Foreign Direct Investment (FDI)

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Definition

- Classical definition: Foreign Direct Investment (FDI) is defined as a company from one country, making a physical investment into building a factory in other countries.

Definition

- Recent definition: FDI is defined as a cross-border investment involving a **long-term relationship and acquiring a lasting management interest** (10% or more of the voting stock) by a resident in one economy (investor) in an enterprise resident in an economy other than that of the foreign direct investor.

FDI Components

- Three components:
  - ***Equity capital***: foreign direct investor’s purchase of shares of an enterprise other than its own.
  - ***Reinvested earnings***: direct investor’s share of earnings not distributed as dividends or remitted to the investor, but reinvested.
  - ***Intra-company loans or intra-company debt transactions***: refer to short or long-term borrowing and lending of funds between direct investors (parent companies) and affiliate enterprises.

Portfolio Investment

- Stock and Bond purchases that, unlike direct investment, do not create a lasting interest in or effective management control over an enterprise.
- The purpose of the investment is solely financial gain.
- Equity investments less than 10% of a company's share are classified as portfolio investments.

FDI Relationship

- **Direct investment enterprises** can take many different legal forms, but they are all corporations:
  - ***Branch***: if its 100% owned by its immediate direct investor.
  - ***Subsidiary***: a controlled enterprise if it is more than 50% owned by its immediate direct investor.
  - ***Associate***: if it is owned between 10 and 50% by its immediate direct investor.

FDI Relationship

- **Fellow Enterprises** are:
  - Related enterprises (those in direct relationship with each other) because both enterprises are owned by the same direct investor.
  - Neither hold 10% or more voting power in the other.

FDI Flows

- ***Inward Direct Investment***: refers to direct investment made by non-resident investors in the reporting economy.
- ***Outward Direct Investment***: refers to direct investment made by the resident of the reporting economy to external economies.

Who can be a direct investor?

- Individual or household
- Enterprise, public or private
- Government or international organizations
- Any combination of the above

How FDI has changed in the past decade?

- Majority of FDI is made in the form of machinery, equipment and building.
- Recently, dramatic increase in the number of high tech companies: example companies whose primary product is an intellectual property right, such as a software program or software-based technology or process.

Factors considered by FDI's investors

- Political and governmental factors:
  - Political stability
  - Openness to foreign investment
  - Extent of bureaucracy and red tape
  - Transparency and corruption
- Legal and regulatory factors:
  - Regulations on FDI and technology transfer
  - Intellectual property protection
  - Tariffs and other trade barriers

Factors considered by FDI's investors

- Human resource factors:
  - Cost, availability and productivity of skilled labor.
  - Involvement of labor unions.
  - Availability and quality of managerial workforce.
  - Employment regulations.
- Infrastructural factors:
  - Availability and quality of manufacturing.
  - Efficiency of physical distribution.
  - Cost, availability and quality of utilities and finance.

Factors considered by FDI's investors

- Market factors:
  – Size and growth of national market.
  – Size and growth of regional market.
  – Proximity of key export markets.
- Economic factors:
  – Cost of land and facilities.
  – State of local economy.
  – Stability of currency.
  – Extent of regional integration and free trade.

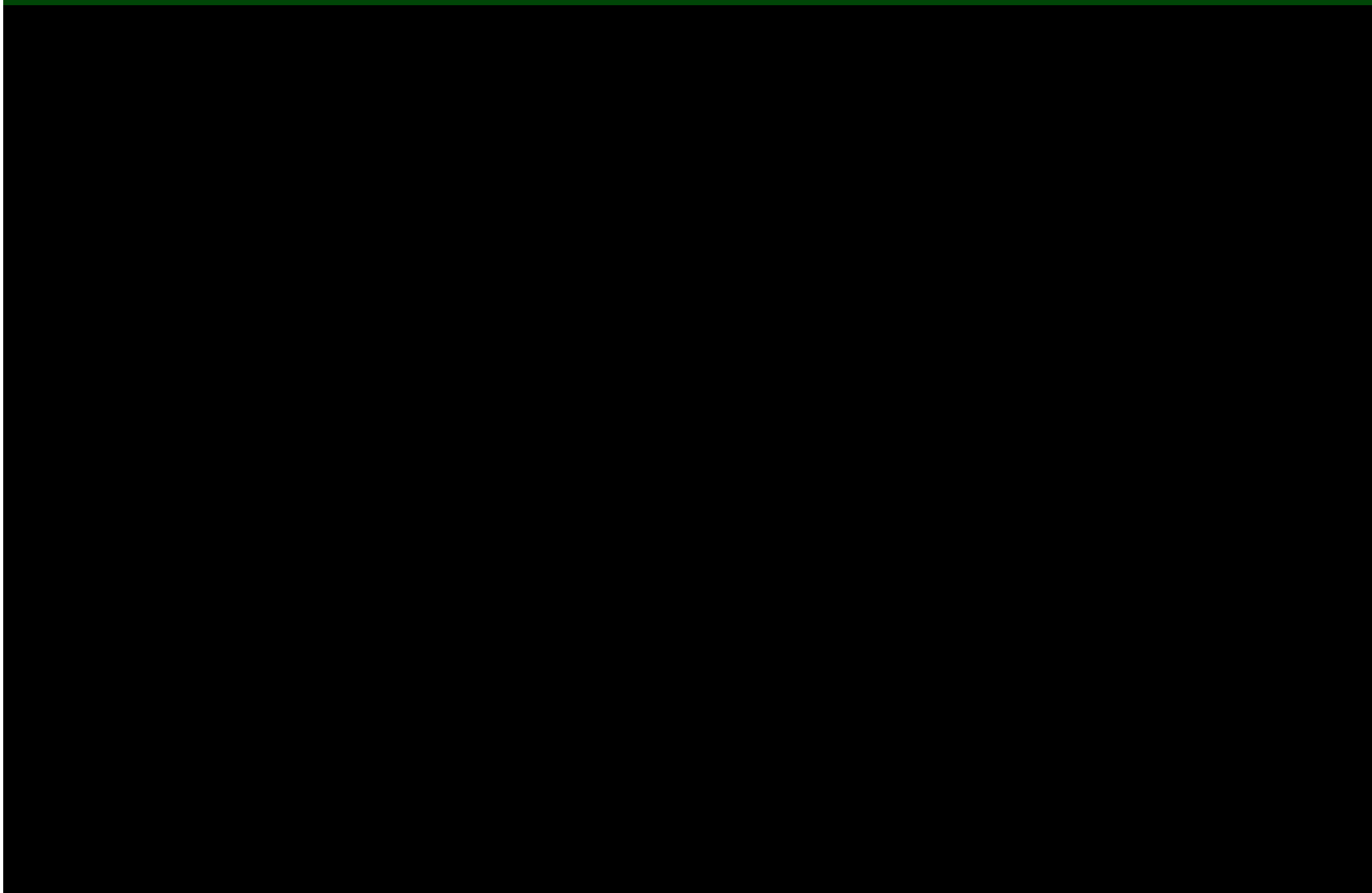
Factors considered by FDI's investors

- Profit retention factors:
  - Types and levels of taxes.
  - Tax rates for profit repatriation.
  - Complexity of tax system.
  - Rate of inflation.

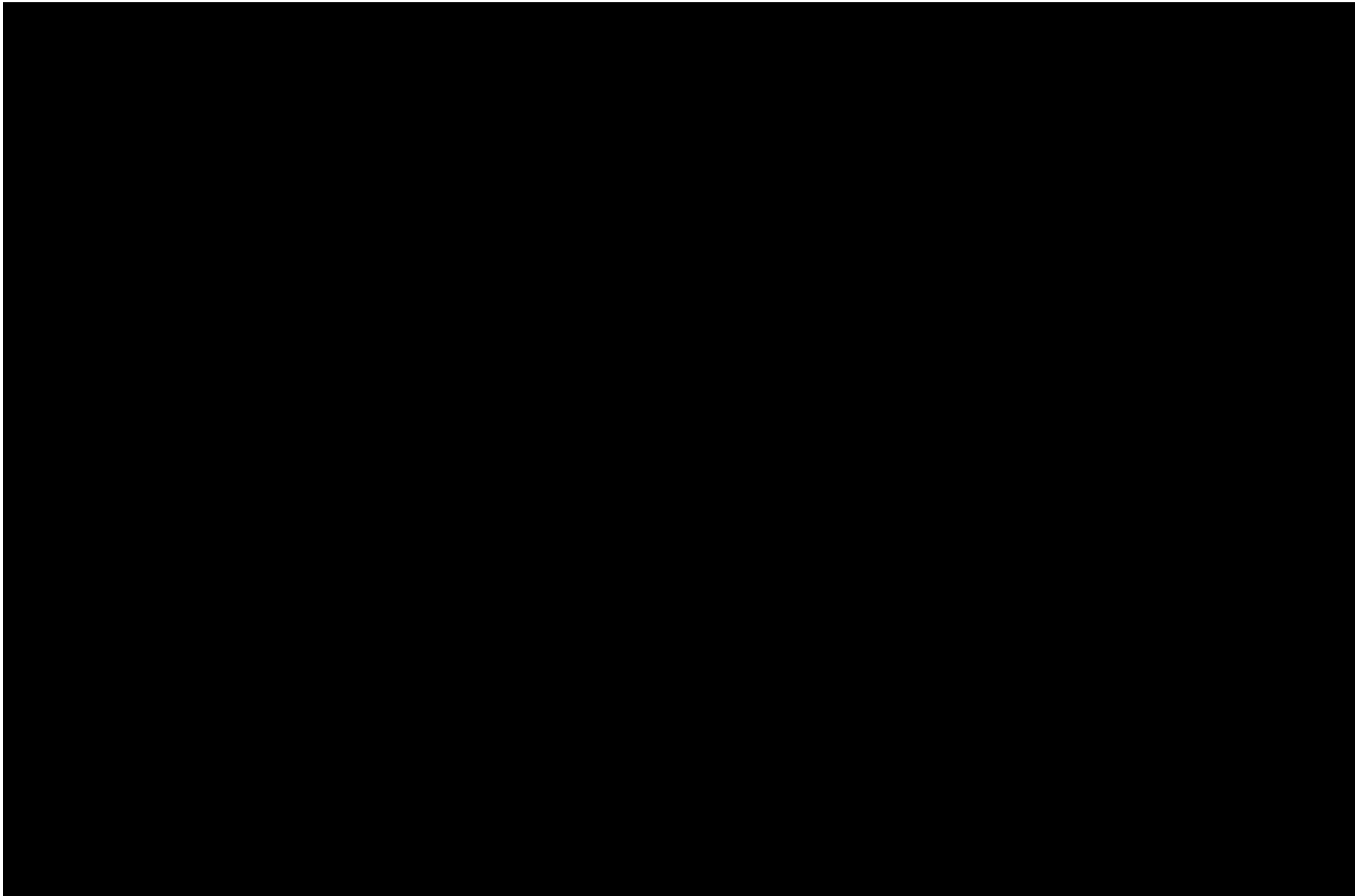
What is the motivation for FDI?

- Market-seeking FDI
  - Goals: supplying local and regional markets.
- Resource-seeking FDI
  - Natural resources tend to be location specific.
- Strategic asset-seeking FDI
  - Strategic assets critical to firms long term strategy, but are not available at home.
- Efficiency-seeking FDI
  - By reducing cost of production.

FDI and Development



Opportunities in Africa



Benefits of FDI

- Free flow of capital across national borders allows capital to seek out the highest rate of return.
- Global integration of capital market contributes to the best practices in corporate governance, accounting, and legal traditions.
- Global mobility of capital limits the ability of governments to pursue bad policies.

Benefits of FDI

- For the host countries:
  - FDI allows the transfer of technology.
  - FDI contributes to human capital development through employee training in the course of operating the new businesses.
  - Profits generated by FDI contribute corporate tax revenues.
  - Enterprise development: effort to raise efficiency and reduce costs.

Disadvantages of FDI

- Foreign ownership in strategic industries can be a concern, example national security concerns.
- Foreign investors gain crucial inside information about the productivity of the firms under their control. They tend to retain high productivity firms under their ownership and control and sell low-productivity firms to the uninformed investors
- Environmental risk

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