Chapter 7

Foreign Direct Investment

Introduction

- Foreign direct investment (FDI) occurs when a firm invests directly in new facilities to produce and/or to market in a foreign country

- Once a firm undertakes FDI it becomes a multinational enterprise

FDI can be:

- Greenfield Investments - the establishment of a wholly new operation (subsidiary) in a foreign country

- Mergers or Acquisitions (M&A) – Brownfield Investment with existing firms in the foreign country

- Joint (International) Ventures

Foreign Direct Investment in The World Economy

- The flow of FDI refers to the amount of FDI undertaken over a given time period

- The stock of FDI refers to the total accumulated value of foreign-owned assets at a given time

- Outflows of FDI are the flows of FDI out of a country

- Inflows of FDI are the flows of FDI into a country

Modes of FDI Expansion

- 1. Greenfield Investment
  - The parent firm establishes a new production plant abroad and owns this plant exclusively
  - It involves high fixed cost.
  - It results in an increase in the number of firms in the host country

- 2. Brownfield Investment – Cross-border M&As
  - The parent firm acquires a part or all of the shares of an already existing firm which is located abroad
  - It transfers to its foreign subsidiary technology, knowhow, etc.
  - It does not result in the increase of the number of firms

Modes of FDI Expansion

- 3. Joint (International) Venture

- The parent firm cooperates with one or more firms for the establishment of a new firm or the acquisition of an existing firm abroad

- The partners provide capital, technology etc.

Forms of FDI Expansion

- 1. Horizontal FDI
- The subsidiary and its parent firm operate at the same stage of production of the vertical production chain.

  e.g., When Ford M.C. builds in Mexico a production plant for the assembly of the cars while it owns similar plants in the USA

- 2. Vertical FDI
- The subsidiary and its parent firm operate at different stage of production of the vertical production chain.

  e.g., When Ford M.C. builds a production plant for the production of car glass abroad while it does not own such a plant in the USA.

Goals of FDI Expansion

- 1. Market Seeking: Aiming at servicing foreign markets in order to increase demand and market size

- 2. Resource Seeking: Aiming at taking advantage of local supply of raw materials and low cost skilled and/or semi-skilled labor

- 3. Efficiency Seeking: Locating different stages of production or the production of different varieties of the product in different countries according to local supply conditions of intermediate inputs. The aim is to develop a regionally integrated productive and marketing network that is cost efficient

Goals of FDI Expansion

- 4. Strategic Asset Seeking: Aiming at the acquisition of specialized tangible and intangible resources, e.g. special types of advanced technology, highly skilled labor, trademarks, copyrights, intellectual property rights etc. that are available in the host country and advance the global competitive position of the parent MNE

The Direction Of FDI

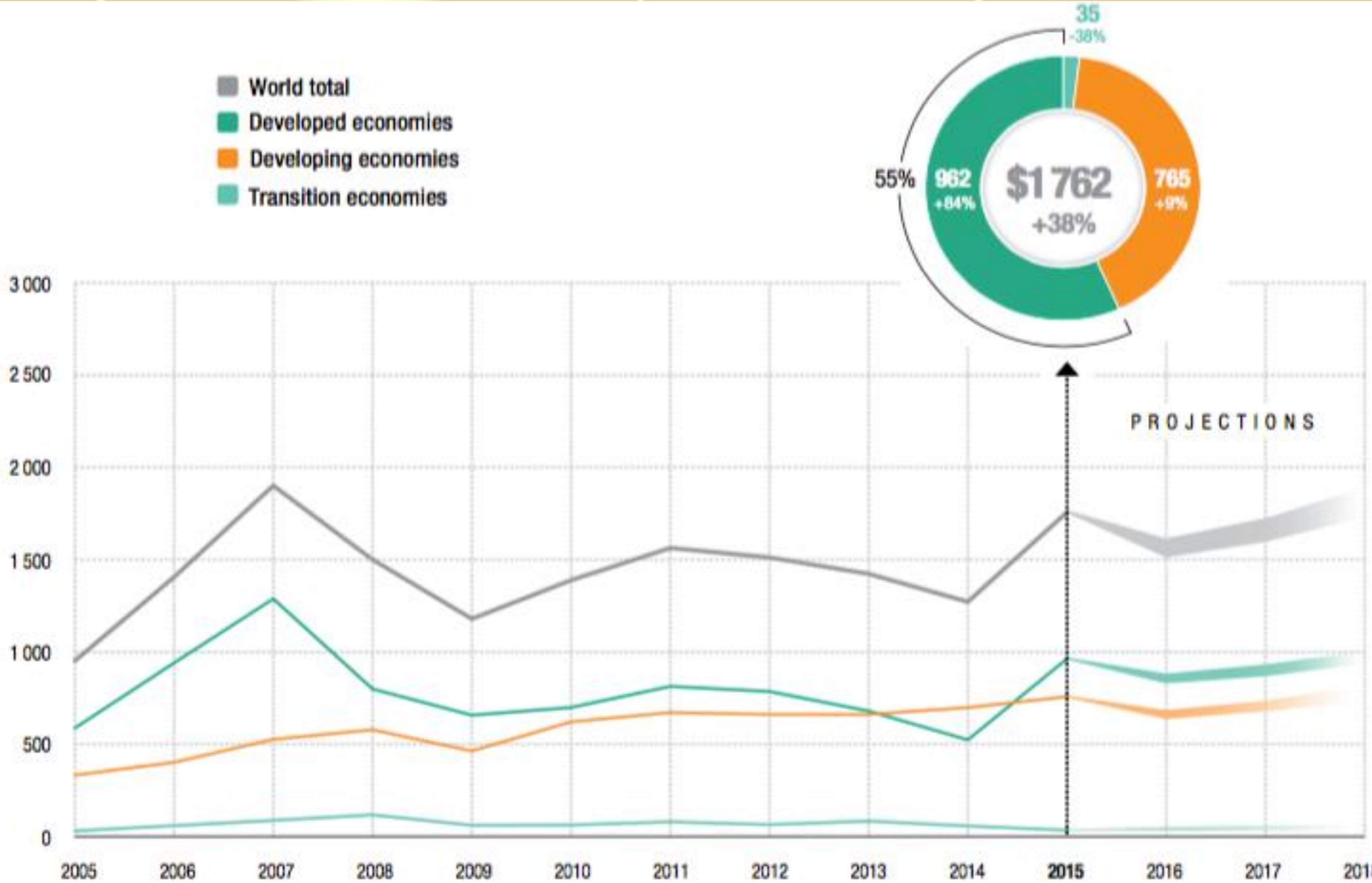
- Most FDI has historically been directed at the developed nations of the world, with the United States being a favorite target

- FDI inflows have remained high during the early 2000s for the United States, and also for the European Union

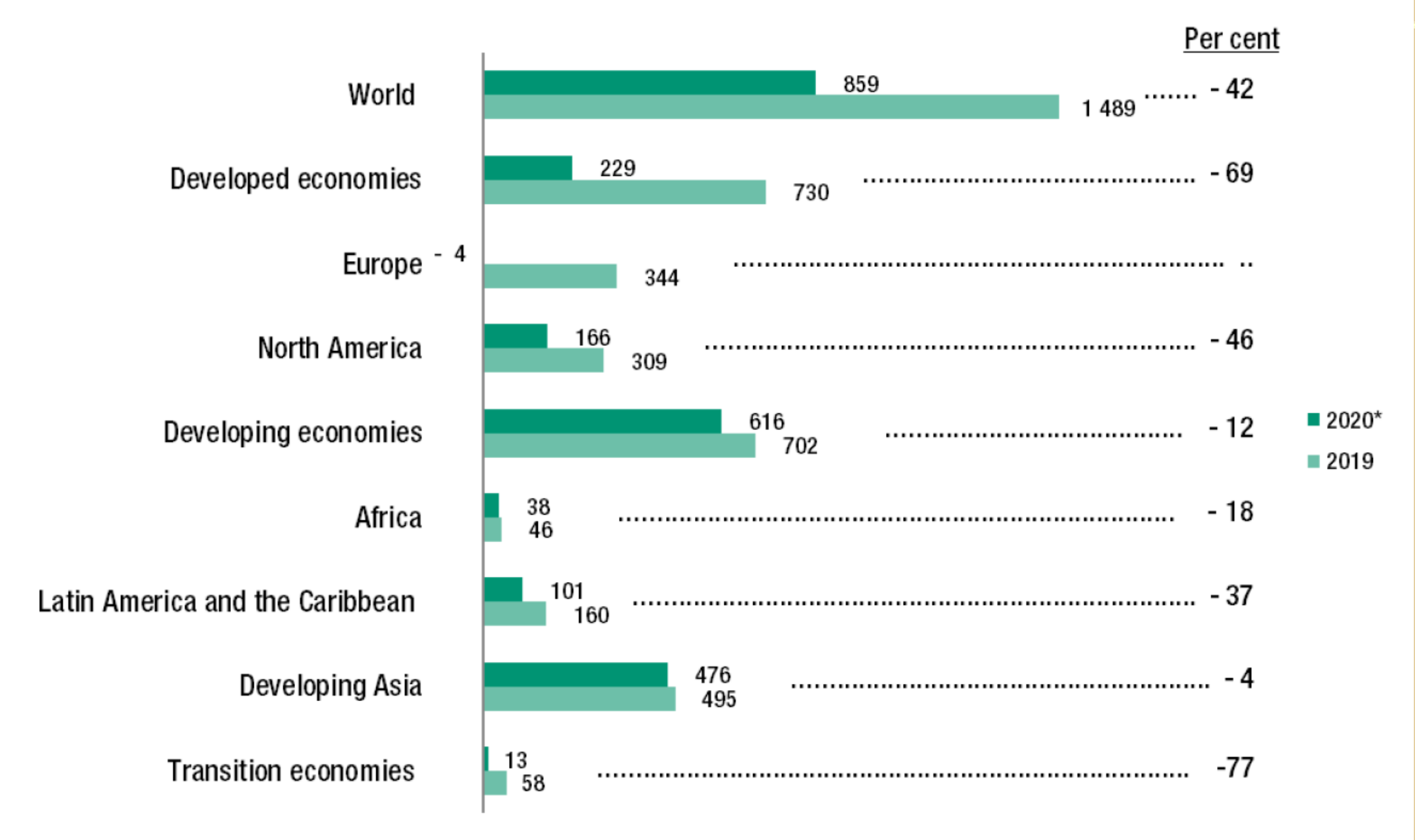
- South, East, and Southeast Asia, and particularly China, are now seeing an increase of FDI inflows

- Latin America is also emerging as an important region for FDI

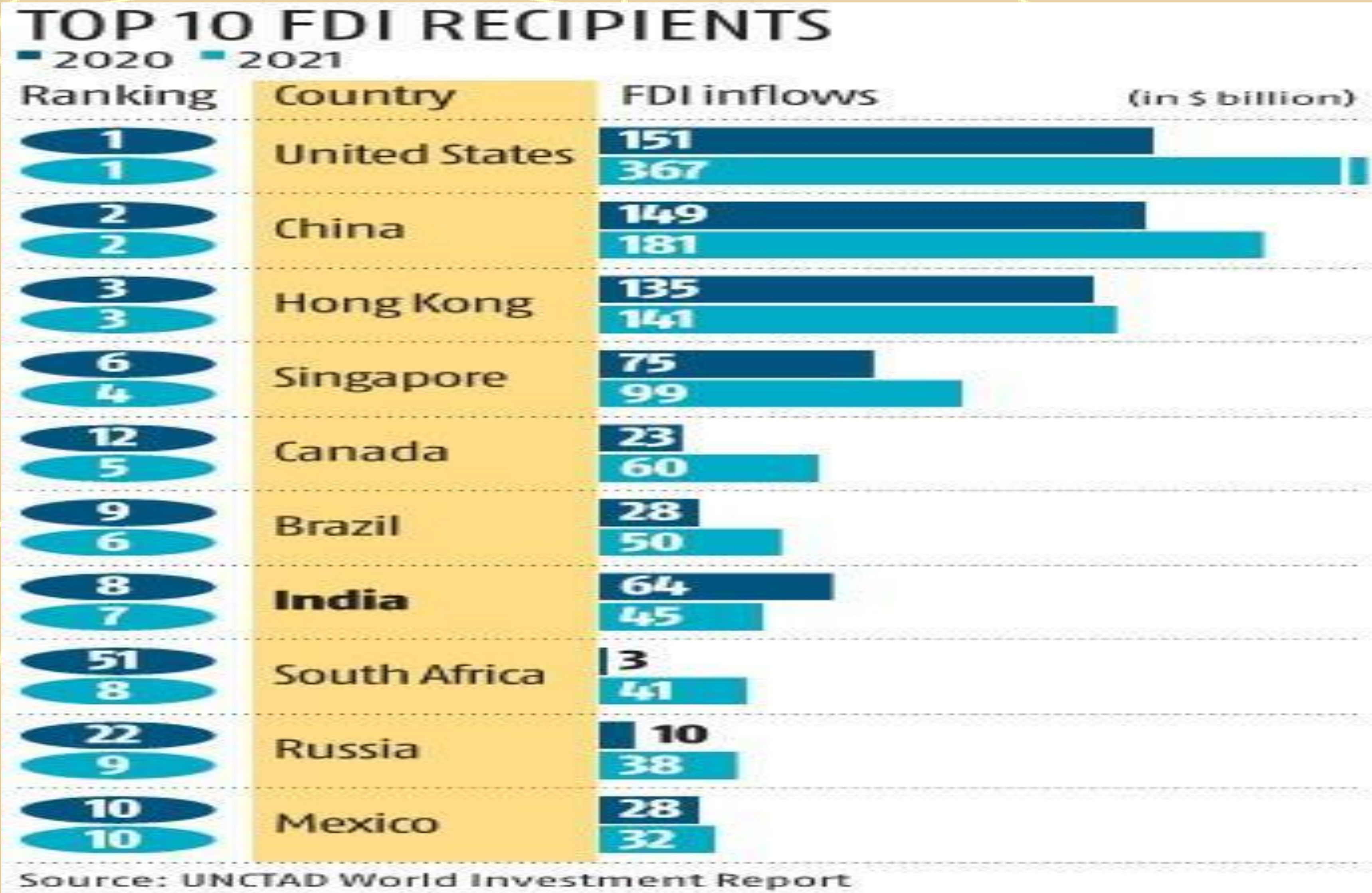
FDI Size: Global Incoming FDI in the period 2005-2015 ($ bil.)



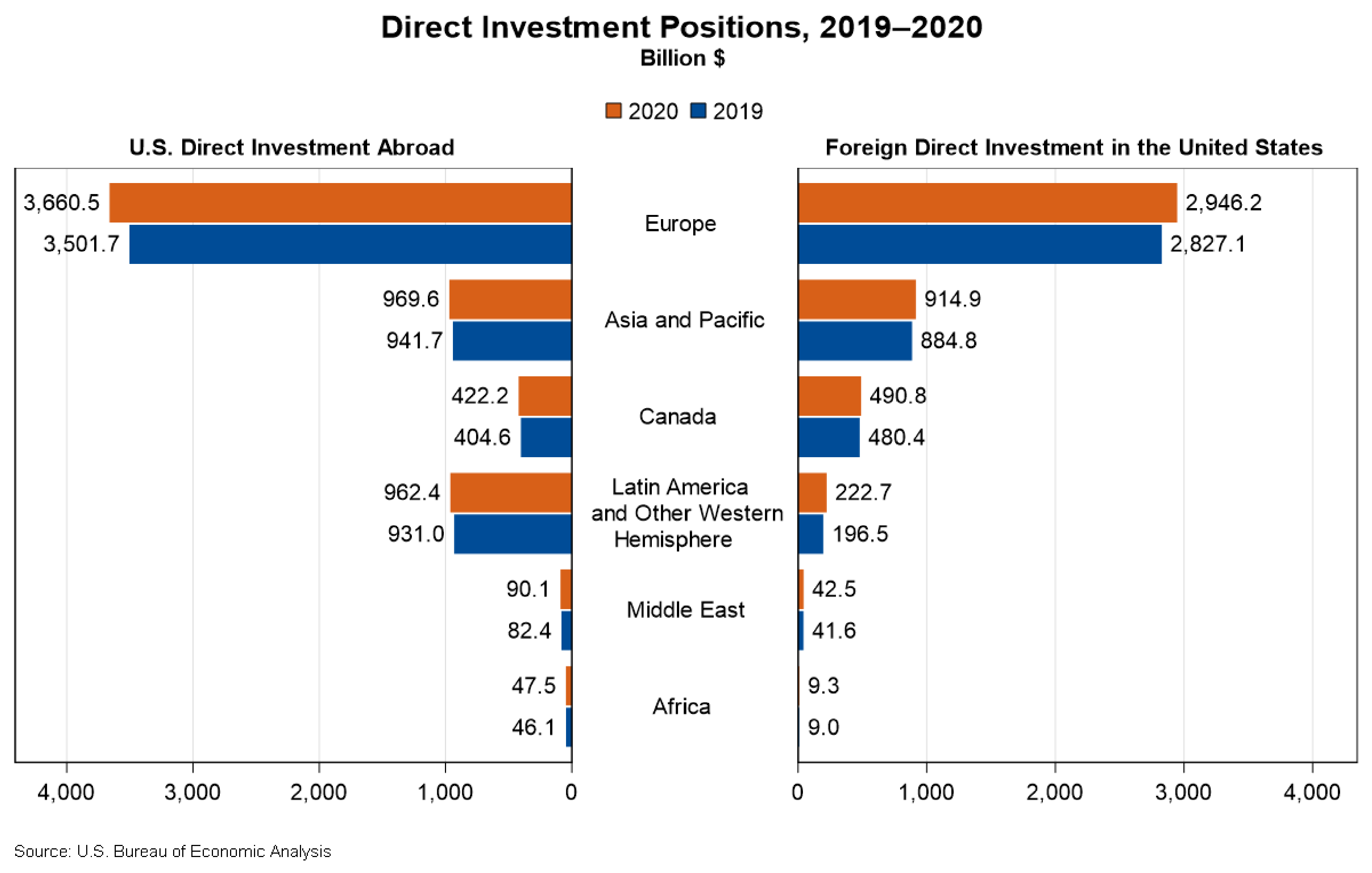
GLOBAL FDI (UNCTAD 2019-20)



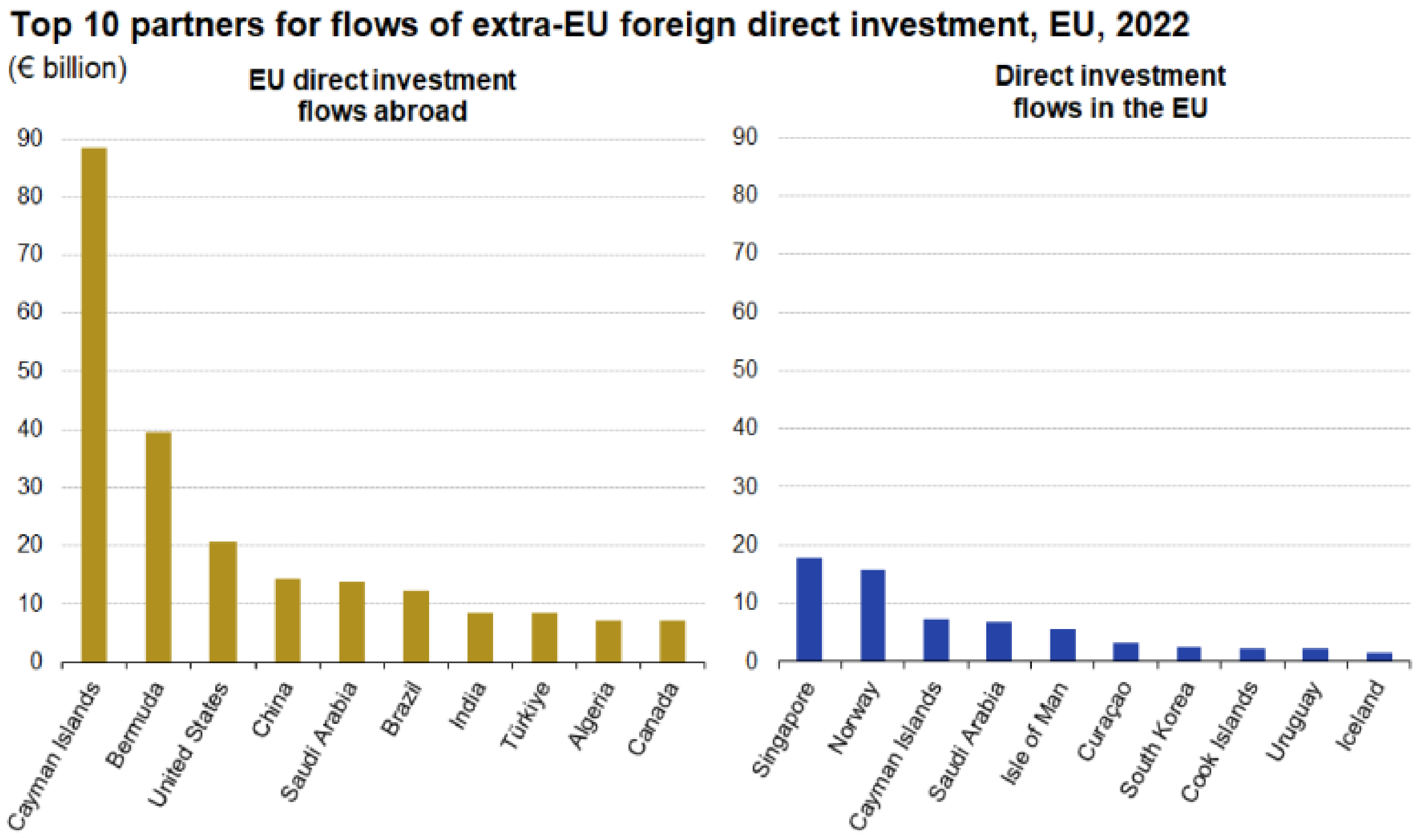
FDI-TOP RECIPIENTS (UNCTAD)



The USA-TOP FDI SOURCE and HOST



EU OUT(IN-)WARD FDI (2022)



Note: the sum of FDI flows to or from the top 10 partners may be greater than the total value of extra-EU flows due to divestment being greater than investment for some partners that are not shown.

Source: Eurostat (online data code: bop_fdi6_geo)

eurostat

FDI: The Shift To Services

- ❖FDI is shifting away from extractive industries and manufacturing, and towards services

The shift to services is being driven by:

- ❖ the general move in many developed countries toward services
- ❖the fact that many services need to be produced where they are consumed
- ❖a liberalization of policies governing FDI in services
- ❖the rise of Internet-based global telecommunications networks

The Form of FDI: M&As Versus Greenfield Investments

❖Most cross-border investment is in the form of M&As rather than Greenfield Investments

Firms prefer to acquire existing assets because:

❖ M&As are quicker to execute than Greenfield Investments

❖ it is easier and perhaps less risky for a firm to acquire desired assets than build them from the ground up

❖ firms believe that they can increase the efficiency of an acquired unit by transferring capital, technology, or management skills

Theories Of FDI

❖ **(Q1): Why do firms invest rather than use exporting or licensing to enter foreign markets?**

❖ **(Q2): Why do firms from the same industry undertake FDI at the same time?**

❖ **(Q3): How can the pattern of FDI flows be explained?**

Why Foreign Direct Investment?

(A1): Why do firms choose FDI instead of:

❖ exporting - producing goods at home and then shipping them to the receiving country for sale

or

❖ licensing - granting a foreign entity the right to produce and sell the firm's product in return for a **royalty fee** on every unit that the foreign entity sells

Why Foreign Direct Investment?

- **Exports Strategy:** can be constrained by transportation costs and trade barriers

- **FDI** may be undertaken as a response to actual or threatened trade barriers such as import tariffs or quotas

Why Foreign Direct Investment?

Licensing: The realization of market imperfections suggests that licensing has three major drawbacks:

(i) may result in a firm's giving away valuable technological know-how to a potential foreign competitor

(ii) does not give a firm the tight control over manufacturing, marketing, and strategy in a foreign country that may be required to maximize its profitability

(iii) a problem arises when the firm's competitive advantage is based not so much on its products as on the management, marketing, and manufacturing capabilities that produce those products

The Pattern of Foreign Direct Investment

(A2): Why do firms from the same industry undertake FDI at the same time

- Firms in the same industry often undertake foreign direct investment around the same time and tend to direct their investment activities towards certain locations

- FDI flows can be a reflection of:

  (i) strategic rivalry between oligopolistic firms in the global marketplace, or

  (ii) multipoint competition (when two or more enterprises encounter each other in different regional markets, national markets, or industries)

The Pattern of Foreign Direct Investment

(A3): How can the pattern of FDI flows be explained?

- Firms undertake FDI at particular stages in the life cycle of a product they have pioneered

- Firms invest in other advanced countries when local demand in those countries grows large enough to support local production, and

- then shift production to low-cost developing countries when product standardization and market saturation give rise to price competition and cost pressures

The Pattern of Foreign Direct Investment

Firms also consider:

- location-specific advantages that arise from using resource endowments or assets that are tied to a particular location and that a firm finds valuable to combine with its own unique assets, and

- Externalities knowledge spillovers that occur when companies in the same industry locate in the same area

The Pattern of Foreign Direct Investment

- Comparative Advantage: international production should be distributed among countries according to the theory of comparative advantage

- The free market view has been embraced by a number of advanced and developing nations, including the United States, Britain, Chile, and Hong Kong

The Pattern of Foreign Direct Investment

Recently, there has been a strong shift toward the free market stance (Trade liberalization --- WTO directives) creating:

- a surge in FDI worldwide (TRIMs – Trade Related Investment Measures)

- an increase in the volume of FDI in countries with newly liberalized regimes

FDI: Host-Country Benefits

Inward FDI has FIVE main benefits:

- 1. Resource transfer effects - FDI can make a positive contribution to a host economy by supplying capital, technology, and management resources that would otherwise not be available

- 2. Employment effects - FDI can bring jobs to a host country that would otherwise not be created there

FDI: Host-Country Benefits

- 3. Foreign firms, more often than not, offer higher wages relative to the domestic firms. This holds both in the developed and in the developing countries, in most sector and in most countries

  Reasons: They tend to:

- operate in sectors of the economy in which wages are high.
- hire more educated and more capable workers than the domestic firms.
- be more capital-intensive
- be more productive than domestic firms, e.g., due to cost advantages

FDI: Host-Country Benefits

- 4. Balance of Payments (BoP) effects: a country's BoP is a record of a country's payments to and receipts from other countries.
  - BoP = Current Account + Capital Account

- The Current Account is a record of a country's export and import of goods and services

- Governments typically prefer to see a current account surplus than a deficit

- FDI can help a country to achieve a **Current Account surplus,** if it is a substitute for imports of goods and services, and if the MNEs use a foreign subsidiary to export goods and services to other countries

FDI: Host-Country Benefits

- 5. Increased competition and economic growth - FDI in the form of Greenfield Investment increases the level of competition in a market, driving down prices and improving the welfare of consumers

Increased competition can lead to increased productivity growth, product and process innovation, and greater economic growth

Moreover, the gains from learning valuable skills from foreign markets that can subsequently be transferred back to the home country

FDI: Host-Country Costs

Inward FDI has <u>THREE</u> main costs:

1. The possible adverse effects of FDI on competition within the host country

❖ subsidiaries of foreign MNEs may have greater economic power than indigenous competitors because they may be part of a larger international organization

FDI: Host-Country Costs

2. Adverse effects on the Balance of Payments

- with the initial capital inflows that come with FDI must be the subsequent outflow of capital as the foreign subsidiary repatriates earnings to its parent country

- when a foreign subsidiary imports a substantial number of its inputs from abroad, there is a debit on the current account of the host country’s balance of payments

FDI: Host-Country Costs

3. The perceived loss of national sovereignty and autonomy

- key decisions that can affect the host country's economy will be made by a foreign parent that has no real commitment to the host country, and over which the host country's government has no real control

FDI: Home-Country Benefits

Outward FDI has <u>THREE</u> main benefits:

- 1. Exports: Empirical studies have shown that on aggregate level FDI can be complementary to Exports

- 2. Outgoing FDI vs local capital formation: FDI if successful, might increase capital available to invest locally, and thus reduce the cost of domestic capital formation. That is, FDI can complement the local capital investments

- 3. Reverse Technology Spillovers: The parent firms can learn from the domestic firms of the host countries – technology sourcing effect. e.g., Swedish firm make more use of patents from countries in which Swedish firms undertake FDI

FDI: Home-Country Costs

Outward FDI has <u>TWO</u> main costs:

❖1. Balance of Payments can suffer:

- from the initial capital outflow required to finance the FDI
- if the purpose of the FDI is to serve the home market from a low cost labor location
- if the FDI is a substitute for direct exports

❖ 2. Employment may also be negatively affected if the FDI is a substitute for domestic production

Government Policy Instruments and FDI

- Home and Host countries alike use various policies to regulate FDI

Governments can encourage and restrict FDI:

- To encourage outward FDI, many nations now have government-backed insurance programs to cover major types of foreign investment risk

- To restrict outward FDI, most countries, including the United States, limit capital outflows, manipulate tax rules, or outright prohibit FDI

Implications For Managers

- ❖What are the implications of foreign direct investment for managers?
- ❖Managers need to consider what trade theory implies, and the link between government policy and FDI

Chapter 12

The Strategy of International Business

Introduction

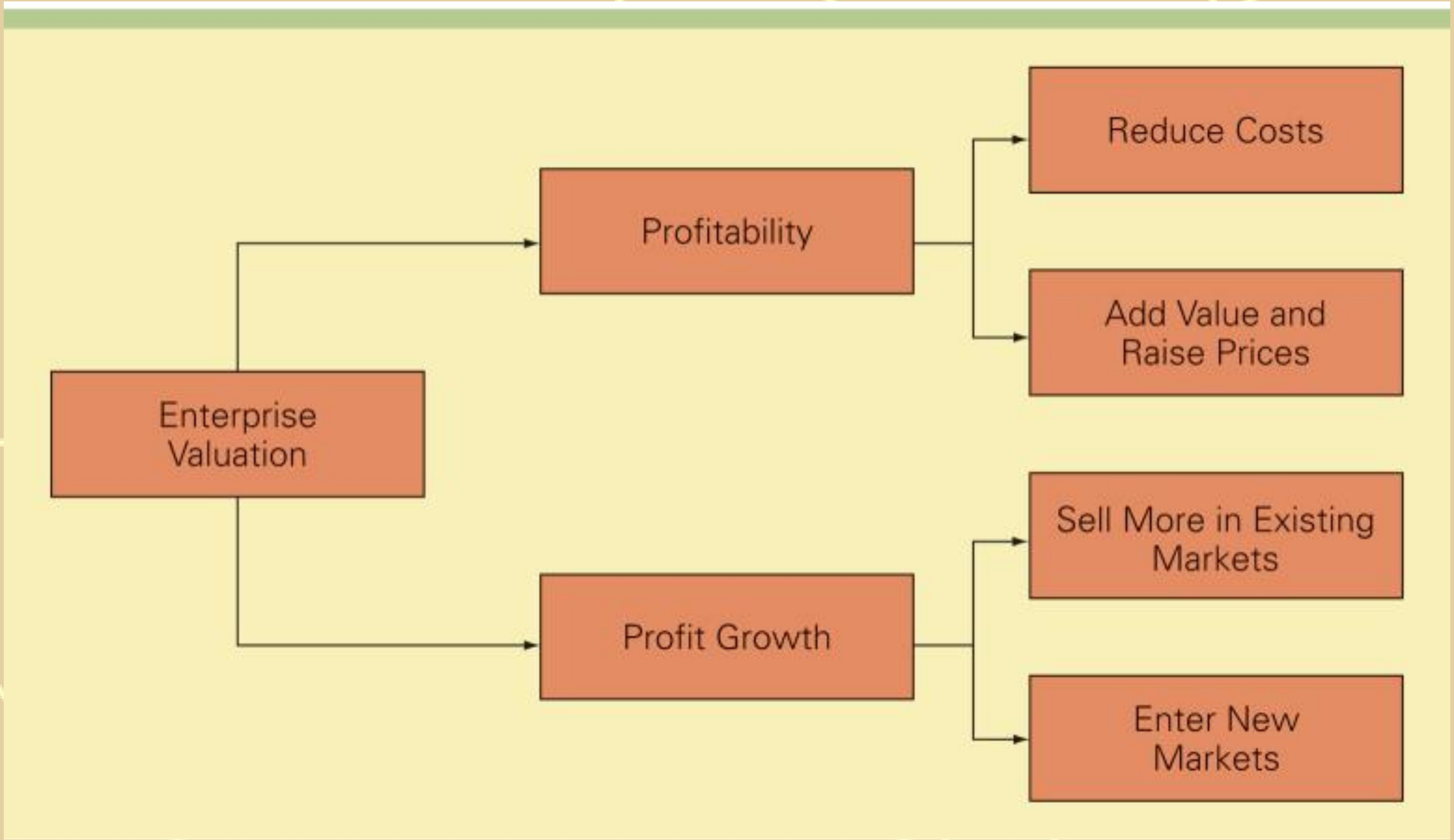
- **The Issues:**

- **(I1): What actions can managers take to compete more effectively as an international business?**

- **(I2): How can firms increase profits through international expansion?**

- **(I3): What international strategy should firms pursue?**

Strategy and the Firm: Determinants of Enterprise Value

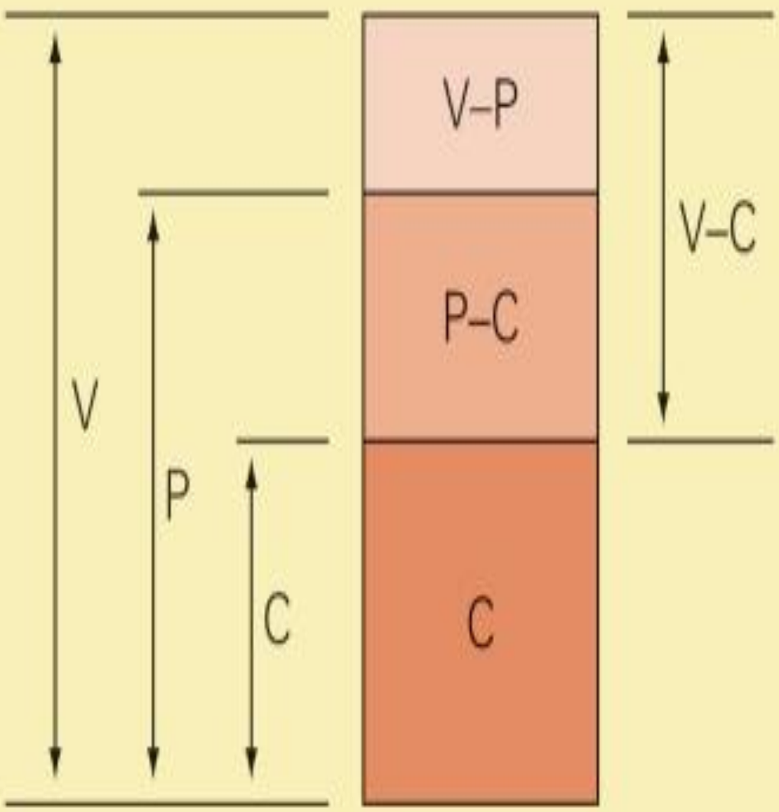


Value Creation

- The value created per unit of a product by a firm is measured by the difference between **V:** the value of the unit of the product to an average consumer (consumers willingness to pay for the product), and **C:** the unit cost of producing that product, i.e., **V- C**

- The higher the value customers/consumers place on a firm's products, the higher the price the firm can charge for those products, and the greater the profitability of the firm

Value Creation



V=Value of product to an average consumer

P=Price per unit

C=Cost of production per unit

V–P=Consumer surplus per unit

P–C=Profit per unit sold

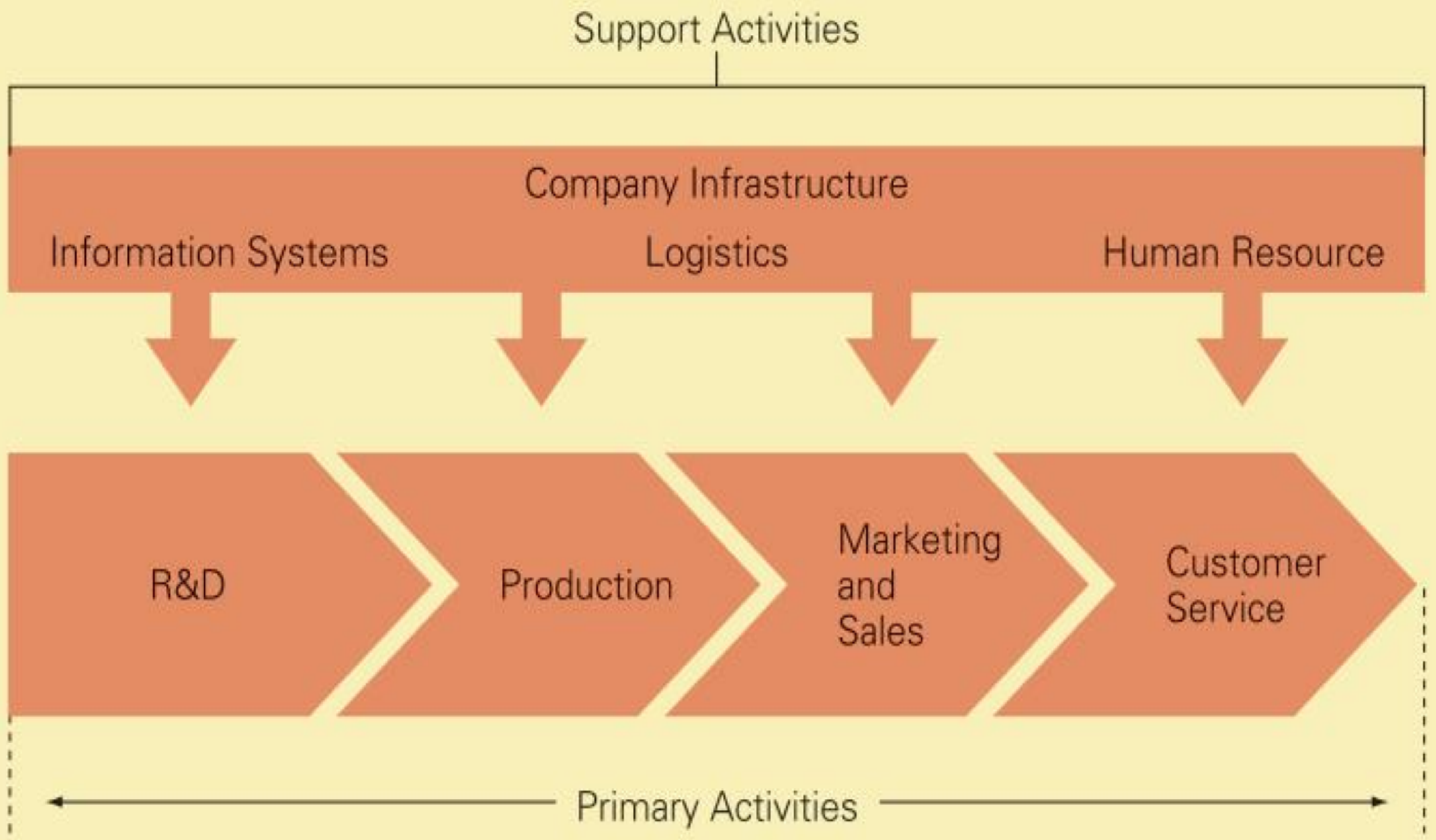
V–C=Value created per unit

Operations: The Firm as A Value Chain

- A firm's operations can be thought of a value chain composed of a series of distinct value creation activities, e.g., production, marketing, materials management, R&D, human resources, information systems, and the firm infrastructure

- Value creation activities can be categorized as primary activities (R&D, production, marketing and sales, customer service) and support activities (information systems, logistics, human resources)

Operations: The Firm as a Value Chain



Profitability, and Profit Growth: Global Expansion

International firms can:

- 1. expand the market for their domestic product offerings by selling those products in international markets
- 2. realize location economies by dispersing individual value creation activities to locations around the globe where they can be performed most efficiently and effectively
- 3. realize greater cost economies from economies of scale effects by serving an expanded global market from a central location, thereby reducing the costs of value creation
- 4. earn a greater return by leveraging any valuable skills developed in foreign operations and transferring them to other entities within the firm's global network of operations

1. Expanding The Market: Leveraging Products and Competencies

- **Firms can increase profits growth by selling goods or services developed at home internationally**

- The success of firms that expand internationally depends on the goods or services they sell, and on their core competencies (skills within the firm that competitors cannot easily match or imitate)

- Core competencies enable the firm to reduce the costs of value creation and/or to create perceived value in such a way that premium pricing is possible

2.a. Location Economies

- Location economies: When firms base each value creation activity at that location where economic, political, and cultural conditions, including relative factor costs, are most conducive to the performance of that activity. That is, the economies that arise from performing a value creation activity in the optimal location for that activity, wherever in the world that might be

- By achieving location economies, firms can:
- lower the costs of value creation and achieve a low-cost position
- differentiate their product offering

2.b. Location Economies

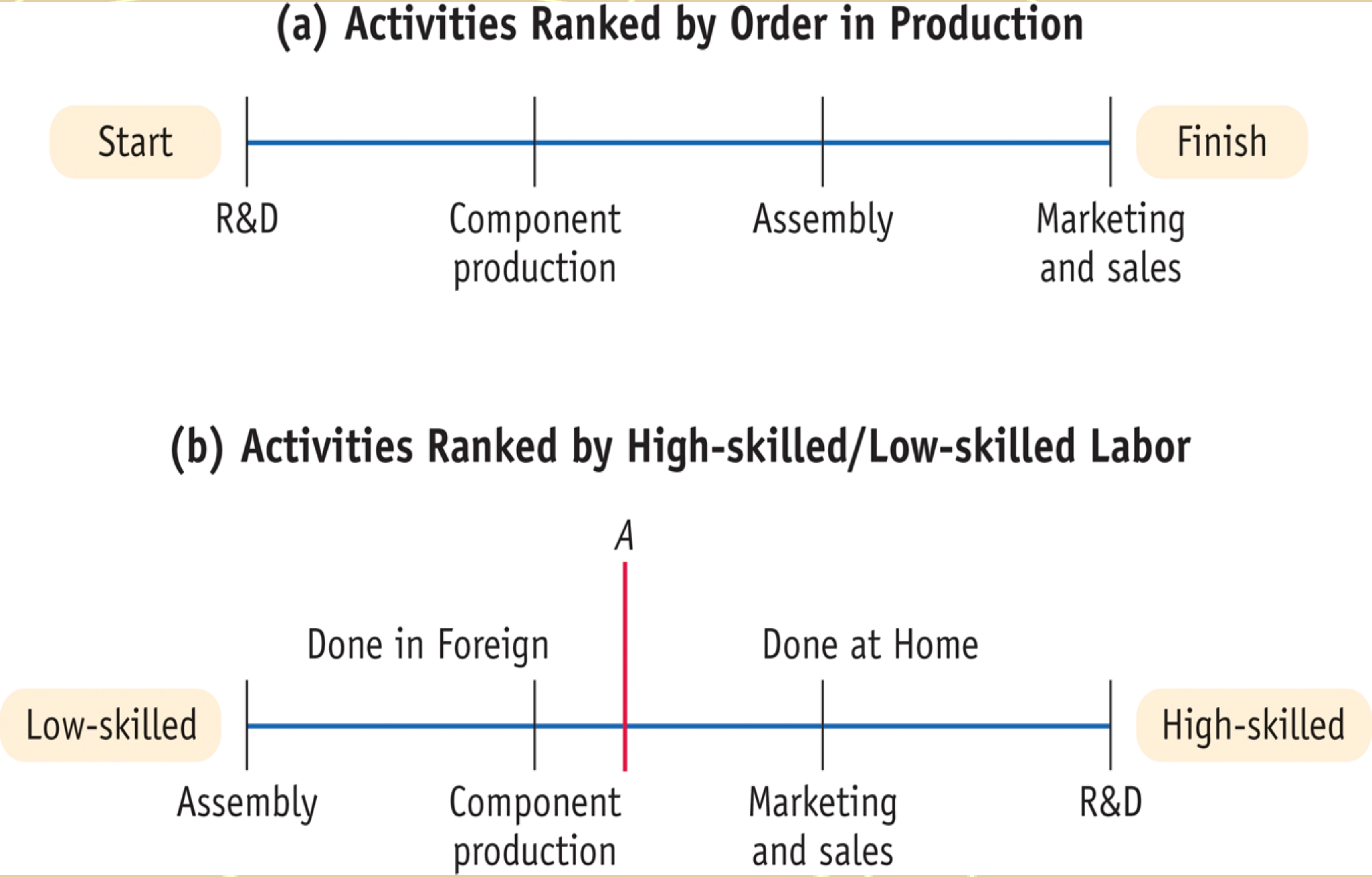
- Firms that take advantage of location economies in different parts of the world, create a global web of value creation activities

- Under this strategy, different stages of the value chain are dispersed to those locations around the globe where perceived value is maximized or where the costs of value creation are minimized

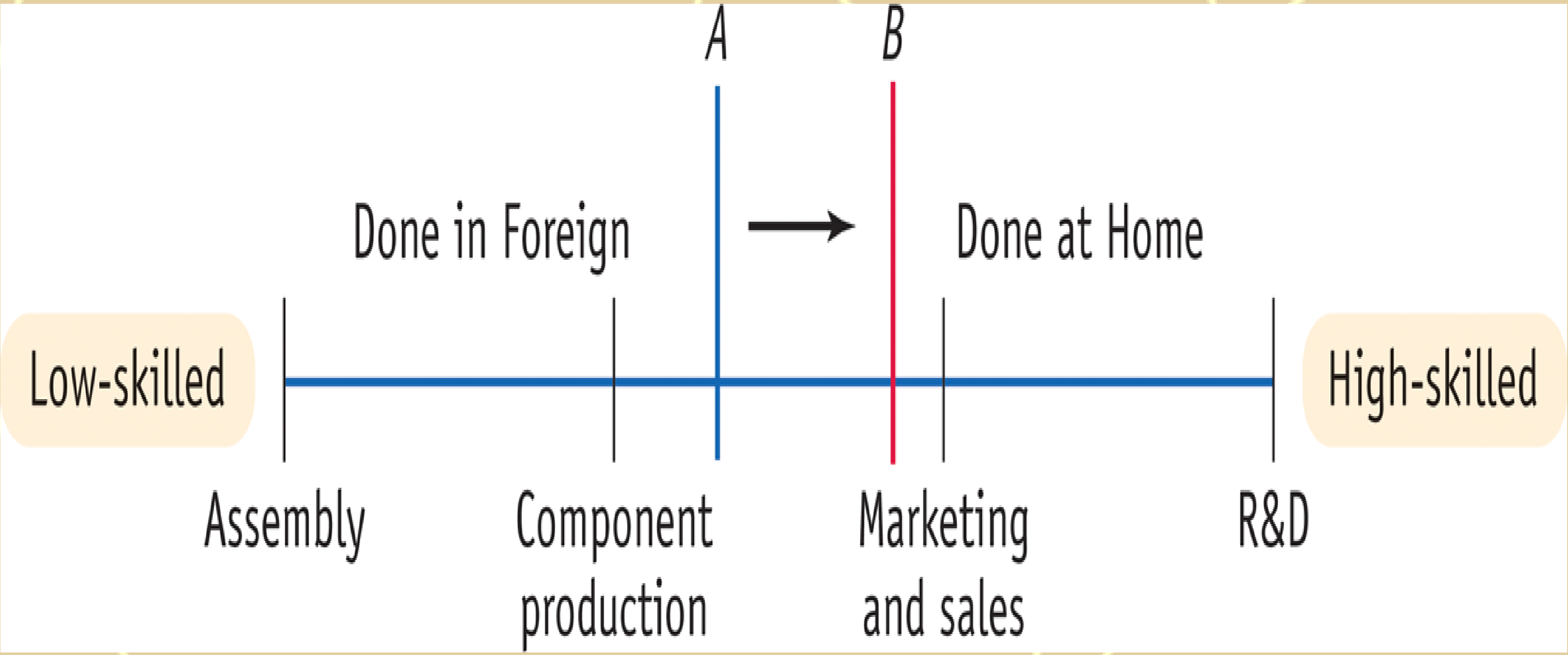
A caveat:

- transportation costs, trade barriers, and political risks complicate this picture

Global Web of Value Creation Activities



Global Web of Value Creation Activities



3.a. Economies of Scale

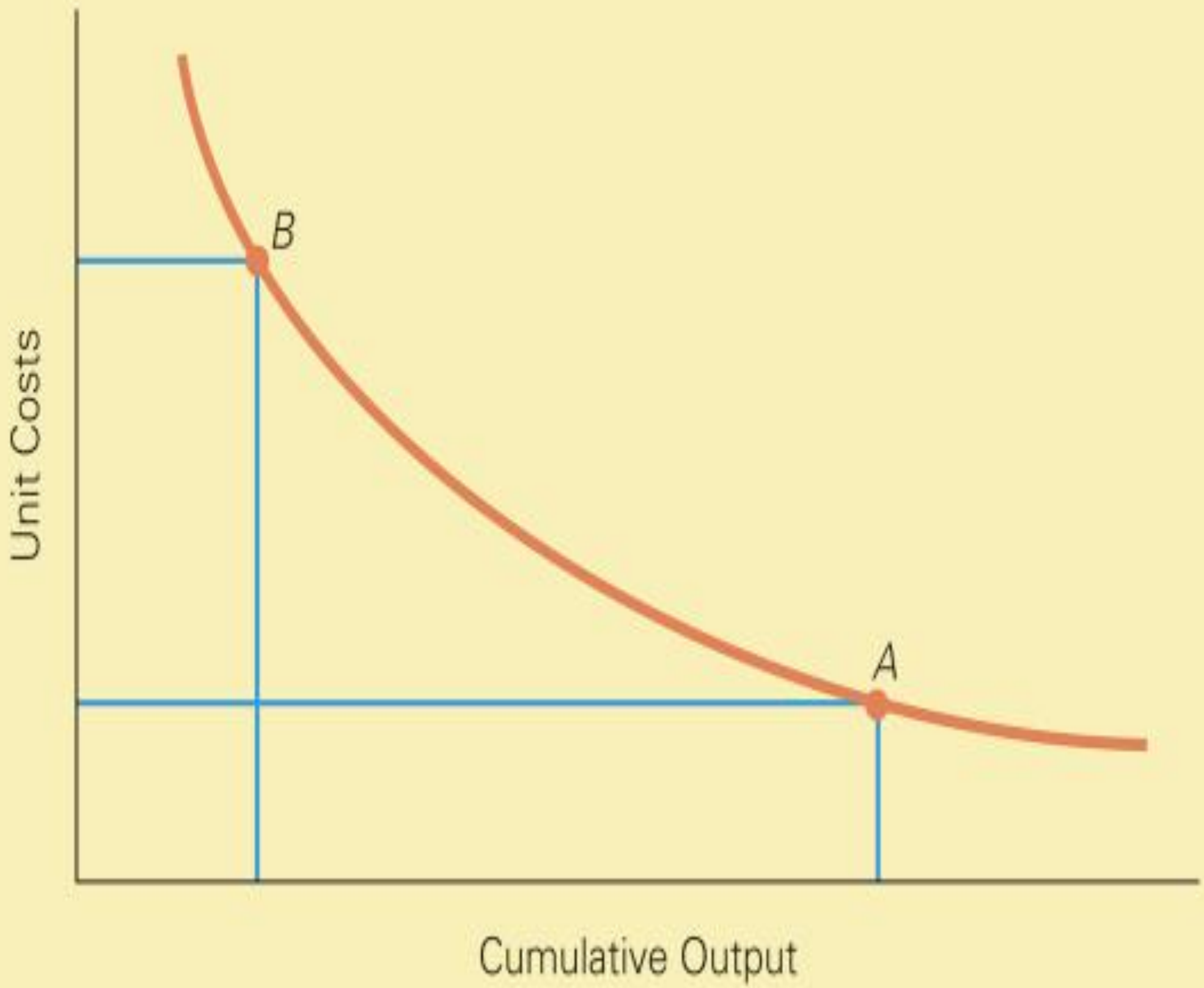
- Economies of scale refer to the reductions in unit cost achieved by producing a large volume of a product

Sources of economies of scale include:

- spreading fixed costs over a large volume
- utilizing production facilities more intensively
- increasing bargaining power with suppliers

- Firms reduce the cost of creating value ….

3.b. Economies of scales



3.c. Cost Pressures and Pressures For Local Responsiveness

Firms that compete in the global marketplace typically face two types of competitive pressures:

- pressures for cost reductions
- pressures for local responsiveness

- Pressures for cost reductions force the firm to lower unit costs

- Pressure for local responsiveness require the firm to adapt its product to meet local demands in each market—a strategy that raises costs

3.d. Pressures For Cost Reductions

Pressures for cost reductions are greatest:

- in industries producing commodities that fill universal needs and price is the main competitive weapon
- when major competitors are based in low cost locations
- where there is persistent excess capacity
- where consumers are powerful and face low switching costs

3.e. Pressures For Local Responsiveness

Pressures for local responsiveness arise when:

- differences in consumer tastes and preferences: consumer tastes and preferences differ significantly between countries
- differences in traditional practices and infrastructure: there are differences in infrastructure and/or traditional practices between countries

3.f. Pressures For Local Responsiveness

- differences in distribution channels: a firm's marketing strategies needs to be responsive to differences in distribution channels between countries

- host government demands: economic and political demands imposed by host country governments may necessitate a degree of local responsiveness

3.g Pressures for Low Cost and Local Responsiveness: Choosing a Strategy

- **Four Strategic Options:**
  - global standardization
  - localization
  - transnational
  - International

- The appropriateness of each strategy depends on the pressures for cost reduction and local responsiveness in the industry

Global Standardization Strategy

- The global standardization strategy: processes, interactions, and arrangements that encompass the "entire planet" or, affect the entire planet even if they don't operate in every part of it!

- Focuses on increasing profitability and profit growth on a global scale, via cost reductions that come from economies of scale, learning effects, and location economies

- The global standardization strategy makes sense when:
  - there are strong pressures for cost reductions
  - minimal demands for local responsiveness

Localization Strategy

- The localization strategy focuses on increasing profitability by customizing the firm's goods or services so that they provide a good match to tastes and preferences in different national markets

- The localization strategy makes sense when:
  - there are substantial differences across nations with regard to consumer tastes and preferences
  - where cost pressures are not too intense

Transnational Strategy

- The transnational strategy: processes or arrangements that span the boundaries of two or more countries (markets).

- Tries to simultaneously achieve:
  - low costs through location economies, economies of scale, and learning effects
  - differentiate the product across geographic markets to account for local differences
  - foster a multi-directional flow of skills between different subsidiaries in the firm's network of operations

- The transnational strategy makes sense when:
  - cost pressures are intense
  - pressures for local responsiveness are intense

Transnational Strategy (con’ed)

❖ Transnational Companies / Firms:

Commercial enterprises that operate substantial facilities, do business in more than one country and do not consider any particular country their national home.

A significant advantage of a transnational companies is that they are able to maintain a greater degree of responsiveness to the local markets where they maintain facilities.

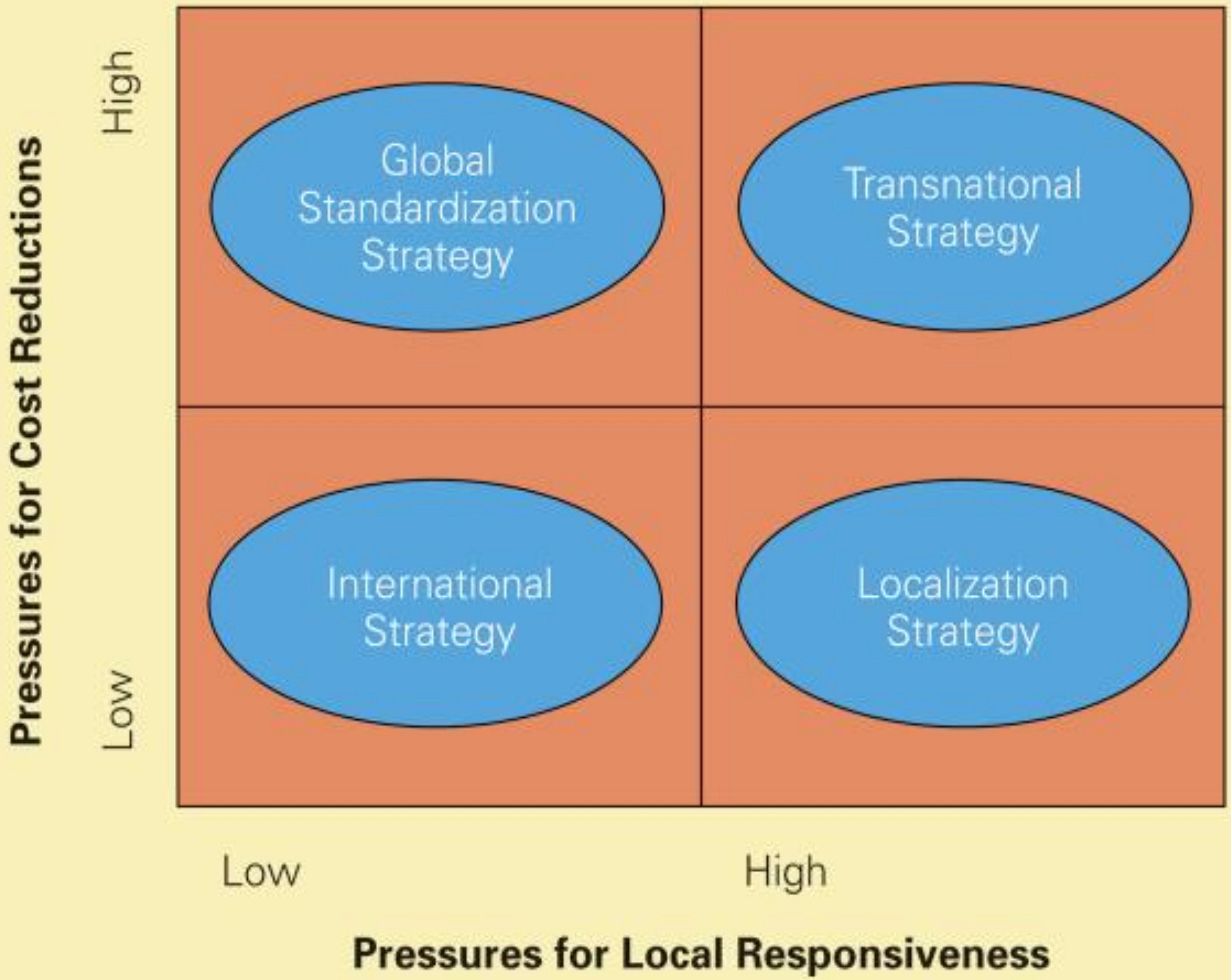
International Strategy

- Firms pursuing an international strategy create value by transferring core competencies from home to foreign subsidiaries

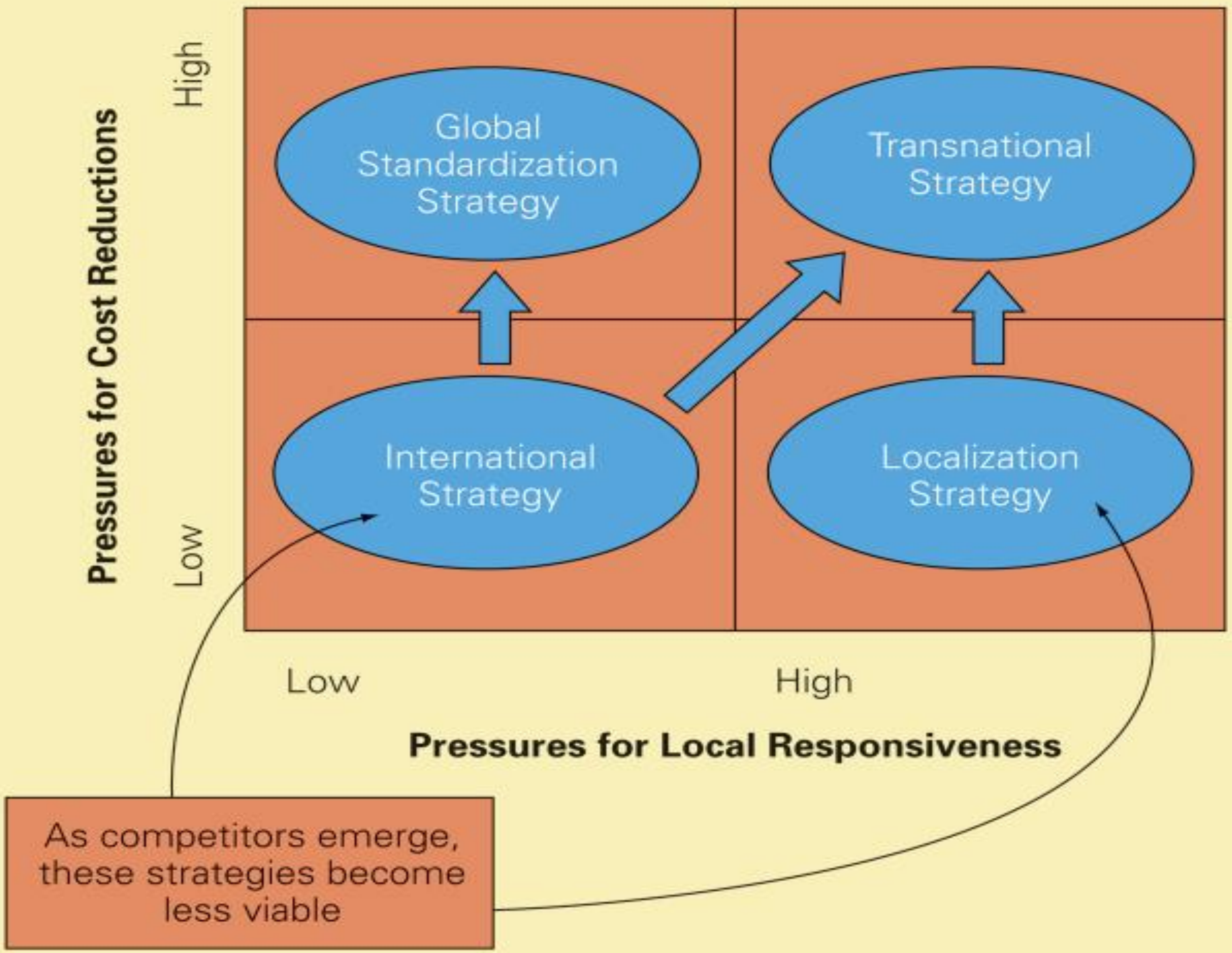
- The international strategy makes sense when:
  - cost pressures are low
  - pressures for local responsiveness are low

- Caveat: often, international firms/companies are importers and exporters, they have no investment outside of their home country.

Choosing A Strategy: Four Basic Strategies



The Evolution of Strategy: Changes in Strategy over Time



4. Earn Higher Return

- International Firms by leveraging any valuable skills developed in foreign operations and transferring them to other entities within the firm’s global network of operations can increase their overall return from FDI

Chapter 13

The Organization of International Business

Organizational Structure

❖ **Organizational structure has three dimensions:**

1. Vertical differentiation - the location of decision-making responsibilities within a structure

2. Horizontal differentiation - the formal division of the organization into sub-units

3. The establishment of integrating mechanisms - the mechanisms for coordinating sub-units

Vertical Differentiation: Centralization And Decentralization

❖ **Vertical differentiation determines where decision-making power is concentrated** (centralized vs. decentralized)

❖ **Centralized vs. decentralized decision-making:**

- facilitates coordination
- ensure decisions consistent with organization’s objectives
- gives top-level managers the means to bring about organizational change
- avoids duplication of activities

2.a Horizontal Differentiation: The Design of Structure

❖ **Horizontal differentiation is concerned with how the firm decides to divide itself into sub-units**

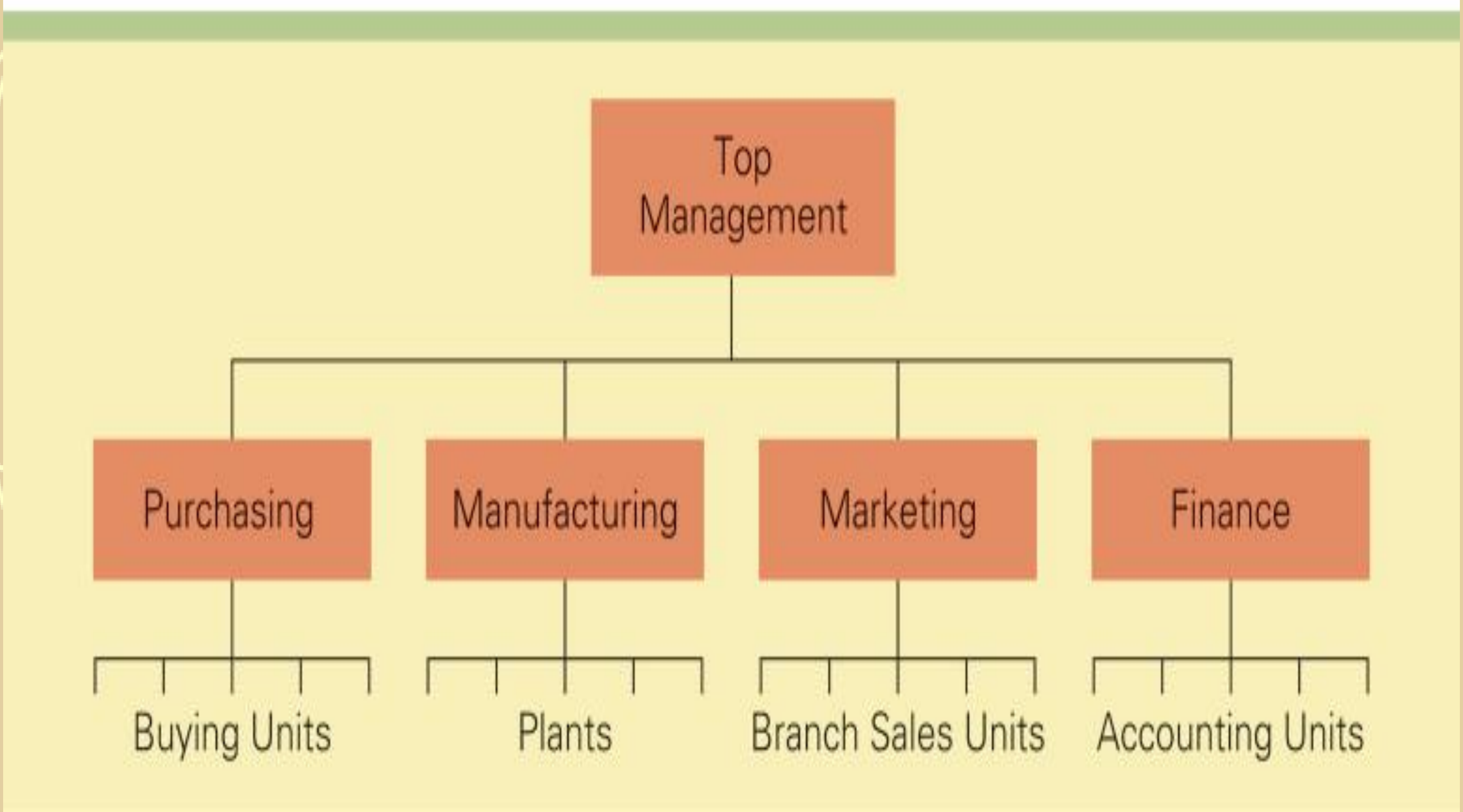
❖ The decision is usually based on:

- function
- type of business
- geographical area

2.b Horizontal Differentiation: The Design of Structure

- Most firms begin with no formal structure
- As they grow, the organization is split into functions reflecting the firm's value creation activities (functional structure)
- The functions are typically coordinated and controlled by top management.
- Decision-making tends to be centralized
- If firms diversify product line, further horizontal differentiation may be necessary. Firms may switch to a product divisional structure where each division is responsible for a distinct product line

2.d Horizontal Differentiation: Localization Strategy

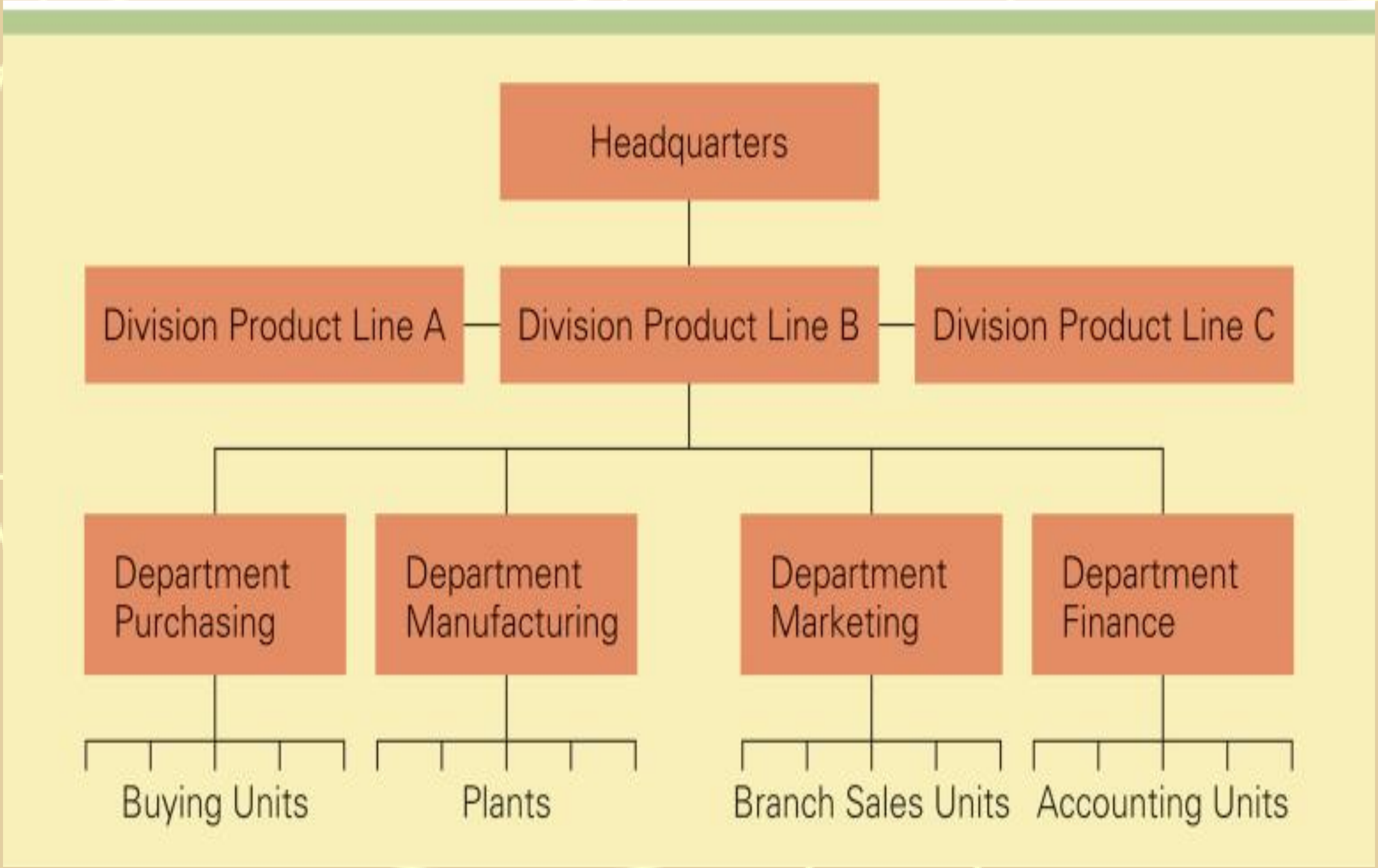


2.c Horizontal Differentiation: Localization Strategy

Firms pursuing a localization strategy focus on local responsiveness.

- They do not have a high need for integrating mechanisms
- Performance ambiguity and the cost of control tends to be low
- The worldwide area structure is common

2.e Horizontal Differentiation: Localization Strategy

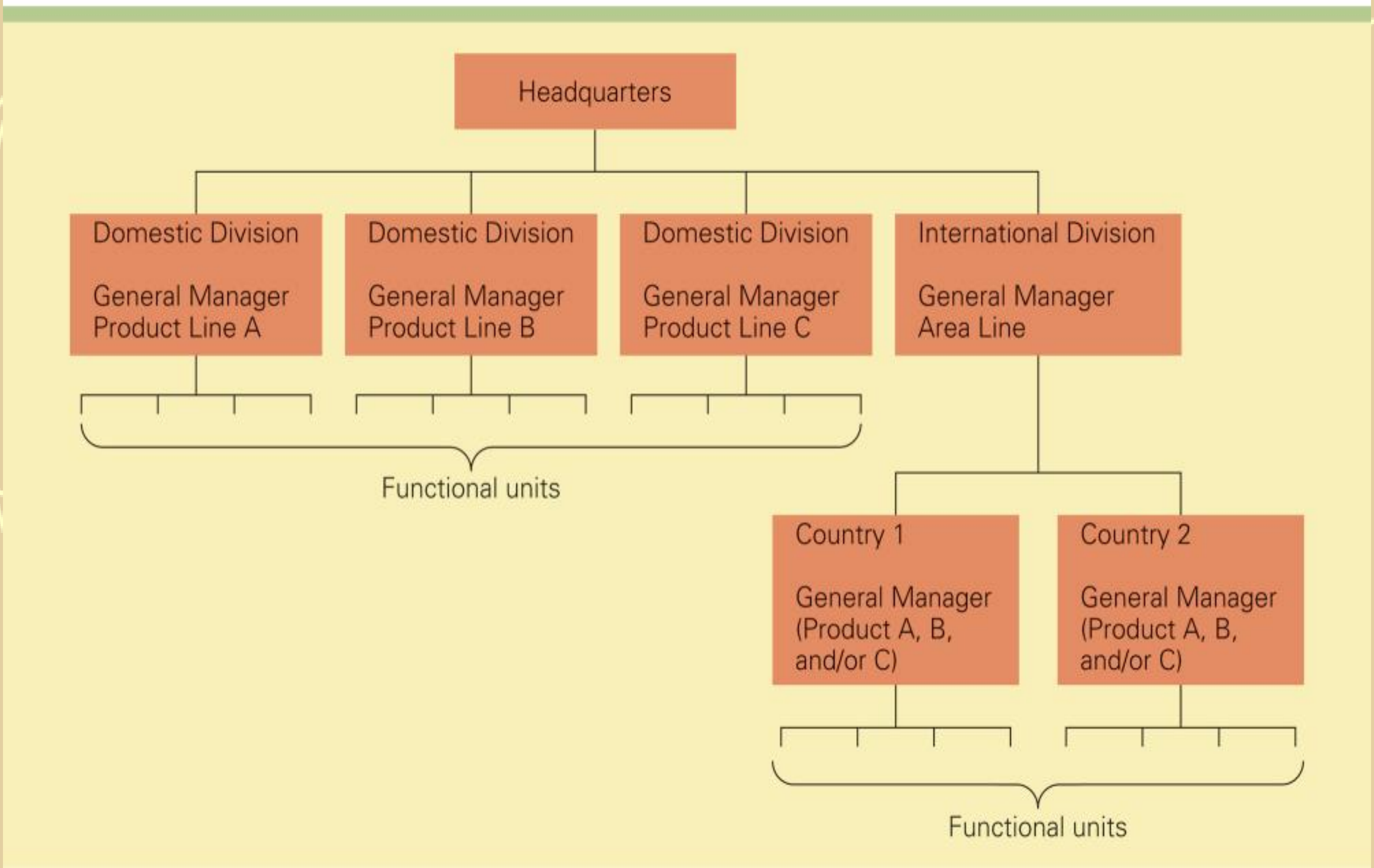


2.f Horizontal Differentiation: International Strategy

Firms pursuing an international strategy create value by transferring core competencies from home to foreign subsidiaries.

- The need for control is moderate
- The need for integrating mechanisms is moderate
- Performance ambiguity is relatively low and so is the cost of control
- The worldwide product division structure is common

2.g Horizontal Differentiation: International Strategy



2.h Horizontal Differentiation: Globalization Strategy

The worldwide area structure:

- is favored by firms with low degree of diversification and a domestic structure based on function
- divides the world into autonomous geographic areas
- decentralizes operational authority
- facilitates local responsiveness
- can result in a fragmentation of the organization
- is consistent with a localization strategy

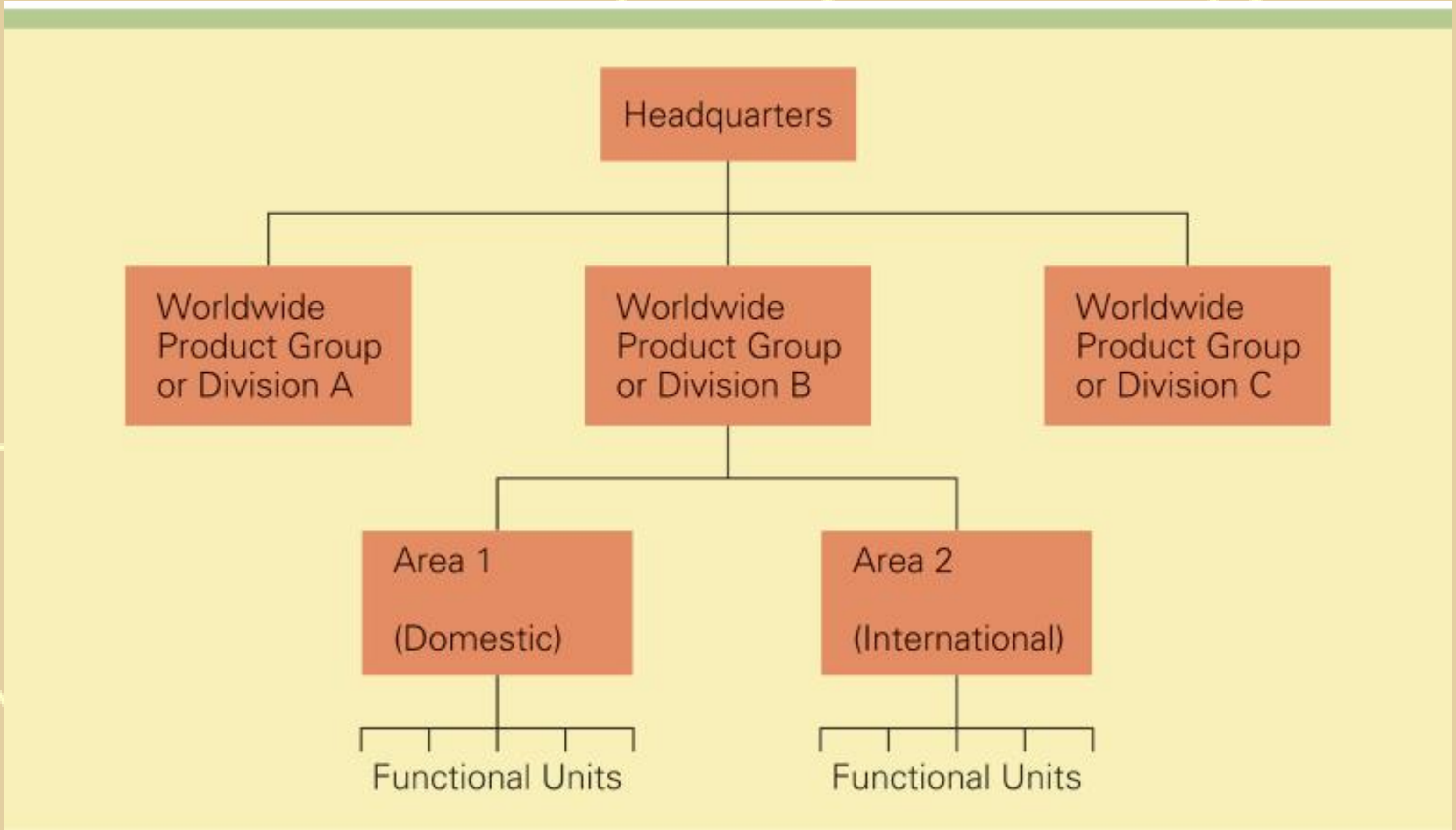
2.i Horizontal Differentiation: Globalization Strategy

Firms pursuing a global standardization strategy focus on the realization of location and experience curve economies.

- Headquarters maintains control over most decisions
- The need for integrating mechanisms is high
- Strong organizational cultures are encouraged
- The worldwide product division is common

2.j Horizontal Differentiation: Globalization Strategy

Figure 13.6: A Worldwide Product Divisional Structure



Environment, Strategy, Architecture, and Performance

For a firm to succeed, two conditions must be met:

1. the firm's strategy must be consistent with the environment in which the firm operates

2. the firm's organization architecture must be consistent with its strategy

Organizational Inertia

- Organizations are difficult to change

Sources of inertia include:

- the existing distribution of power and influence
- the current culture
- senior managers' preconceptions about the appropriate business model or paradigm
- institutional constraints

Implementing Organizational Change

Three basic principles for successful organization change:

1. Unfreeze the organization through shock therapy

- Effective change requires taking bold actions like plant closures or dramatic structural reorganizations

2. Moving the organization to a new state through proactive change in architecture

- Movement requires a substantial change in the form of a firm's organizational architecture so that it matches the desired new strategic posture. Movement should be done quickly

3. Refreeze the organization in its new state

- Refreezing requires that employees be socialized into the new way of doing things