CHAPTER 12

Foreign Direct Investment

12.1 DEFINITION AND CLASSIFICATION

Foreign direct investment (FDI) is the process whereby residents of one country (the source country) acquire ownership of assets for the purpose of controlling the production, distribution and other activities of a firm in another country (the host country). The International Monetary Fund’s Balance of Payments Manual defines FDI as “an investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor’s purpose being to have an effective voice in the management of the enterprise”. The United Nation’s 1999 World Investment Report (UNCTAD, 1999) defines FDI as “an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise, affiliate enterprise or foreign affiliate)”. The term “long-term” is used in the last definition in order to distinguish FDI from portfolio investment, which we dealt with in the previous chapter. FDI does not have the portfolio investment characteristic of being short term in nature, involving a high turnover of securities.

The common feature of these definitions lies in words like “control” and “controlling interest”, which represent the most important feature that distinguishes FDI from portfolio investment, since a portfolio investor does not seek control or lasting interest. There is no agreement, however, on what constitutes a controlling interest, but most commonly a minimum of 10% shareholding is regarded as allowing the foreign firm to exert significant influence, either potentially or actually exercised, over the key policies of the underlying project. Many firms are unwilling to carry out foreign investment unless they have 100% equity ownership and control. Others refuse to make such investments unless they have at least majority control (that is, a 51% stake). In recent years, however, there has been a tendency for indulging in FDI cooperative arrangements where several firms participate and no single party holds majority control (for example, joint ventures).
Classification of FDI

FDI can be classified from the perspective of the investing firm and from the perspective of the host country (the recipient of FDI). From the perspective of the investor, it is possible to distinguish among horizontal FDI, vertical FDI and conglomerate FDI. Horizontal FDI is undertaken for the purpose of horizontal expansion to produce the same or similar kinds of goods abroad (in the host country) as in the home country. Hence product differentiation is the critical element of market structure for horizontal FDI. More generally, horizontal FDI is undertaken to exploit more fully certain monopolistic or oligopolistic advantages such as patents or differentiated products, particularly if expansion at home were to violate anti-trust laws. Vertical FDI, on the other hand, is undertaken for the purpose of exploiting raw materials (backward vertical FDI) or to be nearer to consumers through the acquisition of distribution outlets (forward vertical FDI).

From the perspective of the host country, FDI can be classified into (i) import-substituting FDI, (ii) export-increasing FDI and (iii) government-initiated FDI. Import-substituting FDI involves the production of goods previously imported by the host country, necessarily implying that imports by the host country and exports by the investing firm will decline. This type of FDI is likely to be determined by the size of the host country’s market, transportation costs and trade barriers. Export-increasing FDI, on the other hand, is motivated by the desire to seek new sources of input, such as raw materials and intermediate goods. This kind of FDI is export-increasing in the sense that the host country will increase its exports of raw materials and intermediate products to other countries, where the investing firm and its subsidiaries are located. Government-initiated FDI may be triggered, for example, when a government offers incentives to foreign investors in an attempt to eliminate a balance of payments deficit.

FDI may also be classified into expansionary and defensive types. Expansionary FDI seeks to exploit firm-specific advantages in the host country. This type of FDI has the additional benefit of contributing to sales growth of the investing firm at home and abroad. On the other hand, defensive FDI seeks cheap labour in the host country with the objective of reducing the cost of production.

FDI may take one of three forms: greenfield investment, cross-border mergers and acquisitions (M&As), and joint ventures. Greenfield investment occurs when the investing firm establishes new production, distribution or other facilities in the host country. Typically, host countries prefer greenfield investment because of the job-creating potential and value-added output. FDI may occur via an acquisition of, or a merger with, an established firm in the host country (the vast majority of M&As are indeed acquisitions rather than mergers). This mode of FDI has two advantages over greenfield investment: (i) it is cheaper, particularly if the acquired project is a loss-making operation that can be bought at a low price; and (ii) it allows the investor to get quick