What is foreign direct investment (fdi)?

Economics, Macroeconomics

What is FDI? 1) FDI is not only beneficial to certain individuals of the society; it is spread through out the economy via the theory of the multiplier effect. As workers of an investing firm are paid their wages, they would decide to spend it on their essential needs, which in turn, become the income for other certain individuals. This cycle is repeated, known as the multiplier effect. This ultimately boosts the economy of Thailand raising its standard of living. 2) This investigation will examine the positive and negative implications of Foreign Direct Investment (FDI) on the host countries as well as the investing companies. This study will also touch upon the differences FDI makes for developed countries as well as low economically developed countries (LEDC's). Introduction Foreign Direct Investment is defined as ' any equity holding across national boarders that provides the owner substantial control over the entity' (see Appendix A). This is generally defined as a 10% holding or greater. Most FDI ends up being 100% ownership by a Multi-National Corporation (MNC). FDI has increased dramatically in the past twenty years (see Appendix B need 2 find!), to become the most common type of capital flowing across borders in both developed and developing economies. For the most part politicians and economists welcome the increase of FDI to developing economies. It brings capital needed for economic development in the country in a way that is not as risky as borrowing from overseas. It may also bring a range of additional benefits. However there is conflicting evidence about the real world effects of FDI, which will be analysed during the course of this essay. Firstly, this investigation will look at the positive and negative implications on the host country. The positive consequences of FDI on the host nation To examine the consequences of FDI on the host country,

this report will single out the benefits of FDI to a ‘ developing country’. Foreign Direct Investment has come to be officially encouraged by governments, many of which have formal FDI promotion programs (see appendix B). Governments sometimes provide substantial incentives to companies locating in their countries. This suggests that FDI is generally good for the host country and presents a sound argument in FDI’s favour. The empirical evidence is good that FDI often, though definitely not always, contributes to economic growth. It can be said that this economic growth effectively reduces poverty within the host country, though not necessarily to a more equitable distribution of income. FDI is generally comes from multinational corporations, and these companies are concerned with making investments that will create profits. Therefore, their investments are usually well targeted towards setting up a business that will make money and create jobs. This contrasts especially with aid and loans to governments, which have often been squandered through corruption or spent inefficiently on unneeded infrastructure or other ‘ vanity’ projects. Figure 1 is table showing Gross Domestic Product as well as Foreign Direct Investment in the years 1985 to 2001. As the chart shows FDI is important for china’s continued economic growth (not necessarily more important than several other influences, but nevertheless highly important). As the level of FDI increases so does the figure for china’s GDP, they also seem to grow at a similar rate. Although there may well be other factors for this growth the importance of FDI in China’s rapid economic growth cannot be denied. FDI is beneficial as it is generally spent on ‘ hard assets’ such building factories and equipment, the capital embodied in FDI cannot flee a country in time of crisis as easily as

debt capital. A company cant sell off a factory and pull out of the country as quickly as a bank can sell off the countries bonds, or refuse to roll over short term loans. An example of debt capital desertion was in the Asian Financial crisis in the late nineties. The western investors lost confidence in securities in East Asia and began to pull money out, creating a snowball effect (see appendix C). A successful foreign owned firm should generate profits, and hence generate tax revenue for the host country in the form of corporation tax. Those taxes can then be spent on needed infrastructure, social programs, education etc. This helps explain why governments encourage FDI, however, this is not always the case, the MNC can come up with ways in which it exploits the country that hosts it, however this subject will be explored later on in this essay. FDI can sometimes lead to what has become to be known as a ‘ positive spill over’, this happens as MNC’s typically have greater technological and management expertise than local firms. This expertise can be transferred to other parts of the economy. This obviously happens the most concentrated when the MNC has close ties to local partners, suppliers and customers. Another reason FDI is encouraged is because MNC’s are thought to provide training and better employment opportunities for development of the labour force. It can also be the case that MNCs pay better and train employees more thoroughly than domestic firms in developing economies. It is also claimed that the presence of MNCs in the labour market will provide local firms with an incentive to improve conditions and wages of workers. Therefore, the general workforce of the host country benefit. MNCs by definition require substantial skill in importing and exporting. This is obviously because they operate in more than one

countries, and require already established distribution links around the world. These export orientated foreign firms in a country can help improve local firms efforts in trying to sell overseas. One way this happens is through improvements in shipping and logistics infrastructure (find example)- For example, increased presence of international shipping firms and agents. There is also some knowledge transfer, where managers of local firms learn from the example of the MNC how to open new export markets. Another key component in the ‘ positive spill over’ is the increased demand for inputs of local suppliers that a new MNC can create, which can lead to increased revenue and profits for local firms, as they are selling more. As demand has shifted to the right market forces suggest that local firms can raise prices. This has also become known as an ‘ upward regional multiplier effect’ FDI can also possible provide lower-cost inputs for local suppliers. If the MNC begins creating a product that had previously been imported by local firms, this will drive down local firms costs as they will no longer have to pay import duties the travel expense, they will also now have access to the product a lot faster and easier as it is being produced domestically. This will have a beneficial effect on local firms profit margins. The MNC through FDI will have be incredibly beneficial effect to the host country macro-economically. As the MNC will create demand for the host countries currency, having an ‘ appreciating’ affect. This is especially good if the country imports a lot of goods. Also if the MNC is export orientated, this could help the countries balance of payments. Though, this does rely on however much the company imports. The negative consequences of FDI on the host nation To help examine the possible negatives of FDI this report also

use the same type of economy (developing/emerging economies) as used in the previous section. As the foreign owned firms become established and profitable, the profits they have made in that particular country are not actually reinvested back into that country. The profits are exchanged from the host nations currency, to the currency of where the headquarters of the MNC are. This means that capital is leaving the country, if the base of foreign owned companies is large enough this can lead to a serious capital drain. Also due to demand for the host countries currency decreasing as the MNC will be wanting to sell the host countries currency and buy its home currency, this could potentially lead to the host countries currency depreciating. Therefore, it can be considered a negative for a country to become dependant on FDI. FDI may create damaging competition for local firms; this is often referred to as a ‘ negative spill over’. This is because MNCs often have skill, technology and capital that local firms cannot match. Local firms can be put out of business and from this unemployment would result. (find example where local firms forced out?) however, this could lead to a paradox where in order to survive local firms are forced to modernise and improve efficiency. The question to ask here may be whether local firms will be able to improve enough to compete. If the MNC gains a monopoly position by forcing out all local firms within its industry, it could then raise prices forcing citizens of the host country to pay higher prices as there are no viable substitutes. This is a huge benefit for the MNC which will be able to make supernormal profits in the host country, and then siphon those profits back to its home country. Social protest and disorder can occur when MNCs are seen as exerting too much power, especially monopoly power over

another countries ‘ strategic industries’ (or ‘ infant industries’) such as electricity, water, and communications. For example, in Bolivia 2000 a local water service was taken over by a multinational conglomerate led by ‘ Bechtel’. When this company instantly doubled prices overnight. 3) Multinational sales have grown tremendously in the last two decades. Growth of these sales has even outpaced the remarkable expansion of trade in manufactures. Consequently, the trade literature has sought to incorporate the mode of foreign market access into the ¡°new¡± trade theory. This report recognizes that firms can service foreign buyers through a variety of channels: they can serve them through foreign subsidiaries by engaging in foreign direct investment (FDI), export their products to foreign customers, and license or contract with foreign firms to produce and sell their products. This report focuses on the firm¡¯s choice among export, license and FDI, and the factors for selecting a market entry mode. 2. Foreign direct investment (FDI) 2. 1 Foreign Direct Investment Foreign direct investment (FDI) is the direct ownership of facilities in the target country. It involves the transfer of resources including capital, technology, and personnel. Direct foreign investment may be made through the acquisition of an existing entity or the establishment of a new enterprise. A foreign direct investment means acquiring control by owning more than 50 percent of the operation. But in practice, it is possible for any firm to gain effective control by owning less. In any event, a foreign direct investment turns the firm into a multinational enterprise, one that controls operations in more than one country. Joint ventures and wholly owned subsidiaries are two examples of foreign direct investment. 2. 2 FDI versus foreign portfolio

investment£¨FPI£© It is necessary to distinguish the FDI from foreign portfolio investment (FPI). Foreign portfolio investment is investment by individuals, firms or public bodies (e. g., national and local governments) in foreign financial instruments (e. g., government bonds, foreign stocks). FPI does not involve taking a significant equity stake in a foreign business entity (i. e., the equity stake is less than 10 percent). FPI is determined by different factors than FDI and raises different issues. 2. 3 The form of FDI: Acquisitions versus green-fields Acquisition involves acquiring or merging with an existing firm in the foreign country. Green-field investment is the investment that involves the establishment of a wholly new operation in a foreign country. 2. 4 Horizontal FDI versus vertical FDI Horizontal FDI is FDI in the same industry abroad as a firm operates at home. Vertical FDI is a way of reducing a firm¡¯s exposure to the risks that arise from investments in specialized assets. Compare other entry mode like exporting and licensing, when other things being equal, FDI is expensive and risky. FDI is expensive because a firm must bear the costs of establish production facilities in a foreign country or of acquiring a foreign enterprise. FDI is risky because of the problems associated with doing business in another culture where the ¡°rules game¡± maybe very different. 2. 5 Advantages and disadvantages of FDI Advantages: (1) The benefits of FDI to a host country arise from resource-transfer effects, employment effects, balance-of-payments effects, and its ability to promote competition. Employment effects arise from the direct and indirect creation of jobs by FDI. Balance-of-payments effects arise from the initial capital inflow to export finance FDI, from import substitution effects, and from subsequent exports by the new enterprise. (2) FDI can make a positive

contribution to a host economy by supplying capital, technology, and management resources that would otherwise not be available. Such resource transfers can stimulate the economic growth of the host economy. (3) By increasing consumer choice, foreign direct investment can help to increase the level of competition in national markets, thereby driving down prices and increasing the economic welfare of consumer. (4) The benefits of FDI to the home (source) country include improvement in the balance of payments as a result of the inward flow of foreign earnings, positive employment effects when the foreign subsidiary creates demand for home country exports, and benefits from a reverse resource-transfer effect. A reverse resource-transfer effect arises when the foreign subsidiary learns valuable skills abroad that can be transferred back to the home country. (5) FDI allows the transfer of technology¡ªparticularly in the form of new varieties of capital inputs¡ªthat cannot be achieved through financial investments or trade in goods and services. FDI can also promote competition in the domestic input market. (6) Recipients of FDI often gain employee training in the course of operating the new businesses, which contributes to human capital development in the host country. Disadvantages: (1) Increased Communication and Transportation Costs: Maintaining branch plants or subsidiaries in foreign countries necessitates costs in communication and transportation not faced by domestic firms. These include direct costs such as overseas phone calls and travel expenses for executives as well as time costs due to mail delays and so on. (2) Language and cultural differences: Language and cultural differences between the home country and the foreign (¡°host¡±) inevitably create costs for the MNE that are not faced by domestic firms. (3)

Understanding local laws: Similarly, the MNE, at least initially, does not have a close familiarity with the host country¡¯s business community, tax laws and other government procedures. Local laws often, in fact, tend to discriminate actively against the MNE. (4) Added Uncertainty The MNE faces risks such as exchange rate changes, expropriation or other capricious government actions that are not as important to domestic firms. Thus if the firms and their owners are risk averse, the uncertainty faced by the MNE constitutes a true business cost. (5) Higher Labor Costs The MNE frequently must station managers and technicians abroad. Often, only substantially higher wages can induce these personnel to live abroad. Foreign direct investment (FDI) inflows are foreign capital reported as balance-of-payments net inflows. Data is available from 1995 for 26 regional member countries, namely Armenia, Australia, Azerbaijan, Bangladesh, Brunei Darussalam, Cambodia, People’s Republic of China, Fiji Islands, Hong Kong, India, Indonesia, Japan, Kazakhstan, Republic of Korea, Kyrgyz Republic, Lao PDR, Malaysia, Myanmar, New Zealand, Pakistan, Papua New Guinea, Philippines, Singapore, Thailand, Vanuatu, Viet Nam. A higher volume of FDI indicates higher capital mobility and integration in the region. Foreign direct investment (FDI) share is the percentage of regional FDI inflows to total FDI from the investing region. Data is available from 1995 at the earliest for 26 regional member countries, namely Armenia, Australia, Azerbaijan, Bangladesh, Brunei Darussalam, Cambodia, People’s Republic of China, Fiji Islands, Hong Kong, India, Indonesia, Japan, Kazakhstan, Republic of Korea, Kyrgyz Republic, Lao PDR, Malaysia, Myanmar, New Zealand, Pakistan, Papua New Guinea, Philippines, Singapore, Thailand, Vanuatu, Viet Nam. It is calculated as the

dollar value of FDI of country/region i to country/region j expressed as a percentage share of the dollar value of FDI of country/region i to the world. A higher share indicates a stronger preference for the region and a higher degree of integration. Cumulative foreign direct investment (FDI) inflows are the inclusive sum of foreign capital reported as balance-of-payments net inflows beginning 1995. Data is available for 26 regional member countries. A higher volume of FDI indicates higher capital mobility and integration in the region. Cumulative foreign direct investment (FDI) share is the percentage of regional FDI inflows to total FDI from the investing region beginning 1995. Data is available for 26 regional member countries. It is calculated as the dollar value of cumulative FDI of country/region i to country/region j expressed as a percentage share of the dollar value of cumulative FDI of country/region i to the world. A higher share indicates a stronger preference for the region and a higher degree of integration.