

International Business Management

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Lecture 4

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Chapter 4: Foreign Direct Investment

Learning Objectives

- 4-1 Recognize current trends regarding foreign direct investment (FDI) in the world economy.
- 4-2 Explain the different theories of FDI.
- 4-3 Understand how political ideology shapes a government's attitudes toward FDI.
- 4-4 Describe the benefits and costs of FDI to home and host countries.
- 4-5 Explain the range of policy instruments that governments use to influence FDI.
- 4-6 Identify the implications for managers of the theory and government policies associated with FDI.

Opening Case: Geely Goes Global

Geely, a Chinese auto manufacturer founded by Li Shufu in 1986, began as a manufacturer of refrigerators

Quickly became second largest automobile manufacturer in China

Li's personal favorite car maker was Volvo and he bought it in 2009

- Gained brand name, engineering and design skills

China has emerged as a major market for Volvo

Geely pledged to produce a “death-proof” car by 2020

Following its success with Volvo, Geely now making foreign investments in British, Malaysian, and Swedish automobile industries

Introduction

Foreign direct investment (FDI): a firm invests directly in new facilities to produce or market in a foreign country

- According to U.S. Department of Commerce, FDI occurs when there is a 10 percent interest taken in a foreign business entity
- A firm engaged in FDI is a multinational enterprise

Foreign Direct Investment in the World Economy ¹

Flow of FDI: the amount of FDI undertaken over a given time period

Stock of FDI: the total accumulated value of foreign-owned assets at a given time

Outflows of FDI: the flows of FDI out of a country

Inflows of FDI: the flows of FDI into a country

Foreign Direct Investment in the World Economy 2

Trends in FDI

- Both the flow and stock of FDI in the world economy have increased over the last 25 years
- FDI flow has grown more rapidly than world trade and world output
 - Firms still fear protectionist policies
 - The shift toward democratic political institutions and free market economies encourages FDI
 - Globalization is prompting firms to ensure they have a significant presence in many regions of the world

Foreign Direct Investment in the World Economy 3

The Direction of FDI

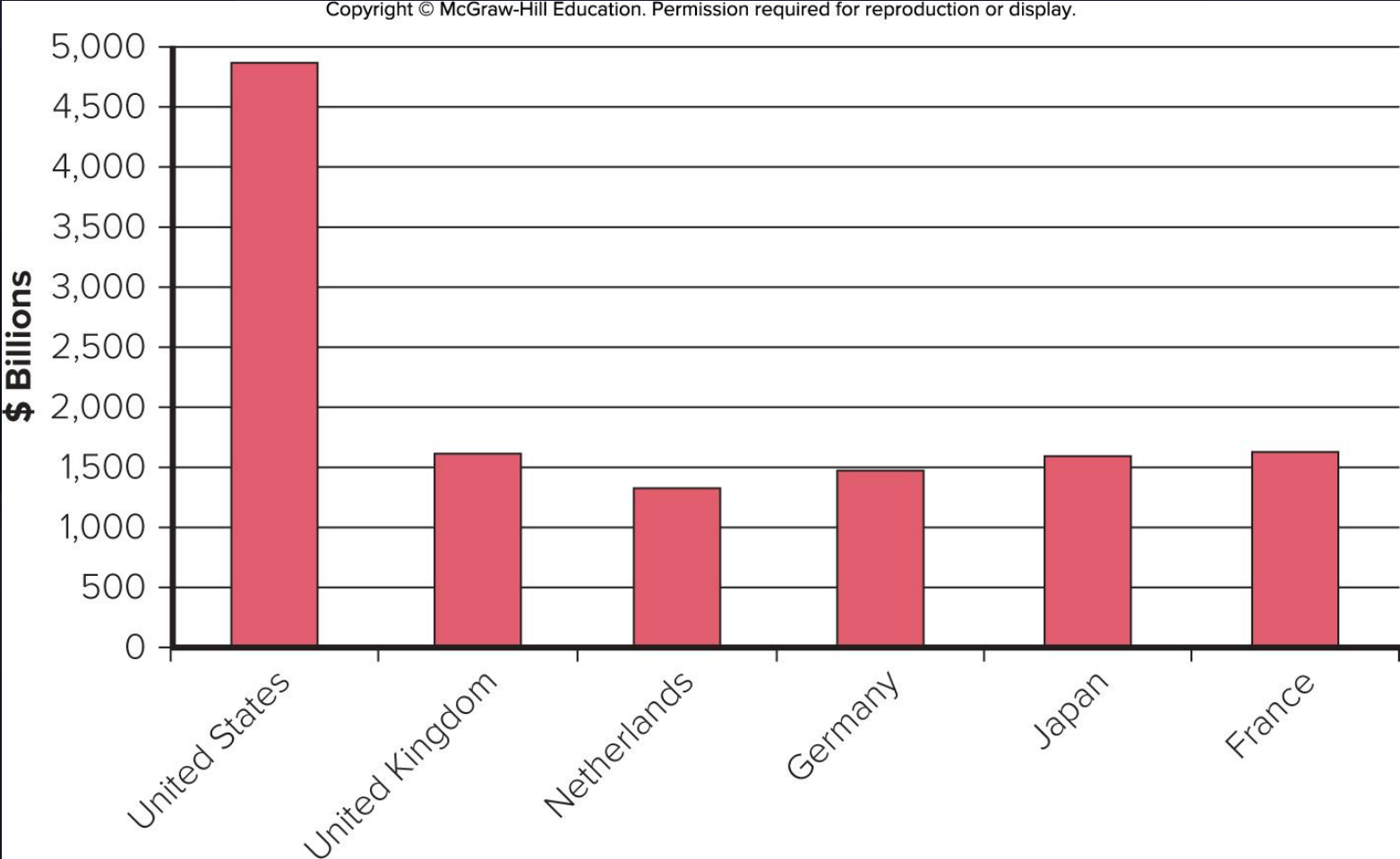
- Historically, most FDI has been directed at the developed nations of the world
 - United States and European Union are favorite targets
- More recently, developing nations have been the recipients of FDI
 - South, East, and Southeast Asia — particularly China — have received significant inflows
 - Latin America is also emerging as an important region for FDI
 - China is becoming a major investor in Africa especially in the extraction industries

Foreign Direct Investment in the World Economy 4

The Source of FDI

- Since World War II, the U.S. has been the largest source country for FDI
- Other important source countries: the United Kingdom, the Netherlands, France, Germany, and Japan
- Chinese firms recently emerging as major foreign investors

Figure 4.3 Cumulative FDI Outflows, 1998 to 2017 (\$ billions)



[Access the text alternative for these images.](#)

Foreign Direct Investment in the World Economy 5

The Form of FDI: Acquisitions versus Greenfield Investments

- **Greenfield investments:** establishing new operations in a foreign country
- Acquisitions are attractive because:
 - They are quicker to execute than greenfield investments
 - It is easier and 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

Theories of Foreign Direct Investment ¹

Three complementary perspectives

- Why does a firm favor direct investment over exporting and licensing?
- Why do firms in same industry undertake foreign direct investment at the same time and favor certain locations as targets for FDI?
- **Eclectic paradigm** combines these two perspectives

Theories of Foreign Direct Investment ²

Why Foreign Direct Investment?

- **Exporting:** producing goods at home and then shipping them to the receiving country for sale
- **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

Theories of Foreign Direct Investment ₃

Why Foreign Direct Investment? continued

- Limitations of Exporting
 - An exporting strategy can be limited by transportation costs and trade barriers
 - When transportation costs are high, exporting can be unprofitable
 - Low value-to-weight ratio
 - Foreign direct investment may be a response to actual or threatened trade barriers such as import tariffs or quotas

Theories of Foreign Direct Investment ⁴

Why Foreign Direct Investment? continued

- Limitations of Licensing
 - **Internalization theory** (or **market imperfections** approach)
 - Licensing could 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
 - Licensing may be difficult if the firm's competitive advantage is not amenable to it

Theories of Foreign Direct Investment ⁵

Why Foreign Direct Investment? continued

- Advantages of Foreign Direct Investment
 - FDI will be favored over exporting when:
 - Transportation costs are high
 - Trade barriers are high
 - FDI will be favored over licensing when:
 - The firm wants control over its technological know-how
 - The firm wants control over its operations and business strategy
 - The firm's capabilities are not amenable to licensing

Theories of Foreign Direct Investment ⁶

The Pattern of Foreign Direct Investment

- Strategic Behavior
 - Knickerbocker explored the relationship between FDI and rivalry in **oligopolistic** industries — industries composed of a limited number of large firms
 - FDI flows reflect strategic rivalry between firms
 - This theory can be extended to **multipoint competition** — when two or more enterprises encounter each other in different regional markets, national markets, or industries
 - Firms will try to match each other's moves in different markets to try to hold each other in check

Theories of Foreign Direct Investment 7

The Eclectic Paradigm

- Dunning's eclectic paradigm: 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:** 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

Location Factors and FDI



Silicon Valley, where Google is based, has long been known as the epicenter of the computer and semiconductor industry.

Political Ideology and Foreign Direct Investment ¹

Ideology toward FDI has ranged from a radical stance that is hostile to all FDI to the noninterventionist principle of free market economies

- Between these two extremes is an approach that might be called pragmatic nationalism

Political Ideology and Foreign Direct Investment 2

The Radical View

- 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 since the 1990s due to:
 - The collapse of communism in Eastern Europe
 - The poor economic performance of those countries that embraced the policy
 - The strong economic performance of developing countries that embraced capitalism

Political Ideology and Foreign Direct Investment 3

The Free Market View

- International production should be distributed among countries according to the theory of comparative advantage
 - Countries should specialize in the production of goods and services they can produce most efficiently
 - FDI by the MNE increases the overall efficiency of the world economy

Political Ideology and Foreign Direct Investment 4

Pragmatic Nationalism

- FDI has benefits and costs
 - Benefits: inflows of capital, technology, skills, and jobs
 - Costs: repatriation of profits to the home country and a negative balance of payments effect
- FDI should be allowed only if benefits outweigh the costs
- Tendency to aggressively court FDI believed to be in the national interest by offering subsidies

Political Ideology and Foreign Direct Investment 5

Shifting Ideology

- In recent years, there has been a strong shift toward the free market stance
 - A surge in the volume of FDI worldwide
 - An increase in the volume of FDI directed at countries that have recently liberalized their regimes
 - China, India, Vietnam
- But, some countries are becoming more hostile to FDI
 - Venezuela, Bolivia

Benefits and Costs of FDI ₁

Host-Country Benefits

- Resource-Transfer Effects
 - FDI can bring capital, technology, and management resources that would otherwise not be available
- Employment Effects
 - FDI can bring jobs that would otherwise not be created there
 - Opponents say not all “new jobs” represent net additions in employment

FDI and Job Creation

Job creation is a result of FDI. These workers assemble cars at a manufacturing plant in Chakan, Maharashtra, India.



Benefits and Costs of FDI ₂

Host-Country Benefits continued

- Balance-of-Payments Effects
 - The **balance-of-payments account** records a country's payments to and receipts from other countries
 - The **current account** records a country's export and import of goods and services
 - A surplus is usually favored over a deficit
 - FDI can help achieve a current account surplus
 - If it is a substitute for imports of goods and services
 - If the MNE uses a foreign subsidiary to export goods and services to other countries

Benefits and Costs of FDI ₃

Host-Country Benefits continued

- 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 leads to:
 - Increased productivity growth
 - Product and process innovation
 - Greater economic growth

Does Foreign Direct Investment Promote Growth?

There are multiple reasons for companies to make foreign direct investments. Lowering the cost of production, increasing capacity (volume) of production, and strategically locating production facilities to serve world regions are some of the many reasons for FDI by a company. For the host countries that receive the investment by multinational corporations, the logic is that the influx of capital and increase in tax revenues will benefit the host country in the form of new infrastructure, increased knowledge, and general economic development. However, the evidence so far is very mixed on the value of FDI to the host, ranging from beneficial to detrimental. **What do you think? Does FDI promote growth in the host country?**

Benefits and Costs of FDI 4

Host-Country Costs

- Adverse Effects on Competition
 - The subsidiaries of foreign MNEs may have greater economic power than indigenous competitors because they may be part of a larger international 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

Benefits and Costs of FDI ⁵

Host-Country Costs continued

- Adverse Effects on the Balance of Payments
 - Two possible adverse effects of FDI on a host country's balance-of-payments:
 1. The capital outflows as foreign subsidiaries repatriate earnings to the parent country
 2. There is a debit on the current account of the host country's balance of payments associated with imports of input products by the foreign subsidiary

Benefits and Costs of FDI 6

Host-Country Costs continued

- Possible Effects on National Sovereignty and Autonomy
 - FDI can mean 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

Benefits and Costs of FDI 7

Home-Country Benefits

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

Benefits and Costs of FDI 8

Home-Country Costs

- Balance-of-payments
 - Suffers from the initial capital outflow required to finance the FDI
 - Current account is negatively affected if the purpose of the FDI is to serve the home market from a low-cost production location
 - Current account suffers if the FDI is a substitute for direct exports
- Employment effects of outward FDI
 - If the home country is suffering from unemployment, there may be concern about the export of jobs

Benefits and Costs of FDI 9

International Trade Theory and FDI

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 ¹

Home-Country Policies

- Encouraging Outward FDI
 - Have government-backed insurance programs to cover major types of foreign investment risk
 - Have special funds or banks that make governmental loans to firms investing in developing countries
 - Have eliminated double taxation of foreign income
 - Many host nations have relaxed restrictions on inbound FDI

Government Policy Instruments and FDI ₂

Home-Country Policies continued

- Restricting Outward FDI
 - Virtually all investor countries, including United States, have exercised some control over outward FDI from time to time
 - 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

Government Policy Instruments and FDI ₃

Host-Country Policies

- Encouraging Inward FDI
 - Governments offer incentives to foreign firms to invest in their countries
 - Gain from the resource-transfer and employment effects of FDI
 - Capture FDI away from other potential host countries

Government Policy Instruments and FDI ⁴

Host-Country Policies continued

- Restricting Inward FDI
 - Ownership restraints:
 - Exclude foreign firms from certain sectors on the grounds of national security or competition
 - Local owners can help maximize the resource-transfer and employment benefits of FDI
 - Performance requirements:
 - Used to maximize the benefits and minimize the costs of FDI for the host country

Government Policy Instruments and FDI ⁵

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 changed this

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

Focus on Managerial Implications ¹

FDI and Government Policy

- The Theory of FDI
 - The location-specific advantages argument associated with Dunning help explain the *direction* of FDI
 - However, internalization theory is needed to explain *why* firms prefer FDI to licensing or exporting

Focus on Managerial Implications ₂

The Theory of FDI continued

- Exporting is preferable to licensing and FDI as long as transportation costs and trade barriers are low
- 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

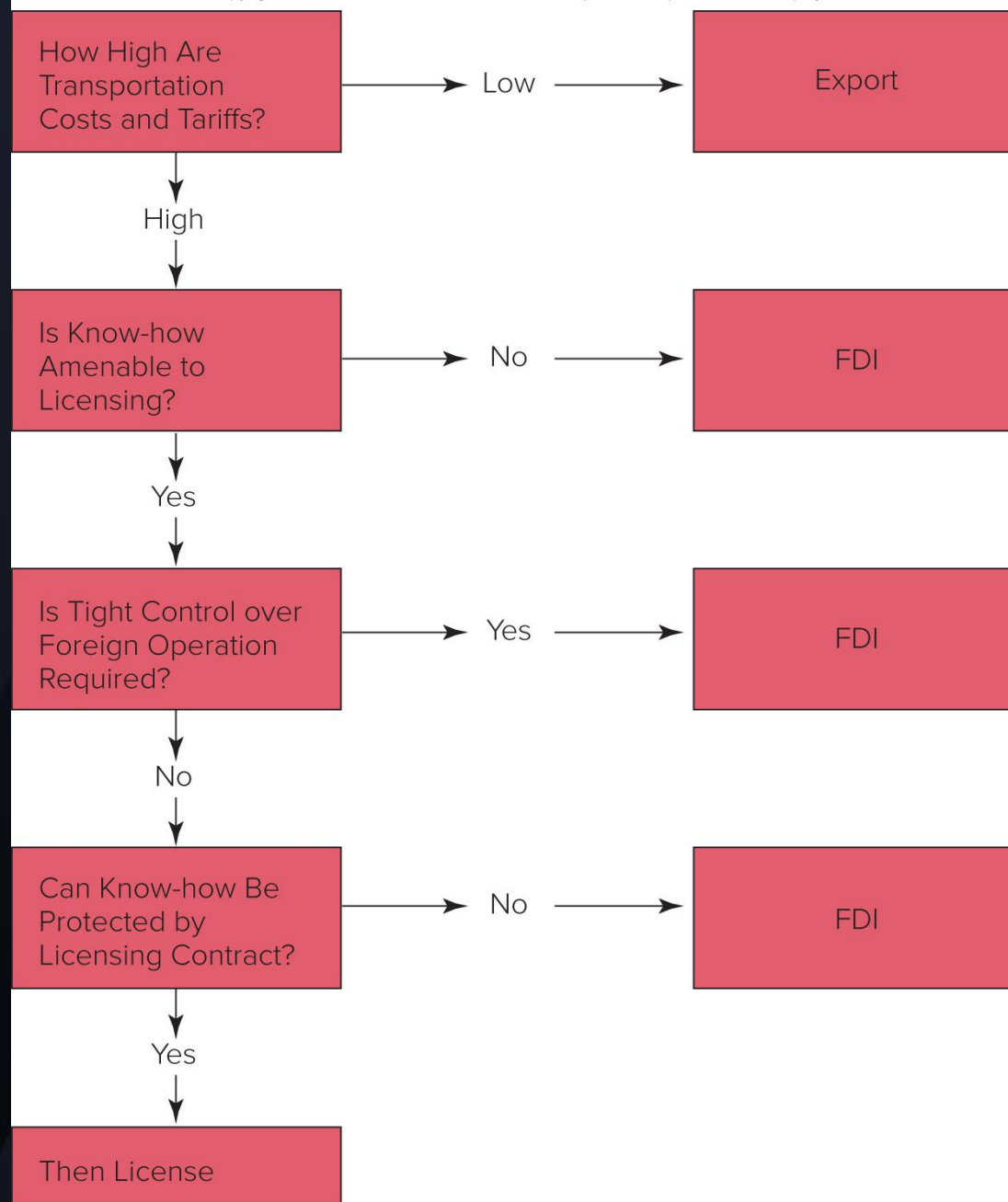


Figure 8.4
A Decision
Framework

Thank you