CHAPTER 7
FOREIGN DIRECT INVESTMENT

LEARNING OBJECTIVES:
1. Describe worldwide patterns of foreign direct investment (FDI) and reasons for these patterns.
2. Describe each of the theories that attempt to explain why foreign direct investment occurs.
3. Discuss the important management issues in the foreign direct investment decision.
4. Explain why governments intervene in the free flow of foreign direct investment.
5. Discuss the policy instruments that governments use to promote and restrict foreign direct investment.

CHAPTER OUTLINE:

Introduction
Patterns of Foreign Direct Investment
   Ups and Downs of Foreign Direct Investment
      Globalization
      Mergers and Acquisitions
      Role of Entrepreneurs and Small Businesses
   Worldwide Flows of FDI
Explanations for Foreign Direct Investment
   International Product Life Cycle
   Market Imperfections (Internalization)
      Trade Barriers
      Specialized Knowledge
   Eclectic Theory
   Market Power
Management Issues in the FDI Decision
   Control
      Partnership Requirements
      Benefits of Cooperation
   Purchase-or-Build Decision
   Production Costs
      Rationalized Production
      Focus on the Mexican Maquiladora
      Cost of Research and Development
   Customer Knowledge
   Following Clients
   Following Rivals
Government Intervention in Foreign Direct Investment
   Balance of Payments
      Current Account
      Capital Account
   Reasons for Intervention by the Host Country
      Balance of Payments
      Obtain Resources and Benefits
         Access to Technology
         Management Skills and Employment
Reasons for Intervention by the Home Country

Government Policy Instruments and FDI

Host Countries: Promotion
- Financial Incentives
- Infrastructure Improvements

Host Countries: Restriction
- Ownership Restrictions
- Performance Demands

Home Countries: Promotion

Home Countries: Restriction

Bottom Line for Business

National Governments and FDI
Foreign Direct Investment in Europe
Foreign Direct Investment in Asia

A comprehensive set of specially designed PowerPoint slides (designated ‘PPT’ below) is available for use with Chapter 7. These slides and the lecture outline below form a completely integrated package that simplifies the teaching of this chapter’s material.

Lecture Outline

1. INTRODUCTION (PPT #3)

   Foreign direct investment (FDI) is the purchase of physical assets or a significant amount of the ownership (stock) of a company in another country to gain a measure of management control. It differs from portfolio investment—an investment that does not involve obtaining a degree of control in a company. Most governments set the threshold for an investment to be called FDI at anywhere from 10 to 25 percent of stock ownership in a company abroad—the U.S. Commerce Department sets it at 10 percent.

2. PATTERNS OF FOREIGN DIRECT INVESTMENT (PPT #4-7)

   A. Ups and Downs of Foreign Direct Investment

      After growing about 20% per year in the first half of the 1990s, FDI inflows grew by about 40% per year in the second half of the decade. Contracting FDI inflows for 2001, 2002, and 2003 reduced FDI to nearly half its peak in 2000. Slight increases since then suggests FDI inflows have bottomed out (Figure 7.1).

         1. Globalization

            a. Companies got around trade barriers in the 1980s through FDI.

            b. Uruguay Round of GATT further cut trade barriers, letting firms produce in the most efficient locations and export to markets. Set off further FDI into newly industrialized and emerging markets.

            c. Globalization also lets emerging-market companies use FDI.

         2. Mergers and Acquisitions

            a. Number of M&As and their exploding values are creating long-term growth in FDI.

            b. Power of largest multinationals seems to multiply each year.

            c. Many cross-border M&A deals are done to:

               • Get a foothold in a new geographic market
• Increase a firm’s global competitiveness
• Fill gaps in companies’ product lines in a global industry
• Reduce costs in R&D, production, or distribution.

3. Role of Entrepreneurs and Small Businesses
   a. Also engage in FDI and account for more of its growth.
   b. Entrepreneurs reveal a can-do spirit, ingenuity and bravado.

B. Worldwide Flows of FDI
1. More than 70,000 MNCs with over 690,000 affiliates drive FDI flows.
2. In terms of share of global FDI inflows, developed countries account for about 58%, and developing countries account for about 36%.
3. The EU, U.S., and Japan attract the vast amount of world FDI inflows.
4. FDI inflows to developing nations were mixed, with China attracting most in Asia and India attracting a fair amount.
5. Outflows of FDI from developing nations also on the rise.

3. EXPLANATIONS FOR FOREIGN DIRECT INVESTMENT

A. International Product Life Cycle (PPT #8)
1. States a company will begin by exporting its product and later undertake foreign direct investment as a product moves through its life cycle.
2. In the new product stage a good is produced entirely in the home market.
   In the maturing product stage a good is produced in the home market and in markets abroad that are large enough to warrant production facilities.
   In the standardized product stage, a company builds production capacity in low-cost developing nations to serve its markets around the world.
3. Yet the international product life cycle theory does not explain why companies choose FDI over other forms of market entry.

B. Market Imperfections (Internalization) Theory (PPT #9)
States that when an imperfection in the market makes a transaction less efficient, a company will undertake FDI to internalize the transaction and remove the imperfection. In a perfect market, prices are as low as possible and goods are easily available. Flaws in the efficient operation of an industry are called market imperfections.
1. Trade Barriers
   a. A trade barrier such as a tariff is a common market imperfection.
   b. Firms undertake FDI when market imperfections are present.
2. Specialized Knowledge
   a. A unique competitive advantage may consist of specialized knowledge, technical expertise, or special marketing abilities.
   b. Companies charge fees for product knowledge, but when a company’s specialized knowledge is embodied in its employees, the only way to exploit an opportunity may be FDI.
   c. A company may FDI if charging another company for access to its knowledge might create a future competitor.

C. Eclectic Theory (PPT #10)
1. States that firms undertake foreign direct investment when the features of a location combine with ownership and internalization advantages to
make a location appealing for investment. When each advantage is present, a company will undertake FDI.

2. **Location Advantage** is the advantage of locating a particular economic activity in a specific location because of the characteristics (natural or acquired) of the location.

3. An **ownership advantage** is the advantage that a company has due to its ownership of some special asset, such as a powerful brand, technical knowledge, or management ability.

4. An **internalization advantage** is the advantage that arises from internalizing a business activity rather than leaving it to a relatively inefficient market.

D. **Market Power** (PPT #11)

1. The **market power** theory states that a firm tries to establish a dominant market presence in an industry by undertaking foreign direct investment.

2. The benefit of market power is greater profit because the firm is better able to dictate the cost of its inputs and/or the price of its output.

3. Companies can gain market power through **vertical integration**—the extension of activities into production that provide a firm’s inputs (backward integration) or absorb its output (forward integration).

4. **MANAGEMENT ISSUES IN THE FDI DECISION** (PPT #12)

A. Control

Many companies invest abroad because they wish to control activities in the local market (e.g., to ensure the selling price remains the same across markets). Yet complete ownership does not guarantee control.

1. Partnership Requirements
   a. Many companies have strict policies regarding how much ownership they take in firms in other nations.
   b. Yet a nation may demand shared ownership in return for market access. Governments may use such requirements to shield workers and industries from exploitation or domination by large multinationals.

2. Benefits of Cooperation
   a. Greater harmony exists today between governments and international companies. Developing nations and emerging markets need investment, employment, tax revenues, training, and technology transfers.
   b. A country with a reputation for overly restricting the operations of multinationals can see its inward investment dry up.
   c. Cooperation can open communication channels to maintain positive relationships in the host country.

B. Purchase-Or-Build Decision

1. The purchase-or-build decision of managers entails deciding whether to purchase an exciting business or build a subsidiary abroad from the ground up—called a **greenfield investment**.

2. An acquiring firm may benefit from the goodwill the existing company has built over the years and, perhaps, brand recognition of the existing
firm. The purchase of an existing business also may allow for alternative methods of financing, such as an exchange of stock ownership.

3. Factors that reduce the appeal of purchasing existing facilities are obsolete equipment, poor labor relations, and an unsuitable location.

4. Adequate facilities are sometimes unavailable and a company must go ahead with a greenfield investment. Greenfield investments have their own drawbacks—obtaining the necessary permits and financing and hiring local personnel can be difficult in some markets.

C. Production Costs

Labor regulations increase the hourly cost of production, and benefits packages and training programs add to wage costs. Although the cost of land and tax rate on profits can be lower locally, they may not remain constant.

1. Rationalized Production
   a. Production in which components are produced where the cost of production is lowest. The components are brought together at one central location for assembly into the final product.
   b. Potential problem is that a work stoppage in one country can halt the entire production process.

2. Focus on the Mexican Maquiladora
   a. The 130-mile-wide strip along the U.S.-Mexican border.
   b. Low-wage regional economy next to a prosperous giant is a model for other regions split by wage or technology gaps.
   c. Yet ethical dilemmas arise over the gap between Mexican and U.S. wages and the loss of U.S. union jobs to maquiladora nonunion jobs. Maquiladoras also do not operate under the stringent environmental regulations that firms in the U.S. do.

3. Cost of Research and Development
   a. Cost of developing subsequent stages of technology has led to cross-border alliances and acquisitions.
   b. One indicator of the significance of technology in foreign direct investment is the amount of R&D conducted by affiliates of parent companies in other countries. FDI in R&D appears to be spurred by supply factors such as access to high-quality scientific and technical human capital.

D. Customer Knowledge

1. The behavior of buyers is an important issue in the decision of whether to undertake FDI. A local presence can give companies valuable knowledge of customers that is unobtainable in the home market.

2. Some countries have quality reputations in certain product categories (e.g., Italian shoes). These perceptions make it profitable to produce in the country with the quality reputation.

E. Following Clients

1. FDI puts companies near those firms they supply. “Following clients” occurs in industries in which component parts are obtained from suppliers with whom a manufacturer has a close working relationship.

F. Following Rivals
1. FDI decisions resemble a “follow the leader” scenario in industries with a limited number of large firms.
2. Many firms believe that not making a move parallel to that of the “first mover” might result in being shut out of a lucrative market.

5. GOVERNMENT INTERVENTION IN FDI
Nations enact laws, create regulations, or construct administrative hurdles for foreign companies. A bias toward protectionism or openness is rooted in a nation’s culture, history, and politics. But FDI tends to raise output and enhance standards of living. Besides philosophical ideals, countries intervene in FDI for practical reasons.

A. Balance of Payments (PPT #13)
1. National accounting system that records all payments to entities in other countries and all receipts coming into the nation.
2. International transactions that result in payments (outflows) to entities in other nations are reductions in the balance of payments accounts and recorded with a minus (–) sign (Table 7.2).
3. International transactions that result in receipts (inflows) from other nations are additions to the balance of payments accounts and recorded with a plus (+) sign.
4. Current Account
   a. National account that records transactions involving the import and export of goods and services, income receipts on assets abroad, and income payments on foreign assets inside the country.
   b. A current account surplus occurs when a country exports more goods and services and receives more income from abroad than it imports and pays abroad.
   c. A current account deficit occurs when a country imports more goods and services and pays more abroad than it exports and receives from abroad.
5. Capital Account
   a. National account that records transactions involving the purchase or sale of assets.
   b. Financial assets such as stocks and bonds and physical assets such as investments in plants and equipment.

B. Reasons for Intervention by the Host Nation (PPT #14)
1. Balance of Payments
   a. Many governments see intervention as the only way to keep their balance of payments under control.
   b. Host countries get a balance-of-payments boost from initial FDI flows. Local content requirements can lower imports, providing an added balance-of-payments boost. Exports from the FDI can further help the balance-of-payments position.
   c. When companies repatriate profits, they deplete the foreign exchange reserves of their host countries; these capital outflows decrease the balance of payments. Thus a host nation may prohibit or restrict nondomestic firms from removing profits.
   d. But host countries conserve their foreign exchange reserves when international companies reinvest their earnings in local
manufacturing facilities. This improves the competitiveness of local producers and boosts a host nation’s exports—improving its balance-of-payments position.

2. Obtain Resources and Benefits
   a. Access to Technology
      Nations encourage FDI in technology because it increases productivity and competitiveness.
   b. Management Skills and Employment
      FDI allows talented foreign managers to train local managers in how to operate the local facilities. Some of these managers will also go on to establish their own businesses.

C. Reasons for Intervention by the Home Nation (PPT #15)
   There are fewer concerns regarding the outflow of FDI among home nations because they tend to be prosperous, industrialized nations.
   1. Reasons for discouraging outward FDI
      a. Investing in other nations sends resources out of the home country and can lessen investment at home.
      b. Outgoing FDI may damage a nation’s balance of payments by reducing exports otherwise sent to international markets.
      c. Jobs resulting from FDI outflows may replace jobs at home.
   2. Reasons for promoting outgoing FDI
      a. Outward FDI can increase long-run competitiveness (e.g., partnering as a learning opportunity).
      b. Nations may encourage FDI in “sunset” industries, those that use outdated and obsolete technologies or employ low-wage workers with few skills.

6. GOVERNMENT POLICY INSTRUMENTS AND FDI

A. Host Countries: Promotion (PPT #16)
   1. Financial Incentives
      a. Host governments commonly offer tax incentives and/or low-interest loans to attract investment.
      b. But incentives can create bidding wars between locations vying for investment; the cost to taxpayers of snaring FDI can be more than what the actual jobs pay.
   2. Infrastructure Improvements
      a. Lasting benefits for communities surrounding the investment location can result from local infrastructure improvements—better seaports for containerized shipping, improved roads, and increased telecommunications systems.

B. Host Countries: Restriction (PPT #17)
   1. Ownership Restrictions
      a. Governments impose ownership restrictions that prohibit non-domestic companies from investing in certain industries or owning certain types of business.
      b. Another restriction is a requirement that non-domestic investors hold less than a 50% stake in local firms. Nations are eliminating such restrictions because companies can choose another location.
2. **Performance Demands**
   a. Some performance demands dictate the portion of a product’s content that originates locally, stipulates the portion of output that must be exported, or requires that certain technologies be transferred to local businesses.

C. **Home Countries: Promotion (PPT #18)**
   1. Offer *insurance* to cover the risks of investments abroad.
   2. Grant *loans* to firms wishing to increase their investments abroad.
   3. Offer *tax breaks* on profits earned abroad or negotiate special tax treaties.
   4. Apply *political pressure* on other nations to get them to relax their restrictions on inbound investments.

D. **Home Countries: Restriction (PPT #19)**
   1. Impose *differential tax rates* that charge income from earnings abroad at a higher rate than domestic earnings.
   2. Impose *sanctions* that prohibit domestic firms from making investments in certain nations.

7. **BOTTOM LINE FOR BUSINESS**
   This chapter presented foreign direct investment (FDI). Like trade decisions, many factors influence a company’s decision about whether to invest in markets abroad. Depending on the philosophy of home or host nations and the impact of FDI on their economic health, a firm can be encouraged or dissuaded to invest in a nation.