

Review Article

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FOREIGN DIRECT INVESTMENTS IN CLASSICAL AND NEOCLASSICAL THEORIES OF INTERNATIONAL TRADE

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Abstract: *The research problem of this paper is related to the research of the evolution of foreign direct investments with emphasis on the key features that distinguish them in relation to other forms of international capital movement. The research subject involves looking at the impact of classical and neoclassical theories of international trade on the appearance and development of foreign direct investments. The aim of the research is to determine the circumstances under which a nation begins to trade outside its borders in order to reach a conclusion about how international trade created the conditions for the emergence of foreign direct investments. The paper discusses and compares the classical theories of international trade (the Theory of absolute advantages and the Theory of relative advantages) and neoclassical theories of international trade (the Heckscher-Ohlin theory and the Modern theory of international trade). The research concludes that by explaining international trade, the aforementioned theories also indirectly address foreign direct investment.*

Keywords: *foreign direct investments (FDI), theories of international trade, foreign direct investments flows*

JEL classification: *B12, B17, F11, F21*

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STRANE DIREKTNE INVESTICIJE U KLASIČNIM I NEOKLASIČNIM TEORIJAMA MEĐUNARODNE TRGOVINE

Sažetak: Problem istraživanja ovog rada se odnosi na istraživanje evolucije stranog direktnog investiranja uz akcenat na ključnim obeležjima koja ih razlikuju u odnosu na druge oblike međunarodnog kretanja kapitala. Predmet istraživanja podrazumeva sagledavanje dopirnosa klasinih i neoklasičnih teorija međunarodne trgovine pojavi i razvoju stranih direktnih investicija. Cilj istraživanja je usmeren ka utvrđivanju okolnosti pod kojima jedna nacija počinje da trguje van svojih granica kako bi se došlo do zaključka o tome na koji način je međunarodna trgovina stvorila uslove za pojavu stranih direktnih investicija. U radu se razmatraju i upoređuju klasične teorije međunarodne trgovine (Teorija apsolutnih prednosti i Teorija relativnih prednosti) i neoklasične teorije međunarodne trgovine (Heckscher-Ohlin theory i Modern theory of international trade). Istraživanjem se dolazi do zaključka da kroz objašnjenje međunarodne trgovine navedene teorije se indirektno bave i stranim direktnim investicijama.

Ključne reči: strane direktne investicije, teorije međunarodne trgovine, tokovi stranih direktnih investicija

1. INTRODUCTION

International capital flows generate multiple benefits at the global level; however, as Grubel (1977) emphasizes, these benefits become fully evident only when the free movement of capital is established. By the end of the 20th century (particularly during the 1990s) and the beginning of the 21st century, many authors advanced the view that such flows can be classified into three categories: portfolio investments, foreign direct investments, and other investments, with particular emphasis on bank lending (IMF (1993); Bosworth, Collins, & Reinhart (1999); and Protsenko (2004)).

Foreign direct investment (FDI) differs from other forms of international capital flows primarily in terms of the nature and maturity of the obligations it entails. Its main purpose is to establish long-term commercial relationships while simultaneously exerting a significant degree of managerial control over the operations of the company in which the investment is made. FDI represents investments that involve the contractual connection of partners, the establishment of long-term relations, permanent interests and the

implementation of control by a company from one country (home country) over a company that is a resident of another country (host country). In this way, the investing company acquires ownership control over the company in which it invests its capital, which is located in another country outside its home country. FDI includes both the initial and all subsequent transactions between the aforementioned actors. The object of foreign investment can be a company, regardless of ownership structure, in which the foreign investor, who is a resident of another country, owns at least 10%, and often a higher percentage of ordinary shares that provide him with voting power (WIR, 2016).

Kumar (2003) states that FDI usually refers to a set of resources that, in addition to capital, also includes production technology, management and organizational skills of managers, market know-how, and sometimes the ability to access markets based on previously established market connections of multinational companies that invest their funds in another country. It is usually expected that FDI will contribute more to economic growth than domestic investment could, and that these resources will flow to entrepreneurs in the host country. FDI implies capital flows arising from the behavior of multinational companies (Agiomirgianakis, Asteriou and Papathoma, 2003). Therefore, the factors that influence the behavior of multinational companies also influence the volume and direction of FDI flows.

2. EVOLUTION OF FOREIGN DIRECT INVESTMENTS

According to certain literature sources, FDI appeared during the nineteenth century and was one of the ways of financing the economic growth of certain countries through loans granted by Great Britain. At that time, foreign investors were particularly interested in investments in the production and sale of consumer goods, but their projects were largely unsuccessful, since their main goal was to expand access to the British market. In the period after the First World War, foreign investments decreased, but on the other hand, direct investments increased, accounting for a quarter of the total investment flows. The mentioned period will also be remembered for the fact that Great Britain lost its status as the world's largest creditor, and the USA emerged as a leading economic and financial power. After the end of the Second World War, FDI inflows started to increase, mainly for two reasons:

- Advances in technology, especially transportation and communication networks, made it possible to exercise control by the parent company, which was often geographically very far from its subsidiaries.
- The growth of the need of European countries and Japan for the inflows of American capital, in order to rehabilitate the damage and restore infrastructure facilities damaged or destroyed during the war.

In the mentioned period, tax regulations favoring FDI flows were in force in the USA. By 1960, the influence of the previously mentioned factors had significantly weakened, so there were sudden changes in the FDI flows. Many countries became resistant to American investment and opposed the control of the local economy, which led to a reduced intensity of investment by American companies. At the same time, the countries that previously hosted American investors partially recovered and improved their economic systems to the extent that some of them became investors in the USA. Inevitably, there was a reduction in the outflow of FDI from the USA to other countries.

In the 1970s, Great Britain again became a leader in foreign direct investment. In the 1980s, the net investment position of the USA became negative, and the country turned into one of the world's largest debtors with intensive FDI inflows from other countries. At the same time, public savings were at an extremely low level, so financing the growing state budget deficit by borrowing funds on the domestic capital market became impossible. The need for foreign capital, which initially came mainly from Japan and Germany, became increasingly apparent. Very restrictive measures of the trade policy, which was applied in the USA, only further encouraged the aforementioned developments. Perhaps the most significant change that occurred in those years was the emergence of Japan as a leading foreign direct investor, which directed its funds primarily into American and European companies, and later to the countries of Southeast Asia.

Building on the aforementioned trends, Sahoo (2006) emphasizes that certainly one of the most significant characteristics of the globalization process during the 1990s was related to private capital flows in the form of FDI. In the 1991 WIR, UNCTAD states that during the 1980s, FDI outflows globally grew at an annual rate of 29%, which was three times faster than the growth of global exports and four times faster than the growth of global output. In the late 1980s and early 1990s, there was an increase in FDI inflows, as investments in the service sector and technology-intensive industries became increasingly prominent, while investments oriented towards the production of raw materials, which were dominant especially in the 1950s, decreased. The manufacturing sector is gaining competition, as FDI began to spread to other economic sectors. At the same time, the number of countries that became FDI investors and directed their funds into the economies of other countries, as well as the number of small companies whose operations became multinational, also increased significantly. The 1990s were marked by the intensive efforts of the governments of many countries in the world to improve the investment climate and by the recognition of the numerous benefits provided by FDI.

The proven advantages of this form of investment are certainly the main reasons why governments of countries compete with each other to ensure the best

conditions and attract foreign investors (Lipsey, 2004). Changes in attitudes towards this form of investment have led to the removal of previous obstacles to investment, especially through deregulation and privatization, as well as to the application of various investment incentives. The end of the 1970s was also marked by a sharp increase in the number of cross-border mergers and acquisitions, which were stimulated by deregulation and improvement of competition law. The liberalization of legal frameworks and regulations that regulate foreign direct investment continued, as well as the increase in the number of contracts on the avoidance of double taxation, all for the purpose of intensifying FDI promotion in the forthcoming period. In modern conditions, investors from the USA, Japan and the European Union usually have the largest share in total global investment flows. There are several methods available to US investors to invest abroad. The most frequently applied method is the direct purchase of securities in the capital markets of other countries (Bodie, Kane & Marcus, 2010).

The first investment boom in the world followed the world oil crisis at the end of the 1970s, the next one was driven by the rapid development of information and telecommunication technologies and the intensification of investments in developed countries, and the last one began in the 1990s when there was a sudden increase in the participation of developing countries in FDI inflows. The USA was the largest individual source of global FDI in the period from 1990 to 1998, while in 1999 Great Britain took over the leadership position. Then there was a growth of FDI inflows of 24% and they reached a value of US\$ 316 billion with a simultaneous growth of FDI outflows at a rate of 35% and a value of US\$ 338 billion (Đurić, Prekajac & Vidas-Bubanja, 2000). Starting from the 1990s, a third investment boom emerged, whose key characteristic was the increase in FDI inflows in developing countries and transition economies, which became increasingly pronounced over time.

In the last decades of the 20th century, countries of Central and Eastern Europe experienced a sharp decline in industrial production, the collapse of large state-owned enterprises, a decrease in living standards, rising unemployment, pronounced impoverishment of the population, a reduction in GDP, a slowdown in investment activity, and the emigration of a large number of highly educated individuals—particularly young professionals—to other countries. The aforementioned indicated the beginning of the transition process, which was based on the transformation of centralist-planned into market economic structures, as well as on overcoming the former socialist regime and accepting capitalism. In the late eighties and early nineties of the XX century, most of the countries of Central and Eastern Europe, as well as the countries of the former Union of Soviet Republics, began the process of economic transition, which

created the conditions for the expansion of transnational companies and the growth of FDI inflows in this region. Walkenforst (2004) emphasizes that precisely in the mentioned countries; FDI played a major role in economic restructuring and provided significant support for the transition and development of market-oriented economies. The importance of FDI for the development of the global economy came to the fore during the 1990s. At the same time, the process of transition from socialist to capitalist economic systems took place as well as the integration of developing countries, especially the countries of Central and Eastern Europe, into world economic flows through trade and capital flows (Buch, Kokta & Piazzolo (2001) and Di Mauro (1999)).

Precisely in the period from 1990 to 1998, when the USA occupied a leading position in terms of inflows and outflows of FDI, many authors were engaged in researching the geographical distribution of FDI in the USA as well as the determinants of the choice of location by American investors in other countries. Among the mentioned authors are Huallacháin & Reid (1997); Hines (1996); Head, Ries & Swenson (1995); Florida (1994); Friedman, Gerlowski & Silberman (1992); Wheeler & Mody (1992); Woodward (1992) and Coughlin, Terza & Arromdee (1991).

3. CLASSICAL THEORIES OF INTERNATIONAL TRADE ABOUT FOREIGN DIRECT INVESTMENTS

The development of classical theories of international trade can be traced back to the ideas of David Hume, followed by the theory of absolute advantage by Adam Smith and the theory of comparative advantage by David Ricardo. These theories laid the foundation upon which neoclassical theories of international trade and modern theories of foreign direct investment were further developed.

3.1. ABSOLUTE ADVANTAGE THEORY

Apsolutne prednosti su poslužile velikim ekonomistima poput Davida Humea i Adama Smita da formulišu sopstvene teorije o međunarodnoj trgovini. Hume je začetnik teorije o ravnoteži tekućeg računa kao dela platnog bilansa jedne zemlje i protivnik merkantilističkih shvatanja o neravnoteži i višku sredstava na tekućem računu. Hume (1870) je kritikovao akumulaciju kapitala, koja bi mogla da dovede do povećanja cena na nacionalnim tržištima dobara i radne snage, što bi zatim uslovljalo porast uvoza i smanjenje izvoza. Takođe je smatrao da nije dobro prekinuti izvoz plemenitih metala kao što su zlato i srebro. Tvrdio je da se ravnoteža između uvoza i izvoza može uspostaviti automatskim usklađivanjem, a da će obeshrabrenje izvoza i podsticanje uvoza dovesti do porasta viška na tekućem računu, što bi bilo pogubno za jednu zemlju.

Absolute advantages served as a basis for prominent economists such as David Hume and Adam Smith to formulate their own theories of international trade. Hume was the founder of the theory of current account equilibrium as part of a country's balance of payments and a critic of mercantilist notions regarding imbalances and surpluses in the current account. Hume (1870) criticized the accumulation of capital, which could lead to rising prices in national markets for goods and labor, thereby prompting increased imports and reduced exports. He also argued that it was unwise to halt the export of precious metals such as gold and silver. He maintained that equilibrium between imports and exports could be achieved through automatic adjustments, whereas discouraging exports and promoting imports would lead to a surplus in the current account, which could be detrimental to a country.

Supporting certain ideas of Hume, Adam Smith was also a critic of mercantilist economic policy (Smith and Nicholson, 1887) and argued that the measures proposed by mercantilists could neither be suitable for the entire nation nor bring prosperity and economic growth to the country as a whole. Smith maintained that mercantilist views benefited only merchants and producers while neglecting the interests of workers (Smith, 1827). Like Hume, Smith considered it completely unacceptable to promote imports while restricting exports.

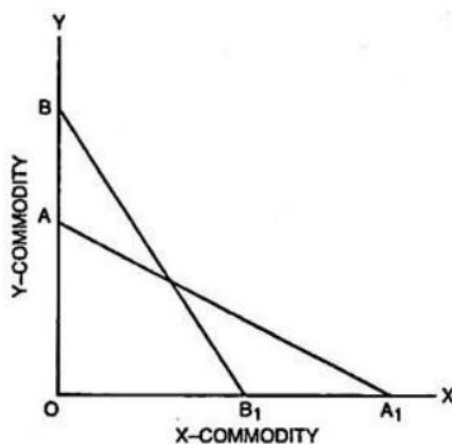


Figure 1. Absolute Advantage Theory

Source. Adam Smith's Theory of Absolute Cost Advantage. *Economics Discussion*. <https://www.economicsdiscussion.net/theory-of-absolute-cost/adam-smiths-theory-of-absolute-cost-advantage-economics/30675>

The Figure 1 shows the production possibility curves of two countries (AA1 and BB1), which allocate all their available resources to the production of two goods, X and Y. In this situation, if the countries focus solely on the production of good X, they will produce OA1 and OB1 units of this good, respectively; if they produce only good Y, they will produce OA and OB units. The slope of the production possibility curve is determined by labor productivity in the production of the respective goods. Since the slope of curve AA1 is smaller than that of curve BB1, it can be concluded that country A has an absolute advantage in the production of good X, while country B has an absolute advantage in the production of good Y.

By promoting the concept of free trade among countries, Smith established the theory of absolute advantage, according to which a country that can produce a particular good at lower costs than another country possesses an absolute advantage in producing that good. He argued that all countries could benefit if they supported and implemented a system of free trade and specialized in their areas of absolute advantage.

Smith emphasizes that specialization of production based on absolute cost advantages would also lead to the maximization of world output. He also proposed that a country should export the goods it can produce at lower costs and higher productivity, while importing goods that it would otherwise produce at higher costs and lower productivity. However, it is not fully explained what actions should be taken if a country holds absolute advantages in the production of several different goods, or if it has no absolute advantage in the production of at least one good. This raises the question of how specialization should be carried out in such circumstances, and whether any gains from engaging in international trade can be realized at all under these conditions.

3.2. COMPARATIVE ADVANTAGE THEORY

Focusing primarily on opportunity cost, but also on absolute production costs, David Ricardo formulated the theory of comparative advantage in 1817. He established that every country would gain from international trade if it specialized in the production of those goods that it could produce at relatively lower costs compared to other countries, and then devoted itself to exporting those goods. Gains would also be realized if a country imported goods that it would otherwise produce at relatively higher costs compared to other countries. Ricardo argued that if a country does not follow these principles, it will inevitably experience a decline in the living standards of its population as well as a slowdown in economic growth (Ricardo, 1951).

Over time, the theory of comparative advantage has been challenged by other researchers, who primarily argued that it represents a simplified model involving only two countries, two goods, and a basic production possibility frontier. They also noted that it does not take into account transportation costs or differences in factor prices.

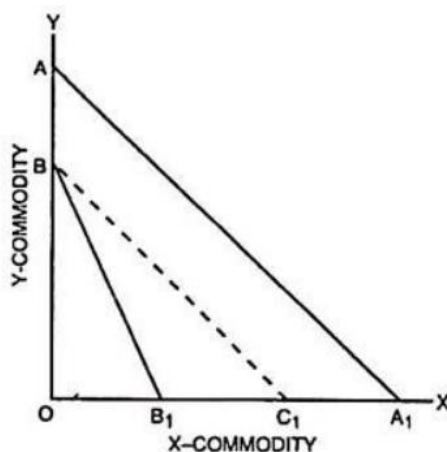


Figure 2. Comparative Advantage Theory

Source. David Ricardo's Theory of Comparative Cost Advantage. *Economics Discussion*. <https://www.economicsdiscussion.net/economic-theories/comparative-costs-theory/david-ricardos-theory-of-comparative-cost-advantage-economics/30673>

Figure 2 shows that, with the same amount of resources, country A can produce larger quantities of both goods (X and Y) than country B, which means that country A has an absolute cost advantage in the production of both goods compared to country B. It is also noticeable that country A has a comparative cost advantage in the production of good X, and will therefore specialize in its production and export. On the other hand, country B has a smaller comparative disadvantage if it produces only good Y, and will thus specialize in its production and export. If the differences in production costs are equal for both countries, there is no possibility of trade between them.

In addition, this theory assumes the fulfillment of full employment and constant returns of production factors, even though each country possesses a fixed amount of production factors and there is no mobility of factors between countries. Due to the lack of realism in the situations it describes, the theory of comparative advantage has often been subject to criticism. However, it should

not be overlooked that the phenomena described must be considered solely within the historical context in which the theory was developed.

4. NEOCLASSICAL THEORIES OF INTERNATIONAL TRADE ABOUT FOREIGN DIRECT INVESTMENT

Respecting and acknowledging certain elements of the theory of comparative advantage, the Heckscher-Ohlin model (H-O model) was developed, which advocates the acquisition of comparative advantages based on the availability of production factors in a certain country (Heckscher and Ohlin, 1991). In addition, the modern theory of international trade combines the assumptions of classical theories of international trade and the Heckscher-Ohlin model, incorporates the research findings of the authors of these theories, and attempts to explain the majority of flows in international trade through their combination.

4.1. HECKSCHER – OHLIN THEORY

This theory assumes a situation in which two countries produce two goods using two production factors (labor and capital), with constant returns and no differences in the applied technology. Comparative advantages arise from differences in resource endowments among countries, viewed from the perspective of the availability of specific production factors (Markusen, 1995). Specifically, if production uses factors that are abundant in a given country, that country should specialize in that type of production and thereby achieve comparative advantages relative to another country that lacks sufficient quantities of those factors but engages in the same type of production.

Leamer (1995) notes that if the factor in question is labor, the country should focus on labor-intensive production. Conversely, if a country is capital-abundant and seeks to achieve comparative advantages, it would be best to pursue capital-intensive production projects. Blaug (1992) agrees, emphasizing that a country should produce and export goods that utilize resources it possesses in abundance and at low cost, while importing goods that would require the use of scarce resources if produced domestically. According to the H-O model, in the absence of international trade in primary goods, production factors will move between countries until their prices are equalized. Factor mobility serves as a substitute for international trade in primary goods (Mundell, 1957). Criticisms of this theory have mostly been based on the argument that it cannot be applied in real-world situations and, like the theory of comparative advantage, has a static character.

4.2. MODERN THEORY OF INTERNATIONAL TRADE

Modern theory of international trade advocates the use of three production factors (labor, capital, and natural resources), the existence of labor division, and the achievement of comparative advantages. However, it has failed to explain many new elements, such as the emergence of firms as the main actors in trade (instead of countries), the exchange of similar products between countries, the growing importance of the state's role in international trade, and the possibility of applying various trade policy measures. The theory does not account for the increasing significance of technology as a factor of production, the role of intellectual property in international exchange, and similar developments.

Although classical theories (the Theory of Absolute Advantage and the Theory of Comparative Advantage) and neoclassical theories (the Heckscher-Ohlin model and the Modern Theory of International Trade) do not explicitly address foreign direct investment, many theorists argue that the postulates of these theories paved the way for a theoretical approach to FDI, particularly the theory of comparative advantage and the H-O factor endowment model (Haile and Assefa, 2006).

5. CONCLUSION

By comparing the classical and neoclassical theories of international trade, we come to the conclusion that the aforementioned theories, dealing with the discovery of the reasons that led a nation to start trading outside its borders, also indirectly touched on the phenomenon of foreign direct investment. By researching the relevant literature, it can be concluded that many authors, regardless of differences in certain views, still agree that FDI and international trade are mutual substitutes and complements (Mundell (1957); Carter and Yilmaz (1999); Hymer (1976) and others. Precisely because of the mentioned characteristic, FDI can more easily eliminate trade barriers.

Numerous authors support the position that FDI brings economic benefits to the host countries as they provide the necessary capital, foreign currency, technology, boost the competitiveness of the economy and contribute to achieving success in conquering new markets (Crespo and Fontura (2007); Brooks and Sumulong (2003); Romer (1993); Caves (1974) and others. In addition to the above, Brooks and Sumulong (2003) emphasize that FDI can strongly stimulate domestic investment and innovation.

The research conducted in this paper provides a scientific contribution in terms of enriching the literature that deals with theories of international trade and foreign direct investment as a phenomenon of global society. In addition, an

overview of evolutionary periods in the development of foreign direct investments and an overview of their role in the global environment provides a significant contribution

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