

3.5: Foreign Direct Investment

Learning Objectives

1. Understand the types of international investments.
2. Identify the factors that influence foreign direct investment (FDI).
3. Explain why and how governments encourage FDI in their countries.

Understand the Types of International Investments

There are two main categories of international investment—portfolio investment and foreign direct investment. **Portfolio investment** refers to the investment in a company's stocks, bonds, or assets, but not for the purpose of controlling or directing the firm's operations or management. Typically, investors in this category are looking for a financial rate of return as well as diversifying investment risk through multiple markets.

Foreign direct investment (FDI) refers to an investment in or the acquisition of foreign assets with the intent to control and manage them. Companies can make an FDI in several ways, including purchasing the assets of a foreign company; investing in the company or in new property, plants, or equipment; or participating in a joint venture with a foreign company, which typically involves an investment of capital or know-how. FDI is primarily a long-term strategy. Companies usually expect to benefit through access to local markets and resources, often in exchange for expertise, technical know-how, and capital. A country's FDI can be both inward and outward. As the terms would suggest, **inward FDI** refers to investments coming into the country and **outward FDI** are investments made by companies from that country into foreign companies in other countries. The difference between inward and outward is called the net FDI inflow, which can be either positive or negative.

Governments want to be able to control and regulate the flow of FDI so that local political and economic concerns are addressed. Global businesses are most interested in using FDI to benefit their companies. As a result, these two players—governments and companies—can at times be at odds. It's important to understand why companies use FDI as a business strategy and how governments regulate and manage FDI.

Factors That Influence a Company's Decision to Invest

Let's look at why and how companies choose to invest in foreign markets. Simply purchasing goods and services or deciding to invest in a local market depends on a business's needs and overall strategy. Direct investment in a country occurs when a company chooses to set up facilities to produce or market their products; or seeks to partner with, invest in, or purchase a local company for control and access to the local market, production, or resources. Many considerations influence its decisions:

- **Cost.** Is it cheaper to produce in the local market than elsewhere?
- **Logistics.** Is it cheaper to produce locally if the transportation costs are significant?
- **Market.** Has the company identified a significant local market?
- **Natural resources.** Is the company interested in obtaining access to local resources or commodities?
- **Know-how.** Does the company want access to local technology or business process knowledge?
- **Customers and competitors.** Does the company's clients or competitors operate in the country?
- **Policy.** Are there local incentives (cash and noncash) for investing in one country versus another?
- **Ease.** Is it relatively straightforward to invest and/or set up operations in the country, or is there another country in which setup might be easier?
- **Culture.** Is the workforce or labor pool already skilled for the company's needs or will extensive training be required?
- **Impact.** How will this investment impact the company's revenue and profitability?
- **Expatriation of funds.** Can the company easily take profits out of the country, or are there local restrictions?
- **Exit.** Can the company easily and orderly exit from a local investment, or are local laws and regulations cumbersome and expensive?

These are just a few of the many factors that might influence a company's decision. Keep in mind that a company doesn't need to sell in the local market in order to deem it a good option for direct investment. For example, companies set up manufacturing facilities in low-cost countries but export the products to other markets.

There are two forms of FDI—horizontal and vertical. **Horizontal FDI** occurs when a company is trying to open up a new market—a retailer, for example, that builds a store in a new country to sell to the local market. **Vertical FDI** is when a company invests

internationally to provide input into its core operations—usually in its home country. A firm may invest in production facilities in another country. When a firm brings the goods or components back to its home country (i.e., acting as a supplier), this is referred to as backward vertical FDI. When a firm sells the goods into the local or regional market (i.e., acting as a distributor), this is termed forward vertical FDI. The largest global companies often engage in both backward and forward vertical FDI depending on their industry.

Many firms engage in backward vertical FDI. The auto, oil, and infrastructure (which includes industries related to enhancing the infrastructure of a country—that is, energy, communications, and transportation) industries are good examples of this. Firms from these industries invest in production or plant facilities in a country in order to supply raw materials, parts, or finished products to their home country. In recent years, these same industries have also started to provide forward FDI by supplying raw materials, parts, or finished products to newly emerging local or regional markets.

There are different kinds of FDI, two of which—greenfield and brownfield—are increasingly applicable to global firms. **Greenfield FDI**s occur when multinational corporations enter into developing countries to build new factories or stores. These new facilities are built from scratch—usually in an area where no previous facilities existed. The name originates from the idea of building a facility on a green field, such as farmland or a forested area. In addition to building new facilities that best meet their needs, the firms also create new long-term jobs in the foreign country by hiring new employees. Countries often offer prospective companies tax breaks, subsidies, and other incentives to set up greenfield investments.

A **brownfield FDI** is when a company or government entity purchases or leases existing production facilities to launch a new production activity. One application of this strategy is where a commercial site used for an “unclean” business purpose, such as a steel mill or oil refinery, is cleaned up and used for a less polluting purpose, such as commercial office space or a residential area. Brownfield investment is usually less expensive and can be implemented faster; however, a company may have to deal with many challenges, including existing employees, outdated equipment, entrenched processes, and cultural differences.

You should note that the terms *greenfield* and *brownfield* are not exclusive to FDI; you may hear them in various business contexts. In general, greenfield refers to starting from the beginning, and brownfield refers to modifying or upgrading existing plans or projects.

Why and How Governments Encourage FDI

Many governments encourage FDI in their countries as a way to create jobs, expand local technical knowledge, and increase their overall economic standards. Ian Bremmer, *The End of the Free Market: Who Wins the War Between States and Corporations* (New York: Portfolio, 2010). Countries like Hong Kong and Singapore long ago realized that both global trade and FDI would help them grow exponentially and improve the standard of living for their citizens. As a result, Hong Kong (before its return to China) was one of the easiest places to set up a new company. Guidelines were clearly available, and businesses could set up a new office within days. Similarly, Singapore, while a bit more discriminatory on the size and type of business, offered foreign companies a clear, streamlined process for setting up a new company.

In contrast, for decades, many other countries in Asia (e.g., India, China, Pakistan, the Philippines, and Indonesia) restricted or controlled FDI in their countries by requiring extensive paperwork and bureaucratic approvals as well as local partners for any new foreign business. These policies created disincentives for many global companies. By the 1990s (and earlier for China), many of the countries in Asia had caught the global trade bug and were actively trying to modify their policies to encourage more FDI. Some were more successful than others, often as a result of internal political issues and pressures rather than from any repercussions of global trade. UNCTAD compiles statistics on foreign direct investment (FDI): “Foreign Direct Investment database,” UNCTAD United Nations Conference on Trade and Development, accessed February 16, 2011, http://unctadstat.unctad.org/ReportFolders/reportFolders.aspx?sRF_ActivePath=P,5,27&sRF_Expanded=P,5,27&sCS_ChosenLang=en.

How Governments Discourage or Restrict FDI

In most instances, governments seek to limit or control foreign direct investment to protect local industries and key resources (oil, minerals, etc.), preserve the national and local culture, protect segments of their domestic population, maintain political and economic independence, and manage or control economic growth. A government use various policies and rules:

- **Ownership restrictions.** Host governments can specify ownership restrictions if they want to keep the control of local markets or industries in their citizens’ hands. Some countries, such as Malaysia, go even further and encourage that ownership be maintained by a person of Malay origin, known locally as *bumiputra*. Although the country’s Foreign Investment Committee

guidelines are being relaxed, most foreign businesses understand that having a *bumiputra* partner will improve their chances of obtaining favorable contracts in Malaysia.

- **Tax rates and sanctions.** A company's home government usually imposes these restrictions in an effort to persuade companies to invest in the domestic market rather than a foreign one.

How Governments Encourage FDI

Governments seek to promote FDI when they are eager to expand their domestic economy and attract new technologies, business know-how, and capital to their country. In these instances, many governments still try to manage and control the type, quantity, and even the nationality of the FDI to achieve their domestic, economic, political, and social goals.

- **Financial incentives.** Host countries offer businesses a combination of tax incentives and loans to invest. Home-country governments may also offer a combination of insurance, loans, and tax breaks in an effort to promote their companies' overseas investments. The opening case on China in Africa illustrated these types of incentives.
- **Infrastructure.** Host governments improve or enhance local infrastructure—in energy, transportation, and communications—to encourage specific industries to invest. This also serves to improve the local conditions for domestic firms.
- **Administrative processes and regulatory environment.** Host-country governments streamline the process of establishing offices or production in their countries. By reducing bureaucracy and regulatory environments, these countries appear more attractive to foreign firms.
- **Invest in education.** Countries seek to improve their workforce through education and job training. An educated and skilled workforce is an important investment criterion for many global businesses.
- **Political, economic, and legal stability.** Host-country governments seek to reassure businesses that the local operating conditions are stable, transparent (i.e., policies are clearly stated and in the public domain), and unlikely to change.

Ethics in Action

Encouraging Foreign Investment

Governments seek to encourage FDI for a variety of reasons. On occasion, though, the process can cross the lines of ethics and legality. In November 2010, seven global companies paid the US Justice Department “a combined \$236 million in fines to settle allegations that they or their contractors bribed foreign officials to smooth the way for importing equipment and materials into several countries.” Kara Scannell, “Shell, Six Other Firms Settle Foreign-Bribery Probe,” *Wall Street Journal*, November 5, 2010, accessed December 23, 2010, <http://online.wsj.com/article/SB10001424052748704805204575594311301043920.html>. The companies included Shell and contractors Transocean, Noble, Pride International, Global Santa Fe, Tidewater, and Panalpina World Transport. The bribes were paid to officials in oil-rich countries—Nigeria, Brazil, Azerbaijan, Russia, Turkmenistan, Kazakhstan, and Angola. In the United States, global firms—including ones headquartered elsewhere, but trading on any of the US stock exchanges—are prohibited from paying or even offering to pay bribes to foreign government officials or employees of state-owned businesses with the intent of currying business favors. While the law and the business ethics are clear, in many cases, the penalty fines remain much less onerous than losing critical long-term business revenues. Kara Scannell, “Shell, Six Other Firms Settle Foreign-Bribery Probe,” *Wall Street Journal*, November 5, 2010, accessed December 23, 2010, <http://online.wsj.com/article/SB10001424052748704805204575594311301043920.html>.

Did You Know?

Hong Kong: From Junks to Jets? The Rise of a Global Powerhouse

Policies of openness to FDI and international trade have enabled countries around the world to leapfrog economically over their neighbors. The historical rise of Hong Kong is one example. Hong Kong's economic strengths can be traced to a combination of factors, including its business-friendly laws and policies, a local population that is culturally oriented to transacting trade and business, and Hong Kong's geographic proximity to the major economies of China, Japan, and Taiwan.

Hong Kong has always been open to global trade. Many people, from the Chinese to the Japanese to the British, have occupied Hong Kong over the centuries, and all of them have contributed to its development as one of the world's great ports and trading centers.

In 1997, Hong Kong reverted back to Chinese control; however, free enterprise will be governed under the agreement of Basic Law, which established Hong Kong as a separate Special Administrative Region (SAR) of China. Under its Basic Law, in force until 2047, Hong Kong will retain its legal, social, economic, and political systems apart from China's. Thus, Hong Kong is guaranteed the right to its own monetary system and financial autonomy. Hong Kong is allowed to work independently with the

international community; to control trade in strategic commodities, drugs, and illegal transshipments; and to protect intellectual property rights. Under the Basic Law, the Hong Kong SAR maintains an independent tax system and the right to free trade.

Hong Kong has an open business structure, which freely encourages foreign direct investment. Any company that wishes to do business here is free to do so as long as it complies with local laws. Hong Kong's legal and institutional framework combined with its good banking and financial facilities and business-friendly tax systems have encouraged foreign direct investment as many multinationals located their regional headquarters in Hong Kong.

As a base for doing business with China, Hong Kong now accounts for half of all direct investments in the mainland and is China's main conduit for investment and trade. China has also become a major investor in Hong Kong.

Culturally, many foreign firms are attracted to Hong Kong by its skilled workforce and the fact that Hong Kong still conducts business in English, a remnant of its British colonial influence. The imprint of the early British trading firms, known as *hongs*, is particularly strong today in the area of property development. Jardine Matheson and Company, for instance, founded by trader William Jardine, remains one of Hong Kong's preeminent firms. In many of these companies, British management practices remain firmly in place. Every aspect of Hong Kong's business laws—whether pertaining to contracts, taxes, or trusts—bears striking similarities to the laws in Britain. All these factors contribute to a business culture that is familiar to people in many multinationals.

Chinese cultural influences have always affected business and are increasingly so today. Many pundits claim that Hong Kong already resembles China's free-trade zone. And, indeed, the two economies are becoming increasingly intertwined. Much of this economic commingling began in the 1990s, when Hong Kong companies began relocating production centers to the mainland—especially to Guangdong province.

Because of the shift in production to mainland China and other Asian countries, there is not much manufacturing left in Hong Kong. What remains is light in nature and veers toward high-value-added products. In fact, 80 percent of Hong Kong's gross domestic product now comes from its high value-added service sector: finance, business and legal services, brokerage services, the shipping and cargo industries, and the hotel, food, and beverage industry.

Local Hong Kong companies, as well as foreign businesses based there, are uniquely positioned to play important roles as brokers and intermediaries between the mainland and global corporations. Doing business in China is not only complex and daunting but also requires connections, locally known as *guanxi*, to influential people and an understanding of local laws and protocol. Developing these relationships and this knowledge is almost impossible without the assistance of an insider. It is in this role that the Hong Kong business community stands to contribute enormously.

Hong Kong's openness to foreign investment coupled with its proximity to China will ensure its global economic competitiveness for decades to come.

KEY TAKEAWAYS

- There are two main categories of international investment: portfolio investment and foreign direct investment (FDI). Portfolio investment refers to the investment in a company's stocks, bonds, or assets, but not for the purpose of controlling or directing the firm's operations or management. FDI refers to an investment in or the acquisition of foreign assets with the intent to control and manage them.
- Direct investment in a country occurs when a company chooses to set up facilities to produce or market its products or seeks to partner with, invest in, or purchase a local company for control and access to the local market, production, or resources. Many considerations can influence the company's decisions, including cost, logistics, market, natural resources, know-how, customers and competitors, policy, ease of entry and exit, culture, impact on revenue and profitability, and expatriation of funds.
- Governments discourage or restrict FDI through ownership restrictions, tax rates, and sanctions. Governments encourage FDI through financial incentives; well-established infrastructure; desirable administrative processes and regulatory environment; educational investment; and political, economic, and legal stability.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What are three factors that impact a company's decision to invest in a country?
2. What is the difference between vertical and horizontal FDI? Give one example of an industry for each type.
3. How can governments encourage or discourage FDI?

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