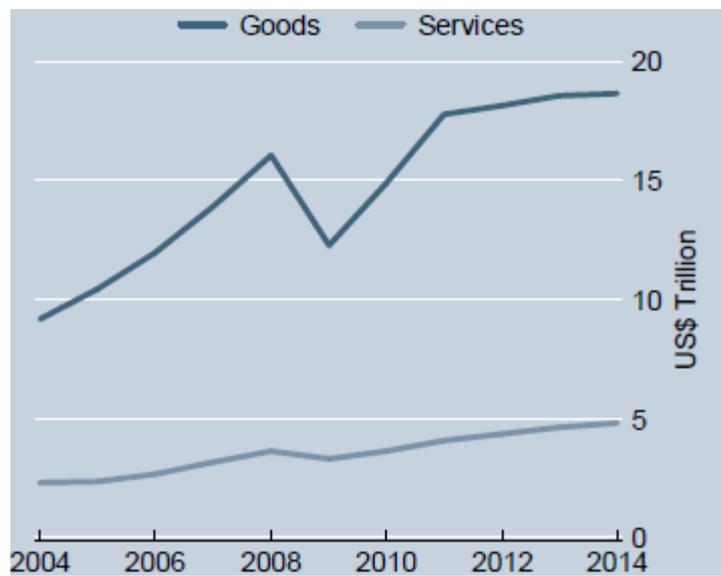


Figure 1: Global FDI inflows, 1995-2014 (Billions of US dollars)



Source: AIM Investment Report 2015.

Figure 2: Trade of Goods and Services

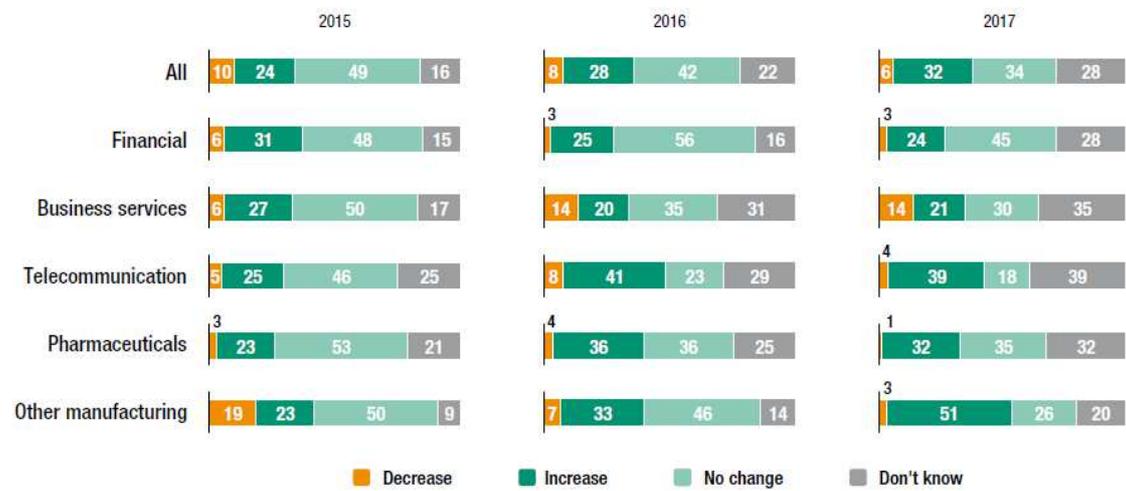


Source: Key Statistics and Trends in International Trade, UNCTAD, 2015.



Figure 3: FDI spending intentions with respect to 2014 levels, by selected industries, 2015-2017

(Per cent of all executives)



Source: UNCTAD World Investment Report, 2015

