6. Theories of International Trade and Investment

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Theories of International Trade and Investment

Why and how do firms internationalize?

Firm Internationalization
- Internationalization Process of the Firm
- Born Globals and International Entrepreneurship

Firm-level Explanations
Internationalization Process vs. Born Global Model

Internationalization Process

- Domestic Focus
- Pre-export Stage
- Experimental Involvement
- Active Involvement
- Committed Involvement

Born Global

- Domestic Focus
- Active Involvement
- Committed Involvement
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Firm-level Explanations

How can internationalizing firms gain and sustain competitive advantage?

Non-FDI-Based Explanations
- International Collaborative Ventures
- Networks and Relational Assets
International Collaborative Ventures

- A form of cooperation between two or more firms.
- Partners pool resources and capabilities to create synergies, and share the risk of joint efforts.
- Collaboration provides access to foreign partners’ know-how, capital, distribution channels, or marketing assets. Also helps overcome government imposed obstacles.

**Equity-based joint ventures:**

- The formation of a new legal entity.
- In contrast to the wholly-owned FDI, the firm collaborates with local partner(s) to reduce risk and commitment of capital.

**Project-based alliances:**

- Do not require equity commitment from the partners.
- A willingness to cooperate in R&D, manufacturing, design, or any other value-adding activity.
- Since project-based alliances have a narrowly defined scope of activities and timeline, they provide greater flexibility to the firm than equity-based ventures.
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Firm-level Explanations

How can internationalizing firms gain and sustain competitive advantage?

FDI-Based Explanations
- Monopolistic Advantage Theory
- Internalization Theory
- Dunning’s Eclectic Paradigm
Monopolistic Advantage Theory

- Argues that MNEs prefer FDI, because it provides the firm
  - control over resources and capabilities in the foreign market.
  - a degree of monopoly power relative to foreign competitors.

- Key sources of monopolistic advantage:
  - proprietary knowledge
  - unique know-how
  - patents
  - ownership of other assets
Internalization Theory

- Explains how the MNE chooses to acquire and retain one or more value-chain activities inside itself.

- Such ‘internalization’ provides the MNE with greater control over its foreign operations.

- Internalization avoids the drawbacks of dealing with external partners, such as reduced quality control and the risk of losing proprietary assets to outsiders.
Dunning’s Eclectic Paradigm

Proposes that three conditions determine whether or not a company will enter a foreign country via FDI:

**Ownership-specific advantages** – firm’s specific competencies such as knowledge, skills, capabilities, relationships, or physical assets.
- similar to the Competitive Advantage

**Location-specific advantages** – specific advantages that exist in the host market, such as natural resources, low-cost labor, or skilled labor.
- similar to the Comparative Advantage

**Internalization advantages** – the degree of control over foreign operations, such as foreign-based manufacturing, distribution, or other value chain activities
- based on the Internationalization Theory

Example: Sony in China

Ownership-specific advantages. Sony possesses a huge stock of knowledge and patents in the consumer electronics industry, as represented by products like the Playstation.

Location-specific advantages. Sony desires to manufacture in China, to take advantage of China’s low-cost, highly knowledgeable labor.

Internalization advantages. Sony wants to maintain control over its knowledge, patents, manufacturing processes, and quality of its products.

Thus, Sony entered China via FDI.
IB theories based on the firm-level

**Firm internationalization**
- Internationalization process model
- Born global model

**Non-FDI-based explanations**
- Equity-based joint ventures
- Project-based alliances

**FDI-based explanations**
- **Monopolistic Advantage Theory**: The firm controls some resources, or offers relatively unique products and services that provide it a degree of monopoly power relative to foreign markets and competitors.
- **Internalization Theory**: The firm acquires and retains some value-chain activities within the firm.
- **Dunning’s Eclectic Paradigm**: Ownership-specific, location-specific, and internalization advantages.
Key Takeaways: Ch 6 – In General

Why do nations trade?

Classical Theories
- Mercantilism
- Absolute Advantage Principle
- Comparative Advantage Principle
- Factor Proportions Theory
- International Product Life Cycle Theory
- New Trade Theory

Contemporary Theories
- Competitive Advantage of Nations
- Michael Porter’s Diamond Model
- National Industrial Policy

How can nations enhance their competitive advantage?

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- Internationalization Process of the Firm
- Born Globals and International Entrepreneurship

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Nation-level Explanations

Firm-level Explanations