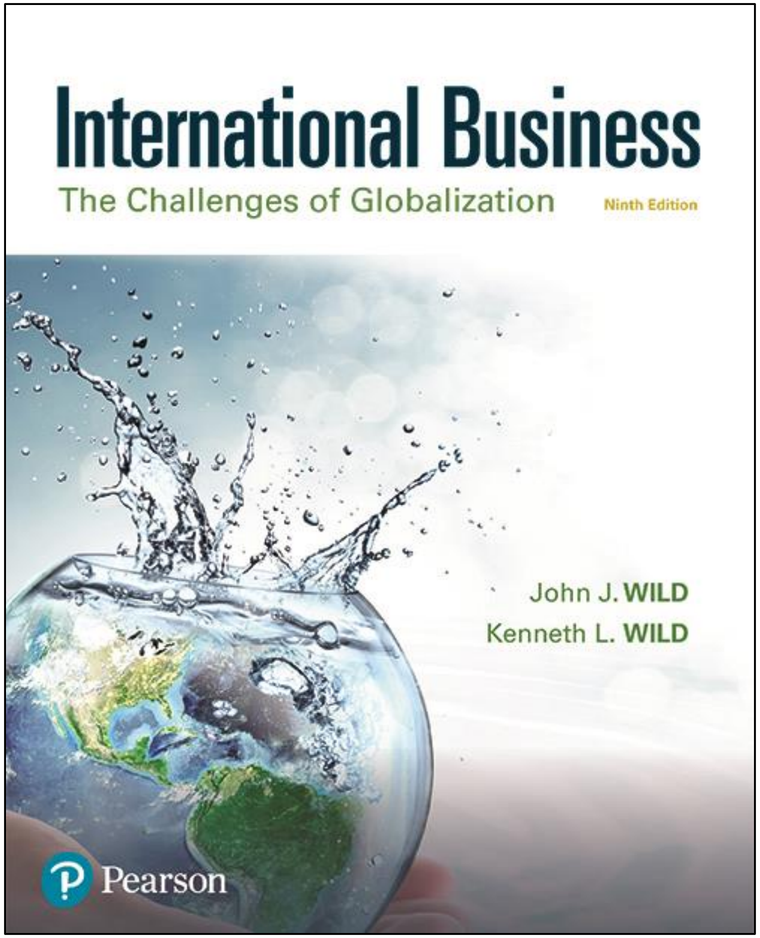
International Business: The Challenges of Globalization

Ninth Edition



Chapter 7

Foreign Direct Investment

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Learning Objectives

7.1 Describe the worldwide pattern of foreign direct investment (FDI).

7.2 Summarize each theory that attempts to explain why FDI occurs.

7.3 Outline the important management issues in the FDI decision.

7.4 Explain why governments intervene in FDI.

7.5 Describe the policy instruments governments use to promote and restrict FDI.

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Das Auto

- Volkswagen Group (www.vw.com)
  - 48 production facilities worldwide
  - Sells to more than 150 countries
  - Top-selling manufacturer in South America and China
  - China accounts for around 30% of VW's total sales
- VW's U.S. expansion
- Modular strategy
- Special protection in Germany

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Foreign Direct Investment

Foreign Direct Investment

- Purchase of physical assets or a significant amount of the ownership (stock) of a company in another country to gain a measure of management control

Portfolio Investment

- Investment that does not involve obtaining a degree of control in a company

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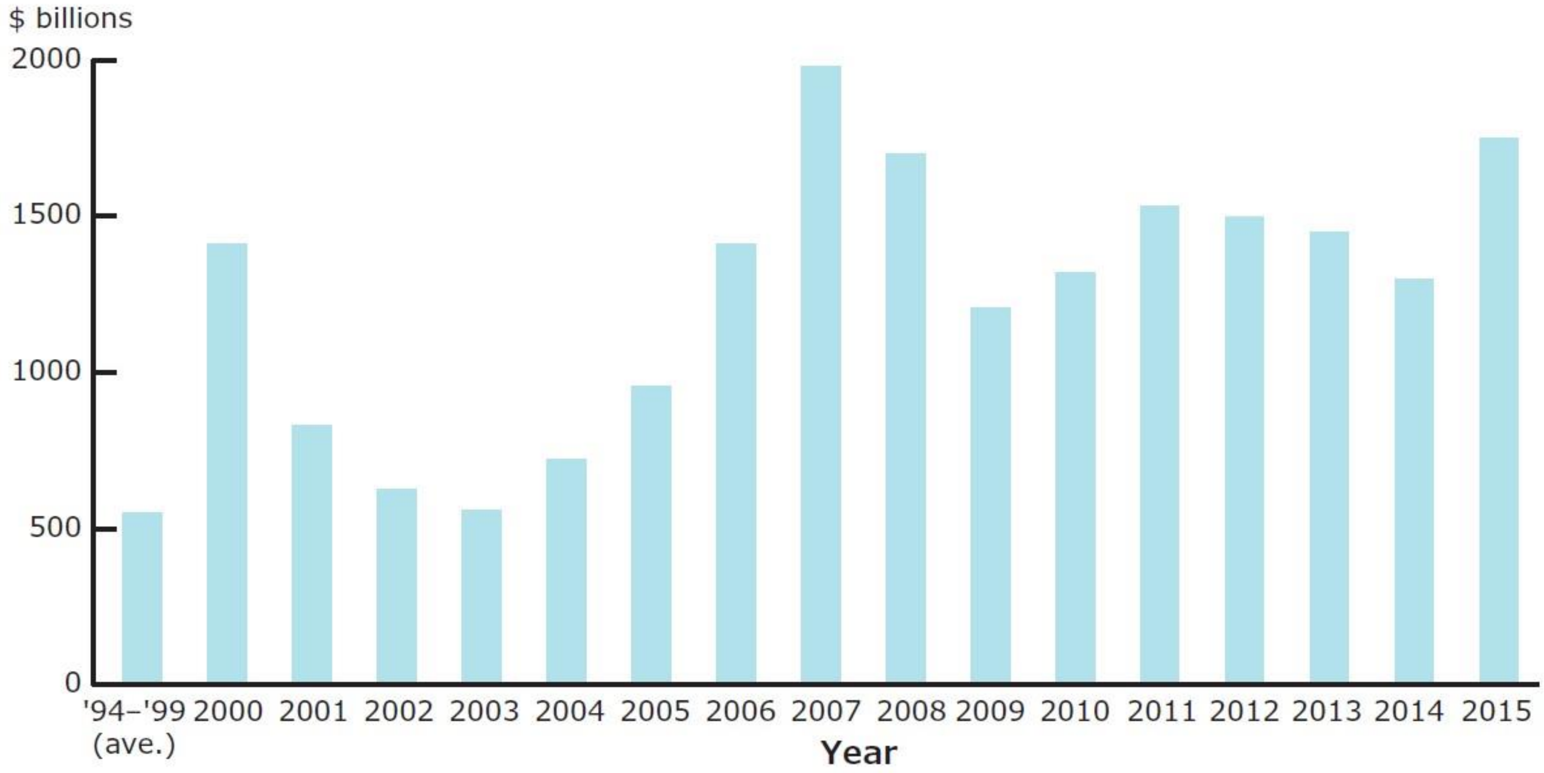
Pattern of Foreign Direct Investment

Figure 7.1 Yearly Foreign Direct Investment Inflows



Source: Based on World Investment Report (Geneva, Switzerland: UNCTAD), various years.

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Drivers of FDI Flows

- Globalization
- Mergers and Acquisitions

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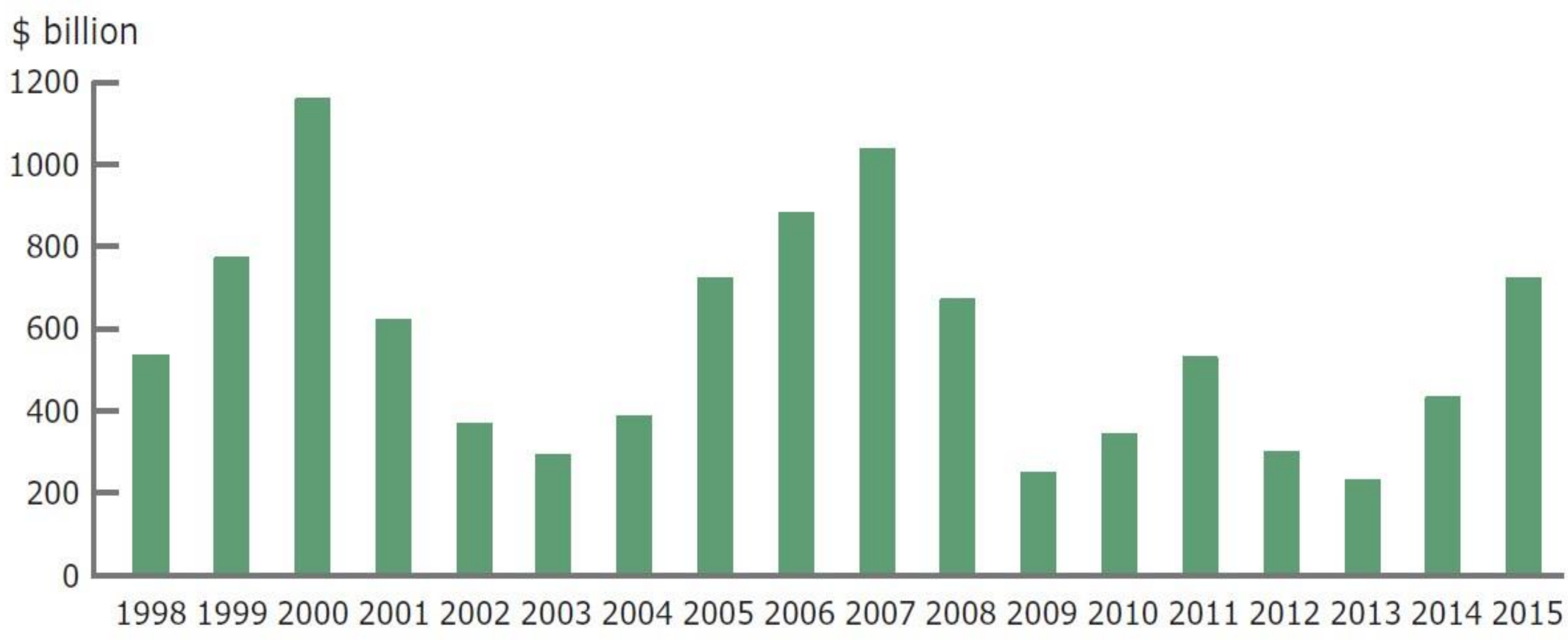
Figure 7.2 Value of Cross-Border Mergers and Acquisitions



Source: Based on World Investment Report (Geneva, Switzerland: UNCTAD), various years.

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Worldwide Flows of FDI

- Driving FDI growth are more than 100,000 multinational companies with more than 900,000 affiliates abroad.
- In 2012, developing countries attracted greater FDI inflows than did developed countries.
- Developed countries account for 42 percent ($561 billion) of total global FDI inflows.
- FDI inflows to developing countries accounted for around 52 percent of world FDI inflows ($703 billion).

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Quick Study 1

1. The purchase of physical assets or significant ownership of a company abroad to gain a measure of management control is called a what?
2. What are the main drivers of foreign direct investment flows?
3. Why might a company engage in a cross-border merger or acquisition?

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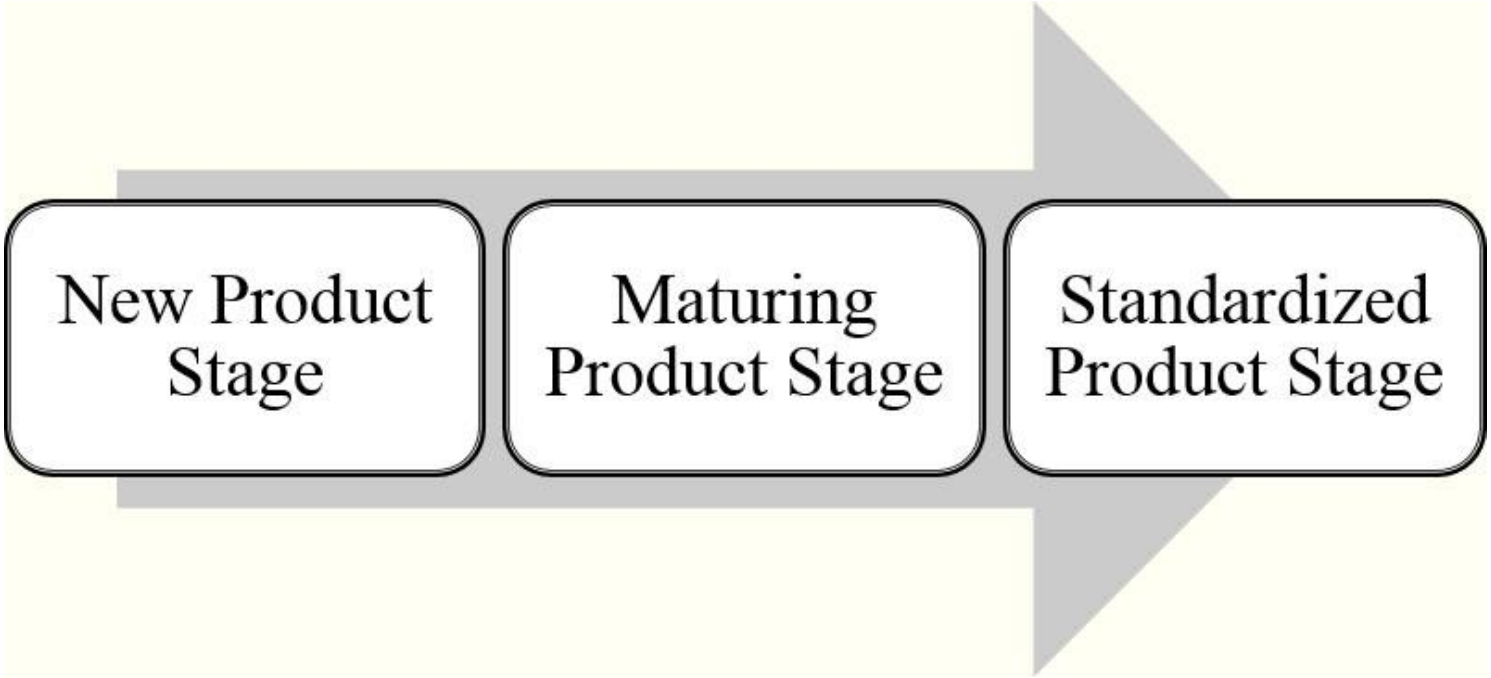
Theories of Foreign Direct Investment (1 of 4)

International Product Life Cycle



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Theories of Foreign Direct Investment (2 of 4)

Market Imperfections (Internalization)

Types of Market Imperfections

- Trade Barriers
- Specialized Knowledge

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Theories of Foreign Direct Investment (3 of 4)

Eclectic Theory

- Location Advantage
- Ownership Advantage
- Internalization Advantage

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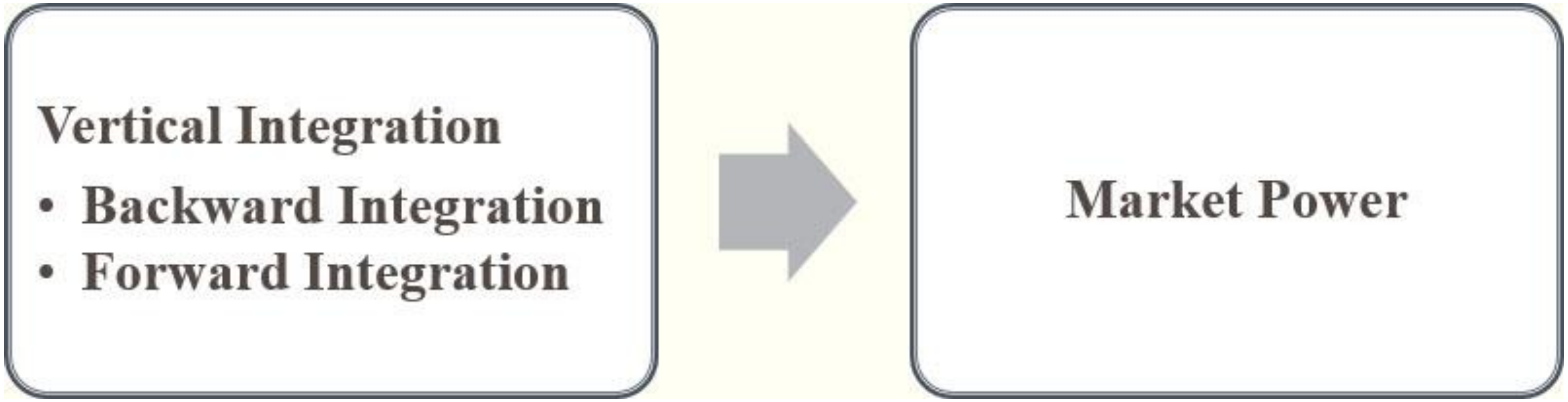
Theories of Foreign Direct Investment (4 of 4)

Market Power



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Quick Study 2

1. What imperfections are relevant to the discussion of market imperfections theory?
2. Location, ownership, and internalization advantages combine in which FDI theory?
3. Which FDI theory depicts a firm establishing a dominant market presence in an industry?

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Management Issues and Foreign Direct Investment

- **Control**
  - Partnership requirements
  - Benefits of cooperation
- **Purchase-or-Build Decision**
  - Greenfield investment
- **Production Costs**
  - Rationalized production
  - Mexico’s Maquiladora
  - Cost of research and development
- **Customer Knowledge**
- **Following Clients**
- **Following Rivals**

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Quick Study 3

1. When adequate facilities are not present in a market, a firm may decide to undertake a what?
2. A system in which a product’s components are made where the cost of producing a component is lowest is called what?
3. What do we call the situation in which a company engages in FDI because the firms it supplies have already invested abroad?

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Why Governments Intervene in FDI (1 of 4)

Balance of Payments

- **Current Account**
  - National account that records transactions involving the export and import of goods and services, income receipts on assets abroad, and income payments on foreign assets inside the country
- **Capital Account**
  - National account that records transactions involving the purchase and sale of assets

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Table 7.1 U.S. Balance of Payments Accounts (1 of 2)

CURRENT ACCOUNT			
Exports of goods and services and income receipts	+		
Merchandise	+		
Services	+		
Income receipts on U.S. assets abroad	+		
Imports of goods and services and income payments			−
Merchandise			−
Services			−
Income payments on foreign assets in United States			−
Unilateral transfers			−
Current account balance		+/−	

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Table 7.1 U.S. Balance of Payments Accounts (2 of 2)

CAPITAL ACCOUNT			
Increase in U.S. assets abroad (capital outflow)			−
U.S. official reserve assets			−
Other U.S. government assets			−
U.S. private assets			−
Foreign assets in the United States (capital inflow)	+		
Foreign official assets	+		
Other foreign assets	+		
Capital account balance		+/−	

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Why Governments Intervene in FDI (2 of 4)

Reasons for Intervention by the Host Country

- Control the Balance of Payments
- Obtain Resources and Benefits
  - Access to Technology
  - Management Skills and Employment

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Why Governments Intervene in FDI (3 of 4)

Home Country: Discouraging Outward FDI

- Investing in other nations sends resources out of the home country and lowers investment at home.
- Outgoing FDI may ultimately damage a nation's balance of payments by taking the place of its exports.
- Jobs resulting from outgoing investments may replace jobs at home.

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Why Governments Intervene in FDI (4 of 4)

Home Country: Promoting Outgoing FDI

- Increase Long-Term Competitiveness
- “Sunset” Industries

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Quick Study 4

1. The national accounting system that records all receipts coming into a nation and all payments to entities in other countries is called what?
2. Why might a host country intervene in foreign direct investment?
3. Why might a home country intervene in foreign direct investment?

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Government Policy Instruments and FDI (1 of 3)

Host Countries

Promotion

- Financial incentives
  - Low or waived taxes
  - Low-interest loans
- Infrastructure improvements
  - Better seaports, roads, and telecom networks

Restriction

- Ownership restrictions
  - Prohibit investment
- Performance demands
  - Local content requirements
  - Export targets
  - Technology transfer

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Government Policy Instruments and FDI (2 of 3)

Home Countries

Promotion

- Insurance on assets abroad
- Loans and loan guarantees
- Special tax treaties
- Tax breaks on profits earned abroad
- Persuade other nations to accept FDI

Restriction

- Higher taxes on foreign income
- Sanctions that prohibit investing in certain nations

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Government Policy Instruments and FDI (3 of 3)

Table 7.2 Instruments of FDI Policy

	FDI Promotion	FDI Restriction
Host Countries	Tax incentives	Ownership restrictions
	Low-interest loans	Performance demands
	Infrastructure improvements	
Home Countries	Insurance	Differential tax rates
	Loans	Sanctions
	Tax breaks	
	Political pressure	

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Quick Study 5

1. What policy instruments can host countries use to promote FDI?
2. What policy instruments can home countries use to promote FDI?
3. Ownership restrictions and performance demands are policy instruments used by whom to do what?
4. Differential tax rates and sanctions are policy instruments used by whom to do what?

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