Week 6 - Foreign Direct Investment (FDI) & The Multinational Enterprise (MNE)

Foreign Direct Investment (FDI)

When a firm invests directly in facilities to produce or market a product in a foreign country.

Once a firm undertakes FDI, it becomes a multinational enterprise.

Subsidiaries are subsequently created in different countries where the headquarters:

has significant control of its operations; and

can affect managerial decisions of the foreign operation

2 Main forms of FDI:

- Greenfield Investment → the establishment of a new operations in a foreign country.
    - Investment in a new facility (Mostly in developing nations)
    - Best for transferring specialized hard to imitate resources
    - Greater control possible compared to exporting or licensing
    - Few coordination problems (compared to mergers and acquisitions)

e.g. Coca Cola, McDonalds, and Starbucks are great examples of American companies that have invested in Greenfield projects around the world.

PROS:
1) Economies of scale and scope in production, marketing, finance, research and development, transportation, and purchasing.
2) Greater control in all aspects
3) Best long term strategy
4) Commitment to market
5) Vendor financing often available
6) Work with authorities from the beginning
7) Control over your brand
8) Control over staff
9) Press opportunities

CONS:
1) Higher expense,
2) Competition in these markets can be difficult to overcome,
3) Entry into these markets can take years to happen.
4) Barriers to entry can be costly
5) Governmental regulations may put these multinational enterprises at a disadvantage in the short term

- Acquisition / Merging with an existing firm in foreign country.
    - Merge with an existing firm or acquire an existing firm
    - More prevalent in developed nations
    - Quicker to execute than Greenfield investments
    - 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

      Why Acquisition?

        - Quicker to execute rather than greenfield investment.
        - Foreign Firm already have several valuable strategic asset, such as brand loyalty, customer relationship, trademarks or patent, etc.
        - Firm can increase efficiency of the acquired unit by transferring capital, technology or management skills.

e.g. Sony Ericsson (SE) is a joint venture established in 2001 between Sony Corporation Japan and the Swedish telecommunications company Ericsson to make mobile phones. Both companies own 50% share of SE. The joint venture is to combine Sony's consumer electronics expertise with Ericsson's technological leadership and large market share in mobile communications. Sony's main motivations for the Joint Venture were based on strategic factors: seeking Ericsson's excellent telecommunications technology (in particular its technical wireless expertise) and market share in order to compete with the market leader, Nokia Corp. On the other hand, Ericsson's aim was towards the acceleration of the companies' financial and technological stance, with an ultimate aim to produce consumer electronics that would rival Nokia's stronghold on the telecommunications industry. The combination of the two companies, sharing a common aim, would allow SE to present a range of products that were far more technologically innovative than anything available during that time.

Types of FDI

- Horizontal Direct Investment

  FDI in the same industry abroad as company operates at home (e.g. Toyota Australia)

  FDI is expensive and risky ('liability of foreignness')

- Vertical Direct Investment

- Backward

  Investments into industry that provides inputs into a firm's domestic production (typically extractive industries)

  occurs when a multinational decides to acquire or build an operation that either fulfills the role of a supplier

  e.g. Starbucks create an agreement with Indo as Indo produces good quality coffee beans.

- Forward

  Investment in an industry that utilizes the outputs from a firm's domestic production (typically sales and distribution)

  occurs when a multinational decides to acquire or build an operation that either fulfills the role of a distributor.
  e.g. iPhone FDI in China to acquire the world's largest market.

Trends in FDI

Flows of FDI have increased in the last 30 years

In spite of declining trade barriers, FDI has grown more rapidly than world trade and output due to:

- Businesses fearing protectionist pressures
- FDI is seen as a way of circumventing tradebarriers
- Liberalization (political and economic changes) of the world economy (especially in developing nations). General shift toward domestic political institutions and free market economies has encouraged FDI and remove many restrictions of FDI.

- Global strategies undertaken by firms

e.g. US make sure that Chinese government does not create trade barriers as their economy depended on US.

Direction of FDI

Traditionally: Directed at developed nations of the world as the firms based in advanced countries invested in other's market.

The US has been the favorite target for FDI inflows due to:

- Large and wealthy population
- Dynamic economy
- Stable political environment
- Openness to FDI

However, FDI to developing nations (i.e. South-South) increasing, especially in Asia

Sources and Destination of FDI

Top five countries (i.e. home country) for FDI outflows (in billions of USD) in 2014

- USA (USD 337)
- Hong Kong (USD 143)
- China (USD 116)
- Japan (USD 114)
- Germany (USD 112)

Top five countries (i.e. host country) for FDI inflows (in billions of USD) in 2014

- China (USD 129)
- Hong Kong (USD 103)
- USA (USD 92)
- UK (USD 72)
- Singapore (USD 68)

Theories of FDI

Why choose FDI when there are alternatives?

FDI is expensive because the firm must bear the cost of establishing production facilities in foreign country or of acquiring foreign enterprise.

FDI is risky as he problems associated with doing the business in a different culture where the rules if the game may be very different.

1. Exporting: Producing goods at home and then shipping them to the receiving country for sale. → Can reduce the cost of FDI by using a natives' sales agent. However:

    a. Can be limited by transportation costs and trade barriers, it becomes unprofitable when ship some products over a large distance as many products have a low value-to-weight ratio and can be produced in many locations.

    b. FDI may be a response to actual or threatened trade barriers such as import tariffs or quotas.

    e.g. the wave of Japanese auto companies in the United States during the 1980s and 1990s was partly driven by protectionist treats from the congress and by quotas on the importation if Japanese cars.

2. Licensing: Granting foreign entity (the licensee) the right to produce and sell the firm's product in return for a royalty fee
On every unit sold.

    Internalization theory (Market Imperfections Theory) suggests that licensing has three major drawbacks compared to FDI:

    - Losing valuable technological know-how to a potential foreign competitor

    e.g. in the 1960, RCA licensed its leading edge color tv technology to number of Japanese companies including Matsushita and Sony. At that time RCA saw licensing as a way to earn a good return from its technological knowhow in Japanese market without the cost and risk of FDI. However, Matsushita and Sony quickly assimilated RCA's technology and used it to enter the US market to compete directly against RCA. As a result, RCA become one of a minor player in its home market.

    - Limited 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
e.g. Toyota is known with its lean production that enables it to produce higher-quality automobiles at a lower cost than its global rivals. As its competitive advantages comes from its management and process capabilities, therefore under licenses, the chances that the entity could not do so efficiently as could Toyota.

The Pattern of FDI

- Strategic behavior
  - FDI flows as the reflection of strategic rivalry between firms in the global marketplace.
    Oligopoly → An industry composed of a limited number of large firm which have major players. → Can cut the price (can shift the competitor), → Multipoint competition when 2 or more enterprise encounter each other by matching the move.
- The Electric Paradigm
  - Location specific advantages → utilizing resources endowments ir asset that are tied to a particular location that a firm find valuable to combine with its own unique asset.

Political ideology of FDI

Three views:

The Radical View

Radical views believe that MNE is an instrument if imperialist domination. They see MNE as a tool for exploiting host countries to the exclusive benefit of their capitalist-imperialist home country. They argue that MNE extract profit from the host country, control all the natural resources, and take them to their home country giving nothing to value to home country. → They should not have any FDI in the world.

The Free Market View

Argues that international production should be distributed among countries according to the theory of comparative advantage. Countries should specialize in the production if goods and services they can produces more efficiently. Therefore, MNE is an instrument for dispersing the production of goods and services to the most efficient locations around the globe. Therefore, FDI by the MNE increases the overall efficiency of the world economy.

Pragmatic Nationalism

Argues that FDI has both benefit and cost. FDI can benefit host country by bringing capital, skill, and technology and jobs but those benefits come at a cost. When foreign company produces product, the profits from that investment go abroad. Many people also argue that foreign company might import many components from its home country which has negative implications for the host country's balance of payment option. Therefore, government should maximize national benefit and minimize the cost.

Shifting ideology

- Countries gravitating to free market view

- Movement away from Marxist ideology

- Freeing up markets to competition

- Increase in the volume of FDI flows

- However nationalism in FDI is still strong

BENEFITS AND COST OF FDI

- Benefits of FDI outflows to home country

  ✓ Improves balance of payments from inward flow of foreign earnings

  ✓ Creates a demand for exports which can lead to job creation

  ✓ Increase knowledge from operating in a foreign environment

  (e.g. Ford invest on Mazda, the Japanese automobile to learn about their production process and transfer their know-how back to the US operations)

  ✓ Benefits the consumer through lower prices

  ✓ Frees up employees and resources for higher value activities