International Business 7e

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McGraw-Hill/Irwin

Chapter 7

Foreign Direct Investment

Introduction

- Foreign direct investment (FDI) occurs when a firm invests directly in new facilities to produce and/or market in a foreign country
- Once a firm undertakes FDI it becomes a multinational enterprise

- Two main forms of FDI:

1) **Merger & Acquisition**: company acquiring or merging with a firm in a different country (in 2005-2006 about 70% of total inflow of FDI)

2) **Greenfield investment**: a firm creating a new operation in a different country (the most important form in emerging economies)

Foreign Direct Investment : some definitions

❖The flow of FDI refers to the amount of FDI undertaken over a given time period

❖The stock of FDI refers to the total accumulated value of foreign-owned assets at a given time

❖Outflows of FDI are the flows of FDI out of a country

❖Inflows of FDI are the flows of FDI into a country

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Trends in FDI

1) Flow and stock increased dramatically in the last 20 years

❖In spite of decline of trade barriers, FDI has grown more rapidly than world trade because

- ❖Businesses fear protectionist pressures: FDI is seen as a way of circumventing trade barriers
- ❖Globalization of the world economy has raised the vision of firms who now see the entire world as their market

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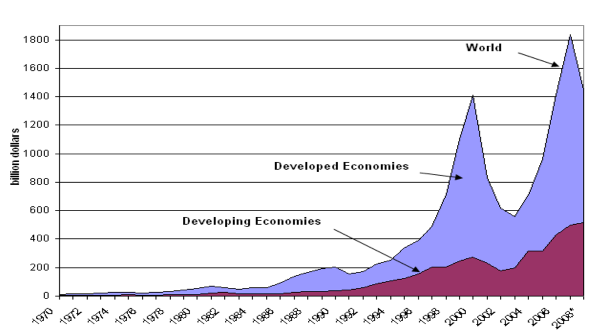
Trends in FDI: FDI inflows, 1980-2008*



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Trends in FDI: Slumping FDI

- Between 2000 and 2004 the value of FDI slumped almost 50% from $1.4 trillion to about $620 billion

  - The slowdown in FDI flows has been most pronounced in developed nations

  - The slowdown has been temporary (FDI in 2007 climbed back to more than $1.8 trillion) and reflects three developments

  a) General slowdown of the world economy

  b) Heightened geopolitical uncertainty following the September 11, 2001 attack

  c) Bursting of the stock market bubble in the US

- Slump in FDI reappeared in 2008 because of the financial crisis

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Trends in FDI: The Destination of FDI

2) Historically, most FDI has been directed at the developed nations

- The US has been the favorite target for FDI inflows
- While developed nations still account for the largest share of FDI inflows, **FDI into developing nations has increased**
  - Most recent inflows into developing nations have been targeted at the emerging economies of South, East, and Southeast Asia

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Trends in FDI: the Destination of FDI

- Gross fixed capital formation summarizes the total amount of capital invested in factories, stores, office buildings, and the like
- All else being equal, the greater the capital investment in an economy, the more favorable its future prospects are likely to be
- So, FDI can be seen as an important source of capital investment and a determinant of the future growth rate of an economy

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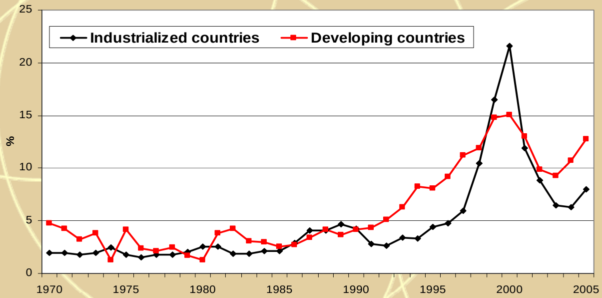
Trends in FDI: FDI inflows
(% of Gross Capital Fixed Formation)



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Trends in FDI: 3) the Source of FDI (mainly developed countries' firms)

Figure 7.5: Cumulative FDI Outflows ($ billions), 1998-2005

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Trends in FDI: the Shift to Services

4) The shift to services: in 2006 62% of FDI stock was in services (up from 49% in 1990)

It is being driven by four factors

- Reflects the general move in many developed economies away from manufacturing and toward service industries
- Many services cannot be traded internationally

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Trends in FDI: the Shift to Services

- Many countries have liberalized their regimes governing FDI in services
- The rise of Internet-based global telecommunications networks has allowed some service enterprises to relocate some of their value creation activities to different nations to take advantage of favorable factor costs

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Two forms of FDI

- **Horizontal Direct Investment (HDI)**
  - FDI in the same industry abroad as company operates at home.
- **Vertical Direct Investment (VDI)**
  - **Backward** - investments into industry that provides inputs into a firm's domestic production (typically extractive industries)
  - **Forward** - investment in an industry that utilizes the outputs from a firm's domestic production (typically sales and distribution)

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Theories of Foreign Direct Investment

- Why do firms invest rather than use exporting or licensing to enter foreign markets?
- Why do firms from the same industry undertake FDI at the same time?
- How can the pattern of foreign direct investment flows be explained?

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Why Foreign Direct Investment?

Why do firms choose FDI instead of:

❖exporting - producing goods at home and then shipping them to the receiving country for sale

or

❖licensing - granting a foreign entity the right to produce and sell the firm's product in return for a royalty fee on every unit that the foreign entity sells

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Why Foreign Direct Investment?

❖An export strategy can be constrained by transportation costs and trade barriers

❖Foreign direct investment may be undertaken as a response to actual or threatened trade barriers such as import tariffs or quotas

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Why Foreign Direct Investment?

Internalization theory (also known as market imperfections theory) suggests that licensing has three major drawbacks:

❖licensing may result in a firm's giving away valuable technological know-how to a potential foreign competitor

❖licensing does not give a firm the tight control over manufacturing, marketing, and strategy in a foreign country that may be required to maximize its profitability

❖a problem arises with licensing when the firm's competitive advantage is based not so much on its products as on the management, marketing, and manufacturing capabilities that produce those products

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The Pattern Of Foreign Direct Investment

- Firms in the same industry often undertake foreign direct investment around the same time and tend to direct their investment activities towards certain locations
- Knickerbocker looked at the relationship between FDI and rivalry in oligopolistic industries (industries composed of a limited number of large firms) and suggested that FDI flows are a reflection of strategic rivalry between firms in the global marketplace
- The theory can be extended to embrace the concept of multipoint competition (when two or more enterprises encounter each other in different regional markets, national markets, or industries)

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The Pattern Of Foreign Direct Investment

- Vernon argued that firms undertake FDI at particular stages in the life cycle of a product they have pioneered
- Firms invest in other advanced countries when local demand in those countries grows large enough to support local production, and then shift production to low-cost developing countries when product standardization and market saturation give rise to price competition and cost pressures
- Vernon fails to explain why it is profitable for firms to undertake FDI rather than continuing to export from home base, or licensing a foreign firm

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The Pattern Of Foreign Direct Investment

According to the eclectic paradigm, in addition to the various factors discussed earlier, it is important to consider:

- location-specific advantages - that arise from using resource endowments or assets that are tied to a particular location and that a firm finds valuable to combine with its own unique assets

and

- externalities - knowledge spillovers that occur when companies in the same industry locate in the same area

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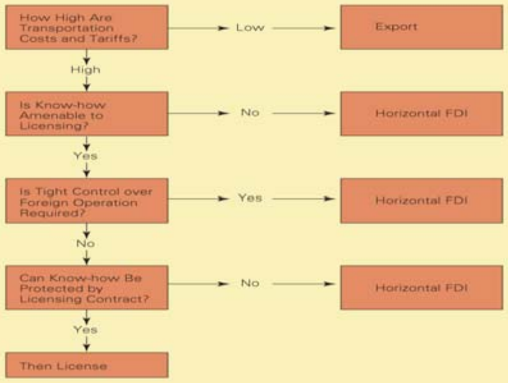
Decision Making Grid For HFDI



Political Ideology And Foreign Direct Investment

- Ideology toward FDI ranges from a radical stance that is hostile to all FDI to the non-interventionist principle of free market economies
- Between these two extremes is an approach that might be called pragmatic nationalism

The Radical View

- The radical view traces its roots to Marxist political and economic theory
- It argues that the MNE is an instrument of imperialist domination and a tool for exploiting host countries to the exclusive benefit of their capitalist-imperialist home countries

The Free Market View

- According to the free market view, international production should be distributed among countries according to the theory of comparative advantage
- The free market view has been embraced by a number of advanced and developing nations, including the United States, Britain, Chile, and Hong Kong

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Pragmatic Nationalism

- Pragmatic nationalism suggests that FDI has both benefits, such as inflows of capital, technology, skills and jobs, and costs, such as repatriation of profits to the home country and a negative balance of payments effect
- According to this view, FDI should be allowed only if the benefits outweigh the costs

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Shifting Ideology

Recently, there has been a strong shift toward the free market stance creating:

- a surge in FDI worldwide
- an increase in the volume of FDI in countries with newly liberalized regimes

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Benefits And Costs Of FDI

❖Government policy is often shaped by a consideration of the costs and benefits of FDI

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Host-Country Benefits

There are four main benefits of inward FDI for a host country:

1. resource transfer effects - FDI can make a positive contribution to a host economy by supplying capital, technology, and management resources that would otherwise not be available

2. employment effects - FDI can bring jobs to a host country that would otherwise not be created there

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Host-Country Benefits

3. balance of payments effects - a country's balance-of-payments account is a record of a country's payments to and receipts from other countries.

❖The current account is a record of a country's export and import of goods and services

❖Governments typically prefer to see a current account surplus than a deficit

❖FDI can help a country to achieve a current account surplus if the FDI is a substitute for imports of goods and services, and if the MNE uses a foreign subsidiary to export goods and services to other countries

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Host-Country Benefits

4. effects on competition and economic growth - FDI in the form of greenfield investment increases the level of competition in a market, driving down prices and improving the welfare of consumers

❖Increased competition can lead to increased productivity growth, product and process innovation, and greater economic growth

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Host-Country Costs

Inward FDI has three main costs:

1. the possible adverse effects of FDI on competition within the host nation

❖subsidiaries of foreign MNEs may have greater economic power than indigenous competitors because they may be part of a larger international organization

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Host-Country Costs

2. adverse effects on the balance of payments

❖with the initial capital inflows that come with FDI must be the subsequent outflow of capital as the foreign subsidiary repatriates earnings to its parent country

❖when a foreign subsidiary imports a substantial number of its inputs from abroad, there is a debit on the current account of the host country's balance of payments

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Host-Country Costs

3. the perceived loss of national sovereignty and autonomy

❖key decisions that can affect the host country's economy will be made by a foreign parent that has no real commitment to the host country, and over which the host country's government has no real control

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Home-Country Benefits

The benefits of FDI for the home country include:

❖the effect on the capital account of the home country's balance of payments from the inward flow of foreign earnings

❖the employment effects that arise from outward FDI

❖the gains from learning valuable skills from foreign markets that can subsequently be transferred back to the home country

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Home-Country Costs

The home country's balance of payments can suffer:

❖from the initial capital outflow required to finance the FDI

❖if the purpose of the FDI is to serve the home market from a low cost labor location

❖if the FDI is a substitute for direct exports

❖Employment may also be negatively affected if the FDI is a substitute for domestic production

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Classroom Performance System

Which of the following is not a cost of outward FDI for host countries?

a) the initial capital outflow required to finance the FDI
b) when FDI is a substitute for direct exports
c) gains from learning valuable skills from foreign markets
d) the effect on employment is FDI is a substitute for domestic production

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International Trade Theory And FDI

- International trade theory suggests that home country concerns about the negative economic effects of offshore production (FDI undertaken to serve the home market) may not be valid

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Government Policy Instruments And FDI

- Home countries and host countries use various policies to regulate FDI

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Home-Country Policies

Governments can encourage and restrict FDI:

❖To encourage outward FDI, many nations now have government-backed insurance programs to cover major types of foreign investment risk

❖To restrict outward FDI, most countries, including the United States, limit capital outflows, manipulate tax rules, or outright prohibit FDI

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Host-Country Policies

Governments can encourage or restrict inward FDI

❖To encourage inward FDI, governments offer incentives to foreign firms to invest in their countries

❖Incentives are motivated by a desire to gain from the resource-transfer and employment effects of FDI, and to capture FDI away from other potential host countries

❖To restrict inward FDI, governments use ownership restraints and performance requirements

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International Institutions And The Liberalization Of FDI

❖Until the 1990s, there was no consistent involvement by multinational institutions in the governing of FDI

❖Today, the World Trade Organization is changing this by trying to establish a universal set of rules designed to promote the liberalization of FDI

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Implications For Managers

- What are the implications of foreign direct investment for managers?
- Managers need to consider what trade theory implies, and the link between government policy and FDI

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The Theory Of FDI

- The direction of FDI can be explained through the location-specific advantages argument associated with John Dunning
- However, it does not explain why FDI is preferable to exporting or licensing

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Government Policy

- A host government’s attitude toward FDI is an important variable in decisions about where to locate foreign production facilities and where to make a foreign direct investment

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