

## Chapter 8 – Foreign Direct Investment

**Foreign Direct Investment (FDI)** - Occurs when a firm invests directly in new facilities to produce or market in a foreign country. Firm engaged in FDI is a multinational enterprise. Two forms of FDI are greenfield investment and acquisition

**Greenfield Investment** – Establishment of a wholly new operation in a foreign country

**Acquisition** – Merging with an existing firm in the foreign country. Most cross-border investments are mergers and acquisitions. Acquisitions are attractive because:

- Quicker to execute than greenfield investments
- 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

**Flow of FDI** – Amount of FDI undertaken over a given time period. There are outflows and inflows of FDI. Outflows are the flows of FDI out of a country. Inflows are the flows of FDI into a country.

**Stock of FDI** – The total accumulated value of foreign-owned assets at a given time

### Theories of FDI

Why do firms prefer FDI to Exporting or Licensing? - Exporting (producing goods at home and shipping them to the receiving country) or Licensing (granting a foreign entity the right to produce and sell the firm's product in return for a royalty fee)

**Limitations of Exporting** – An exporting strategy can be limited 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

**Limitations of Licensing – Internalization Theory (Market Imperfections)**

- Licensing could result in a firm giving away valuable technological know-how to a potential foreign competitor
- Does not give a firm tight control over manufacturing, marketing, and strategy in a foreign country that may be required to maximize its profitability
- May be difficult if the firm's competitive advantage is not amendable to it

**Advantages of Foreign Direct Investment**

- Favored over exporting when
  - o Transportation costs are high and trade barriers are high
- Favored over licensing when:
  - o Firm wants control over its technological know-how
  - o Firm wants control over its operations and business strategy
  - o Firm's capabilities are not amenable to licensing

**Pattern of FDI**

1) Strategic Behavior

- Knickerbocker explored the relationship between FDI and rivalry in oligopolistic industries (industries composed of a limited number of large firms)
  - o Extends to multipoint competition (when two or more enterprises encounter each other in different regional markets, national markets, or industries)

2) The Product Life Cycle

- Firms invest in other advanced countries when local demand in those countries grows large enough to support local production

- Firms shift production to low-cost developing countries when product standardization and market saturation create price competition and cost pressures

**The Eclectic Paradigm** – Two additional factors must be considered when explaining the rationale for and the direction of FDI

- 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

**The Radical View** – 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. 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** – 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. The MNE increases the overall efficiency of the world economy.

**The Pragmatic Nationalist View** – FDI has benefits (inflows of capital, technology, skills, and jobs) and costs (repatriation of profits to the home country and a negative balance of payments effect). FDI should be allowed only if the benefits outweigh the costs

**Shifting Ideology** – 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** – Benefits and costs must be explored from the perspective of both the host (receiving) country and the home (source) country.

**Benefits of FDI (Host Country) –**

- 1) Resource transfer effects – FDI can bring capital, technology, and management resources that would otherwise not be available.
- 2) Employment effects – FDI can bring jobs that would otherwise not be created there.
- 3) Balance-of-Payments Effects – 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 (Surplus is favored over a deficit). FDI can help achieve a current account surplus if it is a substitute for imports of goods and services and if the MNE uses a foreign subsidiary to export goods and services to other countries
- 4) Effect on Competition and Economic Growth – FDI in the form of greenfield investment can increase the level of competition in a market, drive down prices and improve welfare of consumers. Increased competition can lead to increased productivity growth, product and process innovation and greater economic growth

**Costs of Host Country –**

- 1) Adverse Effects on Competition – Subsidiaries of foreign MNEs may have greater economic power than indigenous competitors because they may be part of a larger international organization. MNE could draw on funds generated elsewhere to subsidize costs in local market. This would allow MNE to drive indigenous competitors out of market and create monopoly
- 2) Adverse Effects on the Balance of Payments – Capital outflows as foreign subsidiaries repatriate earnings to the parent country. 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
- 3) 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

### **Home Country Benefits –**

- 1) 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 –**

- 1) Balance-of-Payments
  - 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
- 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** – 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 benefit from lower prices

**Home Country Policies to Encourage Outward FDI** - Many nations have government-backed insurance programs to cover major types of foreign investment risk. This has eliminated double taxation of foreign income. Also, many host nations have relaxed restrictions on inbound FDI

**Home Country Policies to Restrict Outward FDI** – All investor countries, including US have exercised some control over outward FDI. 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 to Encourage Inward FDI** – Governments offer incentives to foreign firms to invest in their countries. 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 to Restrict Inward FDI** – Ownership restraints – Exclude foreign firms from certain sectors on the grounds of national security or competition. Local owners can help to maximize the resource transfer and employment benefits of FDI. Performance requirements – used to maximize the benefits and minimize the costs of FDI for host country

### **Licensing is unattractive when –**

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

### **Firm's bargaining power with Host government is highest when –**

- Host government places a high value on what the firm has to offer
- Few comparable alternatives available
- Firm has long time to negotiate

## Chapter 10 – The Foreign Exchange Market (NO ESSAY QUESTIONS!!)

**Foreign Exchange Market** – Market for converting the currency of one country into that of another country