This theoretical study focuses on the foreign direct investments (FDI) theories. Initially, it attempts to explain briefly the FDI theories. Then, the article determines the applicability of these theories in contemporary research studies. An attempt is also made to conclude with the most relevant FDI theories that would explain the FDI flows between Greece and Moldova.

**Keywords:** developing country, factor, FDI theory, foreign direct investment, motivation.

**Introduction**

“International investment is an important aspect of the economic relations among nations” [1, p.45]. There are two types of international investments – portfolio investments and foreign direct investments (FDI). Investors in the first category invest in a firm’s stocks or assets without seeking control of the company’s operations or management. They simply seek for financial gains of return, in addition to the diversification of the investment risk. The second type of investments – FDI – appears to have a larger significance in the international economy, due to the fact that it is a long-term strategy [2].

The specialized literature is abundant with definitions of FDI. FDI “refers to an investment in or the acquisition of foreign assets with the intent to control and manage them” [Ibidem, p.82]. Also, FDI can be defined as the foreign control of firms through acquisition, lease, or new creation of property or equipment [3]. Further, FDI can be referred to as to a type of cross-border investment in production in order to gain control over the company through acquisition [4]. Lastly, FDI can be defined as an investment through which the investor obtains significant control in a foreign company or when the investor establishes a subsidiary abroad [5]. Based on all the definitions given above, FDI can be defined shortly as an investment which consists of ownership and/or significant controlling interest of a company in a foreign country.

FDI is essential in economic development and in closing the gap between the developed and developing countries [6]. More specifically, nowadays FDI flows represent more than 40% of foreign development finance to developing and transition countries. The FDI trends show that due to instability of the global economy, investment policy uncertainty and increased geopolitical risks, FDI flows declined by 16% in 2014, mainly because of the regional variations. However, recovery is forecasted for the next years [7].

The FDI related subjects are researched and discussed worldwide due to the fact that FDI is linked to economic growth. Some authors argue that FDI enhances economic growth, particularly in the developing countries. For instance, FDI has been an underlying factor in the economic growth of Malaysia, where FDI stimulated the switch from the agricultural structure to the industrial structure of the Malaysian economy [8]. Likewise, FDI had a positive impact in provincial economic growth in China [9]. Further, it is considered that FDI can have an essential influence in the process of creating an enhanced economic environment [10]. At the same time, the latter reveal that FDI has several drawbacks, where weakening of the balance of payments is a major one. Moreover, there is considerable evidence that FDI slows the economic growth [11]. For example, contingent upon post-socialist transition economies, it is better for economic growth to have limited FDI inflows, but increased domestic investment, since quick FDI can lead to economic contraction [12]. Based on all the findings discussed in this section, it appears that the link between FDI and economic growth is heterogeneous across countries. On average, FDI has a long-run influence on economic growth, regardless
of the level of development of the country [10]. Hence, there is no general agreement about the positive
association between FDI inflows and economic growth.

Further, let’s investigate the motivations behind a company’s decision to invest in a foreign country. The
literature identifies numerous factors that determine FDI flows. These factors are clearly structured as follows:
(a) **Marketing factors**, i.e. market size, market growth, closeness to customers, increased export base potential,
following the competition; (b) **Trade restrictions**, i.e. trade barriers, highly ethnocentric consumers; (c) **Cost
factors**, i.e. cheap labor resources, closeness to the sources of supply, availability of raw materials, of capital
and technology, small transportation costs, financial incentives offered by the government; (d) **Investment
climate**, i.e. positive attitude towards FDI, political stability, restrictions in the ownership, stability of foreign
currency, structure of taxes etc. [4].

To expand on the FDI factors, they can be enumerated in the following manner: costs of producing in the
local market, logistics, market potential, access to local natural resources, access to local know-how, customers’
and competitors’ presence in the local market, FDI policy incentives, ease of investment, cultural similarity,
impact on the revenue, expatriation of funds, ease of exiting the local investment [2]. The quality of local
institutions, particularly the corruption level, must also be mentioned as an FDI [13].

The FDI factors were empirically analyzed in several studies. For instance, using an econometric analysis,
it was found in Australia that the interest rates, salary changes, the measure of the openness of the economy
and industrial disagreements are significant factors of FDI inflows [1]. In India, the market size, infrastructure
and higher interest rate are the most essential determinants of making the country attractive to foreign
investors, while openness of the economy and high inflation rate are crucial variables that impact negatively
the FDI inflows [6].

It is of central importance to determine also the relationship between FDI and trade. Firms that engage in
FDI can be referred to as multinational enterprises (MNE). An MNE can maximize its profits by serving
foreign markets either through exporting activities or by setting up a subsidiary through FDI, hence by producing
at home and then exporting or by producing in the host country [14; 15]. Thus, setting up a foreign subsidiary
gives the opportunity to substitute or complement exports. The findings of a research study in the US confirms
the existence of a small trade-off between exports and FDI [15]. Another research study shows that various
dimensions of distance influence exports and FDI differently [14]. FDI sales rise with geographical distance
and import tariffs. However, FDI does not simply substitute for trade in this case.

Due to the increased regional economic agreements over the last decades, it is of essential importance to
investigate also the influence which economic integration has on the magnitude and direction of FDI flows.
In this sense, the results of one research study show that the existence of regional integration agreements has
no impact on the extent and trends of FDI flows; more than that, the investigation found out that the magnitude
and direction of FDI flows are influenced by the economic features of both the investing and the host country
[16]. Nevertheless, the results of some recent empirical investigations show that third-country effects and
regional integration are important factors of FDI in ASEAN countries [17] and that the bilateral investment
treaties affect the FDI, particularly with stronger effects in the long run than in the short run [18].

Having defined the FDI and having investigated FDI-related concepts, such as the factors behind FDI
decisions, the impact of FDI on economic growth, the relationship between FDI and trade, the impact of
regional agreements on FDI flows, we can state now to the purpose of this study. This article will attempt to
examine briefly the FDI theories. The objectives of this study are threefold: (1) to acquire an understanding
of the FDI theories; (2) to determine the applicability of these theories in nowadays’ research studies; (3) to
conclude with the most relevant FDI theories that would explain the FDI flows between Greece and Moldova.
These two countries were chosen, due to the fact that they are important trade partners [19]. Hence, Greece is
for Moldova also a significant foreign investor, particularly because of Moldova’s endeavor to integrate in
the EU. Therefore, the findings of this study could serve in the development of the bilateral investments
between the two countries.

**Research methodology**

This article makes use of classical methods of economic research. More specifically, it uses analysis,
synthesis, comparison and deduction to investigate the existing FDI theories and their applicability.
Overview of FDI theories

There are many theoretical studies that investigate the motivations underlying FDI. For instance, the FDI theories are classified as follows: (1) FDI theories based on the assumption of perfect competition; (2) FDI theories based on the backdrop of imperfect competition; (3) currency-based theory; (4) theories that connect FDI with international trade; (5) theories that link regional integration agreements with FDI; (6) theories that examine the outflow of FDI from developing countries [20].

The theory of perfect competition states that companies produce homogeneous products and have a similar level of access to factors of production [21]. Thus, in this case, the FDI motivations are questionable, since the investor does not gain a competitive advantage. This model exists basically only theoretically, as the reality is different. In fact, firms operate under imperfect competition, due to the fact that companies have different competitive advantages. Therefore, the companies decide to invest overseas in order to take advantage of certain competencies not shared by foreign competing firms [Ibidem].

Under the imperfect competition theories are included: (a) industrial organization theory, which states that in order to make the FDI profitable, firms operating abroad must compete with domestic firms which possess advantages in terms of culture, language, consumer preference etc., by using certain forms of market power, expressed in the form of patent-protected superior technology, brand names, economies of scale, marketing and management skills; (b) FDI based on monopolistic power, which states that the firms are willing to invest abroad if the opportunities to obtain monopoly profits are high, in case the host country’s policy permits it; (c) internalization theory of FDI, which specifies that a firm could operate by using backward or forward integration in different countries, under the conditions that the transactions can be performed at a lower cost, e.g. the output of one subsidiary can be used as input in another subsidiary; (d) oligopolistic theory explaining FDI, which considers that in oligopolistic market conditions, intra-industry companies are likely to imitate each other's location choice, in order to avoid being underprices, in case the competing firm decides to set up a subsidiary instead of exporting to the host country; (e) Dunning’s eclectic paradigm to FDI or OLI paradigm (Ownership-Location-Internalization), which suggests that a company would engage in FDI if three conditions were satisfied: (i) the company must have ownership advantages in comparison to other companies (Ownership); (ii) the firm must decide on the location advantages of its FDI (Location); (iii) the firm must internalize these advantages, instead of depending on external markets, thus gaining increased profitability from operating transactions within the company (Internalization) [20].

Continuing with the above classification of FDI theories, currency-based theory assumes that in comparison with investing countries that have strong currencies, countries with weaker currencies have an enhanced ability to attract FDI, due to the advantages given by market capitalization rate. Further, as regards theories that connect FDI with international trade, it was discussed in the previous chapter some findings vis-à-vis the relationship between FDI and trade, which show that there is a small trade-off between trade and FDI. Vernon is among the first researchers who integrated international trade with international investment [Ibidem]. Using his Product Life Cycle Theory, he explained that FDI was a response to the threat of losing markets due to the fact that products matured and also because the firms needed to lower their costs in front of competing firms.

To move on to theories that link regional integration agreements with FDI, some empirical investigations were discussed in the previous chapter, which showed that regional integration agreement might or might not have an impact on the FDI flows, depending on the case. These mixed findings are confirmed [Ibidem]. Moreover, the earliest studies that investigated the link between regional integration agreements and FDI flows concentrated on the experience of the European Community.

Finally, the last category of FDI theories is the theories that examine the outflow of FDI from developing countries [Ibidem]. The theories described above have mainly captured only the FDI flows from developed countries. However, the developing countries, such as Brazil, Argentina, and India have also shown tendencies of investing in other countries, either in developed or in developing economies. What could explain the motivations of an investor from a developing country to set up a subsidiary abroad? Several reasons were found. Firstly, the Product Life Cycle Theory is able to explain FDI outflows from developing countries, in the meaning that these investors initially export their products and then, when the markets of their products get well established, the investors set up the subsidiary abroad. Secondly, the OLI paradigm could explain these flows, given the following motivations: lower overheads and expatriate costs, familiarity with local
conditions of developing countries, warmer welcome by developing countries due to perceived less-threatening economic and political position of these investors in comparison with the investors from developed countries. Other drivers of FDI outflows from developing countries have been the host and home government policies, restrictions and incentives. Further, diaspora has been shown to have a significant role in the FDI flows from the developing to the developed countries, particularly when the developed country has a high concentration of diaspora, which serves as bridges for the potential investors from their country of origin to the host country. Finally, the currency-based theory offers an explanation for foreign investment from developing countries, i.e. if the domestic currency is stronger than the foreign currency, then it is more profitable to invest abroad.

Moving on to classification of FDI theories by other researchers, one study emphasizes the importance of three FDI theories: (1) market imperfections theory; (2) international production theory; (3) internalization theory [21]. The first and the third theories were described above. The second theory, i.e. international production theory, implies that “the propensity of a firm to initiate foreign production will depend on the specific attractions of its home country compared with resource implications and advantages of locating in another country” [Ibidem, p. 70]. It can be noticed that Nayak & Choudhury [20] include the internalization theory into the category of imperfect competition FDI theories, while Morgan & Katsikeas [21] consider these theories as belonging to two different categories. However, Morgan & Katsikeas [Ibidem] propose a theory not discussed by Nayak & Choudhury [20], i.e. the international production theory, which leads further to the internalization theory.

Another author comes up with a different classification of FDI theories: (1) Production Cycle Theory of Vernon; (2) The Theory of Exchange Rates on Imperfect Capital Markets; (3) The Internalization Theory; (4) The Eclectic Paradigm of Dunning [22]. Again similarities with the classifications of other authors are noticeable. Production Cycle Theory of Vernon represents the basic theory that links FDI with international trade [20]. The Theory of Exchange Rates on Imperfect Capital Markets is, in fact, named as the currency-based theory [Ibidem]. Vintila [22] concentrates on only four theories which are classified as four separate categories, while according to Nayak & Choudhury [20] the last two theories are included into the imperfect market competition theories.

Finally, the last theories’ classification as regards the determinants of FDI discussed in this paper is the one provided by Faeth [23] as follows: (1) early studies of determinants of FDI; (2) neoclassical trade theory, i.e. assumption of perfect competition; (3) ownership advantages; (4) aggregate variables; (5) ownership, location and internalization advantage (OLI) framework; (6) new trade theory, which explains the horizontal and vertical FDI; (7) Markusen’s knowledge-capital model; (8) risk diversification models; (9) a game with two players theory, i.e. policy, fiscal, financial and other incentives variables. As observed, this classification uses a chronological approach of categorizing the determinants of FDI theories. It seems to be a more logical and rational classification, as it shows the theoretical evolution and the emergence of the new theories. Also, the theories described in the above study are similar to the theories presented by Nayak & Choudhury [20].

Based on all the classifications provided above, it can be inferred that Nayak & Choudhury [Ibidem] have proposed the most comprehensive, clear and well-structured classification of the FDI theories, while Faeth [23] has suggested the categorization using a logical and evolutionary method.

Application and actuality of FDI theories in nowadays research

We proceed further to fulfilling the second objective of this study, more specifically, to determine the applicability and actuality of the FDI theories in nowadays’ research studies. First of all, it is important to mention the fact that there is a diversity of models that try to explain the determinants of FDI; researchers haven’t agreed on using in their investigations a certain generally accepted FDI theory. Thus, it is recommended to use a combination of theoretical models in order to analyze the factors of FDI [Ibidem]. Moreover, no single theory is able to give on its own a comprehensive explanation of the FDI determinants [20, 22, 23]. Besides, new elements and/or criticism to the previous models constantly emerge, which adds up to the previous argument that the international investment theories should be used in combination [22]. However, all the FDI theories agree on one aspect – the companies engage in international investment for the benefits they can get abroad in different forms, such as location, company-specific or internationalization of markets [20]. Thus, it is expected to observe in nowadays’ research studies the usage of a mix of FDI models, such as the OLI paradigm, policy variables, currency-based theory, the internalization model, product life cycle theory, oligopolistic theory, monopolistic theory etc.
Results and Discussion

A third objective of this study investigates the most relevant FDI theories that would explain the FDI flows between Greece and Moldova. Before doing that, it is important to mention that Greece is a developed EU country facing an economic crisis, while Moldova is still a developing post-soviet country.

Taking into consideration the geopolitical factors, it is recommended to the researchers to follow the Western theoretical and empirical backgrounds in investigating the FDI flows of the Eastern European countries [3]. Moreover, it is suggested to use the number of investment transactions as a dependent variable rather than the value of the investments, in order to avoid discrimination against smaller companies.

Another theoretical approach that would be appropriate in explaining the bilateral FDI flows between Moldova and Greece is the framework on how corruption influences FDI. More specifically, corruption may not necessarily discourage FDI; on the contrary, countries with similar corruption levels could be excellent FDI partners, as in the case of India and China [13]. In the context of Moldova and Greece, the corruption perceptions indexes of the two countries appeared to have had a small gap of only 13 points in 2015; to be precise, Moldova had a score of 33 and Greece – of 46 on a scale of 0 (highly corrupt) to 100 (very clean) [24]. Hence, the similarity in corruption levels of the two countries could be one more factor in explaining the bilateral FDI flows.

Finally, due to the fact that Moldova is a developing country, the theories that examine the FDI outflow from developing countries could be appropriate in describing the drivers of the FDI flows from Moldova to Greece [20]. Hence, the product Life Cycle Theory, the OLI paradigm, the host and home government policies, restrictions and incentives, diaspora concentration and the currency-based theory are applicable in explaining the FDI flows from Moldova to Greece.

Conclusion

Defined as an investment which consists of ownership and/or significant controlling interest of a company in a foreign country, FDI represents nowadays an essential economic development tool, particularly for the developing countries. Based on a wide theoretical literature, this study acquired an understanding of the FDI theories. More specifically, different researchers classified the FDI theories according to different approaches. This article discussed many FDI theories, such as those based on the assumption of perfect competition, based on the assumption of imperfect competition (i.e. industrial organization theory, theory based on monopolistic power, internalization theory, oligopolistic theory, OLI paradigm), currency-based theory, theories that connect FDI with international trade or with regional integration agreements, international production theory, production cycle theory of Vernon, risk diversification models etc.

Further, this theoretical article determined the applicability and actuality of the FDI theories in nowadays’ research studies. It appears that authors use a combination of FDI theories, due to the fact that there is no single theory that would explain on its own comprehensively the underlying FDI motivations. Moreover, new theories and/or criticism to the existing theories constantly emerge, which is one more reason to apply a mix of FDI theories in FDI research studies.

To conclude, this study proposed several FDI theories that would explain the bilateral FDI flows between Greece and Moldova. The most important recommendation in investigating these FDI flows is to follow the FDI experience of the Western countries, using the number of investment transactions as a dependent variable. Also, the framework on how corruption influences FDI could also be appropriate in achieving this objective. Finally, the theories that examine the FDI outflow from developing countries could also be applied in this context. The application of all the theories proposed above in investigating the FDI flows between Moldova and Greece is the matter of further study.

References:


