Chapter Seven

Foreign Direct Investment
Foreign Direct Investment in the World Economy

- 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.
- The outflows of FDI refer to the flow of FDI out of a country.
- The inflows of FDI refer to the flow of FDI into a country.
Trends in FDI

- Flow and stock increased in the last 20 years
- In spite of decline of trade barriers, FDI has grown more rapidly than world trade because
  - Businesses fear protectionist pressures
  - FDI is seen as a way of circumventing trade barriers
  - Dramatic political and economic changes in many parts of the world
  - Globalization of the world economy has raised the vision of firms who now see the entire world as their market
Slumping FDI

• Between 200 and 2004 the value of FDI slumped almost 50% from $1.2 trillion to about $620 billion
• The slowdown in FDI flows has been most pronounced in developed nations
• The slowdown is probably temporary and reflects three developments
  - General slowdown in the growth rate of the world economy
  - Heightened geopolitical uncertainty following the September 11, 2001 attack
  - Bursting of the stock market bubble in the US
FDI Outflows
The Direction of FDI

- Historically, most FDI has been directed at the developed nations of the world as firms based in advanced countries invested in other markets
  - The US has been the favorite target for FDI inflows
- While developed nations still account for the largest share of FDI inflows, FDI into developing nations has increased
  - Most recent inflows into developing nations have been targeted at the emerging economies of South, East, and Southeast Asia
- Gross fixed capital formation summarizes the total amount of capital invested in factories, stores, office buildings, etc.
  - This makes FDI an important source of capital investment and a determinant of the future growth rate of an economy
FDI Flow by Region

![Graph showing FDI flow by region from 1994 to 2004 for developed and developing nations.](image-url)
Gross Capital Fixed Formation

The diagram shows the gross capital fixed formation for Developed Nations and Developing Nations from 1992-97 to 2003. The x-axis represents the years from 1992-97 to 2003, while the y-axis represents the percentage of gross capital fixed formation. The bars indicate the percentage for each year, with two bars for each year, one for Developed Nations and one for Developing Nations.
The Source of FDI
The Form of FDI

- **Greenfield operation:**
  - Mostly in developing nations

- **Mergers and acquisitions:**
  - Quicker to execute
  - Foreign firms have valuable strategic assets
  - Believe they can increase the efficiency of the acquired firm

- More prevalent in developed nations
The Shift to Services

- The shift to services is being driven by four factors
  - Reflects the general move in many developed economies away from manufacturing and toward service industries
  - Many services cannot be traded internationally
  - Many countries have liberalized their regimes governing FDI in services
  - The rise of Internet-based global telecommunications networks has allowed some service enterprises to relocate some of their value creation activities to different nations to take advantage of favorable factor costs
Horizontal FDI

- Horizontal Direct Investment
  - FDI in the same industry abroad as company operates at home
- FDI is expensive because a firm must bear the costs of establishing production facilities in a foreign country or of acquiring a foreign enterprise
- FDI is risky because of the problems associated with doing business in another culture where the rules of the game may be different
Market Imperfections

- Market imperfections are factors that inhibit markets from working perfectly
  - In the international business literature, the marketing imperfection approach to FDI is typically referred to as internalization theory

- With regard to horizontal FDI, market imperfections arise in two circumstances:
  - When there are impediments to the free flow of products between nations which decrease the profitability of exporting relative to FDI and licensing
  - When there are impediments to the sale of know-how which increase the profitability of FDI relative to licensing
Horizontal FDI – When

- Transportation costs for a product are high
- Market Imperfections (Internalization Theory)
  - Impediments to the free flow of products between nations
  - Impediments to the sale of know-how
- Follow the lead of a competitor - strategic rivalry
- Product Life Cycle - however, does not explain when it is profitable to invest abroad
- Location specific advantages (natural resources)
Vertical FDI

- Vertical FDI takes two forms
  - Backward vertical FDI is an investment in an industry abroad that provides inputs for a firm’s domestic production processes
  - Forward vertical FDI occurs when an industry abroad sells the outputs of a firm’s domestic production processes, this is less common than backward vertical FDI
Strategic Behavior

• One explanation for firm’s choice of vertical FDI is that by using vertical backward integration, a firm can gain control over the source of raw materials
  - This would allow the firm to raise entry barriers and shut new competitors out of an industry

• Another explanation of vertical FDI is that firms use this strategy to circumvent the barriers established by firms already doing business in a country
Market Imperfections

The market imperfections approach offers two explanations for vertical FDI:
- There are impediments to the sale of know-how through the market mechanism.
- Investments in specialized assets expose the investing firm to hazards that can be reduced only through vertical FDI.
Decision Making Grid For FDI

1. How High Are Transportation Costs and Tariffs?
   - Low: Export
   - High:
     2. Is Know-how Amenable to Licensing?
        - No: Horizontal FDI
        - Yes:
          3. Is Tight Control over Foreign Operation Required?
             - Yes: Horizontal FDI
             - No:
               4. Can Know-how Be Protected by Licensing Contract?
                  - No: Horizontal FDI
                  - Yes: Then License
Looking Ahead to Chapter 8

- The Political Economy of Foreign Direct Investment
  - Political ideology and Foreign Direct Investment
  - The benefits of FDI to host countries
  - The costs of FDI to host countries
  - The benefits and costs of FDI to home countries
  - Government policy instruments and FDI