STUDY GUIDE

Chapter 6

INVESTING ABROAD DIRECTLY

Learning Objectives

After studying this chapter, you should be able to:

1. Use the resource-based and institution-based views to answer why foreign direct investment (FDI) takes place.
2. Understand how FDI results in ownership, location, and internalization (OLI) advantages.
3. Identify different political views on FDI based on an understanding of its benefits and costs to host and home countries.
4. Participate in two leading debates concerning FDI.
5. Draw implications for action.

Chapter Outline: Key Concepts and Terms

I. UNDERSTANDING THE FDI VOCABULARY

1. Key Concepts

FDI refers to directly investing in activities that control and manage value creation in other countries. MNEs are firms that engage in FDI. FDI can be classified as horizontal FDI and vertical FDI.

Flow is the amount of FDI moving in a given period in a certain direction (inflow or outflow). Stock is the total accumulation of inbound FDI in a country or outbound FDI from a country.

2. Key Terms

Downstream vertical FDI: expanding through the stages of production and distribution toward distribution.

FDI flow is the amount of FDI moving in a given period (usually a year) in a certain direction.

FDI inflow usually refers to inbound FDI moving into a country in a year.

FDI outflow typically refers to outbound FDI moving out of a country in a year.

FDI stock is the total accumulation of inbound FDI in a country or outbound FDI from a country.

Foreign direct investment (**FDI**) is defined as directly investing in activities that control and manage value creation in other countries.

Foreign portfolio investment (FPI). FPI refers to investment in a portfolio of foreign securities such as stocks and bonds that do not entail the active management of foreign assets.

Horizontal FDI: when a firm *duplicates* its home country-based activities at the same value chain stage in a host country through FDI.

Management control rights: namely, the rights to appoint key managers and establish control mechanisms.

Multinational enterprise (MNE): firms that engage in FDI.

Upstream vertical FDI: expanding back through the stages of production and distribution toward production.

Vertical FDI: a firm through FDI moves upstream or downstream in different value chain stages in a host country.

II. WHY DO FIRMS BECOME MNEs BY ENGAGING IN FDI?

1. Key Concept

The resource-based view suggests that the key word of FDI is D (direct), which reflects firms' interest in directly managing, developing, and leveraging their firm-specific resources and capabilities abroad. The institution-based view argues that recent expansion of FDI is indicative of generally friendlier policies, norms, and values associated with FDI (despite some setbacks).

2. Key Terms

Internalization refers to the replacement of cross-border markets (such as exporting and importing) with one firm (the MNE) locating in two or more countries.

Licensing: selling technology for a fee, a non-FDI-based market entry mode.

Location refers to advantages enjoyed by firms operating in certain areas.

Market imperfection (**market failure**): imperfect rules governing international transactions**.**

OLI advantages: ownership (O) advantages, location (L) advantages, and internalization (I) advantages.

Ownership refers to MNEs' possession and leveraging of certain valuable, rare, hard-to-imitate, and organizationally embedded (VRIO) assets overseas.

III. OWNERSHIP ADVANTAGES

1. Key Concept

Ownership refers to MNEs' possession and leveraging of certain valuable, rare, hard-to-imitate, and organizationally embedded (VRIO) assets overseas.

2. Key Terms

Dissemination risks, defined as the risks associated with unauthorized diffusion of firm-specific know-how.

IV. LOCATION ADVANTAGES

1. Key Concepts

Location refers to certain locations' advantages that can help MNEs attain strategic goals.

2. Key Terms

Agglomeration: the clustering of economic activities in certain locations.

Knowledge spillover knowledge diffused from one firm to others among closely located firms that attempt to hire individuals from competitors.

Oligopoly—industries populated by a small number of players.

V. INTERNALIZATION ADVANTAGES

1. Key Concept

Internalization refers to the replacement of cross-border market relationship with one firm (the MNE) locating in two or more countries. Internalization helps combat market imperfections and failures.

2. Key Term

Intrafirm trade involves trade between two subsidiaries in two countries controlled by the same MNE.

VI. REALITIES OF FDI

1. Key Concepts

The radical view is hostile to FDI, and the free market view calls for minimum intervention in FDI.

Most countries practice pragmatic nationalism, weighing the benefits and costs of FDI. FDI brings a different (and often opposing) set of benefits and costs to host and home countries.

2. Key Terms

Contagion (imitation effect): Local rivals, after observing foreign technology, may recognize its feasibility and strive to imitate it.

Demonstration effect(sometimes also called the **contagion** or **imitation**): local rivals, after observing technology, may recognize its feasibility and strive to imitate it.

Free market view suggests that FDI, unrestricted by government intervention, will enable countries to tap into their absolute or comparative advantages by specializing in the production of certain goods and services.

Pragmatic nationalism: views FDI as having both pros and cons and only approving FDI when its benefits outweigh costs.

Radical view: treats FDI as an instrument of imperialism and as a vehicle for exploitation of domestic resources, industries, and people by foreign capitalists and firms.

Technology spillover: foreign technology diffused domestically that benefits domestic firms and industries.

VII. HOW MNES AND HOST GOVERNMENTS BARGAIN

1. Key Concept

Forces affecting bargaining include common interests, conflicting interests, and compromises as affected by each party's strengths and perception of gain from the bargain.

2. Key Terms

Bargaining power of both sides—the ability to extract a favorable outcome from negotiations due to one party's strengths.

Expropriation: confiscating foreign assets.

Obsolescing bargain: the deal struck by MNEs and host governments which change their requirements after the initial FDI entry.

Sunk costs: the MNE has already invested substantial sums of resources and often has to accommodate some new demands.

VIII. DEBATES AND EXTENSIONS

1. Key Concept

The first debate deals with whether FDI should be undertaken as opposed to outsourcing. The second debate focuses on whether recent anti-FDI incidents represent mere aberrations in the larger environment of having FDI friendlier policies or represent some routine occurrences in the future.

2. Key Term

Sovereign wealth fund: A state owned investment fund composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by foreign exchange assets.

IX. MANAGEMENT SAVVY

1. Key Concept

Managers should carefully assess whether FDI is justified, in light of other options such as outsourcing and licensing. Pay careful attention to the location advantages in combination with the firm's strategic goals. Be aware of the institutional constraints governing FDI and enhance legitimacy in host countries.