

Firm in Transition

Topic 5

Foreign Direct Investment

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PI and FDI

- Capital movements

- Foreign Direct Investment (FDI)

- Movement of capital that involves ownership and control

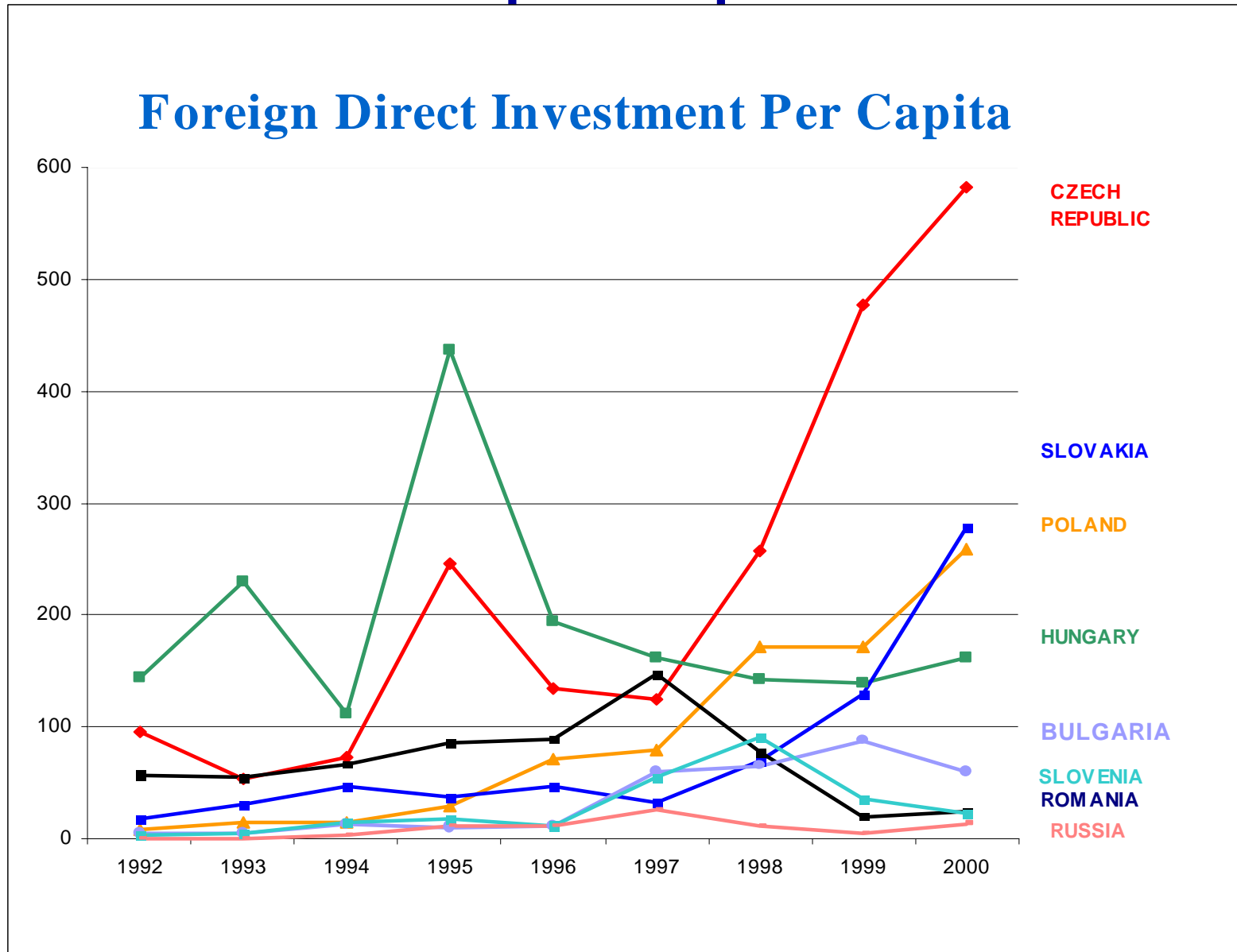
- Multinational Enterprise (MNE)
 - Multinational Corporation (MNC)
 - Transitional Corporation (TNC)
 - Transitional Enterprise (TNE)
 - Real capital involved
 - Impact on production and income generation

- Foreign Portfolio Investment

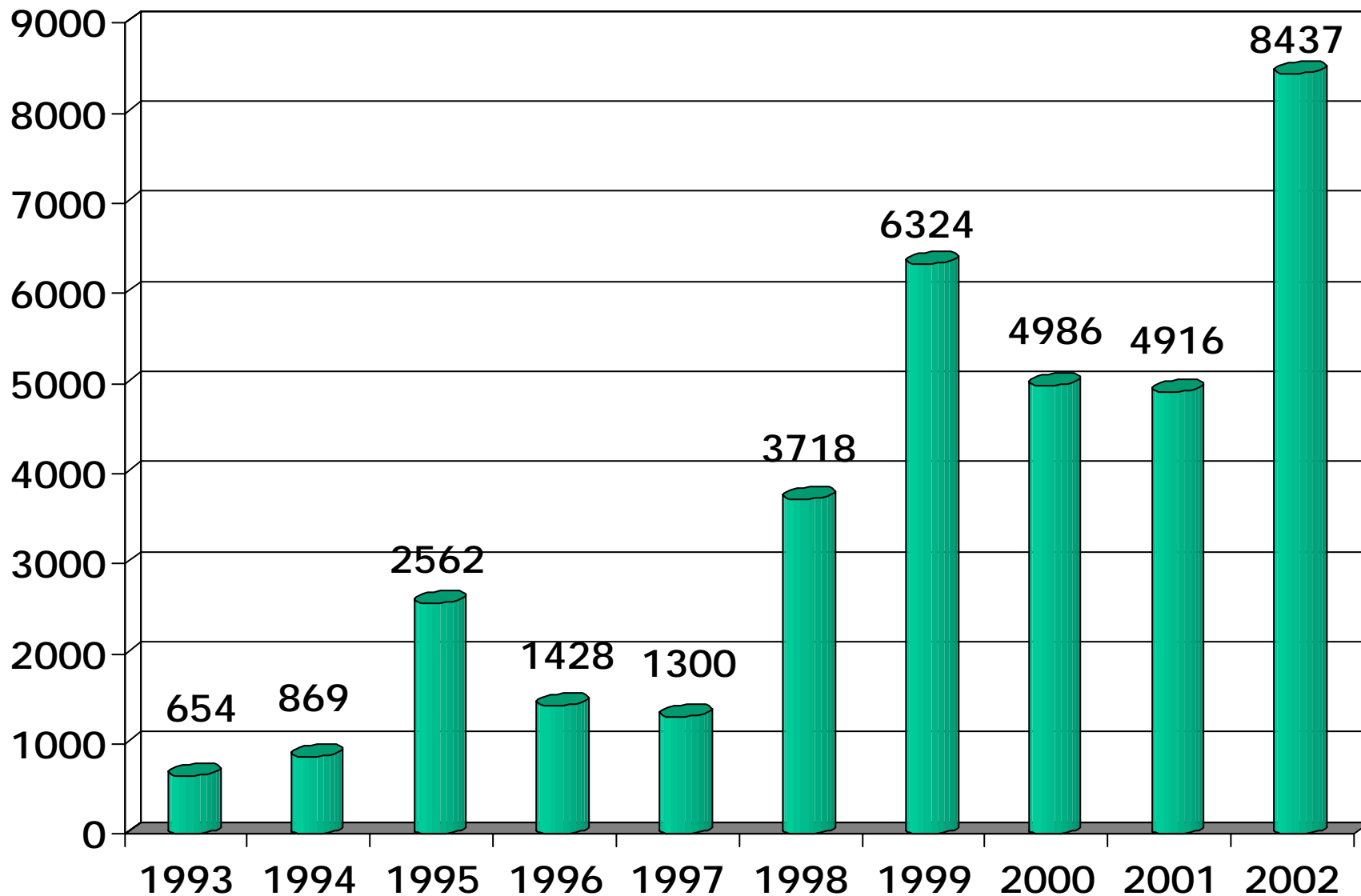
- Does not involve ownership or control

- Financial capital
 - Bonds
 - Impact on Balance of Payment, Exchange rate

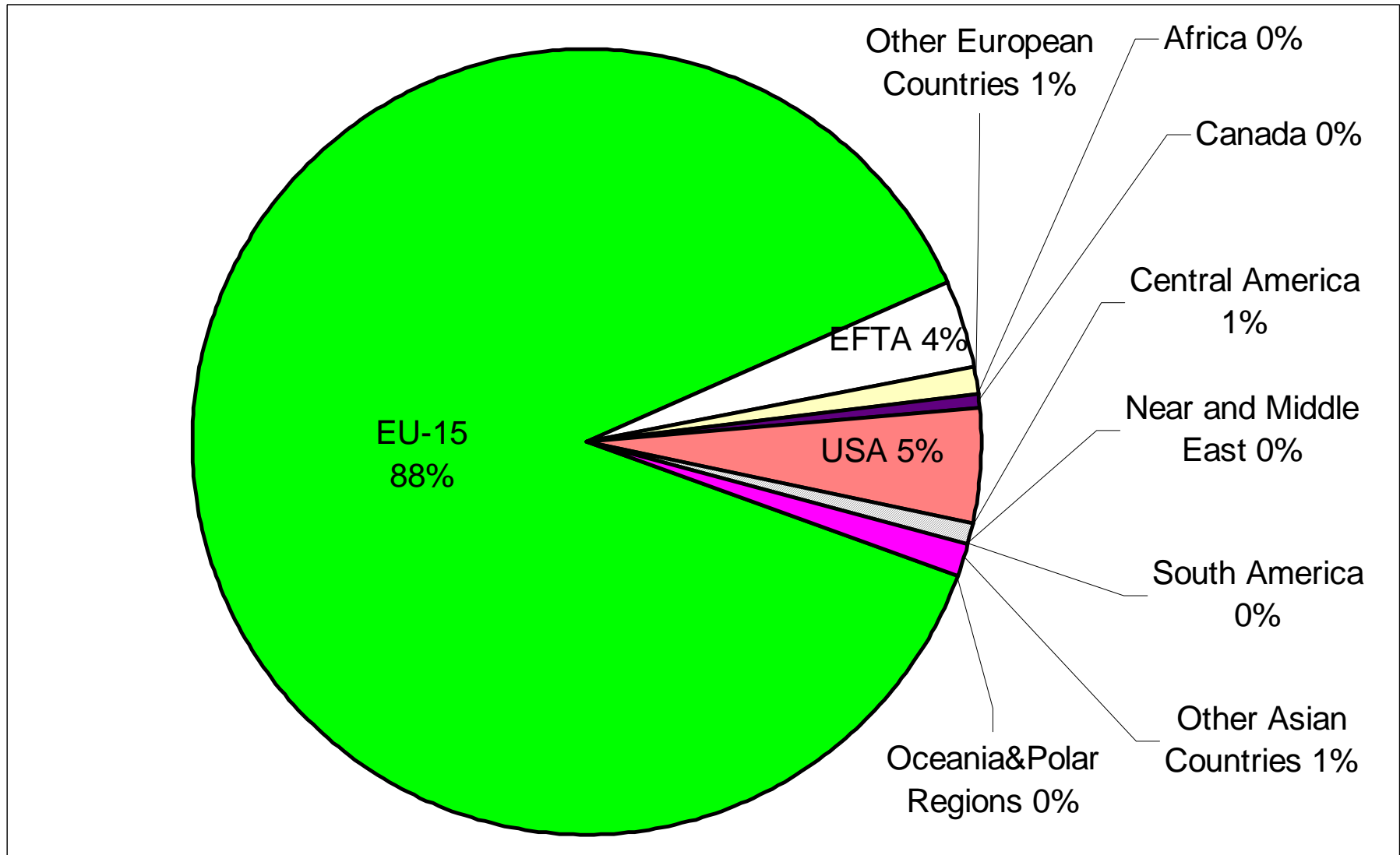
FDI per capita



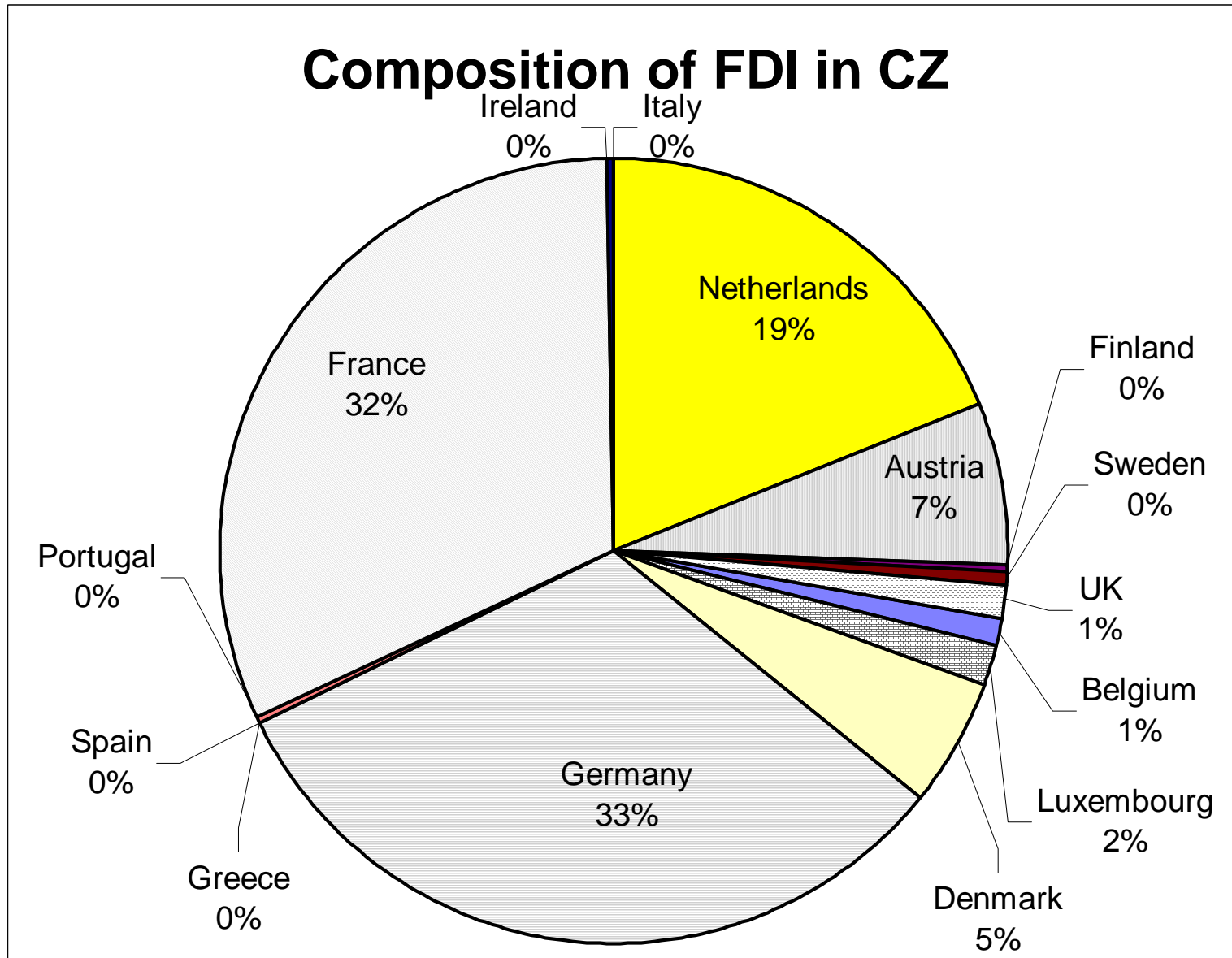
FDI Inflow to CZ, mil USD



FDI Territorial Structure



FDI-EU Sources



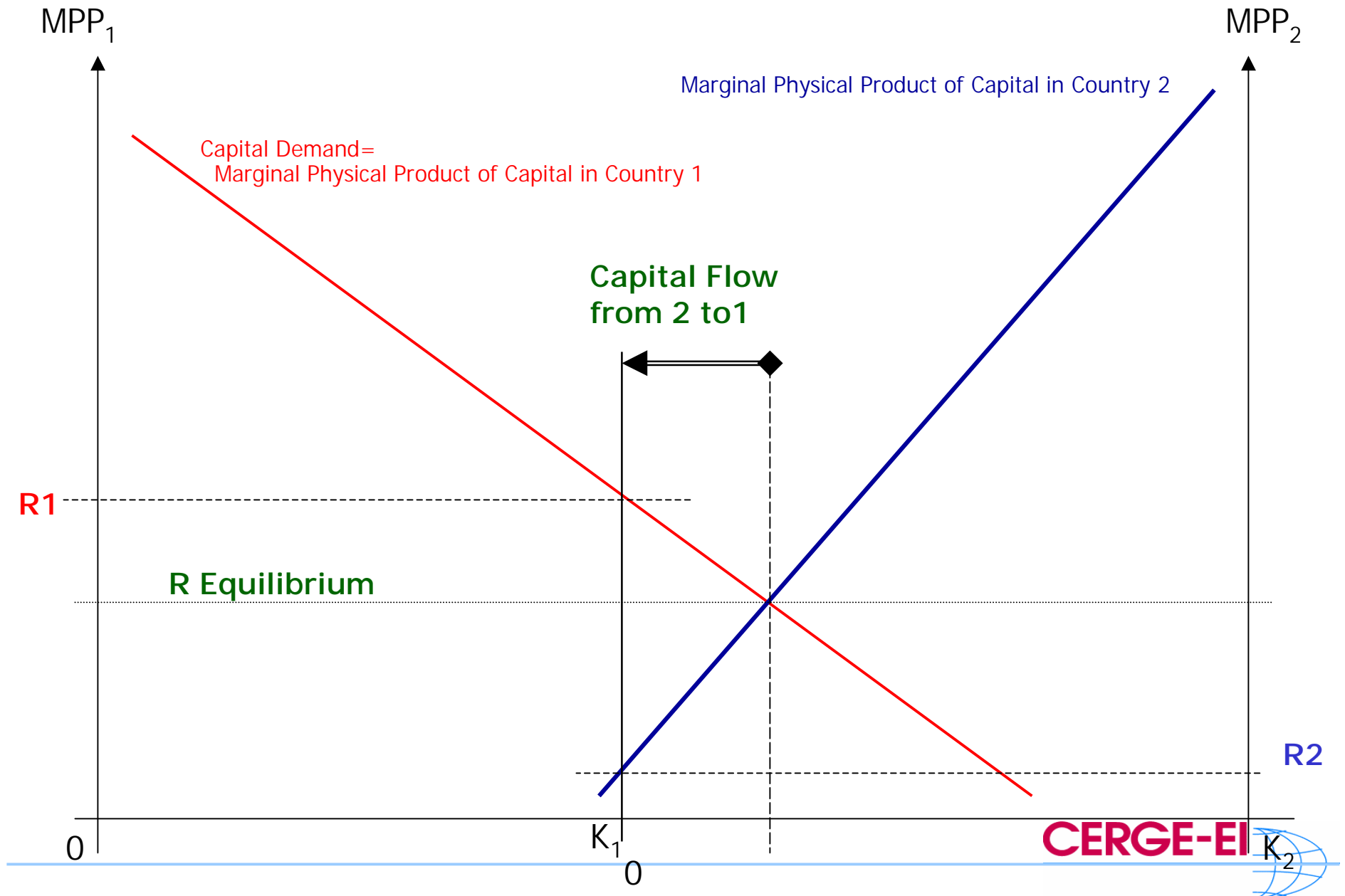
Reasons of Capital Movement

- Capital is moved in response to the expectations of *higher rate of return* in new location
- Hypotheses:
 - response to large and rapidly growing *markets*
 - recipient country has high income per capita
 - secure access to *mineral or raw material deposits*
 - overcome *tariff and non-tariff barriers*
 - advantage of *low wages & labor costs*
 - *defensive move to protect market share*
 - *risk diversification*
 - *firm-specific knowledge or assets*

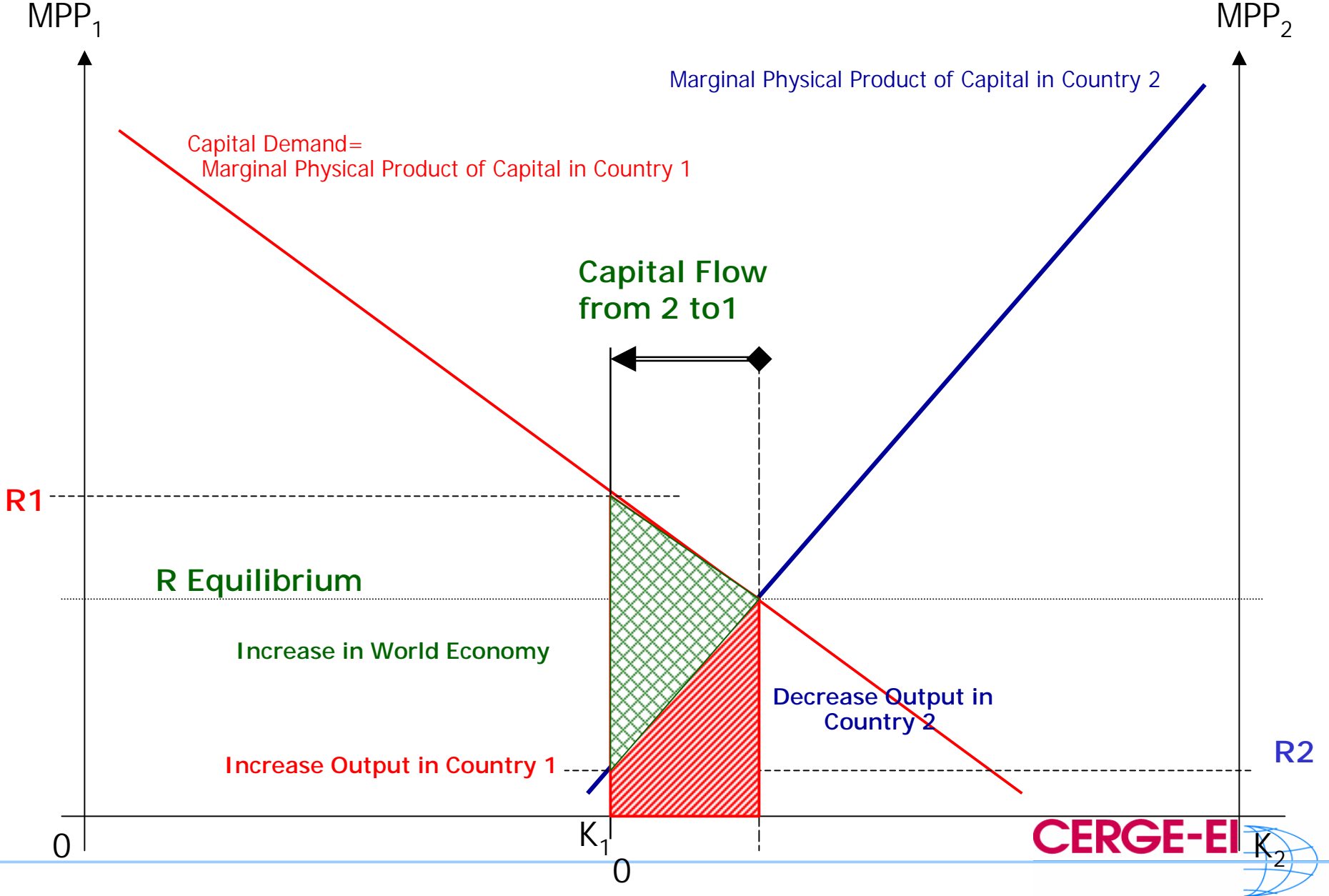
Capital move into LDCs

- Attractors of FDI in LDCs
 - According to Root&Ahmed, 79
 - Economic factors do not explain FDI entirely
 - GDP/capita
 - GDP growth rate
 - Economic integration (no barriers)
 - Availability of infrastructure
 - Urbanization
 - Political stability

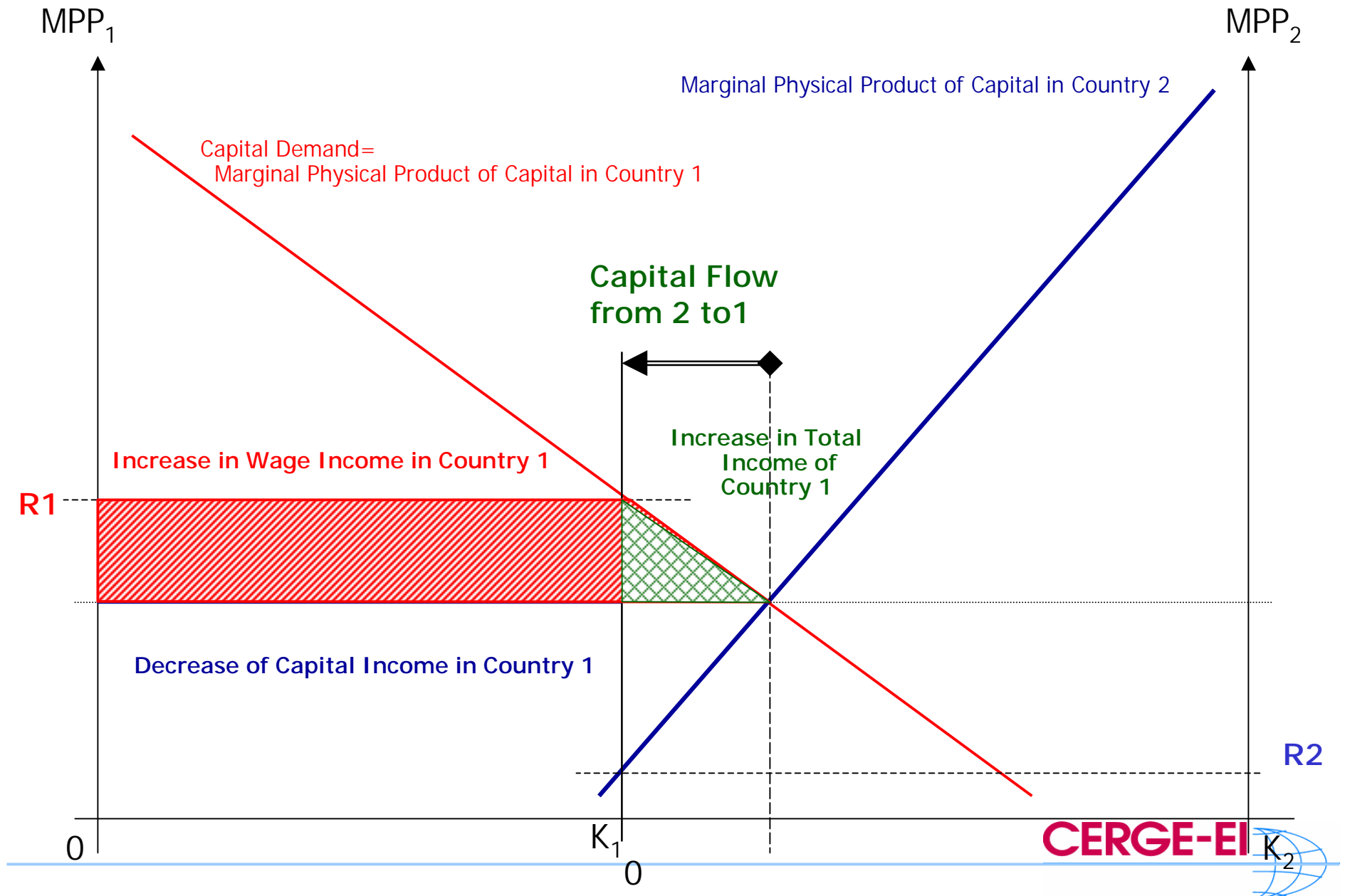
Capital Market Equilibrium



Increase in World Output and Efficiency



Increase in National Income



Host Country

- Potential Benefits
 - Increase in output
 - Increase in wages
 - Increased employment
 - Increased exports
 - Increased tax revenues
 - Realization of economies of scale and scope
 - Provision of technical and managerial skills
 - Weakening power of domestic monopoly
 - Increased competition

Host Country

- Potential Costs
 - Adverse impact on terms of trade
 - Decrease of relative export/import price ratio
 - Transfer pricing
 - Decrease in domestic savings
 - Increased income promotes consumption
 - Decrease in domestic investment
 - Crowding out effect
 - Instability of Balance of Payments
 - Loss of control over domestic policy
 - Increase in unemployment
 - Establishment of local monopoly
 - Inadequate technology to local knowledge and skills

Serving Markets

- Multinational enterprise (MNE) can serve a foreign market:
 1. No direct investment: serve the market by exports or licensing local firms.
 2. Invest directly by a green-field venture.
 3. Invest directly by acquiring a local firm.
 4. Invest directly by merging with a local firm.
 5. Enter into a strategic alliance with a local firm (joint-ventures).

MNE and FDI

- Objectives the MNEs follow:
 1. Resource seeking
 2. Market seeking
 3. Efficiency seeking
 4. Asset seeking

What drives the MNE decision among these alternatives?

OLI Paradigm

OLI paradigm identifying advantages and conditions under which FDI occurs.

- O Net ownership (O) advantages - patents, trade secrets, trademarks, human capital, management and reputation for quality.
- I It must be beneficial for the firm possessing O-type advantages to exploit them internally (I) rather than exchange them on the market through licensing or co-operation agreements with an independent foreign firm. These incentives depend, for example, on the specific characteristics of the knowledge to be transferred and the costs of transferring it.

OLI Paradigm

OLI paradigm identifying advantages and conditions under which FDI occurs.

- L It must be beneficial to utilize those advantages in a foreign rather than in a domestic location. Location advantages (L) - abundant and cheaper factors of production (labor, specific factors) that allow to increase efficiency, economies of scale in a large market, high growth rates attract firms looking for new opportunities of business, improving or defending market shares while preempting competitors of doing likewise.

Other Reasons for FDI

- Other explanations in literature on FDI
 - Gravity approach
 - Agglomeration economies
 - Intellectual property rights protection

OLI and Mode Comparison

Table 1 — *Alternative Routes of Servicing Markets*

		Advantages		
		owner- ship	inter- nalisation	(foreign) location
Route of servicing market	foreign direct invest- ment	yes	yes	yes
	exports	yes	yes	no
	contractual resource transfers	yes	no	no

How OLI Works

Table 2 — *Some Illustrations of How OLI Characteristics May Vary According to Country, Industry and Firm Specific Considerations*

Structural variables OLI	Country (home-host)	Industry	Firm
Ownership	factor endowments (e.g., resources and skilled labour) and market size and character. Government policy towards innovation, protection of proprietary rights, competition and industrial structure, government controls on inward direct investment	degree of product or process technological intensity; nature of innovations; extent of product differentiation; production economies (e.g., if there are economies of scale); importance of favoured access to inputs and/or markets	size, extent of production, process or market diversification; extent to which enterprise is innovative, or marketing-oriented, or values security and/or stability, e.g., in sources of inputs, markets etc.; extent to which there are economies of joint production
Internalisation	government intervention and extent to which policies encourage MNEs to internalise transactions, e.g., transfer pricing; government policy towards mergers; differences in market structures between countries, e.g., with respect to transaction costs, enforcement of contracts, buyer uncertainty etc.; adequacy of technological, educational, communications etc., infrastructure in host countries and ability to absorb contractual resource transfers	extent to which vertical or horizontal integration is possible/desirable, e.g., need to control sourcing of inputs or markets; extent to which internalising advantages can be captured in contractual agreements (cf. early and later stages of product cycle); use made of ownership advantages; cf. IBM with Unilever type operation; extent to which local firms have complementary advantage to those of foreign firms; extent to which opportunities for output specialisation and international division of labour exist	organisational and control procedures of enterprise; attitudes to growth and diversification (e.g., the boundaries of a firm's activities); attitudes toward subcontracting-contractual ventures, e.g., licensing, franchising, technical assistance agreements etc.; extent to which control procedures can be built into contractual agreements
Location	physical and psychic distance between countries; government intervention (tariffs, quotas, taxes, assistance to foreign investors or to own MNEs, e.g., Japanese government's financial aid to Japanese firms investing in South East Asian labour intensive industries	origin and distribution of immobile resources; transport costs of intermediate and final goods products; industry specific tariff and non-tariff barriers; nature of competition between firms in industry; can functions of activities of industry be split? Significance of "sensitive" locational variables, e.g., tax incentives, energy and labour costs	management strategy towards foreign involvement; age and experience of foreign involvement; (position of enterprise in product cycle etc.); psychic distance variables (culture, language, legal and commercial framework); attitudes towards centralisation of certain functions, e.g., R & D; regional office and market allocation etc.; geographical structure of asset portfolio and attitude to risk diversification

Gains of Host

- Potential gains from FDI
 - Allocative efficiency
 - Technical efficiency
 - Technology transfer (more generally, transfer of technological, managerial and marketing knowledge) - we talk about FDI spillovers in this context.
 - demonstration-imitation effect
 - labor mobility
 - backward-forward linkages

Mode of FDI Entry

- Greenfields vs. M&As
 - M&A Fear of:
 - foreign owners, who repatriate earnings
 - loss of technology, skills and strategic knowledge.
 - Greenfield:
 - Productive capacity, new plant equipment,
 - better technology,
 - new employment generation,
 - increase in competition,
 - no threat to national enterprises or 'denationalization' of valuable assets.

Mode of FDI Entry

- Benefits of M&A over greenfield are:
 - rapid entry
 - access to firm-specific assets (skills, technology, organization, information, supply networks, brands, contacts).
 - access to undervalued capital assets
 - local market knowledge,
 - established distribution systems and contacts with the government,
 - suppliers, access to inputs and resources.
- Costs of M&As over greenfield are:
 - 'Inertia' inherent in acquired firm

Conclusions

- FDI Cost/Benefit Analysis of Ownership Package
 - + Transfer of knowledge in addition to capital
 - + Possible positive externalities (spillovers)
 - + Vehicle of technology transfer
 - Not proper technology
- FDI Cost/Benefit Analysis of Labor market
 - + Increase in wages
 - + Increase in employment
 - + Better working conditions
 - Abuse of monopsonistic position

Conclusions

- FDI Cost/Benefit Analysis of Fiscal Impact
 - + Tax revenues
 - Tax concession
 - Transfer pricing
- FDI and Balance of Payments
 - + Short-term effect
 - + Inflow of capital
 - Long-term effect
 - Outflow of interest
 - royalties
 - dividends

Conclusions

- FDI and National sovereignty
 - MNE can influence policy decisions

- General Conclusion
 - Each case should be evaluated at its own merit