From International Trade to Firm Internationalization

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Abstract

This paper aims to investigate the evolution of economic theories that explain firms' internationalization and the development of foreign direct investments. Arguments are intended to show that theoretical approaches in this field are rooted in the period of classical theories of the international trade. Theoretic fundamentals regarding the internationalization of the firm comprise of the literature review, mentioning the main theoretical trends based of which present understanding on transnational companies is formulated. Conclusions show that as the complexity of larger companies' activity increases, the need for a new theoretical development to explain the relationships among different economic actors appears. Also, the evolution of the economic theories shows that a single theory cannot explain by itself the complexity of the present and especially of the future economic environment.

Keywords: theories of international trade, theories of foreign direct investment, theories of firm internationalization

JEL Classification: F10, F20

Introduction

Literature's development on the transnational companies starts from the theories of international trade, where from, in time, theories on foreign direct investments (FDI) and theories on firm internationalization, two interdependent aspects, came apart. Towards the last half of the century, neither the theories of international trade, nor those of foreign direct investments have been sufficient to describe the movements of the merchandise, services and financial flows of large companies. Theories of firm internationalization became more and more parts of international trade theories, a good example in this respect being the theory of competitive advantages that integrates both macroeconomic (the role of the production factors, the demand) and microeconomic approaches (competitors). Firm's internationalization was explained by many theorists (Penrose, 1968; Caves, 1969; Kindleberger, 1971; Hymer, 1976; Dunning, 1980, quoted in Morgan and Katsikeas, 1997) by relating it to the competitive mechanism and firm's behaviour in the circumstances of this mechanism.

1. Theories of International Trade

Classical theories of international trade, although not considering firm's earnings from free trade, but nation's earnings, constituted a theoretic key start point in the explanation of the internationalisation's rationales.

Advantages offered by specialization, explained by the **theories of absolute advantage** (Adam Smith, 1776) and **of comparative advantage** (David Ricardo, 1817), and later by the theory of factor endowments, have been taken and adapted for the level of the firm. The theory of absolute advantage brought to the attention for the first time the possibility for a country to produce cheaper a given product than another country. In this case, countries' specialization in the production of goods with smaller costs and the trade of the production surplus was beneficial for both countries. Although it represented a major step in demonstrating the benefits of specialization, Adam Smith's theory could not offer the same perspectives for the countries that did not poses an absolute advantage for any category of products.

From this situation, David Ricardo demonstrated that specialization is possible and beneficial even when a country doesn't poses and absolute advantage in the production of any good. Resources' allocation toward those goods that can be obtained cheaper than others and their export can bring benefits to both countries. This was a major demonstration that fundament the theories developed later, regardless of the fact that they confirmed, enriched or contradicted the hypotheses of the comparative advantages theory.

At the beginning of the 20th century, two Swedish researchers Ohlin and Hecksher argue that the difference between countries is given by the production factors, and the products are different because of the production factors incorporated. According to the model (**Ohlin – Hecksher factor proportion theory**), a country holds a comparative advantage and thus will export the product that incorporates the abundant production factors in the respective country. Thus, the more abundant a production factor is, the cheaper it becomes. So, the difference in the production factors is given by the difference in their prices, generating the competitive advantage.

Technological developments in the '60-ies and the substantially ample development of multinationals lead the specialists to look for new theoretical fundamentals that explain the complex evolutions of the international trade.

The product life cycle theory developed by Vernon in the '60-ies proved to be a good frame of reference for explaining and predicting patterns of international trade, but of multinational companies as well. This can be considered the theory that unifies the development of multinational companies, showing without a doubt that trade flows are linked to the international trade (Morgan and Katsikeas, 1997, p. 69). The life cycle theory suggests that a trade cycle begins when a product is made by the mother company, then by its subsidiaries, and then by any other company anywhere in the world, where the production costs are the lowest possible. At the same time, the theory explains how a country that initially appears as an exporter of the products can end as an importer, when the product reaches the last stage of its life cycle. The essence of this theory is influenced by the technological innovations and market expansion. Technology is the main factor in the development and creation of new products, whereas the size and the structure of the market are generated by the expansion and the type of internationalization adopted by the firm.

The new theory of international trade developed by Krugman in the '70-ies constitutes a critique brought to the classical theories of international trade based on free trade. The supporters of this new theory questioned the positive effects of free trade in the case of infantile industries. An important argument of the new theory is represented by the fact that, using protectionist measures to sustain certain industries for a given period of time, conditions for those industries to become leaders on national and international markets can be created. A good exemplification of this theory is that of the Asian countries like South Korea and Japan, that sustained the representative companies from specific industries to penetrate the international markets and afterwards they became leaders of international level (for instance, the case of Samsung).

Of much interest is the new **theory of competitive advantages** launched in the last decade of the last century by Michael Porter in his book “The Competitive Advantage of Nations”. Porter’s diamond, as the fundamental elements of the theory were called, represents an economic model that explains why some industries become competitive in certain situations. The diamond has four constitutive elements, plus two factors of influence: production factors, demand, support industries, firm structure and competition at branch level, governmental regulations and the chance. The theory of competitive advantages considers those six elements interact one with each other, allowing the creation of those combinations to enhance competitiveness’ increase.

The development of transnational companies from certain countries and industries verify some applications from Michael Porter’s theory. In media, for instance, American firms have a higher level of competitiveness. The come from a market where advanced production factors are very well emphasized, meet a sophisticated demand from buyers with strong purchasing power and requirements, where upstream and downstream industries function without problems, and the competition within the industry is extremely high.

Apart from the theories of the international trade, firm’s development was explained by a series of other theories that showed the reasons that could determine a company to expand, not only within the national borders, but also beyond them. The theories of the international trade have failed to explain why firms choose a specific location instead of another, why they prefer the production abroad and not the export towards another country. On the background of the expansion of large firms and the theoretical approaches to analyze market imperfections, a category of theories trying to extend the limits of the international trade theories and to explain foreign direct investments have emerged.

2. Theories of Foreign Direct Investments

Market imperfections represent, according to some specialists (Hymer, 1970; Kindleberger,1971, Caves 1969, quoted in Morgan and Katsikeas, 1997) the main factor that determined firm’s internationalization. According to Hymer, market imperfections are of structural nature and come from the deviation from the perfect competition on the final product’s market, as a consequence of an exclusive and permanent control of property rights on technology, access to resources, scale economies, distribution system and product differentiation. Profits decrease, due to competition increase, may lead to the reduction in the number of companies, by mergers and acquisitions, as a way to counteract competition effects (Pitelis and Sugden, 2000). Firms are permanently looking for market opportunities raised by these imperfections in the endowment with production factors and in the production of goods, their decision to invest abroad being considered a strategy to capitalize on the advantages competitors do not poses on those markets.

The **theory of international production** suggests that the ability of a firm to produce abroad depends on the particular attraction of the country of origin in relation to the advantages offered by other markets. The additional element brought by this theory is the identification of multiple factors’ importance in the decision to externalize the production of a company and to proceed with foreign direct investment. Not only the endowment with production factors and their productivity make a company to invest beyond the borders of its own country, but also the governmental actions that transforms into an attraction factor for investors.

Strongly connected to the international production theory was developed the **theory of internalization**, that introduces the idea that firms wish to create their own internal market to outrun the borders of their country of origin. The internalization implies a form of vertical integration, that includes activities once performed by intermediaries (Morgan and Katsikeas, 1997, p. 70).

Location theory - initiated by the German school starting with Johann Heinrich von Thünen at the beginning of the 19th century - , is linked to the geographical location of the economic activity (Crosier, 2001). The base of this theory is given by the answers to the following questions: what economic activity needs to be located, where to and why is that? Thus, as spaces and local and national economic environments open to the global economy, it becomes more obvious that large corporations are the coordinating units of the current economic relations, much more than national economies. And, once with the opening of the national economies, it proves to be possible and advantageous for a corporation to benefit of the existent differences between regions and cities in terms of salary levels, market potential, employment regulations, taxation, environmental regulations, local infrastructural facilities and human resources. Thus, firms will choose locations that will maximize their profits, and consumers will choose those locations that will maximize their utility. Although the location theory does not provide criteria to determine a firm to choose the best locations, it can provide details on the ways companies internationalize, at global level, based on the elements associated to the location: tax level, technological transfer's requirement, political risk, unions' power, attitude towards foreign companies etc.

Demand structure hypothesis, that starts from the classical economic theories (initiated by the one that used the terms demand and supply for the first time - James Denham-Steuart[1]) and continues with the post-Keynesian approaches of Hicks or Phillips, considers that a similar structure demand existing in two countries will favour the commercial flows between those countries. To exemplify, at the level of the transnational companies, the heading of their investments shows an attraction to those countries with a demand structure similar to that of their home country, rather than to countries with a different demand structure. Trade flows between developed countries dominate the international trade, as foreign direct investments from developed countries target mainly developed countries as well.

Transaction costs theory, developed by Ronald Coase in 1937 and afterwards by McManus in 1972, Buckley and Casson in 1976, Brown in 1976 and Hennart in 1977 brought in the discussion the differences between the transactions within the company and those outside the company. Coase argues that although the transactions outside the company cannot be necessarily controlled by the company, those within the company are performed according to company's interest. Extrapolating this behaviour of the firm, the development of the transnational companies allows the manipulation of the transactions within the company, so as to lower losses. Thus, the concept of the internalisation of the international trade associated with the transnational companies and the way they utilize transfer prices between subsidiaries to maximize profits emerged.

[1] In 1767, James Denham-Steuart published *Inquiry into the Principles of Political Oeconomy*. Actually, this represented the first book on economics published in the world.

An extension of the costs theory was represented by **the eclectic theory**. The reasons for which transnational companies make foreign direct investments, according to the eclectic theory developed by John Dunning in the '80-ies do not consider only the structure of the firm, but also some advantages raised by ownership (brand - if owned by the company, managerial capabilities), location (availability of raw materials, salary level, tax level) and the international environment (the advantages of licensing and joint ventures). Known also as the OLI Model (Ownership, Location, Internationalisation), the theory tries to explain the reasons and the motivational power of foreign investments and the way in which resource allocation and the organisational structure of the firm are interconnected. The theory allows the analysis of market advantages, both at the level of firm's needs and from the perspective of the international environment. Also, with the use of OLI theory one can make a prediction of the areas (countries or regions) where the probability for firms to invest is the highest (Dunning, 1993). Firm-specific advantages (ownership) can be easily transferred in the case of internationalisation, comprising of technology, brand etc. They can generate a higher profit or can contribute to the decrease of the production cost at global level. Unlike a firm that activates in the home market, the one present at international level is confronted with additional costs due to the differences in the legislative environment, the knowledge regarding the external market, the communication costs and the operation at larger distances. Thus, to reduce these costs there must be another advantage for the internationalized firm as opposed to the local firms. These advantages, leveraged by internationalization, translate into abilities raised by the monopoly position (patents, ownership rights for rare resources), technology (innovation and research within the firm that can be easily exported to foreign subsidiaries) or firm's size (financing is more available, specialisation is more profitable).

The advantages that derive from location are, in fact, accessible to everyone. Natural resources, the workforce, the capital, the technology, or the organisational and information systems are available to all competitors. They are exploited and transformed into advantage if their use generates profit and superiority in competing. Location – specific advantages are generated by economic factors (the quality and quantity of the production factor, telecommunications and infrastructure costs, objectives and size of the market), political factors (incentives for foreign direct investments), social and cultural factors (language spoken, cultural diversity, and attitude towards foreign investors). Advantages of internationalization appear when the export costs are much higher than the costs generated by the establishment of a subsidiary. The internationalization is generated by the perception a company has, both internally and externally, regarding the comparison of benefits resulted from the internationalization in relation to the costs it implies.

3. Theories of Firm Internationalization

The movement to internationalization, as theoretical approach, was needed due to the fact the more and more theorists noticed that the performances in the field of the international trade cannot be explained only by referring to macro-economic phenomena. Firms' role is very important and it influences the commercial performances of the nations. As opposed to the theories of the international trade and foreign direct investments, the theories of firm internationalization explain how and why a firm engages in foreign activities and how the dynamics of the nature of this behaviour can be conceptualized.

The internationalization can be described as a movement of firm's operations beyond the borders of the home country, a process of the increase of firm's implication in complex operations outside national borders. This acceptance of the internationalization process allows the analysis of the multiple activities performed by firms abroad, which are of extreme complexity: from licensing, to franchising, to joint ventures or mergers and acquisitions. The theory of firm internationalization allowed the broadening of new horizons for the analysis of the corporative phenomenon: management, marketing, finances or human resources. If at macro-economic level, between the firms that perform activities at international level distinctions are not made, at micro-economic level, management and marketing strategies identify particularities specific to each internationalisation level.

Firm internationalization theories analyze the factors that generate the advance firms win in the process of internationalization, the stages firms cover in the process of internationalization, and the elements that define the internationalization behaviour of firms.

A model for firm internationalization is represented by **the Uppsala Model**, developed by the Swedish researchers (Blomstermo and DeoSharma, 2003). They consider that the internationalization process is an evolutionary and sequential one, which develops as the firm becomes more and more involved on the international market. According to the approach of the Swedish theorists, firms enter foreign markets in a gradual way, in accordance to the level of knowledge and the information accumulated about the destination market. Firms gain knowledge and experience from their activity on the internal market, and, at a certain point, turn to external markets. The external markets have different degrees of attractiveness, in accordance to the geographical and cultural proximity to the home country. The Uppsala Model considers that the firms starts the approach of the international markets with the usage of the traditional export methods to countries closer from the perspective of geographical and cultural proximity, gradually developing complex ways to operate, at firm level, at destination country level, and towards geographical and cultural more distant countries. There can be distinguished four such methods for market penetration: irregular export, export through an agent, subsidiary and production.

The lack of information and knowledge about the international markets represents a major obstacle in the way of internationalization, but this can be overcome by researching the peculiarities of the target markets. The decisions regarding the investment arrangements are made as the degree of non-information decreases. The more the firm knows about a foreign market, the perceived risk is lower. As consequence, the level of investments increases. The level of knowledge about the new market directly influences firm's involvement, generating a certain degree of involvement towards the external market.

Innovation-related internationalization taxonomies examines the way in which firms progress in the process of internationalization and suggest that this process is a sequence of stages with stagnation periods, influenced by the degree of involvement in the global economy. Over these static periods, firms accumulate the needed resources to reply to the challenges launched by the international environment and to pass to the next level (Morgan and Katsikeas, 1997).

Innovation allows firms to obtain new products with superior features and to decrease costs by developing new production processes and production technologies etc. In this way, using innovation, firms obtain advantages that allow them to be competitive in international environments distinct from that of the home country. The higher the level of innovation absorption is, the competitive ability increases and firma expand on markets even more different than the origin market (Stoian and Zaharia, 2009).

The synthesis of the main theories that lead from the international trade to the internationalization of large firms is presented in Table 1 below.

Table no. 1. Main theoretical approaches that lead to the explanation of the development of transnational companies

Theories	Emphasis	Credited writers
	International trade theories	
Absolute advantage theory	Countries win if they specialize in the production of goods for which they hold an absolute cost advantage.	Adam Smith, 1776
Comparative advantage theory	Countries win if they specialize in the production of goods for which they hold a comparative cost advantage.	Ricardo, 1817
Factor proportion theory	Countries tend to specialize in the production of those goods that intensively use the most abundant production factors.	Hecksher and Ohlin, 1933
Product life cycle theory	Different stages: production and export to a foreign country, external production, external production for export, product import from abroad.	Vernon, 1966
New theory of international trade	Utilizing protectionist measures to develop an important industrial base in some industries allows these industries to dominate the global market.	Krugman, 1970
Competitive advantage theory	Advantages are given not by the endowment with production factors, but by the availability of advanced production factors and the degree of competitiveness of an economy.	Porter, 1990
	Foreign direct investment theories	
Market imperfections theory	Market imperfections are structural and come from the deviations from the perfect competition on the market of the final product, as a consequence of an exclusivist and permanent control on the rights of property on technology, access to resources, scale economies, distribution system and product differentiation.	Hymer, 1970
International production theories: Demand structure theory Location theory Eclectic theory	 - Investments direction shows a higher attraction to the countries with a similar demand structure to that in the country of origin, in relation to countries with a different demand structure - What economic activity needs to be located, where and why? - The reasons for localization are linked to several advantages generated by ownership, firm's location and the international environment	 Hicks, 1939 Phillips, 1958 Weber, 1929 Dunning, 1980
Internalization theory - Transaction costs theory	The development of transnational companies allows the manipulation of the transactions within the firm, so as to minimize losses	Ronald Coase, 1937 Buckley and Casson, 1976, 1985
	Internationalization theories of the firm	
Uppsala Model	Firms penetrate foreign markets in a gradual way, in accordance to the level of knowledge and information they accumulate about the destination market	Johanson and Wiedersheim-Paul, 1975
Innovation-related	The internationalization process is a stepwise	Bilkey and Tesar,

internationalization taxonomies	process, with stagnation periods, over which firms utilize innovation to respond to the challenges launched by the international environment and to move to the next level.	1977, Cavusgil, 1980, Czinkota, 1982, Lim, 1991, Rao and Naidu, 1992

Source: Prepared by the author after Morgan and Katsikeas, 1997, p.70

Conclusions

Classical theories of the international trade lead to the idea that the fundament of the international trade is given by the differences that exist in production and in the endowment with resources. In general, they tried to explain how and why the trade between two countries develops and what earnings could be obtained as a result of specialization.

The removal of monopoly and the emergence of an increasing number of firms lead to the development of the theories on the international trade which, this time, made clear reference to certain industries, or to certain companies. More than that, some theoretical approaches of the international trade set the theoretical base for firm internationalization theories. On the background of the expansion of large firms and of the theoretical approaches that have analyzed market imperfections, a new category of theories has emerged that tried to expand the limits of the theories on the international trade and to explain foreign direct investments.

The move to internationalization as a theoretical approach was needed due to the fact that more theorists noticed the performances in the field of the international trade cannot be explained only in relation to the macro-economic phenomena. Firms' role is very important and influences the commercial performances of nations. As opposed to the theories of the international trade and foreign direct investments, the theories of firm internationalization explain how and why a firm engages in foreign activities and how the dynamics of the nature of this behaviour can be conceptualized. It is obvious that as the complexity of large firms' activity increases, the need for new theoretical development capable to explain the relationships between different economic actors appears. Also, from the evolution of the economic theories it results that a single theory is unable to explain the complexity of the present and future economic environment.

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