Foreign Direct Investment
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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.

FDI is not foreign portfolio investment (investment by individuals, firms, or public bodies in foreign financial instruments)

FDI takes on two main forms:
• A greenfield investment (the establishment of a wholly new operation in a foreign country)
• Acquisition or merging with an existing firm in the foreign country
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FOREIGN DIRECT INVESTMENT IN THE WORLD ECONOMY

• 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

Over the past 20 years there has been a marked increase in both the flow and stock of FDI in the world economy.

FDI has grown more rapidly than world trade and world output because:

- firms still fear the threat of protectionism
- the general shift toward democratic political institutions and free market economies has encouraged FDI
- the globalization of the world economy is having a positive impact on the volume of FDI as firms undertake FDI to ensure they have a significant presence in many regions of the world
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The Direction of FDI

- Historically, most FDI has been directed at the developed nations of the world, with the United States being a favorite target.

- FDI inflows have remained high during the early 2000s for the United States, and also for the European Union.

- South, East, and Southeast Asia, and particularly China, are now seeing an increase of FDI inflows.

- Latin America is also emerging as an important region for FDI.
The crisis ends the 4 year global FDI boom

FDI Flows ($ billions)

- Global FDI declined from $2 trillion in 2007 to $1.7 trillion in 2008.
- FDI flows to developed economies fell by 29%, to $962 billion.
- FDI flows to developing economies rose 17%, to $621 billion.
- Transition economies posted a new record high, with inflows reaching $114 billion, a 26% increase.
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- **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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The Source of Foreign Direct Investment

• For most of the period after World War II, the U.S. was by far the largest source country for FDI

• Other important source countries were the United Kingdom, the Netherlands, France, Germany, and Japan
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The Form of FDI: Acquisitions versus Greenfield Investments

The majority of cross-border investment is in the form of mergers and acquisitions rather than greenfield investments.

Firms prefer to acquire existing assets because:
- mergers and acquisitions are quicker to execute than greenfield investments
- it is easier and perhaps less risky for a firm to acquire desired assets than build them from the ground up
- firms believe that they can increase the efficiency of an acquired unit by transferring capital, technology, or management skills
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The Shift to Services

Over the last 20 years, there has been a shift away from FDI in extractive industries and manufacturing, and towards services. The shift to services is being driven by:

• the general move in many developed countries toward services
• the fact that many services need to be produced where they are consumed
• a liberalization of policies governing FDI in services
• the rise of Internet-based global telecommunications networks that have allowed some service enterprises to relocate some of their value creation activities to different nations to take advantage of favorable factor costs
Why Foreign Direct Investment?

Why do firms prefer FDI to either 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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Limitations of Exporting

• The viability of an exporting 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
Limitations of Licensing

**Internalization theory** suggests that licensing has three major drawbacks as a strategy for exploiting foreign market opportunities:

- 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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Advantages of Foreign Direct Investment

• A firm will favor FDI over exporting as an entry strategy when transportation costs or trade barriers make exporting unattractive

• A firm will favor FDI over licensing when it wishes to maintain control over its technological know-how, or over its operations and business strategy, or when the firm’s capabilities are simply not amenable to licensing
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.
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Strategic Behavior

• 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 Product Life Cycle

Vernon’s view is 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.
The Eclectic Paradigm

John Dunning’s eclectic paradigm argues that in addition to the various factors discussed earlier, 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) must also be considered when explaining both the rationale for and the direction of foreign direct investment.
POLITICAL IDEOLOGY AND FOREIGN DIRECT INVESTMENT

Ideology toward FDI has 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

Supporters of the radical view, which traces its roots to Marxist political and economic theory, argue 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.
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This position lacked support by the end of the 1980s because of:

- the collapse of communism in Eastern Europe
- the poor economic performance of those countries that followed the policy
- a growing belief by many of these countries that FDI can be an important source of technology and jobs and can stimulate economic growth
- the strong economic performance of developing countries that embraced capitalism rather than ideology
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The Free Market View

• The free market view argues that 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

• The pragmatic nationalist view is 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

Shifting Ideology

• In recent years, there has been a strong shift toward the free market stance creating a surge in FDI
BENEFITS AND COSTS OF FDI

Host Country Benefits

The main benefits of inward FDI for a host country are:

- the resource transfer effect
- the employment effect
- the balance of payments effect
- effects on competition and economic growth
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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

Employment Effects

• FDI can bring jobs to a host country that would otherwise not be created there
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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
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FDI can help a country to achieve a current account surplus:

• if the FDI is a substitute for imports of goods and services

• if the MNE uses a foreign subsidiary to export goods and services to other countries
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Effect 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

There are three main costs of inward FDI:

• the possible adverse effects of FDI on competition within the host nation
• adverse effects on the balance of payments
• the perceived loss of national sovereignty and autonomy
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Adverse Effects on Competition

- Host governments worry that the subsidiaries of foreign MNEs operating in their country may have greater economic power than indigenous competitors because they may be part of a larger international organization.
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Adverse Effects on the Balance of Payments

There are two possible adverse effects of FDI on a host country’s 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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National Sovereignty and Autonomy

• Many host governments worry that FDI is accompanied by some loss of economic independence

• The concern is that 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 to 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 most important concerns center around the balance-of-payments and employment effects of outward FDI.

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.
GOVERNMENT POLICY INSTRUMENTS AND FDI

Home Country Policies

Home countries can both encourage and restrict FDI by local firms.
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Encouraging Outward FDI

• Many investor nations now have government-backed insurance programs to cover major types of foreign investment risk

Restricting Outward FDI

• Virtually all investor countries, including the United States, have exercised some control over outward FDI from time to time
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Host Country Policies

Host countries adopt policies designed both to restrict and to encourage inward FDI.
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Encouraging 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
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Restricting Inward FDI

The most common controls to restrict FDI are ownership restraints and performance requirements.

The rationale underlying ownership restraints is twofold:
• first, foreign firms are often excluded from certain sectors on the grounds of national security or competition
• second, ownership restraints seem to be based on a belief that local owners can help to maximize the resource transfer and employment benefits of FDI for the host country
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International Institutions and the Liberalization of FDI

• Until recently there has been no consistent involvement by multinational institutions in the governing of FDI

• The formation of the World Trade Organization in 1995 is changing this
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IMPLICATIONS FOR MANAGERS

The Theory of FDI

• The location-specific advantages argument associated with John Dunning help explain the direction of FDI

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