Investment Decisions: Drivers of FDI – Emerging Markets

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Foreign Direct Investment (FDI)

['fȯr-ən də-'rekt in-'ves(t)-mənt]

The purchase of an interest in a company by an investor located in another country.

What is Foreign Direct Investment (FDI)?

Foreign direct investment (FDI) is an investment from a party in one country into a business or corporation in another country with the intention of establishing a lasting interest. Lasting interest differentiates FDI from foreign portfolio investments, where investors passively hold securities from a foreign country. A foreign direct investment can be made by obtaining a lasting interest or by expanding one's business into a foreign country.

Lasting Interest and the Element of Control

An investment into a foreign firm is considered an FDI if it establishes a lasting interest. A lasting interest is established when an investor obtains at least 10% of the voting power in a firm.

The key to foreign direct investment is the element of control. Control represents the intent to actively manage and influence a foreign firm's operations. This is the major differentiating factor between FDI and a passive foreign portfolio investment.

Methods of Foreign Direct Investment

As mentioned above, an investor can make a foreign direct investment by expanding their business in a foreign country. Amazon opening a new headquarters in Vancouver, Canada would be an example of this.

Reinvesting profits from overseas operations, as well as intra-company loans to overseas subsidiaries, are also considered foreign direct investments.

Finally, there are multiple methods for a domestic investor to acquire voting power in a foreign company. Below are some examples:

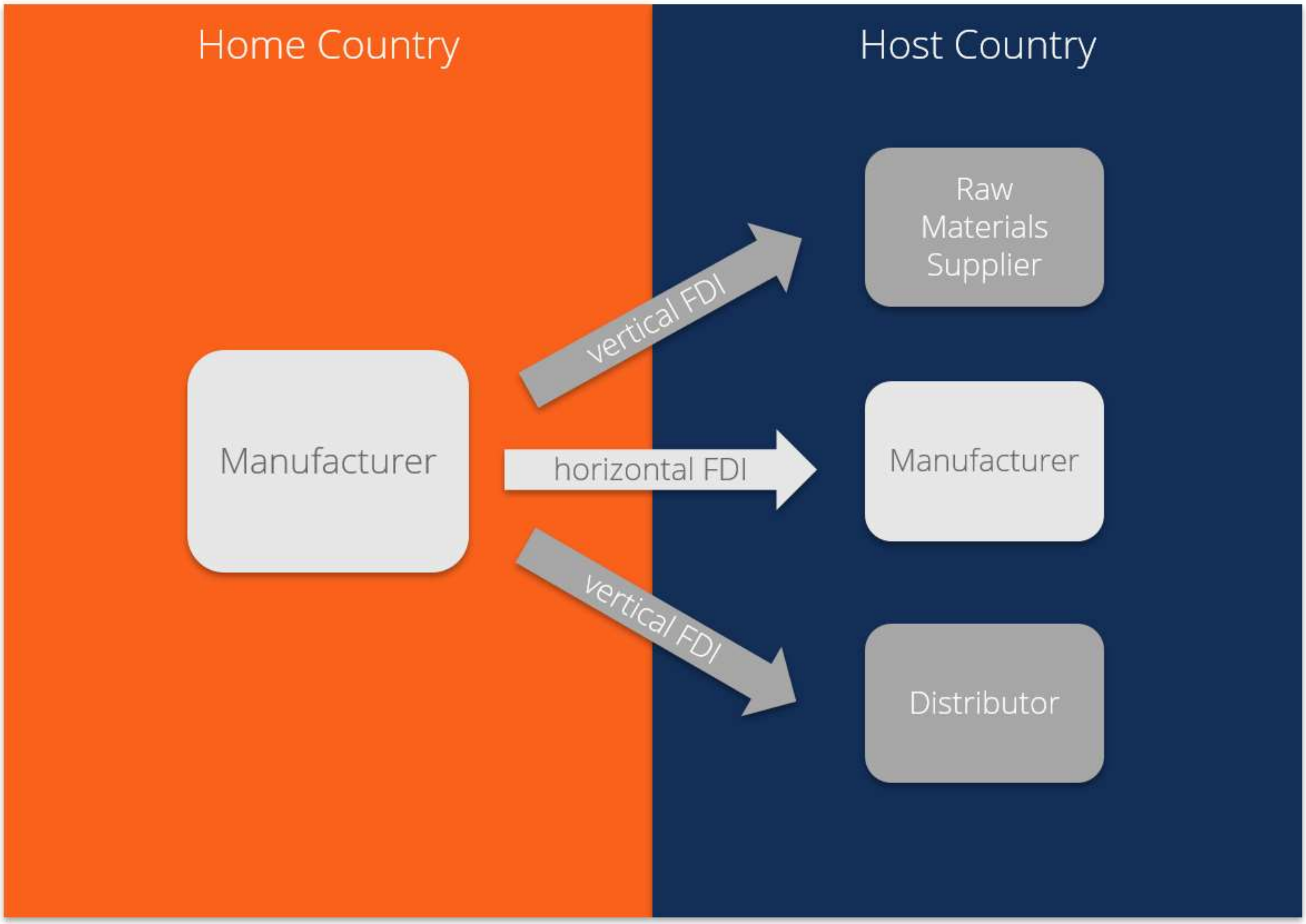
- Acquiring voting stock in a foreign company
- Mergers and acquisitions
- Joint ventures with foreign corporations
- Starting a subsidiary of a domestic firm in a foreign country

Types of FDI

Typically, there are two main types of FDI: horizontal and vertical FDI.

Horizontal: a business expands its domestic operations to a foreign country. In this case, the business conducts the same activities but in a foreign country. For example, McDonald's opening restaurants in Japan would be considered horizontal FDI.

Vertical: a business expands into a foreign country by moving to a different level of the supply chain. In other words, a firm conducts different activities abroad but these activities are still related to the main business. Using the same example, McDonald's could purchase a large-scale farm in Canada to produce meat for their restaurants.


Home Country
Host Country
Raw Materials Supplier
vertical FDI
Manufacturer
horizontal FDI
Manufacturer
vertical FDI
Distributor

However, two other forms of FDI have also been observed: con-glomerate (multi-industry/business company) and platform FDI.

Con-glomerate: a business acquires an unrelated business in a foreign country. This is uncommon, as it requires overcoming two barriers to entry: entering a foreign country and entering a new industry or market. An example of this would be if Virgin Group, which is based in the United Kingdom, acquired a clothing line in France.

Platform: a business expands into a foreign country but the output from the foreign operations is exported to a third country. This is also referred to as export-platform FDI. Platform FDI commonly happens in low-cost locations inside free-trade areas. For example, if Ford purchased manufacturing plants in Ireland with the primary purpose of exporting cars to other countries in the EU.

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Key Takeaways - FDI

Companies or governments considering a foreign direct investment (FDI) generally consider target firms or projects in open economies that offer a skilled workforce and above-average growth prospects for the investor. Light government regulation also tends to be prized.

FDI frequently goes beyond mere capital investment. It may include the provision of management, technology, and equipment as well.

A key feature of foreign direct investment is that it establishes effective control of the foreign business or at least substantial influence over its decision making.

The net amounts of money involved with FDI are substantial, with more than $1.8 trillion of foreign direct investments made in 2021. In that year, the United States was the top FDI destination worldwide, followed by China, Canada, Brazil, and India. In terms of FDI outflows, the U.S. was also the leader, followed by Germany, Japan, China, and the United Kingdom

Key Takeaways - FDI

FDI inflows as a percentage of gross domestic product (GDP) is a good indicator of a nation's appeal as a long-term investment destination. The Chinese economy is currently smaller than the U.S. economy in nominal terms, but FDI as a percentage of GDP was 1.7% for China as of 2020, compared with 1.0% for the U.S. For smaller, dynamic economies, FDI as a percentage of GDP is often significantly higher: e.g., 110% for the Cayman Islands, 109% for Hungary, and 34% for Hong Kong (also for 2020).

In 2020, foreign direct investment tanked globally due to the COVID-19 pandemic, according to the United Nations Conference on Trade and Development. The total $859 billion global investment that year compared with $1.5 trillion the previous year.

And China dislodged the U.S. in 2020 as the top draw for total investment, attracting $163 billion compared with investment in the U.S. of $134 billion. In 2021, global FDI bounced back by 88%.

Difference between FDI & Foreign Portfolio Investment (FPI)

Foreign portfolio investment (FPI) is the addition of international assets to the portfolio of a company, an institutional investor such as a pension fund, or an individual investor. It is a form of portfolio diversification, achieved by purchasing the stocks or bonds of a foreign company. Foreign direct investment (FDI) instead requires a substantial and direct investment in, or the outright acquisition of, a company based in another country, and not just their securities.

FDI is generally a larger commitment, made to enhance the growth of a company. But both FPI and FDI are generally welcome, particularly in emerging nations. Notably, FDI involves a greater responsibility to meet the regulations of the country that hosts the company receiving the investment.

Major political ideologies behind FDI

The radical view

The free market view

Pragmatic Nationalism

The radical view

Marxist political and economic theories

The multinational cooperation is an instrument of imperialist domination as well as a tool for exploiting host countries to the exclusive benefit of their capitalist or imperialist home countries.

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 the goods and services that they can produce most efficiently.

Adam Smith

David Ricardo

Embraced by advanced economies and developed countries

Acquire legitimacy to compete in and gain profit from foreign countries

Pragmatic Nationalism

FDI has both advantages and disadvantages

FDI should only be allowed if the benefits outweigh the costs.

Until the 1980s, Japanese government blocked the majority of applications for investing in their country.

Firms that possessed important technology were often permitted to engage in FDI if they agreed to either license their technology to a Japanese firm or enter into a joint venture with a Japanese enterprise.

IBM

TEXAS INSTRUMENTS

Most countries have now adopted the pragmatic nationalism to some extent

Video: Importance of FDI

Link: https://youtu.be/QI8zEyplFn4

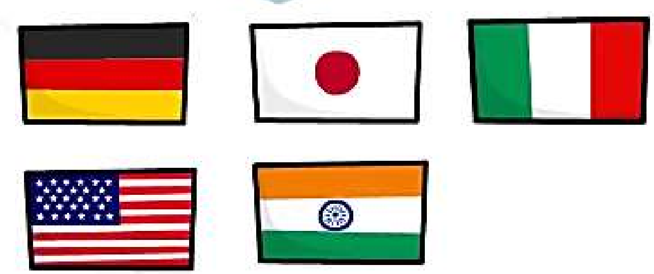
4 types of motives for FDI

1. Resource Seeking
2. Market Seeking
3. Efficiency Seeking
4. Favorable government policy seeking

1. Resource Seeking

Firms are motivated to invest abroad to acquire specific resources at a lower cost than could be obtained in their home country.

1. physical resources
2. cheap and diligent unskilled or semiskilled labor
3. technological capacity, management or marketing expertise, and organizational skills



2. Market Seeking

Firms that invest in a particular country or region in order to serve markets in that country or region.

1. *Follow main suppliers or customers*
2. *Adapt to local tastes*
3. *Save production and transaction costs*
4. *Part of global strategy*

Generate more sales abroad than in their home countries!

X series (SUVs) for USA

Caterpillar entered Japan to Counter their major competitor

3. Efficiency Seeking

Rationalize production, distribution, and marketing activities through common governance of and synergy-building among geographically dispersed operations.

1. *The advantages of differences in the cost of factor endowments between countries*

2. *The economies of scale and scope*

China

Mexico

Eastern Europe

India

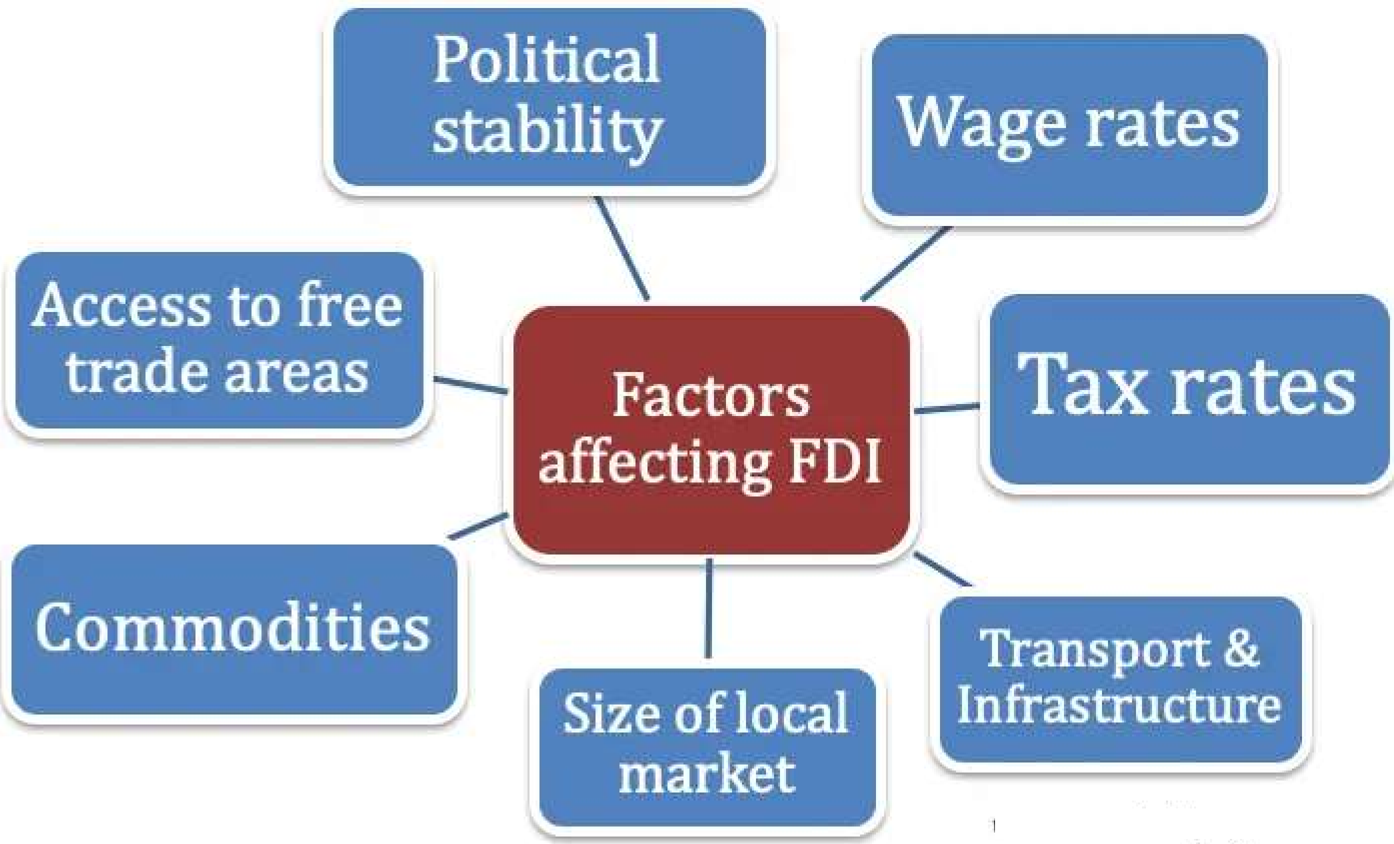
4. Favorable Government Policy Seeking

Subsidies
Low-interest loans
Tax concessions

$147 million incentive package in the 1990s

Tax breaks
State spending on infrastructure
Low-interest loans

Factors Driving Investment in China


Political stability
Wage rates
Access to free trade areas
Factors affecting FDI
Tax rates
Commodities
Size of local market
Transport & Infrastructure

Factors affecting FDI

1. Wage rates: A major incentive for a multinational to invest abroad is to outsource labor-intensive production to countries with lower wages. If average wages in the US are $15 an hour, but $1 an hour in the Indian sub-continent, costs can be reduced by outsourcing production. This is why many Western firms have invested in clothing factories in the Indian sub-continent.

However, wage rates alone do not determine FDI, countries with high wage rates can still attract higher tech investment. A firm may be reluctant to invest in Sub-Saharan Africa because low wages are outweighed by other drawbacks, such as lack of infrastructure and transport links.

2. Labour skills: Some industries require higher skilled labour, for example pharmaceuticals and electronics. Therefore, multinationals will invest in those countries with a combination of low wages, but high labour productivity and skills. For example, India has attracted significant investment in call centers, because a high percentage of the population speak English, but wages are low. This makes it an attractive place for outsourcing and therefore attracts investment.

Factors affecting FDI

3. Tax rates: Large multinationals, such as Apple, Google and Microsoft have sought to invest in countries with lower corporation tax rates. For example, Ireland has been successful in attracting investment from Google and Microsoft. In fact, it has been controversial because Google has tried to funnel all profits through Ireland, despite having operations in all European countries.

4. Transport and infrastructure: A key factor in the desirability of investment are the transport costs and levels of infrastructure. A country may have low labour costs, but if there is then high transport costs to get the goods onto the world market, this is a drawback. Countries with access to the sea are at an advantage to landlocked countries, who will have higher costs to ship goods.

5. Size of economy / potential for growth: Foreign direct investment is often targeted to selling goods directly to the country involved in attracting the investment. Therefore, the size of the population and scope for economic growth will be important for attracting investment.

Factors affecting FDI

6. Political stability / property rights: Foreign direct investment has an element of risk. Countries with an uncertain political situation, will be a major disincentive. Also, economic crisis can discourage investment.

For example, the recent Russian economic crisis, combined with economic sanctions, will be a major factor to discourage foreign investment. This is one reason why former Communist countries in the East are keen to join the European Union. The EU is seen as a signal of political and economic stability, which encourages foreign investment. Related to political stability is the level of corruption and trust in institutions, especially judiciary and the extent of law and order.

7. Commodities: One reason for foreign investment is the existence of commodities. This has been a major reason for the growth in FDI within Africa – often by Chinese firms looking for a secure supply of commodities.

8. Exchange rate: A weak exchange rate in the host country can attract more FDI because it will be cheaper for the multinational to purchase assets. However, exchange rate volatility could discourage investment.

Factors affecting FDI

9. Clustering effects: Foreign firms often are attracted to invest in similar areas to existing FDI. The reason is that they can benefit from external economies of scale – growth of service industries and transport links. Also, there will be greater confidence to invest in areas with a good track record. Therefore, some countries can create a virtuous cycle of attracting investment and then these initial investments attracting more.

10. Access to free trade areas: A significant factor for firms investing in Europe is access to EU Single Market, which is a free trade area but also has very low non-tariff barriers because of harmonization of rules, regulations and free movement of people. For example, UK post-Brexit is likely to be less attractive to FDI, if it is outside the Single Market.

Factors affecting FDI

Evaluation

There are many different factors that determine foreign direct investment (FDI) and it is hard to isolate individual factors, given there are many different variables. It also depends on the type of industry.

For example, with manufacturing FDI, low wage costs tend to be the most important, as they are a labor-intensive industry.

For the service sector, FDI, macro-economic stability and political openness tend to be more important.

Also, it depends on the source of FDI, American firms may value political openness more than Chinese firms. Or American firms may have a preference for countries where English is spoken more.

Reasons firms engage in FDI

Most foreign direct investment is undertaken by firms and multinational corporations, who hope to benefit from some of these advantages:

- Take advantage of lower labor costs in other countries (e.g. India is one of biggest recipients of FDI, where labor costs are much lower than in the OECD.
- Take advantage of proximity to raw materials rather than transport them around the world.
- Avoid tariff barriers and other non-tariff barriers to trade.
- Reduce transport costs. For example, by producing cars in the UK, Nissan has lower transport costs for selling to the UK market.
- Opportunities for using local knowledge to help tap into domestic markets. For example, by investing in a foreign country and working with local workers, a multinational can gain a better insight into what works well for local markets.

Benefits of FDI

Foreign direct investment offers advantages to both the investor and the foreign host country. These incentives encourage both parties to engage in and allow FDI.

Below are some of the benefits for businesses:

- Market diversification
- Tax incentives
- Lower labor costs
- Preferential tariffs
- Subsidies

The following are some of the benefits for the host country:

- Economic stimulation
- Development of human capital
- Increase in employment
- Access to management expertise, skills, and technology

For businesses, most of these benefits are based on cost-cutting and lowering risk. For host countries, the benefits are mainly economic.

Disadvantages of FDI

1. MNCs Bring own management teams
2. too much power to MNCs
3. practice of transfer pricing
4. increased pollution due to low regulations
5. MNCs extract natural resources from host country
6. MNCs use capital intensive production methods
7. MNCs purchase domestic firms
8. MNCs often repatriate profits

Examples of FDI

One of the most sweeping examples of FDI in the world today is the Chinese initiative known as One Belt One Road (OBOR). This program, sometimes referred to as the Belt and Road Initiative, involves a commitment by China to substantial FDI in a range of infrastructure programs throughout Africa, Asia, and even parts of Europe. The program is typically funded by Chinese state-owned enterprises and organizations with deep ties to the Chinese government. Similar programs are undertaken by other nations and international bodies, including Japan, the United States, and the European Union.

Major FDIs in Year 2021

Open 1,117 stores outside the U.S.

Build a chip plant in the U.S.

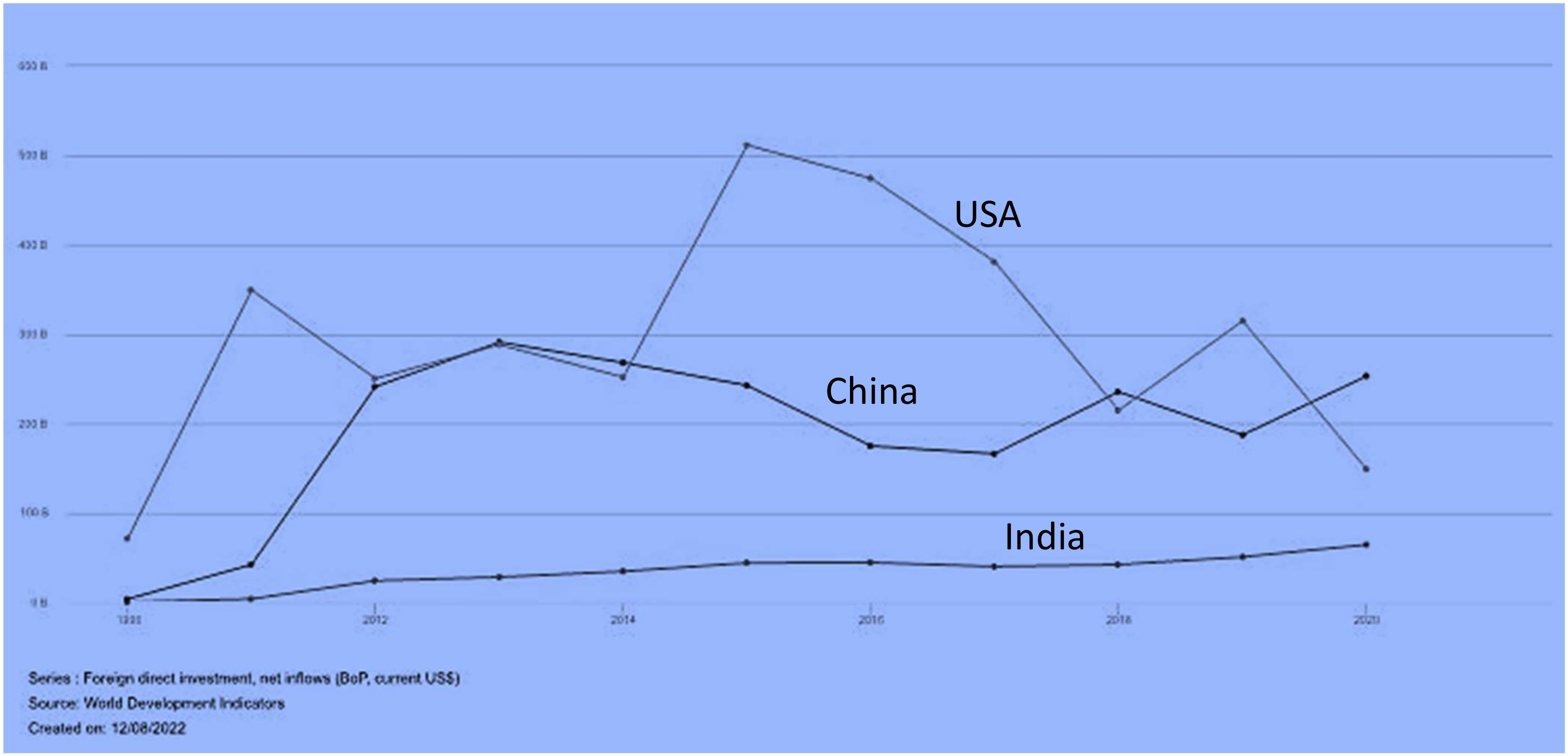
Expand Gigafactories in China and Germany

Video: Understanding FDI

Link: https://youtu.be/xP3nDn_fzGQ

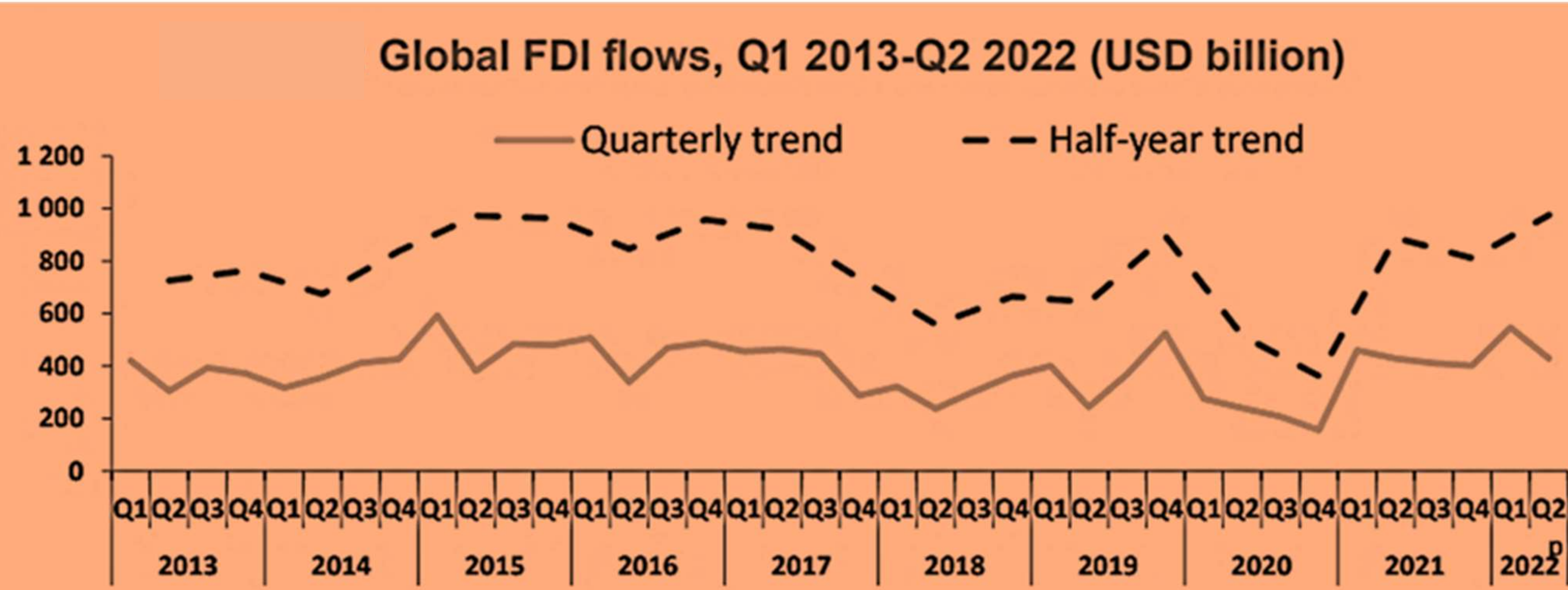
FDI (Net Inflow) – World in US Trillion $

FDI (Net Inflow) – World in US Trillion $



2019:
China - 187 Billion US $
USA - 315 Billion US $
India - 51 Billion US $

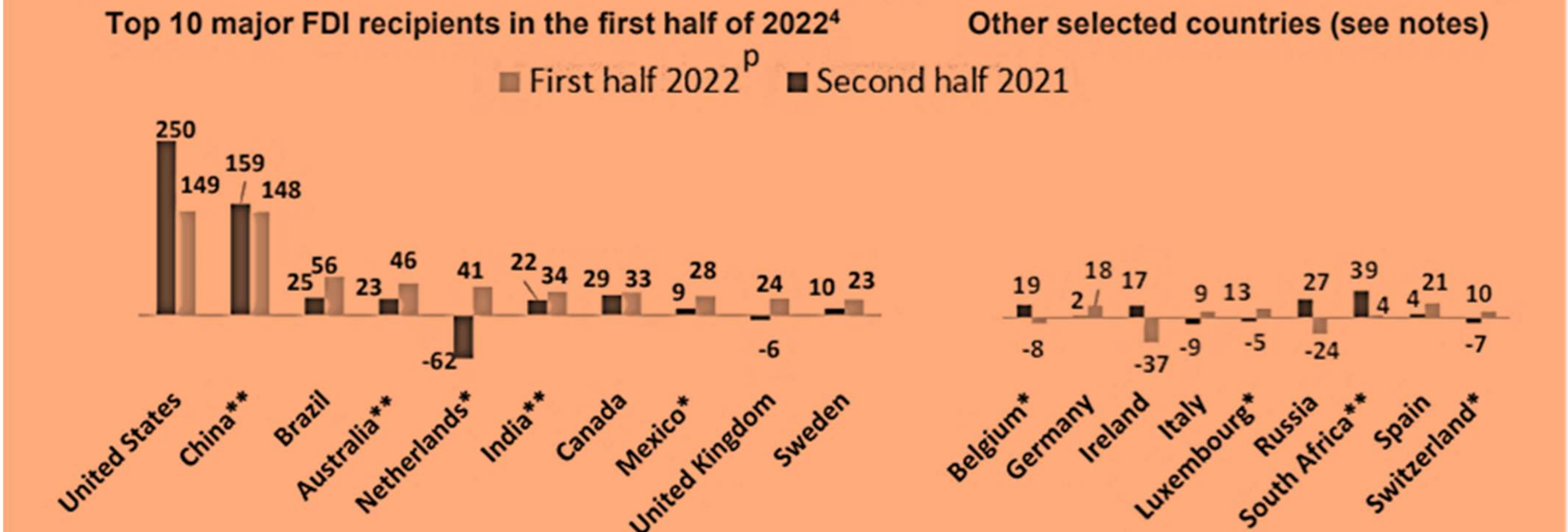
2020:
China - 253 Billion US $
USA - 149 Billion US $
India - 60 Billion US $



Notes: p: preliminary estimates.

Source: OECD International Direct Investment Statistics database.

FDI inflows for selected countries, Q3 2021 – Q2 2022 (USD billion)

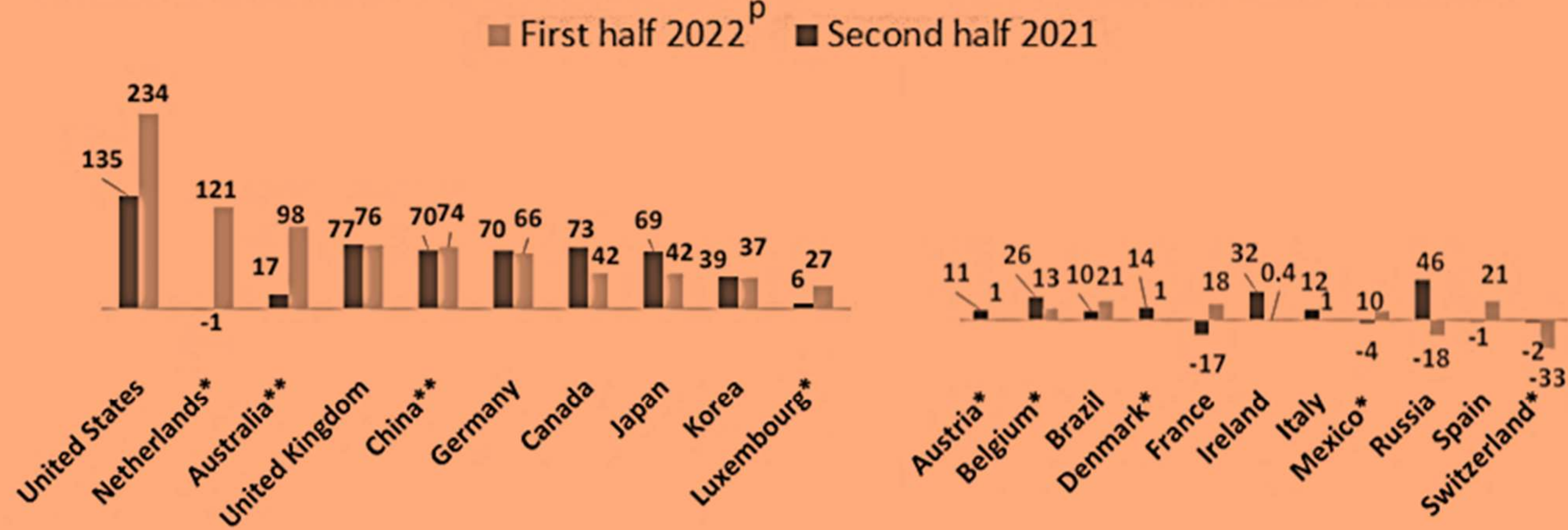


Notes: p: preliminary estimates. 'Other selected countries' recorded increases or decreases of more than USD 10 billion in their FDI inflows. * Data exclude resident SPEs. **Asset/liability basis.

Source: OECD International Direct Investment Statistics database.

FDI outflows from selected countries, Q3 2021-Q2 2022 (USD billion)

Top 10 major FDI investors in the first half of 2021[4] **Other selected countries (see notes)**



Notes: p: preliminary estimates. 'Other selected countries' displayed in this chart recorded more than USD 10 billion increase or decrease in their FDI outflows. * Data exclude resident SPEs. **Asset/liability basis.

Source: OECD International Direct Investment Statistics database.

"We know that Investment causes Growth.
But it is also true that Growth causes Investment"

thank you!