Global Business Today 6e

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Chapter 7

Foreign Direct Investment

Introduction

Question: What is foreign direct investment?

- 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
- There are two forms of FDI
  - 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

Foreign Direct Investment in the World Economy

- There are two ways to look at FDI
  - 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

Classroom Performance System

A company that establishes a new operation in a foreign country has made

a) An acquisition

b) A merger

c) A greenfield investment

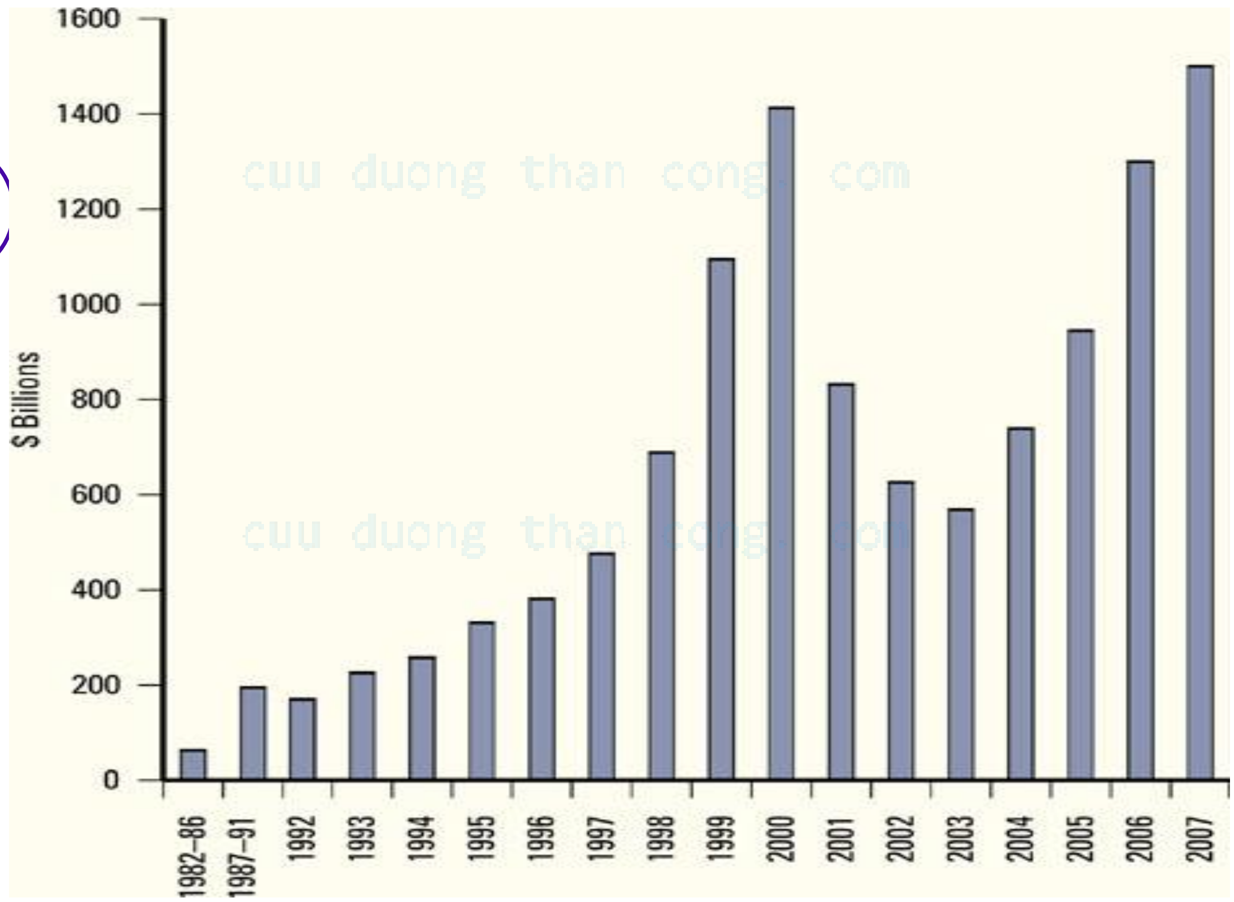
d) A joint venture

Trends in FDI

- Both the flow and stock of FDI in the world economy has increased over the last 20 years
- 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 prompting firms to undertake FDI to ensure they have a significant presence in many regions of the world

Trends in FDI

FDI Outflows 1982-2007

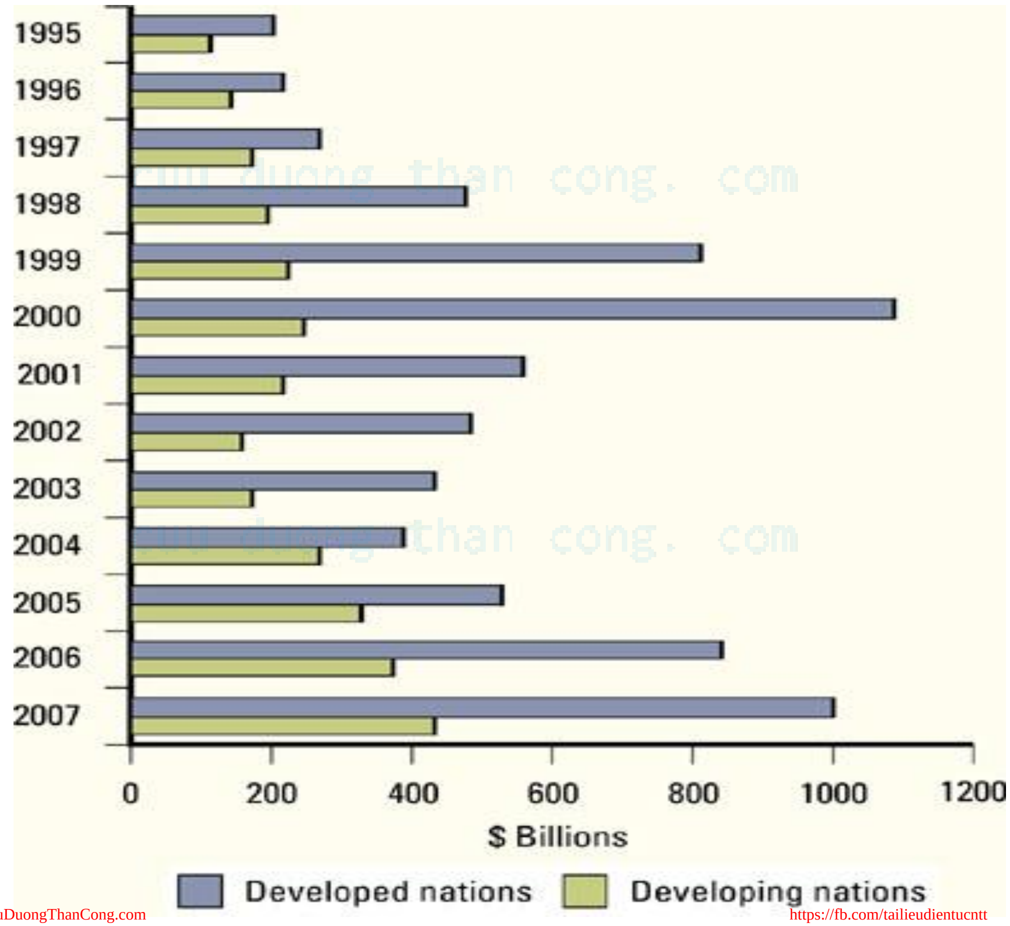


The Direction of FDI

- 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 Direction of FDI

FDI Inflows by Region 1995 -2007



The Direction of FDI

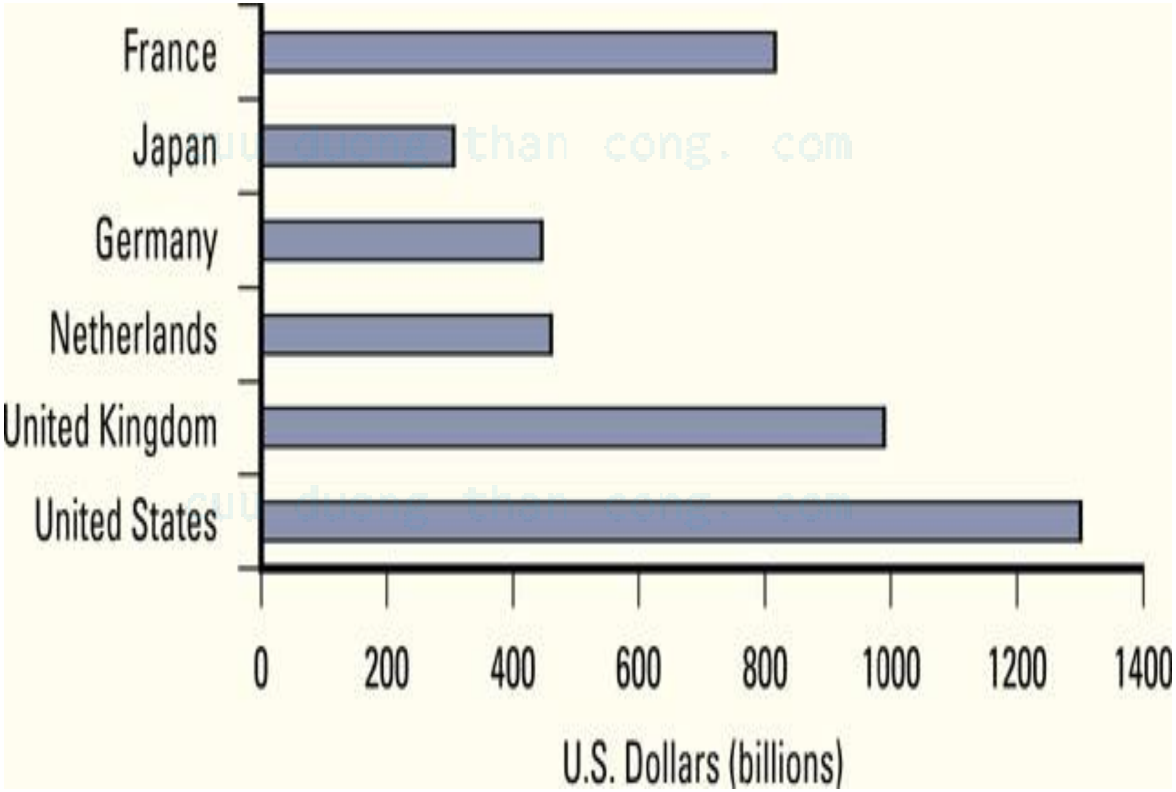
- FDI can also be expressed as a percentage of gross fixed capital formation summarizes (the total amount of capital invested in factories, stores, office buildings, and the like)
- All else being equal, the greater the capital investment in an economy, the more favorable its future prospects are likely 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

The Source of FDI

- Since World War II, the U.S. has been the largest source country for FDI
- Other important source countries include the United Kingdom, the Netherlands, France, Germany, and Japan
- These countries also predominate in rankings of the world's largest multinationals

The Source of FDI

Cumulative FDI Outflows 1998 - 2006



The Form of FDI: Acquisitions versus Greenfield Investments

- The majority of cross-border investment involves 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 they can increase the efficiency of an acquired unit by transferring capital, technology, or management skills

The Shift to Services

- In the last two decades, there has been a shift towards FDI in services
- The shift to services is being driven by
  - the general move in many developed countries toward services
  - the fact that many services cannot be exported
  - 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

Classroom Performance System

Which of the following statements is true?

a) Over the years, there has been a marked decrease in the stock and flow of FDI

b) Over the years, there has been a marked increase in the stock and flow of FDI

c) Over the years, there has been a marked decrease in the stock and an increase in the flow of FDI

d) Over the years, there has been a marked increase in the stock and an decrease in the flow of FDI

Theories of Foreign Direct Investment

Question: 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)?

- To answer this question, we need to look at the limitations of exporting and licensing, and the advantages of FDI

Theories of Foreign Direct Investment

1. Limitations of Exporting

- The viability of an exporting strategy can be constrained by transportation costs and trade barriers
  - When transportation costs are high, exporting can be unprofitable
  - Foreign direct investment may be a response to actual or threatened trade barriers such as import tariffs or quotas

Theories of Foreign Direct Investment

2. Limitations of Licensing

- Internalization theory (also known as market imperfections) suggests that licensing has three major drawbacks
  1. it may result in a firm's giving away valuable technological know-how to a potential foreign competitor
  2. it 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
  3. It may be difficult if the firm's competitive advantage is not amendable to licensing

The Pattern of Foreign Direct Investment

3. Advantages of Foreign Direct Investment

- A firm will favor FDI over exporting as an entry strategy when
  - transportation costs are high
  - trade barriers are high
- A firm will favor FDI over licensing when
  - it wants control over its technological know-how
  - it wants over its operations and business strategy
  - the firm’s capabilities are not amenable to licensing

The Pattern of Foreign Direct Investment

- It is common for firms in the same industry to
  1. have similar strategic behavior and undertake foreign direct investment around the same time
  2. direct their investment activities towards certain locations at certain stages in the product life cycle

The Pattern of Foreign Direct Investment

1. Strategic Behavior

- Knickerbocker explored the relationship between FDI and rivalry in oligopolistic industries (industries composed of a limited number of large firms)
- Knickerbocker suggested that FDI flows are a reflection of strategic rivalry between firms in the global marketplace
- This 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)

The Pattern of Foreign Direct Investment

2. The Product Life Cycle

- Vernon argues 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
- Firms then shift production to low-cost developing countries when product standardization and market saturation give rise to price competition and cost pressures

The Eclectic Paradigm

- John Dunning's eclectic paradigm argues that in addition to the various factors discussed earlier, two additional factors must be considered when explaining both the rationale for and the direction of foreign direct investment
  - 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)
  - externalities (knowledge spillovers that occur when companies in the same industry locate in the same area)

Classroom Performance System

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 are

a) First mover advantages

b) Location advantages

c) Externalities

d) Proprietary advantages

Political Ideology and Foreign Direct Investment

- Ideology toward FDI has ranged 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 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 radical view has been in retreat because of
  - the collapse of communism in Eastern Europe
  - the poor economic performance of those countries that had embraced the policy
  - the strong economic performance of developing countries that had embraced capitalism

The Free Market View

- The free market view argues that international production should be distributed among countries according to the theory of comparative advantage
  - So, the MNE increases the overall efficiency of the world economy
- The free market view has been embraced by advanced and developing nations, including the United States, Britain, Chile, and Hong Kong

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 the volume of FDI worldwide
  - an increase in the volume of FDI directed at countries that have recently liberalized their regimes

Benefits and Costs of FDI

Question: What are the benefits and costs of FDI?

- The benefits and costs of FDI must be explored from the perspective of both the host (receiving) country and the home (source) country

Host Country Benefits

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

1. the resource transfer effect
2. the employment effect
3. the balance of payments effect
4. effects on competition and economic growth

Host Country Benefits

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

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
- A current account surplus is usually favored over a deficit
- FDI can help 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

Host Country Benefits

4. Effect on Competition and Economic Growth

- FDI in the form of greenfield investment
  - increases the level of competition in a market
  - drives down prices
  - improves the welfare of consumers
- Increased competition can lead to
  - increased productivity growth
  - product and process innovation
  - greater economic growth

Classroom Performance System

Benefits of FDI include all of the following except

a) The resource transfer effect

b) The employment effect

c) The balance of payments effect

d) National sovereignty and autonomy

Host Country Costs

- There are three main costs of inward FDI

1. the possible adverse effects of FDI on competition within the host nation
2. adverse effects on the balance of payments
3. the perceived loss of national sovereignty and autonomy

Host Country Costs

1. 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
  - As part of larger organization, the MNE could draw on funds generated elsewhere to subsidize costs in the local market
  - Doing so could allow the MNE to drive indigenous competitors out of the market and create a monopoly position

Host Country Costs

2. 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

Host Country Costs

3. National Sovereignty and Autonomy

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

Home Country Benefits

- The benefits of FDI to the home country include
  1. the effect on the capital account of the home country's balance of payments from the inward flow of foreign earnings
  2. the employment effects that arise from outward FDI
  3. the gains from learning valuable skills from foreign markets that can subsequently be transferred back to the home country

Home Country Costs

- The most important concerns for the home country center around
  1. The balance-of-payments
     - The balance of payments suffers from the initial capital outflow required to finance the FDI
     - The current account is negatively affected if the purpose of the FDI is to serve the home market from a low-cost production location
     - The current account suffers if the FDI is a substitute for direct exports

Home Country Costs

2. Employment effects of outward FDI

- If the home country is suffering from unemployment, there may be concern about the export of jobs

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
  - FDI may actually stimulate economic growth by freeing home country resources to concentrate on activities where the home country has a comparative advantage
  - Consumers may also benefit in the form of lower prices

Government Policy Instruments and FDI

- FDI can be regulated by both home and host countries
- Governments can implement policies to

1. encourage FDI
2. discourage FDI

Home Country Policies

1. Encouraging Outward FDI

- Many nations now have government-backed insurance programs to cover major types of foreign investment risk
  - This type of policy can encourage firms to undertake FDI in politically unstable nations
- Many countries have eliminated also double taxation of foreign income
- Many host nations have relaxed restrictions on inbound FDI

Home Country Policies

2. Restricting Outward FDI

- Virtually all investor countries, including the United States, have exercised some control over outward FDI from time to time
- Some countries manipulate tax rules to make it more favorable for firms to invest at home
- Countries may restrict firms from investing in certain nations for political reasons

Host Country Policies

1. 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

Host Country Policies

2. Restricting Inward FDI

- Ownership restraints and performance requirements (controls over the behavior of the MNE's local subsidiary) are used to restrict FDI
- Ownership restraints
  - exclude foreign firms from certain sectors on the grounds of national security or competition
  - are often based on a belief that local owners can help to maximize the resource transfer and employment benefits of FDI
- Performance requirements are used to maximize the benefits and minimize the costs of FDI for the host country

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
  - The WTO has had some success in establishing a universal set of rules to promote the liberalization of FDI

Implications for Managers

Question: What does FDI mean for international businesses?

- The theory of FDI has implications for strategic behavior of firms
- Government policy on FDI can also be important for international businesses

The Theory of FDI

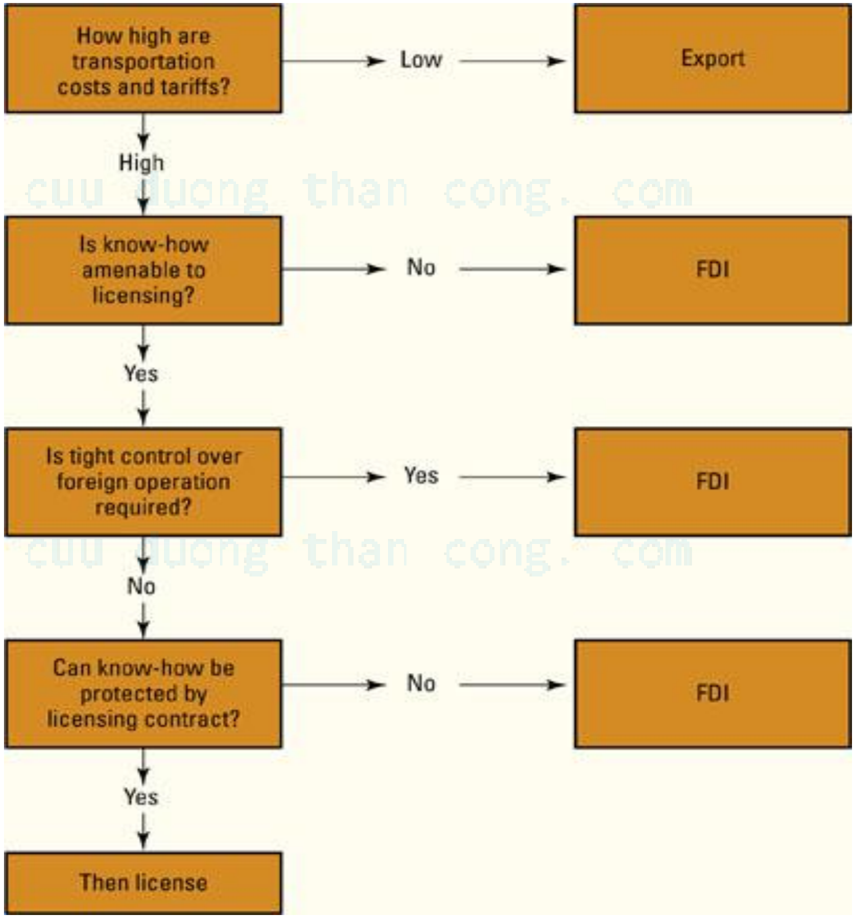
- The location-specific advantages argument associated with John Dunning help explain the direction of FDI
- However, internalization theory is needed to explain why firms prefer FDI to licensing or exporting
  - Exporting is preferable to licensing and FDI as long as transportation costs and trade barriers are low

The Theory of FDI

- Licensing is unattractive when
  - the firm's proprietary property cannot be properly protected by a licensing agreement
  - the firm needs tight control over a foreign entity in order to maximize its market share and earnings in that country
  - the firm's skills and capabilities are not amenable to licensing

The Theory of FDI

A Decision Framework



Government Policy

- A host government's attitude toward FDI is an important in decisions about where to locate foreign production facilities and where to make a foreign direct investment
- A firm's bargaining power with the host government is highest when
  - the host government places a high value on what the firm has to offer
  - when there are few comparable alternatives available
  - when the firm has a long time to negotiate

Critical Discussion Question

1. In 2004, inward FDI accounted for some 24 percent of gross capital formation in Ireland, but only 0.6 percent in Japan. What do you think explains this difference in FDI inflows into the two countries?

Critical Discussion Question

2. Compare and contrast these explanations of FDI: internalization theory, Vernon’s product life cycle theory, and Knickerbocker’s theory of FDI. Which theory do you think offers the best explanation of the historical pattern of horizontal FDI? Why?

Critical Discussion Question

3. Reread the Management Focus on Cemex and then answer the following questions:

a) Which theoretical explanation, or explanations, of FDI best explains Cemex's FDI?

b) What is the value that Cemex brings to the host economy? Can you see any potential drawbacks of inward investment by Cemex in an economy?

c) Cemex has a strong preference for acquisitions over greenfield ventures as an entry mode. Why?

d) Why do you think Cemex decided to exit Indonesia after failing to gain majority control of Semen Gresik? Why is majority control so important to Cemex?

e) Why do you think politicians in Indonesia tried to block Cemex's attempt to gain majority control over Semen Gresik? Do you think Indonesia's best interests were served by limiting Cemex's FDI in the country?

Critical Discussion Question

4. You are the international manager of a US business that has just invented a revolutionary new personal computer that can perform the same functions as PCs, but costs only half as much to manufacture. Your CEO has asked you to decide how to expand into the European Union market. Your options are (i) to export from the United States, (ii) to license a European firm to manufacture and market the computer in Europe, and (iii) to set up a wholly owned subsidiary in Europe. Evaluate the pros and cons of each alternative and suggest a course of action to your CEO.