Chapter Fifteen

Foreign Direct Investment

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Chapter Objective:

This chapter discusses various issues associated with foreign direct investments by MNCs, which play a key role in shaping the nature of the emerging global economy.

Chapter Outline

- Global Trends in FDI
- Why Do Firms Invest Overseas?
- Cross-Border Acquisitions
- Political Risk and FDI

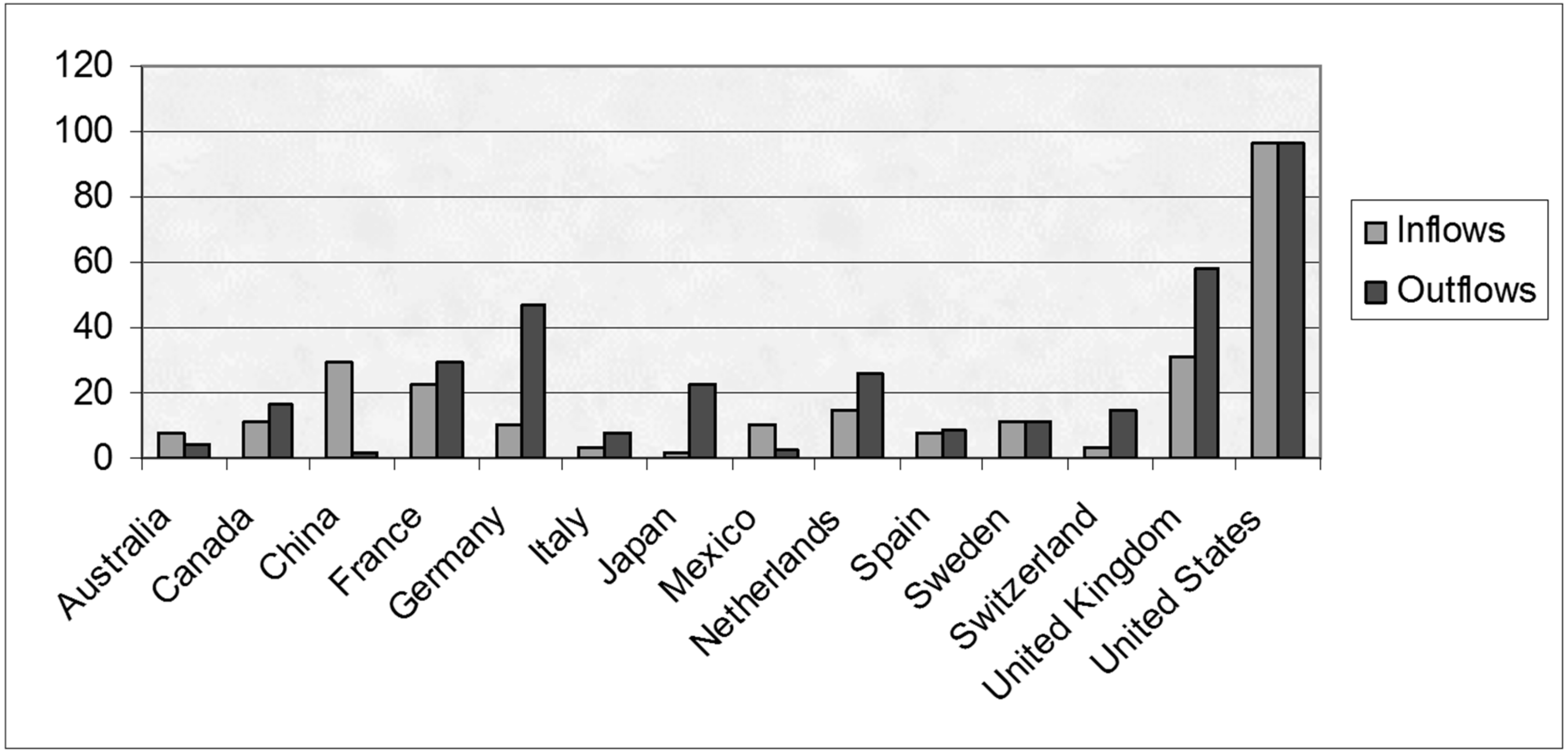
Global Trends in FDI

- Foreign Direct Investment often involves the establishment of production facilities abroad.
- Greenfield Investment
  - Involves building new facilities from the ground up.
- Cross-Border Acquisition
  - Involves the purchase of existing business.

Global Trends in FDI

- Several developed nations are the sources of FDI *outflows*.
  - About 90% of total world-wide FDI comes from the developed world.
- Both developing *and* developed nations are the recipient of inflows of FDI.

Average Annual FDI (in Billions)



Why Do Firms Invest Overseas?

- Trade Barriers
- Labour Market Imperfections
- Intangible Assets
- Vertical Integration
- Product Life Cycle
- Shareholder Diversification

Trade Barriers

- Government action leads to market imperfections.
- Tariffs, quotas, and other restrictions on the free flow of goods, services and people.
- Trade Barriers can also arise naturally due to high transportation costs, particularly for low value-to-weight goods.

Labour Market Imperfections

- Among all factor markets, the labor market is the least perfect.
  - Recall that *the factors of production* are land, labor, capital, and entrepreneurial ability.
- If there exist restrictions on the flow of workers across borders, then labor services can be underpriced relative to productivity.
  - The restrictions may be immigration barriers or simply social preferences.

Labour Market Imperfections

Persistent wage differentials across countries exist. This is one on the main reasons MNCs are making substantial FDIs in less developed nations.

Country	*Hourly Cost*
Germany	$27.37
Japan	$21.38
France/U.S.	$17.10
Israel	$9.06
Taiwan	$5.47
Mexico	$2.57

Intangible Assets

- Coca-Cola has a very valuable asset in its closely guarded "secret formula".
- To protect that proprietary information, Coca-Cola has chosen FDI over licensing.
- Since intangible assets are difficult to package and sell to foreigners, MNCs often enjoy a comparative advantage with FDI.

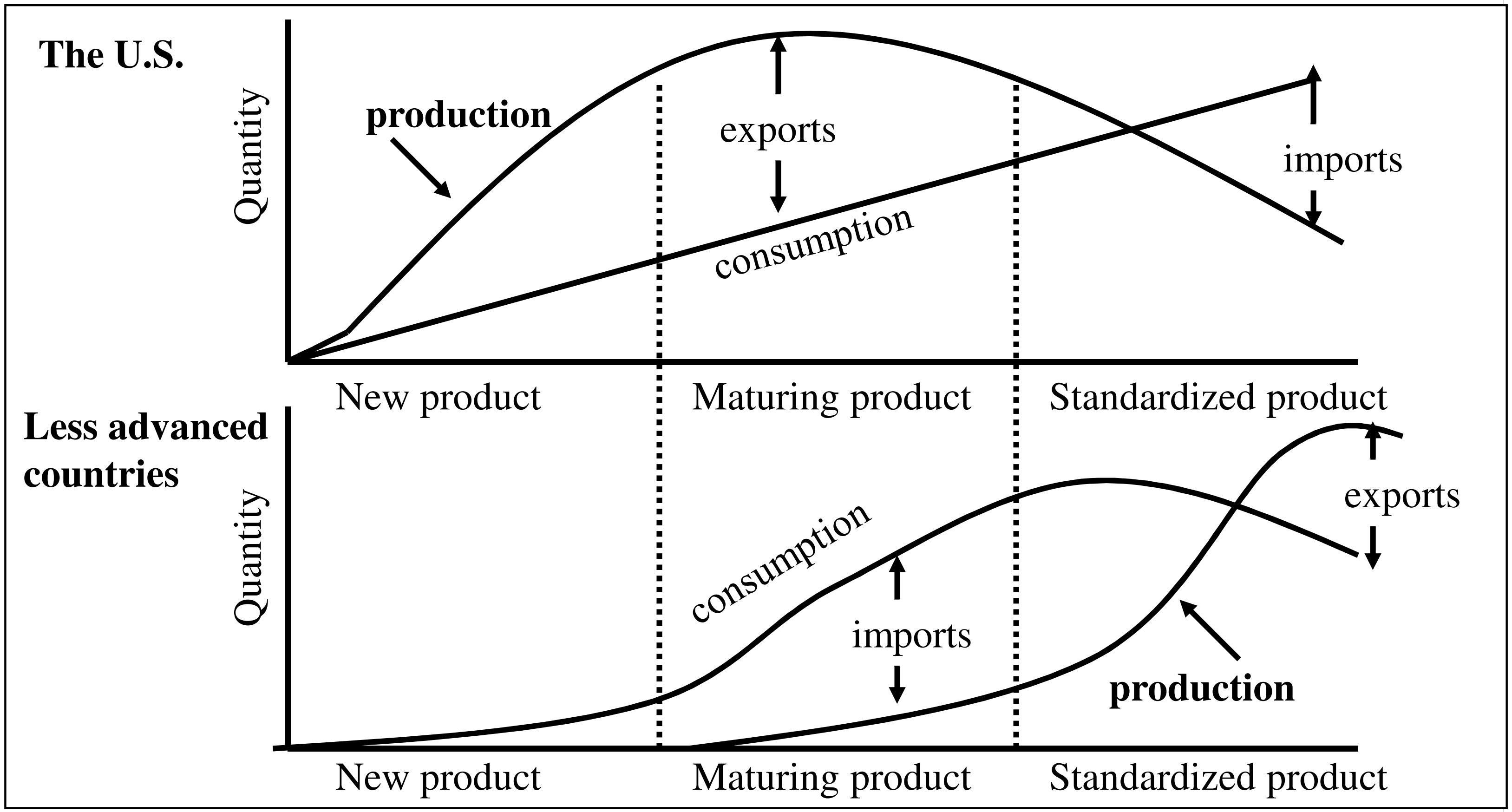
Vertical Integration

- MNCs may undertake FDI in countries where inputs are available in order to secure the supply of inputs at a stable accounting price.
- Vertical integration may be backward or forward:
  - Backward: *e.g*. a furniture maker buying a logging company.
  - Forward: *e.g*. a U.S. auto maker buying a Japanese auto dealership.

Product Life Cycle

- U.S. firms develop new products in the developed world for the domestic market, and then markets expand overseas.
- FDI takes place when product maturity hits and cost becomes an increasingly important consideration for the MNC.

Product Life Cycle



Shareholder Diversification

- Firms *may* be able to provide indirect diversification to their shareholders if there exists significant barriers to the cross-border flow of capital.
- Capital Market imperfections are of decreasing importance, however.
- Managers can therefore probably not add value by diversifying for their shareholders as the shareholders can do so themselves at lower cost.

Cross-Border Acquisitions

- Greenfield Investment
  - Building new facilities from the ground up.
- Cross-Border Acquisition
  - Purchase of existing business.
  - Cross-Border Acquisition represents 40-50% of FDI flows.
- Cross-border acquisitions are a politically sensitive issue:
  - Greenfield investment is usually welcome.
  - Cross-border acquisition is often unwelcome.

Political Risk and FDI

- Unquestionably this is the biggest risk when investing abroad.
- "Does the foreign government uphold the rule of law?" is a more important question than normative judgements about the appropriateness of the foreign government's existing legislation.
- A big source of risk is the non-enforcement of contracts.

Political Risk and FDI

- Macro Risk
  - All foreign operations put at risk due to adverse political developments.
- Micro Risk
  - Selected foreign operations put at risk due to adverse political developments.

Political Risk

- Transfer Risk
  - Uncertainty regarding cross-border flows of capital.
- Operational Risk
  - Uncertainty regarding host countries policies on firm's operations.
- Control Risk
  - Uncertainty regarding expropriation.

Hedging Political Risk

- Geographic diversification
  - Simply put, don't put all of your eggs in one basket.
- Minimize exposure
  - Form joint ventures with local companies.
    - Local government may be less inclined to expropriate assets from their own citizens.
  - Join a consortium of international companies to undertake FDI.
    - Local government may be less inclined to expropriate assets from a variety of countries all at once.
  - Finance projects with local borrowing.

Hedging Political Risk

- Insurance
  - The Overseas Private Investment Corporation (OPIC) a U.S. government federally owned organization, offers insurance against:
    1. The inconvertibility of foreign currencies.
    2. Expropriation of U.S.-owned assets.
    3. Destruction of U.S.-owned physical properties due to war, revolution, and other violent political events in foreign countries.
    4. Loss of business income due to political violence

End Chapter Fifteen