

Foreign direct and indirect investments

[Finance](#), [Investment](#)



Foreign direct investment can be defined as the process where both firms as well as individual entrepreneurs offer capital to newly or already established firms in other countries. Firms engaged in foreign direct investment are termed as multinational enterprises or multinational corporations. (MNE's or MNC's). Jonathan Jones and Colin Wren. (2006, 6-7) FDI is also defined as investment geared to adding or deduction from an operating enterprise and out of which long lasting relationship is ensured. OCED also points out that FDI includes equity capital, reinvested earnings as well as intra company loans.

According to Xiaowen Tian in his distinguished book 'managing international business in China' the major difference between foreign direct investment and foreign indirect investment lies on the mode by which MNC's and MNE's enter the foreign markets. It depends on whether a foreign investor opts to invest directly in an economy or he/she opts for an effective share of production in an enterprise all with the aim of creating long term influence. In both foreign indirect and direct investment the investors offer their technological know-how or skills, management as well as capital.

The major distinction between the indirect and direct investment by the foreign investors is difference between equity and non-equity investment. The importance of this distinction is that it determines the level of involvement attached to each of them in the host countries. Tian Xiaowen (2007, 76) Upon making the decision to invest in a foreign market, MNC's or MNE's have to weigh their options or rather conduct a cost benefit analysis to determine which would be the best approach to enter the economy in

question. There are various factors that influence which approach that a firm will use to enter an economy or a market.

Intellectual property rights are a major factor to consider before any firm decides whether to use the various forms of indirect investment or to opt for direct investment. Markusen R. (2002, 35-38). Weak intellectual property rights encourage imitation or counterfeit production which is of a negative impact to any MNC or MNE. Regulations for instance on production and trade policies also influence the approach or mode of entry that any MNC is to take. Foreign direct investment is favoured to foreign indirect investment when transportation costs are very high.

Low transportation cost favours exportation which is an indirect form of investment Bora B (2002, 197). Another factor that attracts FDI is the presence of a relatively high productivity cost compared to cost of labour. Other factors to consider when making the decision of whether to use FDI or foreign indirect investment are the overall fixed cost of establishment as well as the nature of operation or business in question. McDonald et al (2002, 229). The exporting option of foreign indirect investment entails the process where MNE or MNC establishes an importer in a foreign economy. Wertz B and Wensley R (2002, 458).

Foreign direct investment entails the setting of production facilities in a foreign economy and political stability and governance has a significant role to play. Steven G and Shapiro D (2002, 1900). MNE's would prefer to invest in a safe and secure country as insecurity would be of a negative impact to business for instance a country where demonstrations and protests are the order of the day will be a disincentive to any MNC or MNE's investment.

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David A (1994, 200). During protests violence could be registered leading to the destruction of property translating to losses for the MNE's.

The major aim of any MNE's investment is to make profits and firms would do all in their power to ensure that losses are minimized. Indirect investment could be in form of licensing, processing as well as franchising. Tian Xiaowen (2007, 76) To Ian and Kenneth in ' globalization for development', foreign direct investment refers to the acquisition of shares by a firm in a foreign based economy which exceeds a threshold of 10%. FDI embraces managerial participation. They also noted that FDI can be a source of both direct as well as indirect source of employment in a country.

Other advantages perceived to be accrued to FDI include increased competition which precipitates innovation. Innovation ensures that there is quality production of goods and services and at a lower price; and this is beneficial to the local citizens. . Bora B (2002, 1). Through the various training conducted by most FDI's the host country human capital is improved. The host country also benefits in the sense that they acquire new technology which makes production easier and efficient. FDI is also linked with negative effects on the host country as it is blamed for exposing people to unsafe working conditions at some instances. (OCED 2002b).

Environmental concerns are also raised towards MNC's and MNE's. Some host countries complain that MNC's pollute their environment either through water, air or sound thus compromising on their natural environment. FDI is also blamed for a change in the host country's culture where at some instances foreign culture dominates the host country's culture. To Ian and Kenneth, foreign indirect investment is synonymous to equity portfolio

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investment and it entails ownership of shares in foreign nations but it differs from FDI in the sense that the share holding is quite small to be of significant managerial influence or participation.

In most cases a firm's long term or short term ambitions will have a role to play in determining if they are to opt for FDI or foreign indirect investment. Short term ambitions or goals will favour foreign indirect investment over FDI. Foreign direct investment has played a very significant role in the development of nations especially the less developed ones. It is their most important source of foreign capital flows especially for the low income countries which are characterized by inadequate capital as well as inadequate technological know how.

(Goldin I and Reinert K, 86). Ian and Kenneth also noted that in the recent times there has been stagnant trend in as far as the flow of FDI is concerned both for the low income countries as well as the medium income economies. A notable feature however has been the increased mergers and acquisitions as well as the need for increased capital flows especially to the less developed countries. Various changes have been recorded overtime and the developing countries are also being engaged in the export of capital.

The developed world is today exporting rather than just importing capital to the developing countries. Countries registering this trend are mostly from East Asia as well as from the Middle East. (Goldin I and Reinert K, 88). Global capital flows are responsible for the development of financial sector but the magnitude at which this is attained depends on the approach taken that is if firms opt for FDI or foreign indirect investment. Another trend worth

mentioning in the analysis of capital flows is the aspect of flight capital. Brooks D and Hill H (2003, 4).

Most less developed countries have limited investment opportunities in the face of high risks at the domestic level triggering most residents to hold assets abroad. It is estimated that approximately 40% of the private wealth of both African and east is held abroad due to the aforementioned reasons. This is to mean that should the conditions in their home countries improve these assets would be repatriated. In 2004, statistics had it that despite their considerable contribution towards global population the less developed countries contributed less than 10% to the global gross domestic product and less than 5% of the global FDI.

In the same year middle income countries which contributed 47% of the total global population 36% of the global GDP and 31% of the global FDI. The developed countries contributed the highest at 66% of the global FDI but this figure comprised of FDI to developed as well as developing nations. (Goldin I and Reinert K, 93) Inaccessibility to modern technologies is a major impediment to the effective involvement of developing countries in foreign investment. This is bore witness by the fact that over ?

of MNC's are engaged in research and development investment increasing the developing country's accessibility to this technology. There at times arises a conflict of interest where MNC's tend to apply the strategies that are more beneficial to them and not necessarily the best for the host country. Again, since research was first done in their home countries the results arrived at may not be comprehensive or accurate to warrant a generalization as the two are different cultures and environments altogether.

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According to Thomas Dorsey and others the capital flow trends have been changing for the past decade. Actually, it is estimated that the capital as well as capital like inflows increased from a tune of 4% in the 80's to more than 10% of the less developed country's GDP by the year 2006. This trends have been blamed on changing policies by the developed countries for instance on the change from loans to grant to reduce the debt burdens most LDC's had with the developed countries.

The increased tendency in foreign direct investment could be blamed on the globalization in both the corporate as well as financial sectors, diversified capital account liberalization, changed and better macro economic policies in LDC's as well as the increased demand for commodities in the world economy. This can be said to be a reflection of the migration patterns, increased incomes in the less developed countries as well as the falling costs of transfers across nations as well as in the financial intermediation. (Dorsey et al).

Increased inflows have been registered in both highly indebted LDC's as well as low indebted LDC's. Other factors that have not changed the manner in which capital inflows over the past decade have been going on are the endowment in natural resources. Countries which are highly endowed have registered similar capital inflow rates as those without. According to IMF officials the official capital inflows for LDC's as a percentage of their GDP has been changing over the years. Between 1981 and 1985 it stood at 2%, 1. 9% between 1986 and 1990, 2. 1% in 1991-95, 2. 2% between 1995 and 2000, and 1.

9% between 2001 and 2005 while in 2006 it stood at 2.7%. Improvement in the investment environment can also be attributed to the recorded changes in the trend of FDI. John A. (2006, 681). Such policies are on trade policies, policies affecting the cost of establishment of business as well as the costs of operation and other factors that could affect or discourage foreign investment. Over the years there have been a positive effect to favour FDI and trade has also liberalized. Major factors that have also influenced the flow of FDI include the stable macroeconomic as well as the political environment.

Macro economic policies like fiscal policies, rate of inflation as well as the external balances have had a role to play in as far as the flow of FDI especially to the less developed countries is concerned. Increased economic development in the world economy is also to be blamed regarding the flow of FDI. With increased economic development in the developed economies investment in their economies have earned them less benefits and this has triggered their increased interest in the less developed nations.

Increase in assets in the sovereign wealth funds for both resource exporters as well as other newly or emerging markets have also played a significant role in as far as the need to invest in less developed countries is concerned. (East Asian capital flows). In the East Asia for instance the increased flow of foreign direct investment could be blamed on the stronger rates of economic growth as well as the liberalization of investment. In 1997-98 however, there was the East Asian financial crises which led to the withdrawal of most foreign investors from the Asian economies.

After the financial crisis the flow of FDI picked up gradually even during the 2001 economic downturn and the end of technology bubble. Inflow of capital has remained relatively constant after the crisis and the portfolio investment has recorded a sign of recovery, although the lending of foreign banks remains flat. Foreign direct investment to the East Asia region has intensified over time due to China's low costs of labour, its strong growth as well as her entry into the World Trade Organization. Market liberalization in the previously government controlled economy can be blamed for increased investment in China by foreigners.

Through mergers and acquisitions between the US and Europe the flows of global foreign investment increased tremendously from 1997-2000. Inter-regional foreign direct investment was also recorded. From 1998 to 2002 the global net inflows of foreign direct investments have been fluctuating. In 1998 it stood at the \$650, \$1100 billion in 1999, \$1400 in 2000, \$810 in 2001 and \$610 billion in 2002. FDI plays a greater role in as far as foreign capital inflow is concerned. The East Asia region has benefited from FDI through acquisition of skills as well as technology.

FDI has contributed a tune of 17% to 19% of the fixed investments in the Asia region. The flows of capital from the US have significantly declined which is a clear indication of a weak US economy. Japan plays a significant role in as far as the development of foreign direct investment in the Asian region is concerned. Increased foreign direct investment by Japanese is due to rapid growth as well as the industrialization of Japanese multinational which triggered their interest in investing offshore. Another factor explaining this trend is the increased production cost at home.

In 2002, statistics have it that China overthrew the US as the largest developing country receiving foreign direct investment. At the global level she attains 33% of the total global FDI in flows that were being channelled to the developing countries. In terms of FDI inflows into the East Asia region, she recorded the highest proportion at 60% (East Asian capital inflows) It is also argued that foreign direct investment has a role to play in as far as good governance; better organizations as well as managerial skills are concerned especially in cases where mergers and acquisitions are involved.

Flows can also benefit an economy through the dissemination of technologies all geared to ensuring that there is population abatement. There are spill over effects associated with the flow of FDI especially when local firms imitate the foreign companies methods of production. The more the foreign investors invest in a growing economy the larger or more their profit margins and the opposite is true. References: Bijit Bora. 2002. Foreign Direct Investment: Research Issues. Routledge Publishers. Frank McDonald and Fred Burton, Peter Walton, Peter Dowling, Helen Decieri.

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