Foreign Direct Investment

Book Chapter 6 (178-209) = Chapter 8 on Connect

FDI

- Most involved ***entry mode*** a company can choose

FDI

- Most involved ***entry mode*** a company can choose
- Often used as a measure for trade development and comparing different markets


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MTR


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What's in store?

India's supermarket chains, 2014

Company	Food & grocery formats	Number of stores
Reliance Industries	Reliance Fresh	550
Future Group	Big Bazaar; Food Bazaar; Foodhall; KB's Fairprice	530
Aditya Birla Group	More	504
REI Agro Ltd	6Ten	344
Bharti Group	Easyday	210
RP-Sanjiv Goenka Group	Spencer's	135
Avenue Supermarkets	D-Mart	79
Godrej Group	Nature's Basket	32
Tata Sons	Star Bazaar	11

Sources: Company websites; news reports


Shopping local
Urban respondents who prefer traditional outlets to supermarkets, % of total
September 2012, by annual income levels in rupees:
<0.15m
0.15m - 0.5m
>0.5m
50
60
70
80
90
100
Fruit & vegetables
Dairy products
Grocery: food
Grocery: non-food
Staple goods
Source: Boston Consulting Group

FDI

- Firm invests directly in new facilities to produce and/or market in a foreign country

Forms of FDI

- Greenfield Investment (wholly new operation)
- Brownfield Investment (partner with or acquire with existing firm in the country)

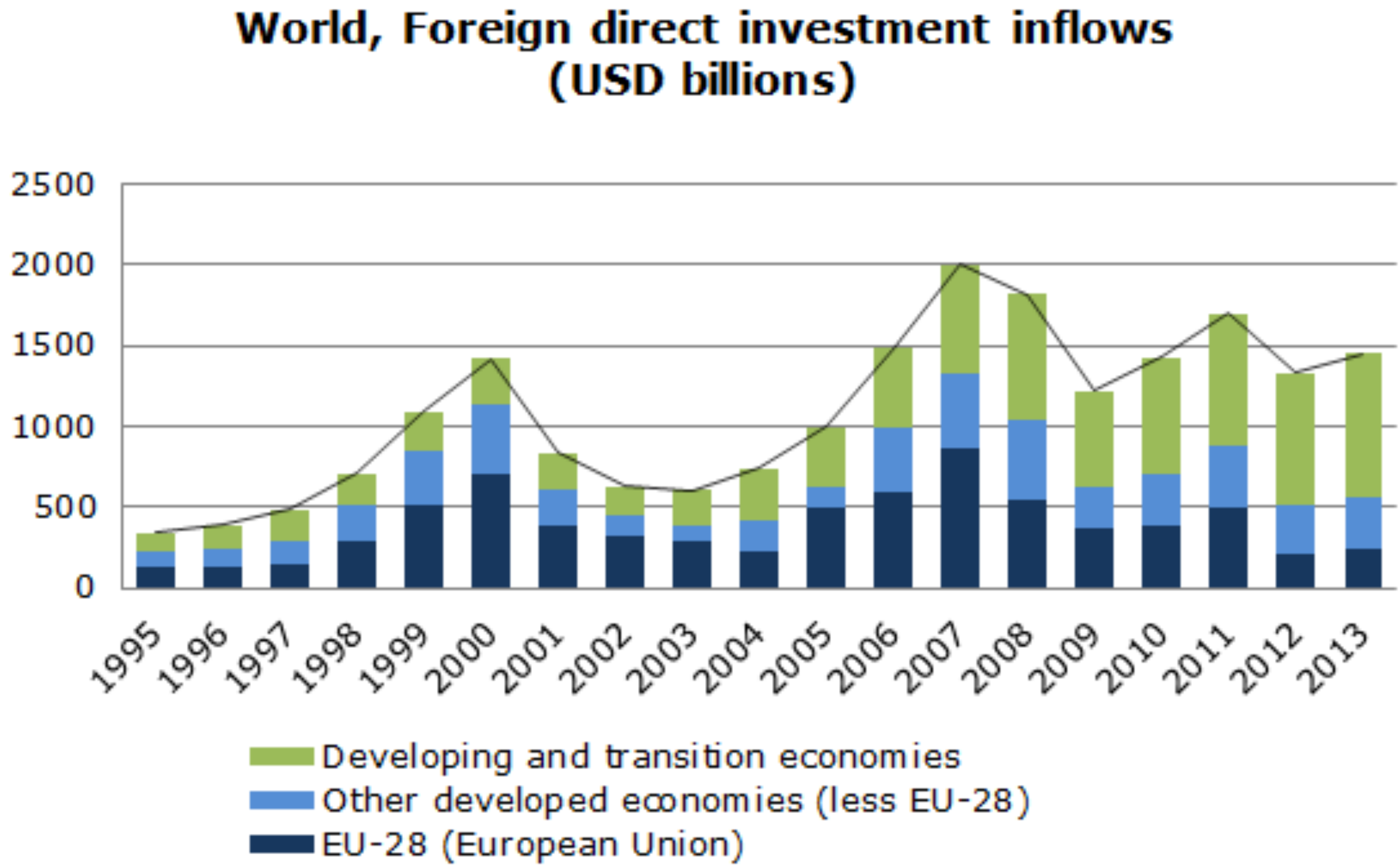
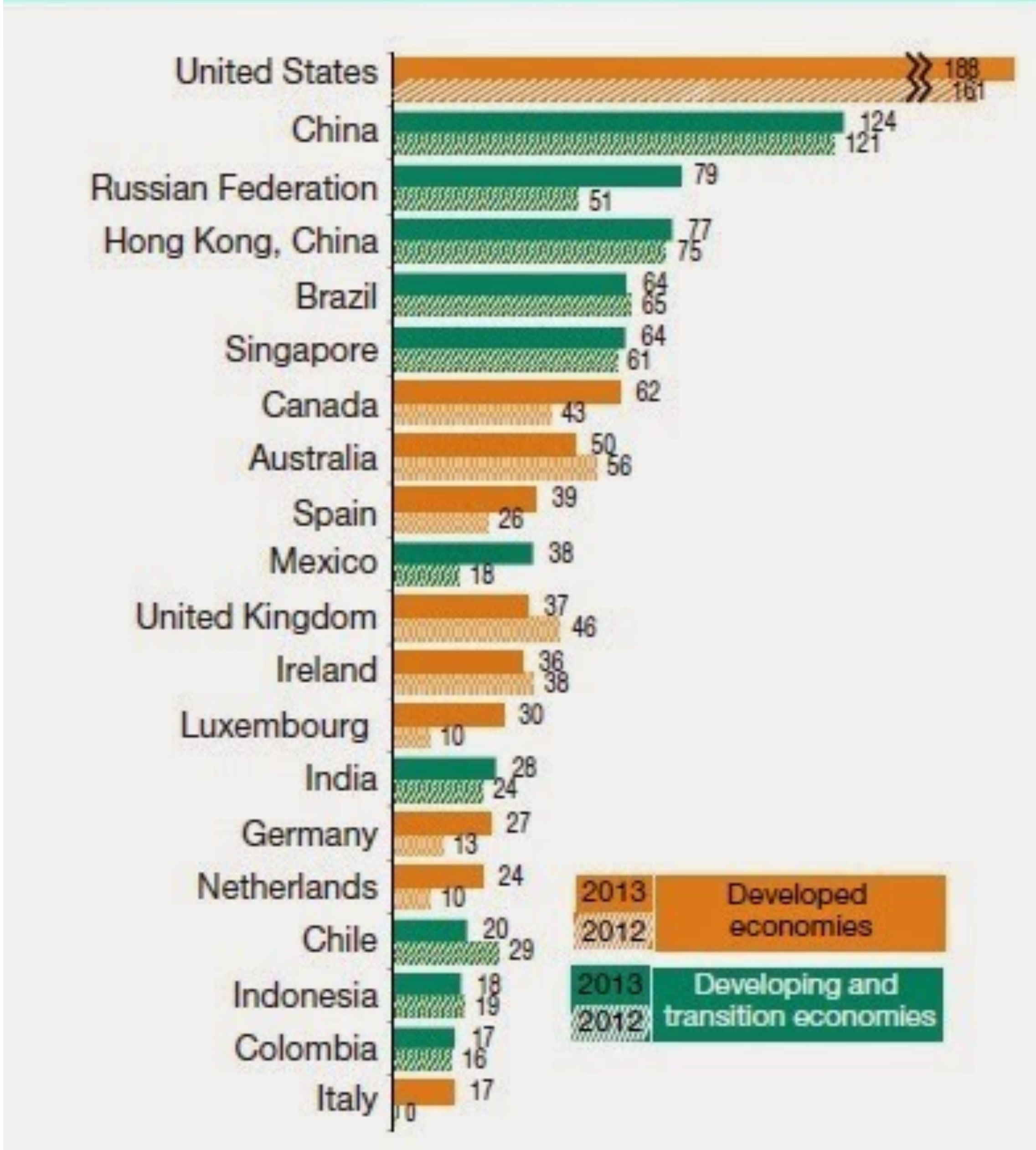
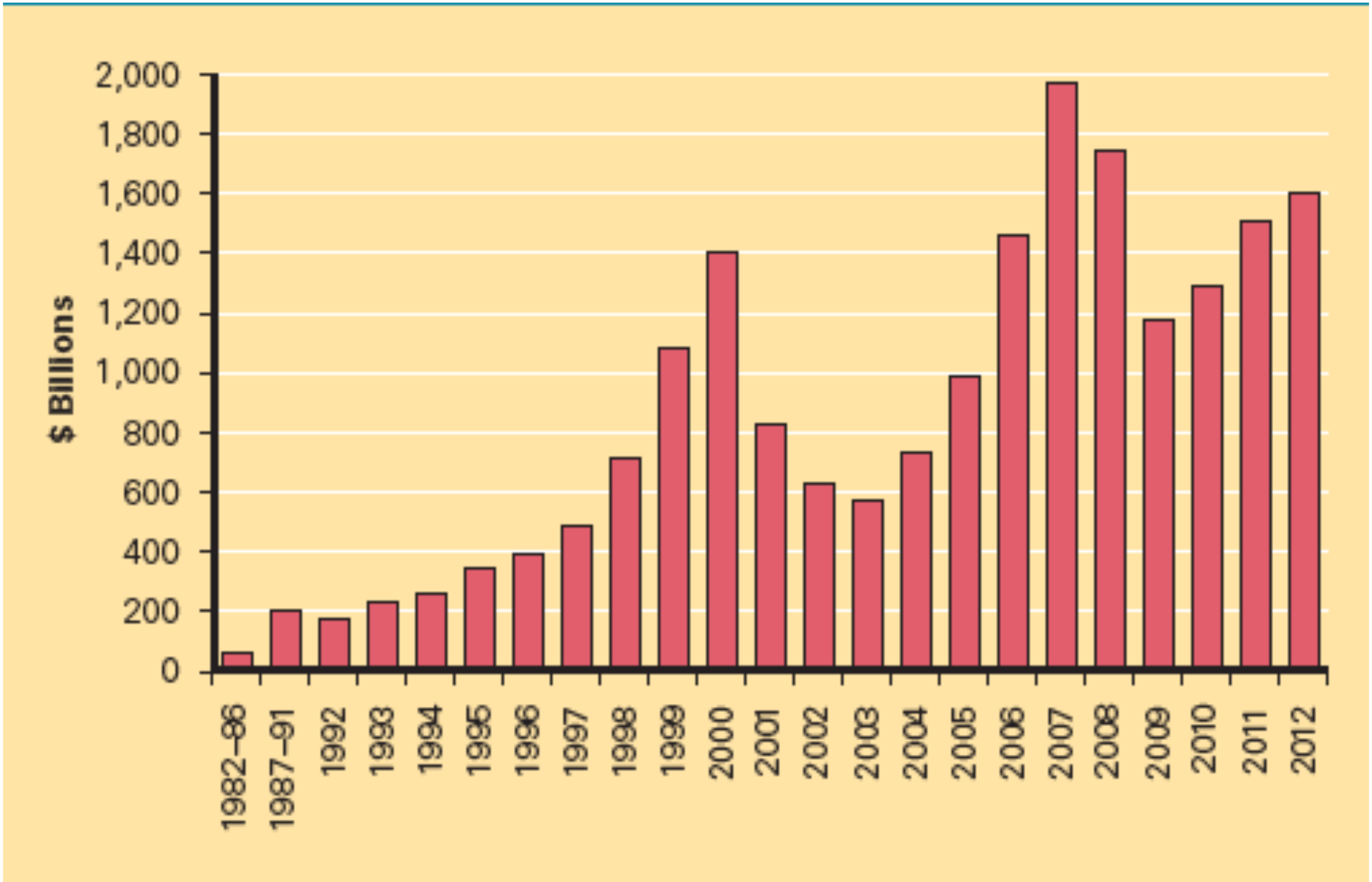
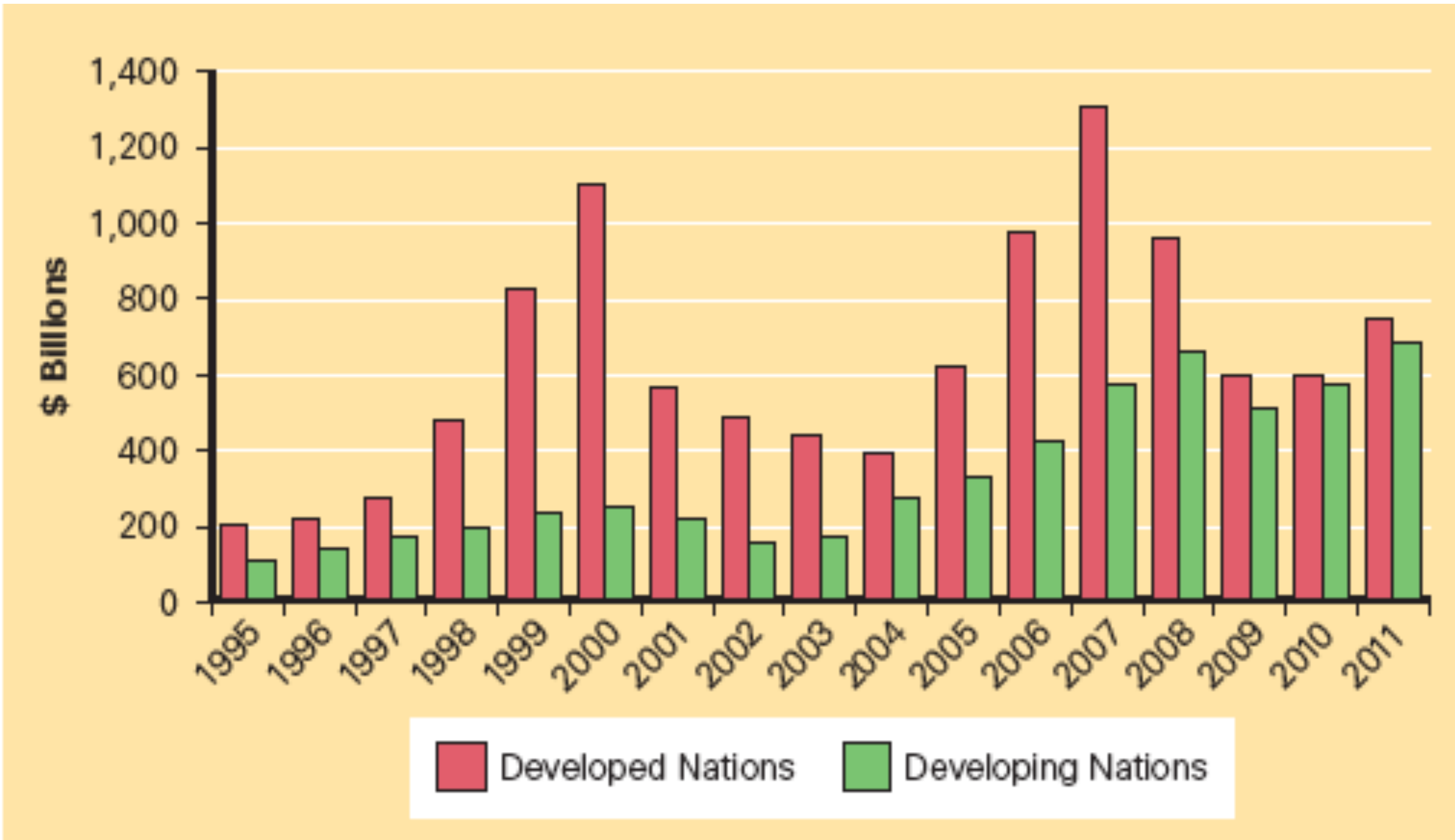

World, Foreign direct investment inflows
(USD billions)
2500
2000
1500
1000
500
0
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
Developing and transition economies
Other developed economies (less EU-28)
EU-28 (European Union)

Figure 2. FDI inflows: top 20 host economies, 2012 and 2013
(Billions of dollars)



Trends in FDI


$ Billions
2,000
1,800
1,600
1,400
1,200
1,000
800
600
400
200
0
1982–86
1987–91
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012

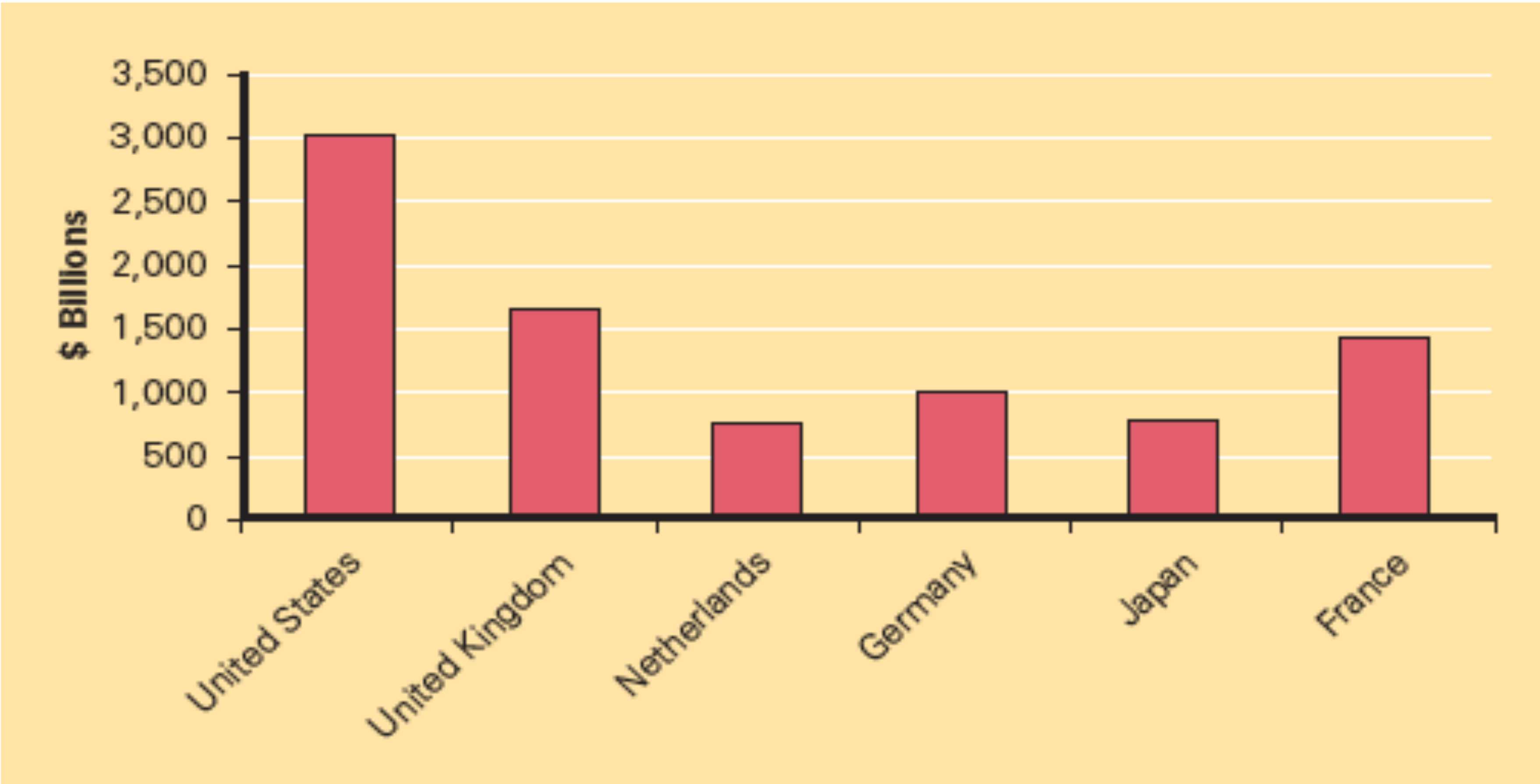


$ Billions
1,400
1,200
1,000
800
600
400
200
0
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Developed Nations
Developing Nations

- The growth of FDI is a result of
  1. a fear of protectionism
     - want to circumvent trade barriers
  2. political and economic changes
     - deregulation, privatization, fewer restrictions on FDI
  3. new bilateral investment treaties
     - designed to facilitate investment
  4. the globalization of the world economy
     - many companies now view the world as their market
     - need to be closer to their customers

- FDI is an important factor in the future growth of an economy…

- Since World War II, the U.S. has been the largest source country for FDI
  - the United Kingdom, the Netherlands, France, Germany, and Japan are other important source countries
  - together, these countries account for 60% of all FDI outflows from 1998-2011


3,500
3,000
2,500
2,000
1,500
1,000
500
0
$ Billions
United States
United Kingdom
Netherlands
Germany
Japan
France

- Most cross-border investment is in the form of mergers and acquisitions rather than greenfield investments
  - between 40-80% of all FDI inflows per annum from 1998 to 2011 were in the form of mergers and acquisitions
    - but in developing countries two-thirds of FDI is greenfield investment
      - fewer target companies

- Firms prefer to acquire existing assets because
  - mergers and acquisitions are quicker to execute than greenfield investments
  - it is easier and perhaps less risky for a firm to acquire desired assets than build them from the ground up
  - firms believe that they can increase the efficiency of an acquired unit by transferring capital, technology, or management skills

- Question: Why does FDI occur instead of exporting or licensing?
  1. Exporting - producing goods at home and then shipping them to the receiving country for sale
     - exports can be limited by transportation costs and trade barriers
     - FDI may be a response to actual or threatened trade barriers such as import tariffs or quotas

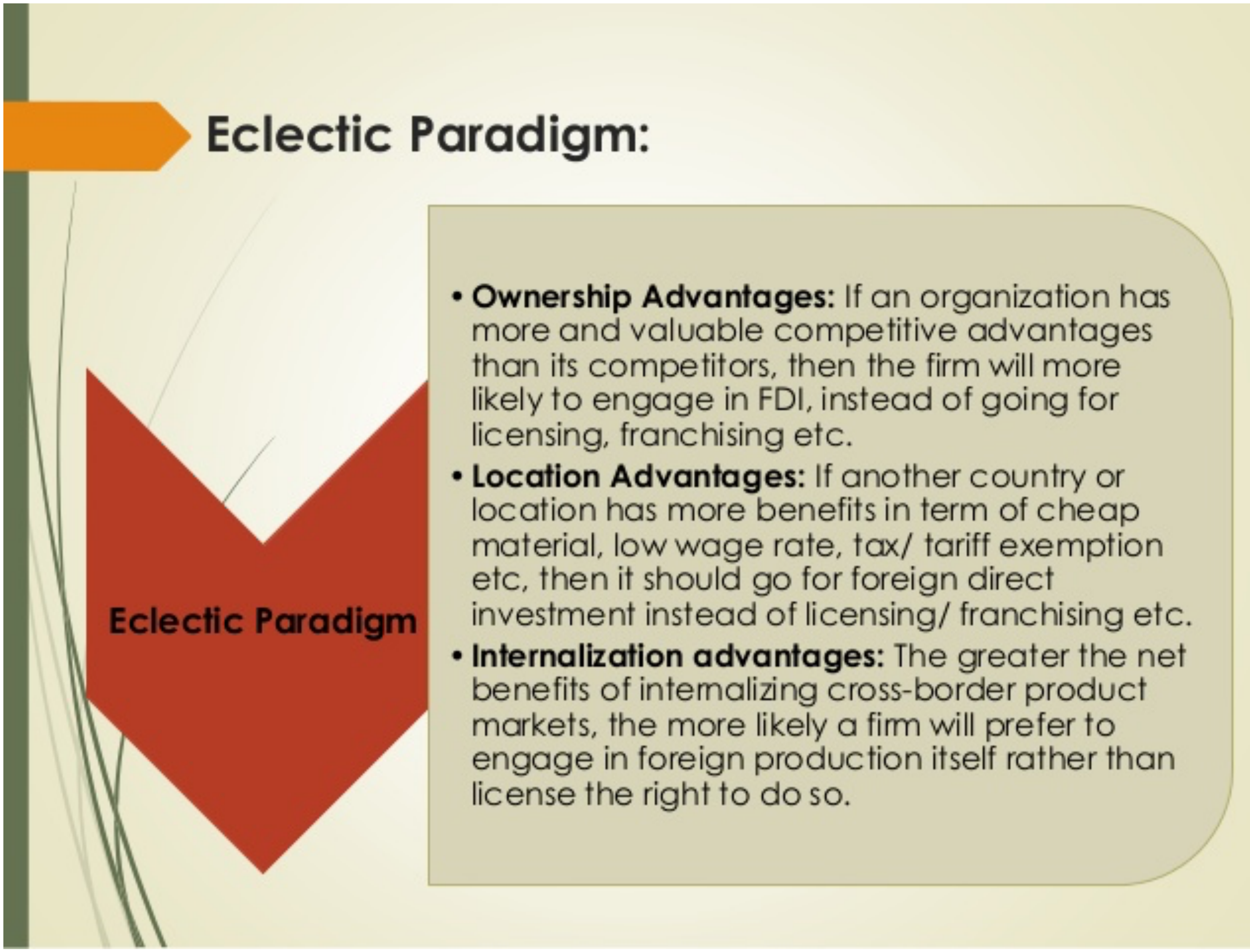
2. Licensing - granting a foreign entity the right to produce and sell the firm's product in return for a royalty fee on every unit that the foreign entity sells

- Internalization theory (aka market imperfections theory) - compared to FDI licensing is less attractive
  - firm could give away valuable technological know-how to a potential foreign competitor
  - does not give a firm the control over manufacturing, marketing, and strategy in the foreign country
  - the firm's competitive advantage may be based on its management, marketing, and manufacturing capabilities

- Question: Why do firms in the same industry undertake FDI at about the same time and the same locations?
- Knickerbocker - FDI flows are a reflection of strategic rivalry between firms in the global marketplace
  - multipoint competition -when two or more enterprises encounter each other in different regional markets, national markets, or industries

- Question: But, why is it profitable for firms to undertake FDI rather than continuing to export from home base, or licensing a foreign firm?
- Dunning's eclectic paradigm - it is important to consider
  - location-specific advantages - that 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

Eclectic Paradigm (OLI)



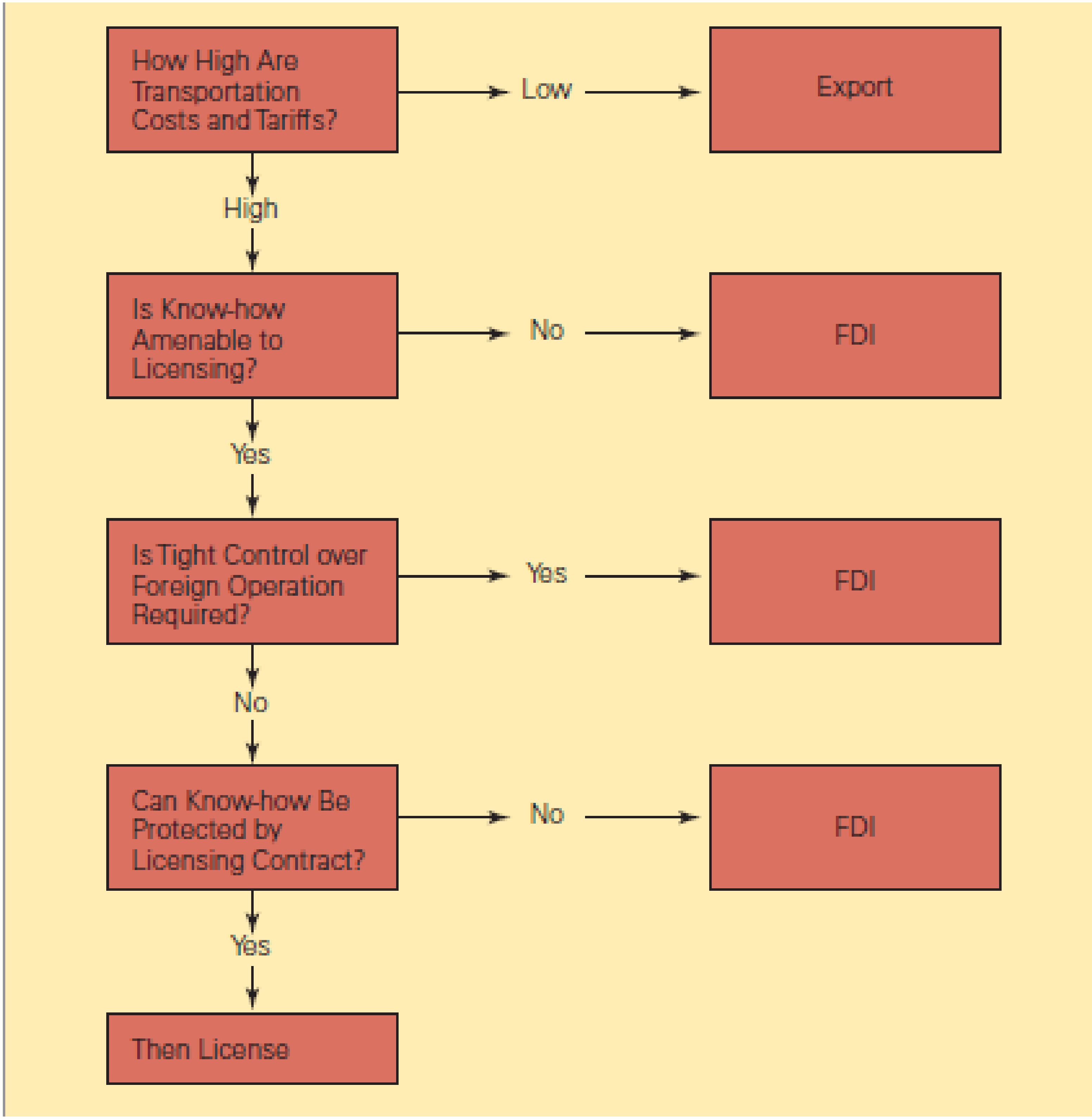
- There are four main benefits of inward FDI for a host country
  1. Resource transfer effects - FDI brings capital, technology, and management resources
  2. Employment effects - FDI can bring jobs

3. Balance of payments effects - FDI can help a country to achieve a current account surplus
4. Effects on competition and economic growth - greenfield investments increase the level of competition in a market, driving down prices and improving the welfare of consumers
   - can lead to increased productivity growth, product and process innovation, and greater economic growth

- Governments can encourage outward FDI
  - government-backed insurance programs to cover major types of foreign investment risk
- Governments can restrict outward FDI
  - limit capital outflows, manipulate tax rules, or outright prohibit FDI

- Governments can encourage inward FDI
  - offer incentives to foreign firms to invest in their countries
    - gain from the resource-transfer and employment effects of FDI, and capture FDI away from other potential host countries
- Governments can restrict inward FDI
  - use ownership restraints and performance requirements

- Managers need to consider what trade theory implies about FDI, and the link between government policy and FDI
- The direction of FDI can be explained through the location-specific advantages argument associated with John Dunning
  - however, it does not explain why FDI is preferable to exporting or licensing, must consider internalization theory


How High Are Transportation Costs and Tariffs?
Low
Export
High
Is Know-how Amenable to Licensing?
No
FDI
Yes
Is Tight Control over Foreign Operation Required?
Yes
FDI
No
Can Know-how Be Protected by Licensing Contract?
No
FDI
Yes
Then License

- A host government’s attitude toward FDI is important in decisions about where to locate foreign production facilities and where to make a foreign direct investment
  - firms have the most bargaining power when the host government values what the firm has to offer, when the firm has multiple comparable alternatives, and when the firm has a long time to complete negotiations