

UNIT 5 FOREIGN DIRECT INVESTMENT

FOREIGN DIRECT INVESTMENT

- ⦿ A **foreign direct investment (FDI)** is an ownership stake in a company, made by a foreign investor, company, or government from another country. More specifically, it describes a controlling ownership of an asset in one country by an entity based in another country.
- ⦿ Foreign direct investment (FDI) is an investment made by a company or an individual in one country into business interests located in another country. FDI is an important driver of economic growth.

Definition:-

- ⦿ Foreign direct investment (FDI) is a substantial, long-term investment made by a company or government into a foreign project or firm.

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1. Horizontal FDI

- ⦿ **Definition:** Investment in the same industry abroad as the company operates in at home.
- ⦿ **Horizontal Foreign Direct Investment (FDI)** occurs when a company invests in the **same type of business operation in a foreign country** as it operates in its home country.
- ⦿ **Example:** A U.S.-based car manufacturer opening a car production facility in Germany.
- ⦿ **Purpose:** To access new markets and reduce transportation costs.

FOREIGN DIRECT INVESTMENT

1. Horizontal FDI

Key Points

- ⦿ The company **duplicates its home-country operations** in another country.
- ⦿ The **product or service remains the same**.
- ⦿ The goal is usually to **expand market reach, reduce costs, or avoid trade barriers**.

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2. Vertical FDI

- ⊙ **Definition:** Investment in different stages of the production process in a foreign country.
- ⊙ **Vertical Foreign Direct Investment (FDI)** occurs when a company invests in a **foreign business that is part of its supply chain**, but **not in the same industry level** as its home operations.
- ⊙ **Subtypes:**
 - **Backward vertical FDI:** Investing in an earlier stage of production (e.g., raw materials).
 - **Forward vertical FDI:** Investing in a later stage (e.g., distribution or retail).
 - **Example:** A U.S. furniture company investing in a timber company in Canada (backward) or opening retail stores in France (forward).

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2. Vertical FDI

Key Points:

- ⦿ The company expands **upstream or downstream** in its supply chain in a foreign country.
- ⦿ It involves **different stages of production**, not the same product or service as in the home country.

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3. Conglomerate FDI

- ⦿ **Definition:** Investment in a completely unrelated business abroad.
- ⦿ **Conglomerate Foreign Direct Investment (FDI)** happens when a company invests in a **foreign business that is completely unrelated** to its core operations or industry.
- ⦿ **Example:** A Japanese electronics company investing in a food processing business in Brazil.
- ⦿ **Purpose:** Diversification or risk management.

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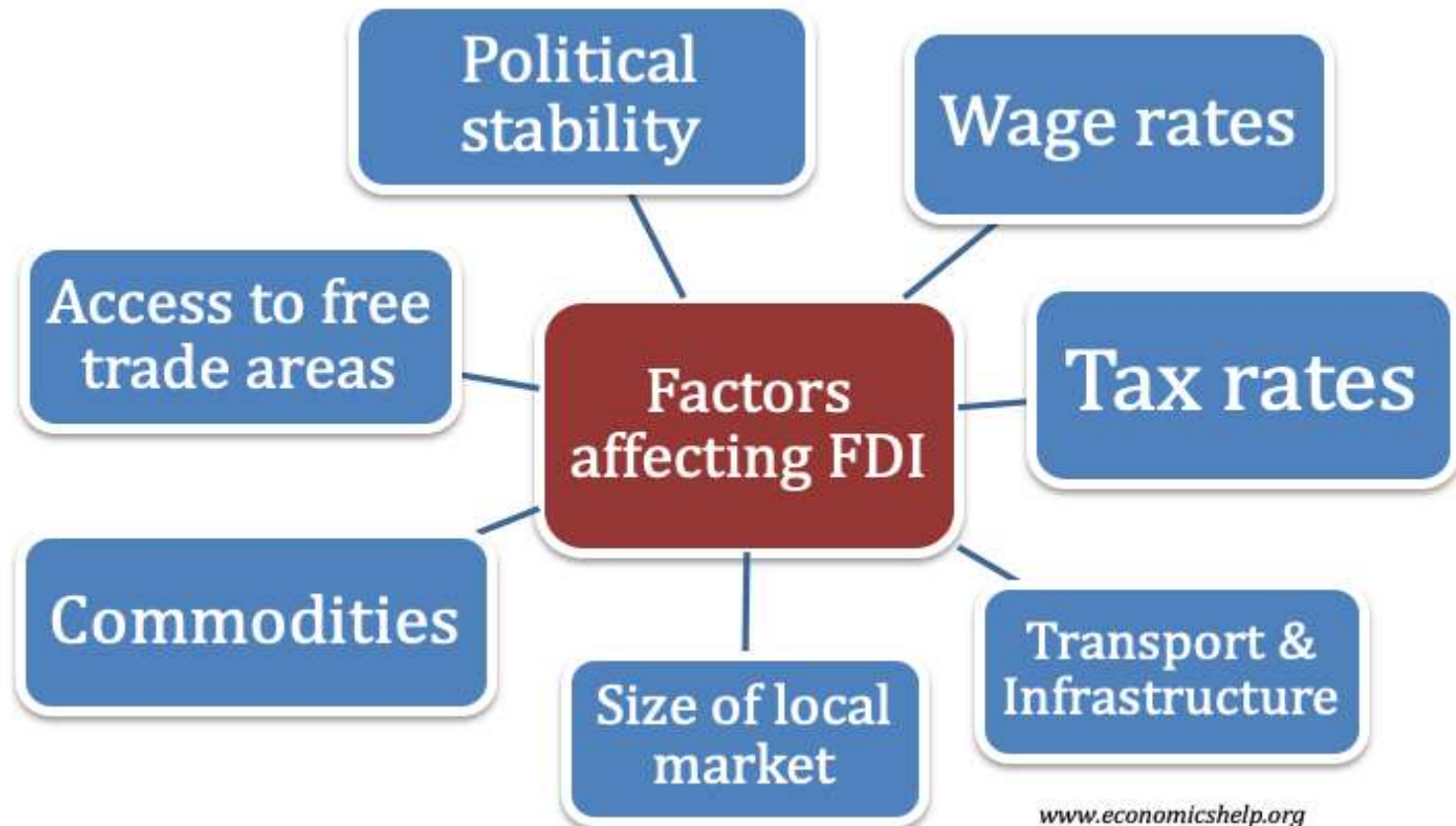
3. Conglomerate FDI

Key Points

- ⦿ The investing company enters a **different industry** in a foreign country.
- ⦿ There is **no direct link** between the company's existing business and the new foreign investment.
- ⦿ It often involves **diversification of risk** or taking advantage of **new opportunities**.

FOREIGN DIRECT INVESTMENT

Factors Affecting FDI



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Factors Affecting FDI

1. Wage rates

- ⦿ A major incentive for a multinational to invest abroad is to outsource labour-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.

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 centres, 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.

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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.

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Factors Affecting FDI

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. For example, Eastern European countries, with a large population, e.g. Poland offers scope for new markets. This may attract foreign car firms, e.g. Volkswagen, Fiat to invest and build factories in Poland to sell to the growing consumer class.

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.

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Factors Affecting FDI

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.

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Merits & Demerits of FDI

Merits of FDI

Economic growth

- ⦿ The creation of jobs is the most obvious advantage of FDI, one of the most important reasons why a nation (especially a developing one) will look to attract foreign direct investment. FDI boosts the manufacturing and services sector which results in the creation of jobs and helps to reduce unemployment rates in the country.

Human capital development

- ⦿ Human capital involved the knowledge and competence of a workforce. Skills that employees gain through training and experience can boost the education and human capital of a specific country. Through a ripple effect, it can train human resources in other sectors and companies.

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Merits & Demerits of FDI

Technology

- Targeted countries and businesses receive access to the latest financing tools, technologies, and operational practices from all across the world. The introduction of newer and enhanced technologies results in company's distribution into the local economy, resulting in enhanced efficiency and effectiveness of the industry.

Increase in exports

- Many goods produced by FDI have global markets, not solely domestic consumption. The creation of 100% export oriented units help to assist FDI investors in boosting exports from other countries.

Exchange rate stability

- The flow of FDI into a country translates into a continuous flow of foreign exchange, helping a country's Central Bank maintain a prosperous reserve of foreign exchange which results in stable exchange rates.

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Merits & Demerits of FDI

Improved Capital Flow

- Inflow of capital is particularly beneficial for countries with limited domestic resources, as well as for nations with restricted opportunities to raise funds in global capital markets.

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Merits & Demerits of FDI

Demerits of FDI

Hindrance of domestic investment

- ⦿ Sometimes FDI can hinder domestic investment. Because of FDI, countries' local companies start losing interest to invest in their domestic products.

The risk from political changes

- ⦿ Other countries' political movements can be changed constantly which could hamper the investors.

Negative exchange rates

- ⦿ Foreign direct investments can sometimes affect exchange rates to the advantage of one country and the detriment of another.

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Merits & Demerits of FDI

Demerits of FDI

Higher costs

- ⦿ When investors invest in foreign countries, they might notice that it is more expensive than when goods are exported. Often times, more money is invested into machinery and intellectual property than in wages for local employees.

Economic non-viability

- ⦿ Considering that foreign direct investments may be capital-intensive from the point of view of the investor, it can sometimes be very risky or economically non-viable.

Poor performance

- ⦿ Multinationals have been criticized for poor working conditions in foreign factories.

THANK YOU