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Faculty Name	:Dr. Mrs. S. Jayalakshmi
Designation	: Assistant Professor

Unit- IV: Foreign Direct Investment

International Business

Foreign Direct Investment

Focus

- This chapter seeks to identify the economic rationale that underlies Foreign Direct Investment. For example, why do some firms prefer FDI to exporting or licensing. Is the need for control, part of the answer?

Foreign Direct Investment

- FDI occurs when a firm invests directly in facilities to produce and/or market a product in a foreign country.
  - Once a firm undertakes FDI, it becomes a multinational enterprise (multinational = more than one country).
- FDI takes two forms:
  - Greed-field investment: establishing a wholly new operation in a foreign country.
  - Acquiring or merging with an existing firm in the foreign country.
- Investing in foreign financial instruments (Portfolio Investment) IS NOT FDI.

Flow and Stock of FDI

- Flow:
  - **The amount of FDI undertaken over a given period of time (usually one year).**

- Stock:
  - **Total accumulated value of foreign-owned assets at a given time.**

FDI Outflows
1982-2000

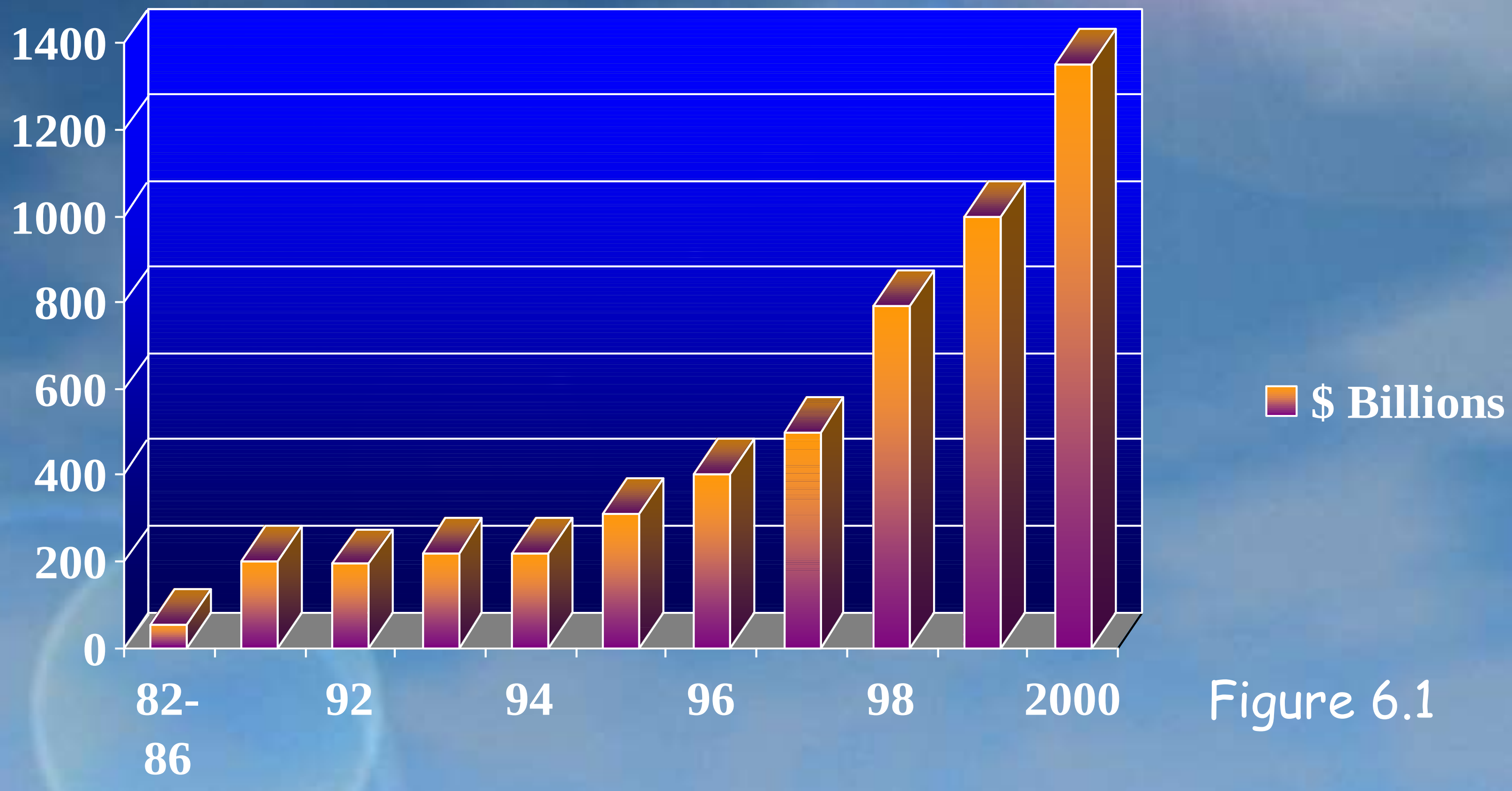


Figure 6.1

FDI Flows by Region

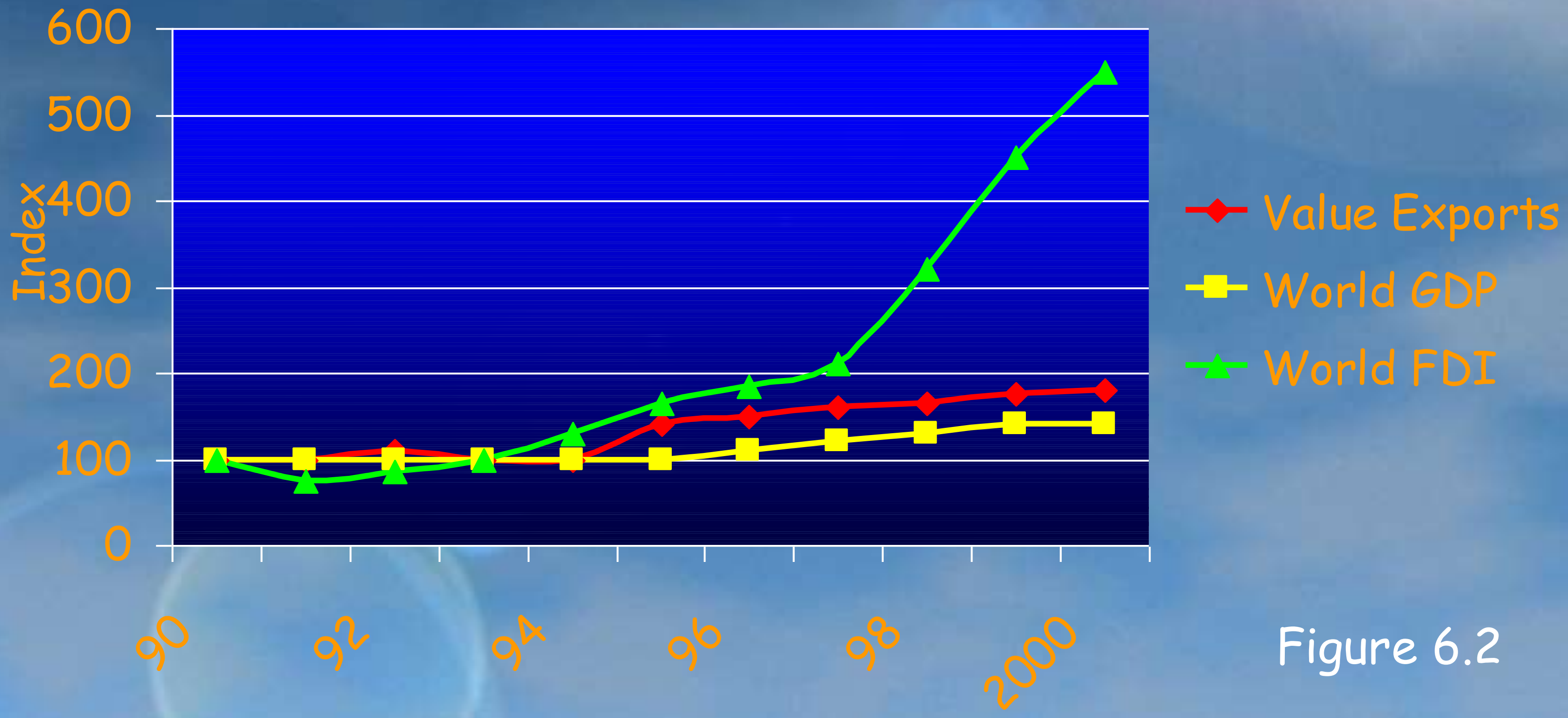
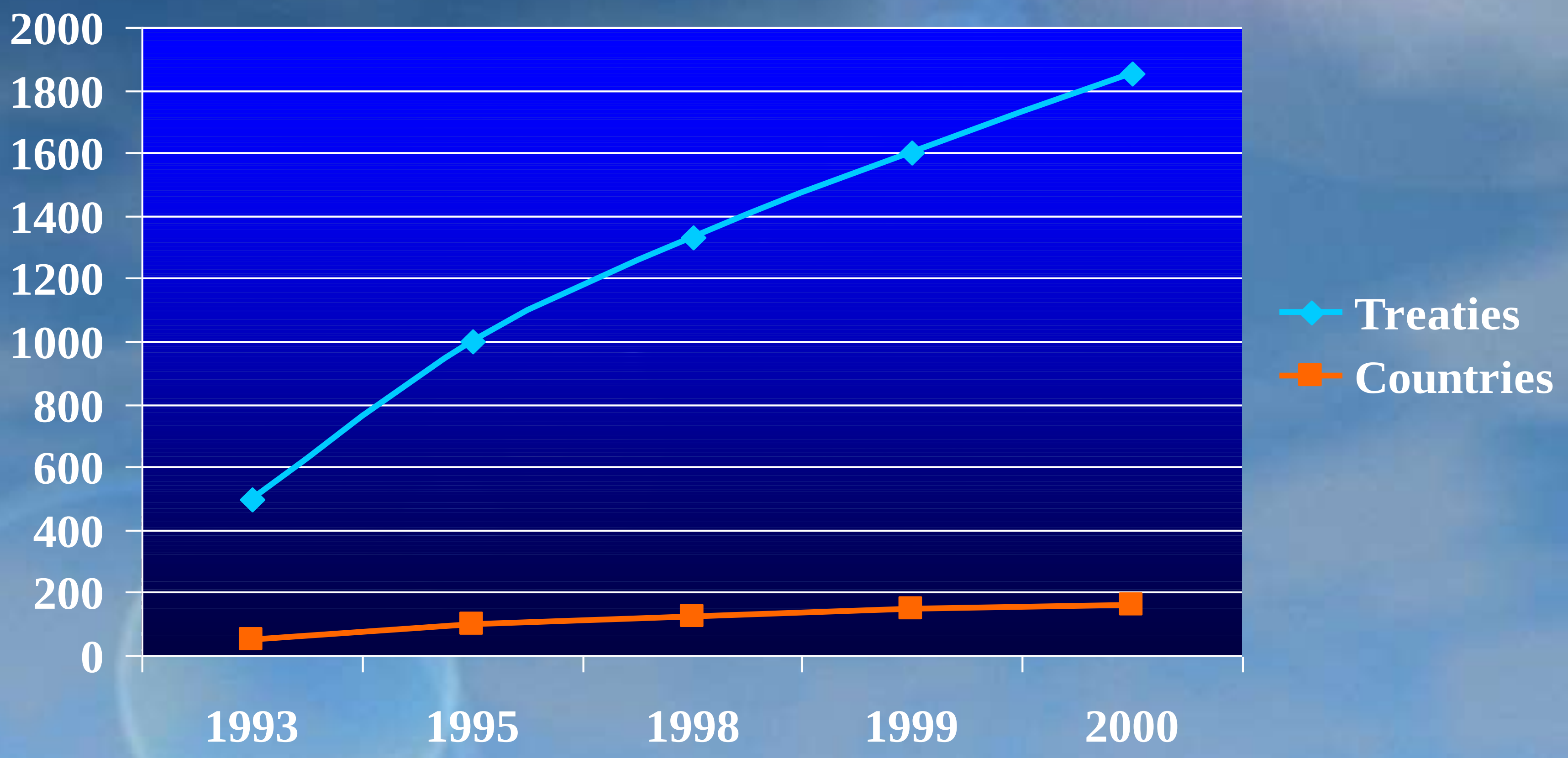


Figure 6.2

Reasons for FDI Growth

- FDI circumvents potential future trade barriers.
- Dramatic political and economic changes occurring in developing countries.

Increase in the Number of Bilateral Trade Treaties



FDI into Developed and Developing Nations: 1990-2000

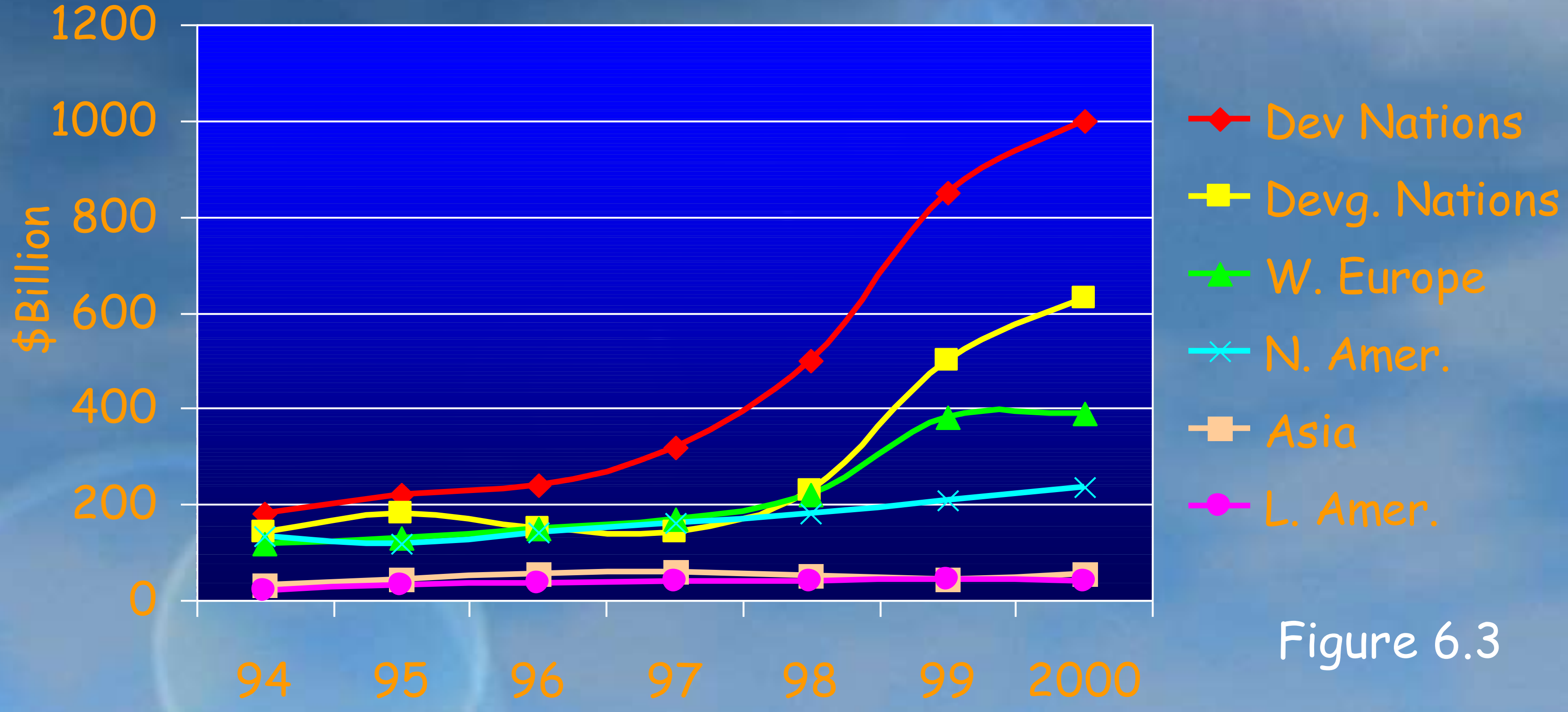


Figure 6.3

Inward FDI Flows as a Percentage of Gross Fixed Capital Formation, 1998

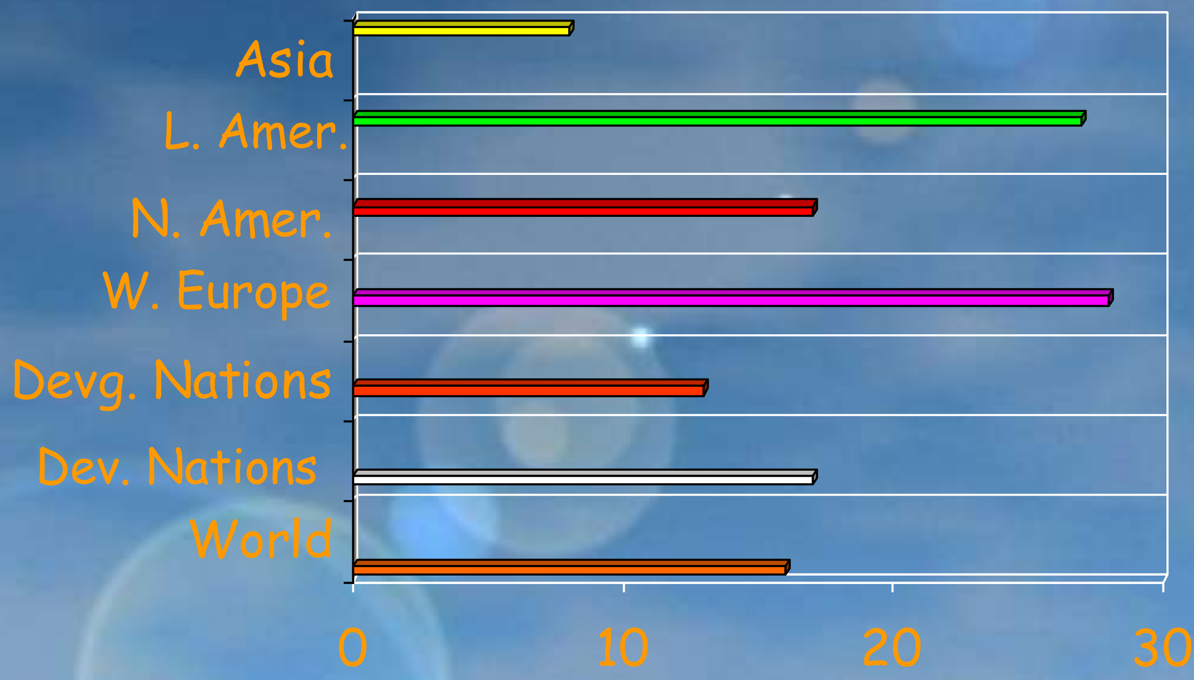


Figure 6.4

FDI Outflows by Selected Countries, 1994-1999

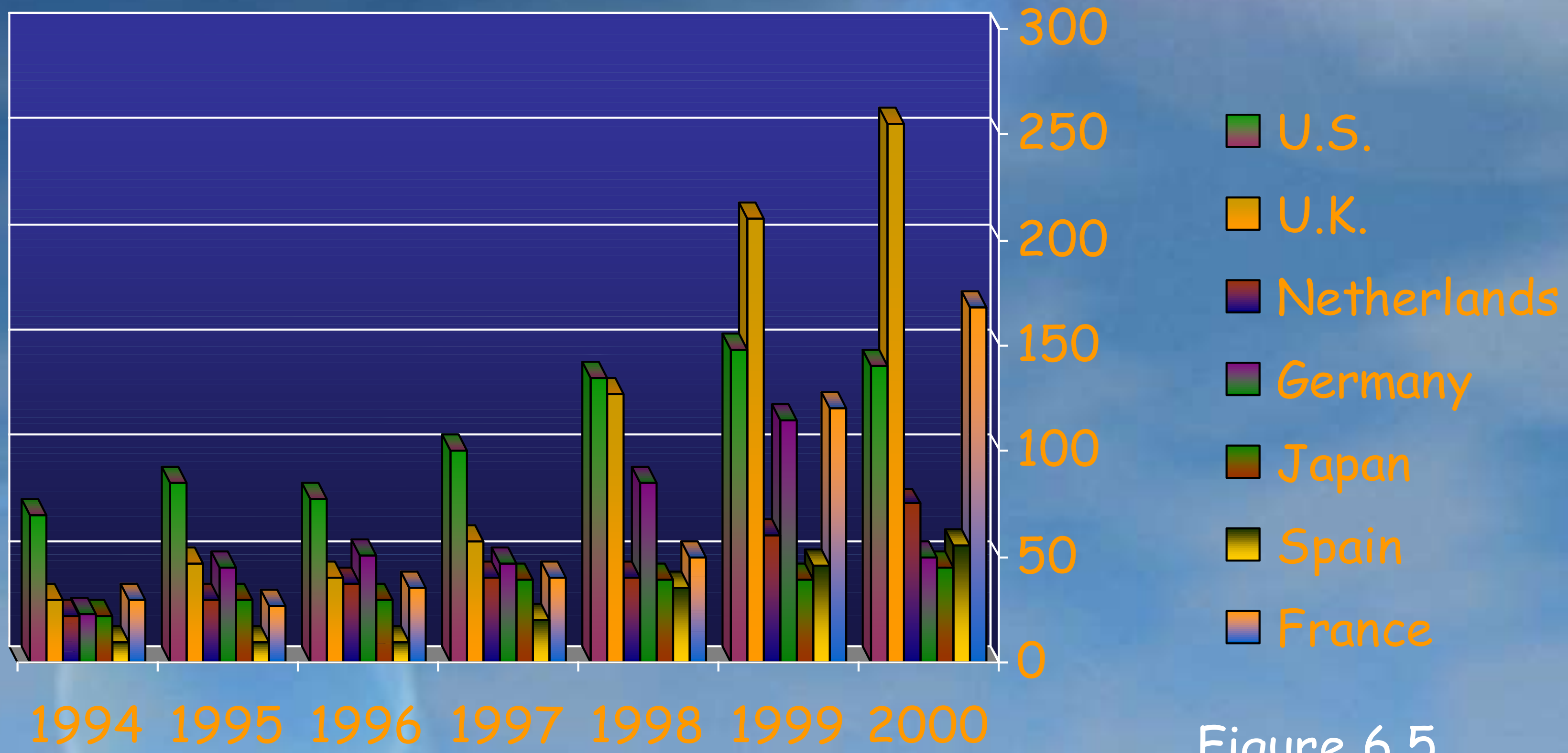


Figure 6.5

The Form of FDI: Acquisitions versus Greed-Fields

- The majority of investments is in the form of mergers & acquisitions:
  - Represents about 77% of all flows in *developed* countries.
  - Represent about 33% of all flows in *developing* countries.
    - Fewer target firms.

- Why the preference for mergers & acquisitions?
  - Quicker to execute.
  - Foreign firms have valuable strategic assets.
  - Believe they can increase the efficiency of the acquired firm.

FDI and Risk

- FDI is expensive and risky compared to exporting or
- licensing:
  - Costs of establishing facilities.
  - Problems with doing business in a different
  - Culture.
- Horizontal Direct Investment: FDI in the same industry as the firm operates at home.
  - Factors to consider:
    - Transportation Costs.
    - Market Imperfections.
    - Following Competitors.
    - Strategic Competitors
    - Location Advantages.

Horizontal FDI and Factor Considerations

Transportation Costs: High/low value to weight impacts costs.

Market Imperfections (Internalization Theory): Factors that inhibit markets from working perfectly. This includes (1) governments impeding the free flow of products between nations, and (2) impediments to the sale of know-how.

Strategic Behavior: Concentrated industries (oligopoly) tend to mimic each other's moves. Where there is multipoint competition, competing firms match each other's moves to keep the competitor in check.

Horizontal FDI and Factor Considerations

The Product Life Cycle: Suggests that foreign market demand leads to FDI, probably not true and therefore is not a good predictor of FDI.

Location-Specific Advantages: Advantages that arise from using resource endowments or assets tied to a particular location (Dunning - eclectic paradigm)

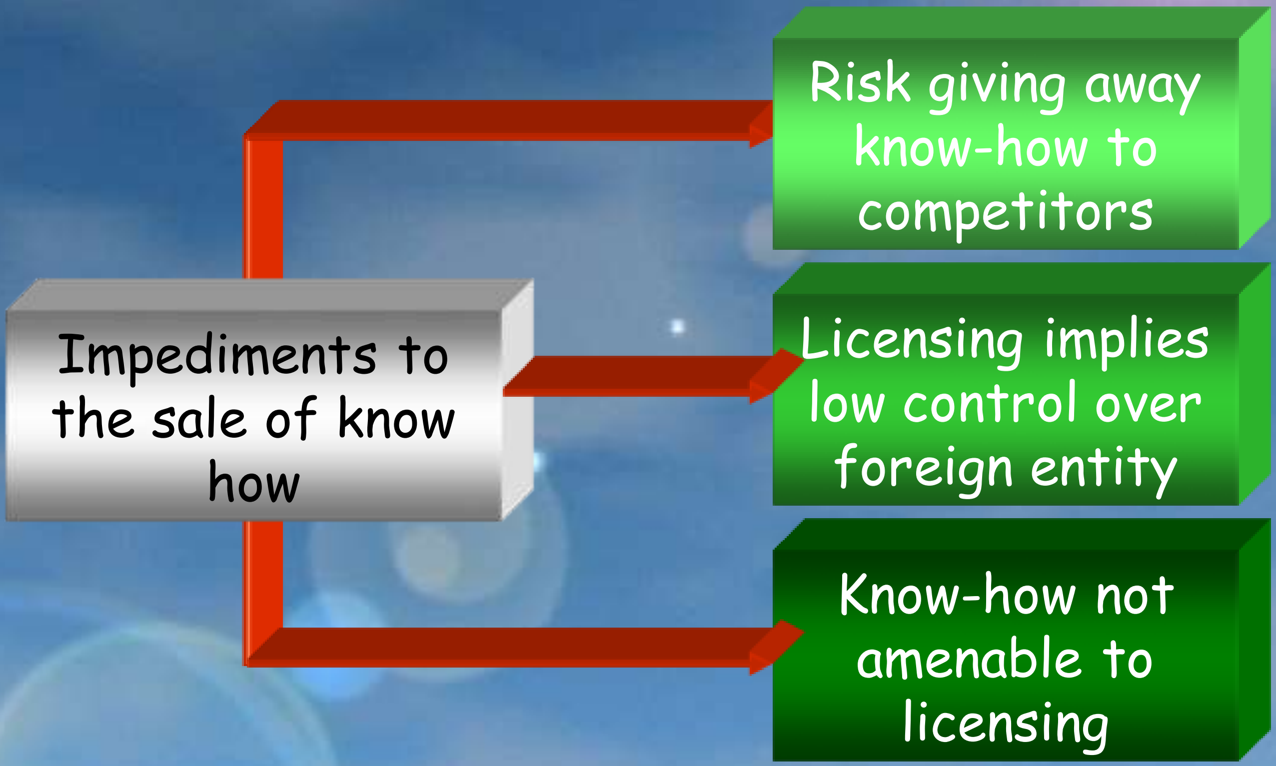
Vertical FDI

- Two forms:
  - Backward: Providing inputs (raw materials, parts) for a firm's domestic production processes.
  - Forward: An industry abroad sells the outputs of the firm's domestic production processes.

Why Do Companies Engage in FDI?

- Strategic Behavior: Can raise entry barriers or shut out new competitors, or circumvent barriers established by companies already doing business in the foreign country.
- Market Imperfections: Need to overcome lack of know-how or the firm must invest in specialized assets whose value depends on inputs provided by a foreign supplier.

Impediments to the Sale of Know-how



A Decision Framework

Figure 6.6