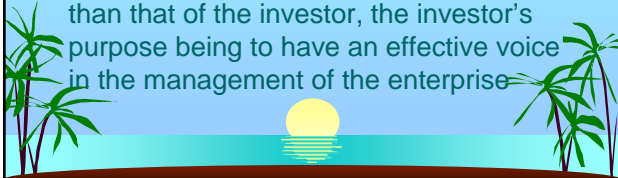


## Foreign Direct Investment (FDI)

- Definition - all capital transferred between a non-banking firm and its new and established affiliates.
- IMF - FDI is an investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise



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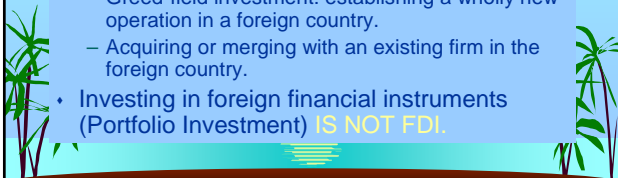
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## Foreign Direct Investment

- FDI occurs when a firm invests directly in facilities to produce and/or market a product in a foreign country.
  - Once a firm undertakes FDI, it becomes a multinational enterprise (multinational = more than one country).
- FDI takes two forms:
  - Green-field investment: establishing a wholly new operation in a foreign country.
  - Acquiring or merging with an existing firm in the foreign country.
- Investing in foreign financial instruments (Portfolio Investment) **IS NOT FDI.**



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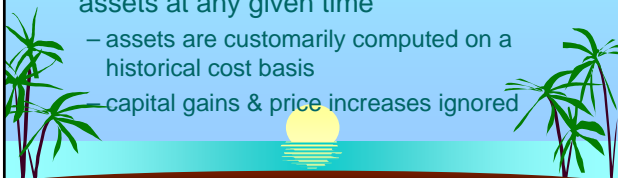
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## Foreign Direct Investment (FDI)

- Flow of FDI - refers to amount of FDI undertaken over a given period of time
- Stock of FDI - refers to total accumulated value of foreign owned assets at any given time
  - assets are customarily computed on a historical cost basis
  - capital gains & price increases ignored



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## Reasons for FDI Growth

- FDI circumvents potential future trade barriers.
- Dramatic political and economic changes occurring in developing countries.

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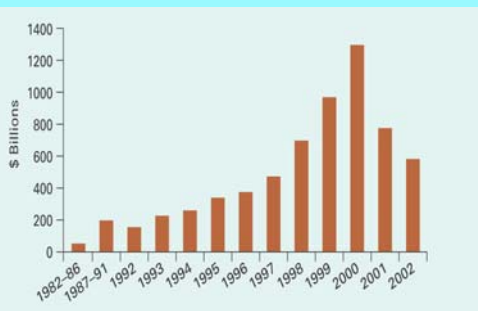
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## FDI outflows, 1982-2002

Fig 6.1



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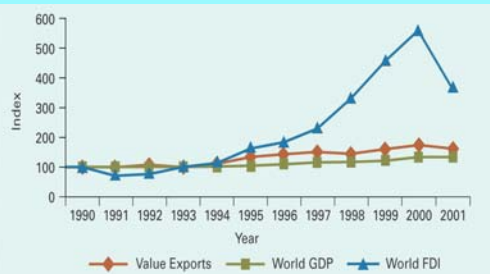
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## Growth in world exports

Fig 6.2



World GDP and FDI 1990-2001 (index = 100 in 1990)

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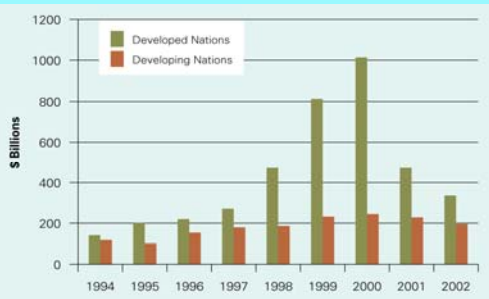
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## FDI flows by region

Fig. 6.3




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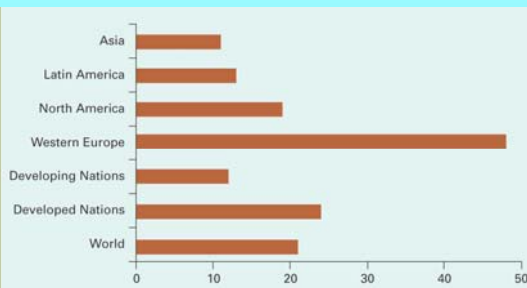
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## Inward FDI flows

Fig. 6.4



As a percentage of gross fixed capital formation, 2001

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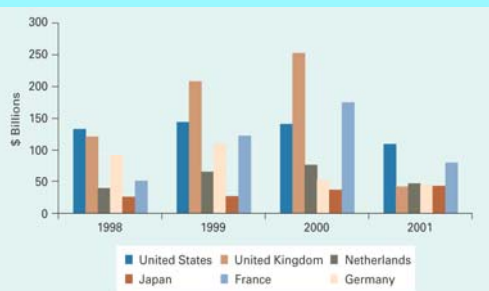
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## FDI outflows by select country 1998-2001

Fig. 6.5




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## The Form of FDI: Acquisitions versus Green-Fields

- The majority of investments is in the form of mergers & acquisitions:
  - Represents about 77% of all flows in **developed** countries.
  - Represent about 33% of all flows in **developing** countries.
    - ◆ Fewer target firms.
- Why the preference for mergers & acquisitions?
  - Quicker to execute.
  - Foreign firms have valuable strategic assets.
  - Believe they can increase the efficiency of the acquired firm.

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## Motivations for FDI

- ◆ Marketing Factors
  - size of market
  - market growth
  - desire to maintain share of market
  - desire to follow customers
  - desire to follow competition
  - establish export base
  - maintain close customer contact

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## Motivations for FDI

- ◆ Cost Factors
  - desire to be near source of supply
  - lower labor costs
  - availability of raw materials
  - availability of capital/technology
  - lower transportation costs
  - financial inducements by governments
  - infrastructure

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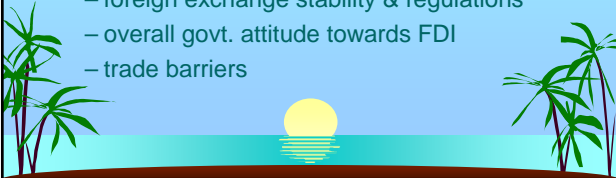
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## Motivations for FDI

- Investment Climate
  - political stability
  - limitations on ownership
  - tax policy
  - foreign exchange stability & regulations
  - overall govt. attitude towards FDI
  - trade barriers



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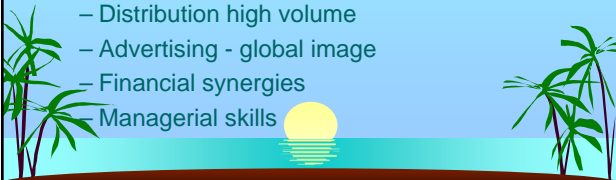
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## Eclectic Theory of FDI -Dunning

- Ownership-specific Advantages
  - Proprietary technology
  - Brand name/image
  - Scale economies in production
  - Scale economies in purchasing
  - Distribution high volume
  - Advertising - global image
  - Financial synergies
  - Managerial skills



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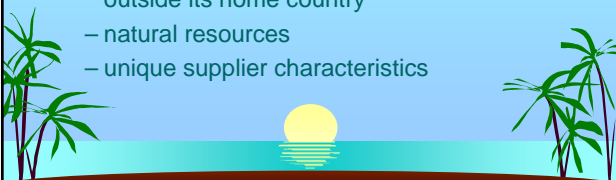
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## Eclectic Theory of FDI -Dunning

- Location-specific Advantages
  - host country policies
  - host country cost factors
  - does it pay for the firm to locate production outside its home country
  - natural resources
  - unique supplier characteristics



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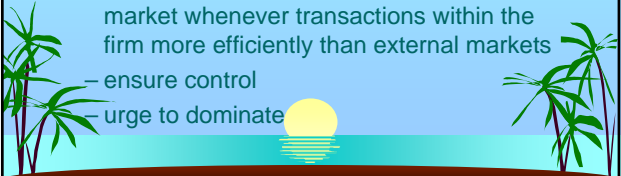
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# Eclectic Theory of FDI -Dunning

- Internalization
  - motivation of the firm to extend its own operations rather than use external markets
  - firms have incentives to create an internal market whenever transactions within the firm more efficiently than external markets
  - ensure control
  - urge to dominate



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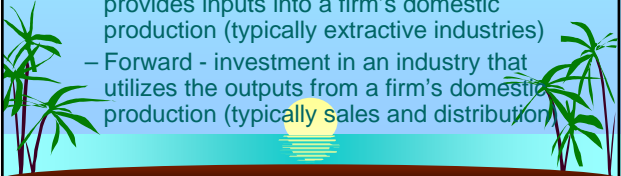
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# Two forms of FDI

- Horizontal Direct Investment
  - FDI in the same industry abroad as company operates at home.
- Vertical direct investment
  - 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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# Political Ideology and FDI



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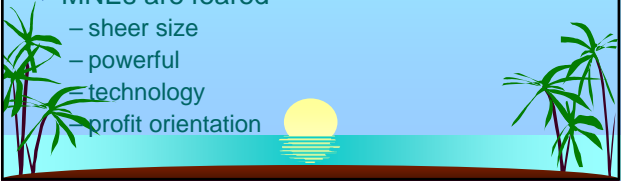
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## Political Ideology and FDI

- Radical/Marxist view
  - MNEs keep LDCs relatively backward and dependent upon advanced nations for investment, jobs, & technology
  - prohibit FDI or nationalize foreign subsidiaries of MNEs
- MNEs are feared
  - sheer size
  - powerful technology
  - profit orientation




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## Political Ideology and FDI

- Free market view
  - classical economic roots
  - MNE is an instrument for allocation of production to most efficient locations
- Pragmatic Nationalism
  - govts. should pursue policies designed to maximize national benefits & minimize national costs of FDI
  - bargain aggressively with MNEs
  - offer financial incentives




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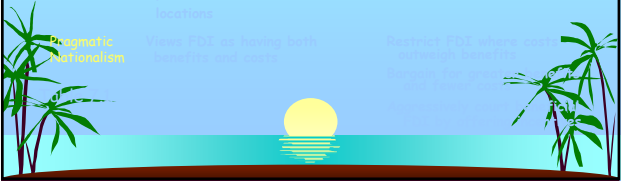
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## Political Ideology Toward FDI

Ideology	Characteristics	Host-Government Policy Implications
Radical	Marxist roots Views the MNE as an instrument of imperialist domination	Prohibit FDI Nationalize subsidiaries of foreign-owned MNEs
Free Market	Classical economic roots (Smith) Views the MNE as an instrument for allocating production to most efficient locations	No restrictions on FDI
Pragmatic Nationalism	Views FDI as having both benefits and costs	Restrict FDI where costs outweigh benefits Attract FDI where benefits outweigh costs




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## Costs of FDI to Host Countries



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## Benefits of FDI to Host Country

- bring resources into a country that would not be brought in otherwise
- MNEs bring in technology (product & process) - leads to economic growth
- managerial skills, increase the productive use of country's resources
- increased employment & creation of new jobs
- beneficial effect on BOP
  - initial capital investment
  - substitute for imports helps trade balance
  - lead to exports helps trade balance



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## Costs of FDI to Host Countries

- MNEs repatriation of profits affects BOP
- throttle domestic firms
- if MNEs import high % of components
  - negative effect on trade balance
- threat to national sovereignty
  - decisions made in foreign countries affect local communities



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## Benefits and Costs of FDI to Home Countries



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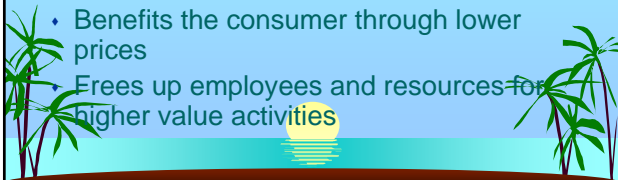
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## Home country FDI benefits

- Improves balance of payments for inward flow of foreign earnings
- Creates a demand for exports
  - Export demand can create jobs
- Increased knowledge from operating in a foreign environment
- Benefits the consumer through lower prices
- Frees up employees and resources for higher value activities



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## Home country problems with FDI

- Negative effect on Balance of Payments
  - Initial capital outflow
  - MNC uses foreign subsidiary to sell back to home market
  - MNC uses foreign subsidiary as a substitute for direct exports
- Potential loss of jobs



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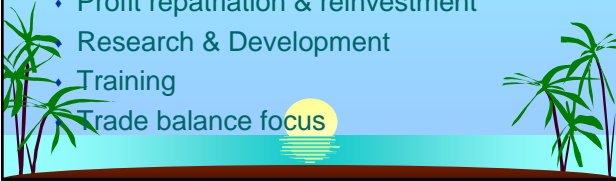
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## Government Restrictions on FDI

- Ownership (% equity)
- Employment
- Management
- Local content
- Location
- Profit repatriation & reinvestment
- Research & Development
- Training
- Trade balance focus



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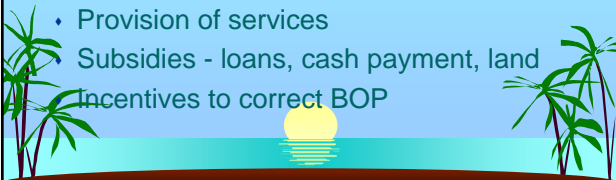
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## Incentives by Governments

- Reduced tariffs
- Development of new industries
- Reduce taxes
- Provision of facilities
- Provision of services
- Subsidies - loans, cash payment, land
- Incentives to correct BOP



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