Situational Considerations for FDI

As a result, certain forms of FDI are preferred in certain situations.

- A firm will favour FDI **over exporting if:**
- Transportation costs are **high.**
- Trade barriers are **high**

A firm will favour FDI **over licensing if:**

- The firm wants control over technical know-how.
- The firm wants control over manufacturing
- The firm cannot transfer their **competitive advantage**.

Dunning's Eclectic Paradigm

The reason for FDI and whether the firm **can/should** commit to FDI is summarised in this model.

A firm will be successful in FDI if it has:

1. *Ownership Advantage*
    - It must have some sort of **firm specific advantage** i.e. technology, product, customer service etc.
2. *Location Advantage*
    - The **FDI destination** must offer factors that make it **advantage to locate there**. i.e. labour costs, regulation, market etc.
3. *Internalisation Advantage*
    - There is an advantage to **internalising the production** as opposed to licensing i.e. costs, safeguarding technical know-how etc.

Types of FDI

Horizontal FDI

When a firm from one country owns a company in another industrial country but **duplicates their activities.** Reasons for this are as follows:

- To **avoid tariffs and quotas**
- **Improving access** to that economy
- Alliance between production divisions of **firms allows technical expertise to be shared**

Vertical FDI

When a firm from one country owns a company in another industrial country **with a particular stage/stages of production.** Reasons for this are as follows:

- Mainly driven by production cost **differences**

Why does it matter?

FDI is a **component of Aggregate Demand (AD)** : AD = C + I + G + (X-M) or Investment in this case. Therefore:

- It contributes to **Economic Growth.**
- It reduces investment elsewhere
- Reduces imports – as firms produce locally
- Increases exports – as firms export locally produced goods.
- Firm specific advantages are transferred to the Host country.