FUNDAMENTALS OF FDI

Training Course on Promotion, Attraction and Facilitation of Foreign Direct Investment for Inclusive and Sustainable Development,
Hpa An, 14-16 June 2017
Monywa, 19-21 June 2017
OUTLINE OF PRESENTATION

- How is FDI defined?
- How can FDI be explained?
- Which types and modes of FDI can be identified?
- What motives do TNCs have to engage in FDI?
  (determinants of FDI)
DEFINITION AND RATIONALE OF FDI
DEFINING FDI
UNCTAD – MACRO ECONOMIC PERSPECTIVE

- **Foreign Direct investment (FDI)** is an investment made by an entity (i.e. the foreign investor) to acquire a lasting interest in or effective control over another entity operating outside of the economy of the investing entity.

- The “other” entity may be established new or exist already.

- Foreign investor can be an individual but typically a company known as transnational corporation (TNC) or multinational enterprise or corporation.

- FDI net inflows are the value of inward direct investment made by foreign investors in the reporting economy, including reinvested earnings and intra-company loans, net of repatriation of capital and repayment of loans.
EFFORTS AT HARMONIZING FDI DEFINITIONS

- Sixth edition of the IMF’s *Balance of Payments and International Investment Position Manual* (BPM6)

- Fourth edition of the OECD’s *Benchmark Definition of Foreign Direct Investment* (BD4)
Direct investment is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy.

Direct investment enterprise: the unincorporated or incorporated enterprise in which direct investment is made.

Two ways of having control or influence are identified:

- **Immediate direct investment relationships** arise when a direct investor directly owns equity that entitles it to 10% or more of the voting power in the direct investment enterprise. Control is determined to exist if the direct investor owns more than 50 percent of the voting power in the direct investment enterprise. A significant degree of influence is determined to exist if the direct investor owns from 10 to 50 percent of the voting power in the direct investment enterprise.

- **Indirect direct investment relationships** arise through the ownership of voting power in one direct investment enterprise that owns voting power in another enterprise or enterprises, that is, an entity is able to exercise indirect control or influence through a chain of direct investment relationships.
DIFFERENT LEVELS OF CONTROL

- **Subsidiaries** are direct investment enterprises of which 50% or more of the voting power is held by the direct investor;
- **Associates or affiliates** are direct investment enterprises of which 10-50% of the voting power is held by the direct investor; and
- **Branches** are direct investment enterprises of which 100% of the voting power is held by the direct investor.
ESTABLISHING NATIONALITY: THREE METHODS

- The first method is to determine the place of incorporation of the TNC, i.e. the state/country under which laws the TNC was established.

- The second method is the *siège social*, i.e. the state/country which is the principal seat or centre of administration or headquarters of the TNC.

- The third method is related to control or substantial interest, i.e. nationality is established on the basis of the nationality of shareholders who hold majority shares or substantial portion of the shares.
THREE COMPONENTS OF FDI

- **Equity capital** comprises equity in branches, all shares in subsidiaries and associates (except non-participating, preferred shares that are treated as debt securities and are included under other direct investment capital) and other capital contributions such as provisions of machinery, etc.

- **Reinvested earnings** consist of the direct investor’s share (in proportion to direct equity participation) of earnings not distributed, as dividends by subsidiaries or associates and earnings of branches not remitted to the direct investor. If such earnings are not identified, all branches’ earnings are considered, by convention, to be distributed.

- **Other direct investment capital** (or inter-company loans) covers the borrowing and lending of funds, including debt securities and trade credits, between direct investors and direct investment enterprises and between two direct investment enterprises that share the same direct investor.
FDI is often associated with particular benefits for host countries, including a net financial inflow. However, if a resident investor in a given country channels funds abroad and then returns the funds to the country in the form of FDI, the associated benefits of FDI will not materialize. This phenomenon is known as “round-tripping.” Round-tripping is not genuine FDI and may reduce tax receipts and regulatory oversight in the country of the resident investor.
Economies sometimes offer tax or other incentives to foreign investors to locate in their economy. If local investors do not receive this same preferential treatment, then they may engage in round-tripping to receive these benefits.

Some economies have controls on capital movements or exchange rates that may lead domestic investors to round-trip to have more flexibility in managing their capital.

Some economies may not have well-developed capital markets; so domestic investors first invest overseas to access better financial services and then return the funds to the home economy.

If an economy has investment treaties that give greater protections to foreign investors, domestic investors may round-trip to ensure their investments receive these greater protections.

Some investors may want to conceal their identity.
FOREIGN PORTFOLIO INVESTMENT

- Foreign portfolio investment (FPI) is a passive investment by foreigners in securities (i.e. bonds and stock) issued by companies (and the government) in a given country, none which entails an active management or control of the securities' purchased by the investor.

- Investors engaging in FPI are interested in financial gain only and are not interested in involvement in the effective control or management of a company.

- There are stock exchanges where portfolio investments can be purchased, sold and/or exchanged (secondary markets).

- FDI is not speculative in nature, FPI usually is.

- FDI takes a long-term view, FPI a short-term view
Firm level data includes only those FDI projects that generate economic value (i.e. new jobs, invested capital expenditure in land, facilities, machinery, etc.)

FDI project data consist of the following types of FDI projects:

- Greenfield investment (a new operation)
- Brownfield investment (expansions or re-investment in existing foreign affiliates or sites)
- New forms of investment (joint ventures, strategic alliances, licensing and other partnership agreements), only when they lead to a new physical (Greenfield or Brownfield) operation
DEFINING SUSTAINABLE FDI

- Contributes to sustained economic growth
- Is socially inclusive
- And environmentally sustainable
Sustainable FDI consists of four dimensions that all together contribute to a host country's sustainable development:

- Economic development: linkages, technology transfer, training, etc.
- Environmental sustainability: minimizing adverse impacts, mobilizing conservation (energy efficiency/renewable energy) technologies, etc.
- Social development and inclusion: labour and employment standards, community health and consultations, education, training, etc.
- Good governance: fair and efficient negotiations, contracts, etc.

These four dimensions are unevenly addressed by investment promotion agencies (IPAs) and investment promotion strategies.

The dimension of “Economic development” (e.g. employment generation) is prioritized by IPAs.
SOCIAL INVESTMENT: A RANGE OF MODELS

- **Socially responsible investment**: investment that factors environmental, social and corporate governance (ESG) factors in decision-making (negative screening)

- **Social investment and impact investment**: investment that seeks a maximum impact on creating social value or a social/environmental good (profit or non-profit) (positive screening)

Applies to both FDI and FPI
WHAT EXPLAINS FDI?

- Economists have tried to explain the existence of FDI for a long time
  - This is a complex field, involving several areas of economics
  - In a perfectly competitive economy, there would be no FDI
  - Today, economists focus on imperfect competition to explain FDI
    - Market (monopolistic, oligopoly)
    - International trade barriers
    - Other forms of protectionism
STEPHEN HYMER (1960)

“for firms to own and control foreign value-adding activities they must possess some kind of innovatory, cost, financial or marketing advantages - specific to their ownership - which is sufficient to outweigh the disadvantages they face in competing with indigenous firms in the country of production”
OWNERSHIP-SPECIFIC ADVANTAGES

- Access to raw materials
- Access to skilled and productive human resources
- Economies of scale
- Intangible assets such as trade names, patents, superior management, etc.
- Reduced transaction costs when replacing an arm's length transaction (third party) in the market by an internal firm transaction
Internalization theory asks why business transactions take place within a firm (or supply chain controlled by the firm) rather than between independent firms in a market.

Make or Buy?
DYNAMICS BEHIND MAKE OR BUY DECISION

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**Requires unique knowledge?**
- Yes
- No

**Need for speed?**
- High
- Low

**Opportunity to buy (i.e. target is up to sale)**

**Cooperation can be a stepping stone to towards Make or Buy**
- High business risk (i.e. cooperation requires sharing intelligence, IP in turn for sharing investment costs)

**Make or Buy**
- Make

**Lack of funding for acquisition or purchase**
FIRM-SPECIFIC ADVANTAGES

- To possess internalization as well as ownership advantages is a necessary but not sufficient condition for FDI to take place

  - Why FDI and not exports?
  - Why does it not licence a domestic firm to produce?
JOHN DUNNING’S ECLECTIC (OLI) PARADIGM

- John Dunning attempts to integrate a variety of strands of thinking

- He draws partly on macroeconomic theory and trade, as well as microeconomic theory and firm behaviour (industrial economics)
THE OLI PARADIGM

- Ownership Advantages
- Internalization Advantages
- Location Advantages
LOCALIZATION ADVANTAGES

Examples of Localization advantages:

- Producing close to final consumers or downstream customers
- Saving transportation costs
- Labour costs
- Obtaining cost effective capital inputs (land, capital, labour)
- Jumping trade barriers
- Local incentives
- Close to natural resources
- Product cannot be exported
TYPES AND MODES OF FDI AND MARKET ENTRY
HORIZONTAL VS. VERTICAL FDI

- **Horizontal (usually market-oriented FDI)**
  - Investment in the “same” industry as a firm operates in at home
    - Examples:
      - Ikea, Tesco Lotus and Shell and their international expansion
      - MacDonald’s, KFC and Starbucks and their international expansion

- **Vertical (along the supply chain)**
  - Investment in a downstream supplier (backward) or upstream purchaser (forward) as compared to the business that the firm operates in its home country
    - Examples:
      - Backward: Volkswagen + Shanghai Automotive Industry Corporation (SAIC) + First Automotive Works (FAW) to produce gearbox (an input to Volkswagen’s home operation)
      - Forward: Less common. Volkswagen’s acquisitions of dealers in the US (Volkswagen “sold” cars to the dealers in the US. I.e., Volkswagen sold the output of its home country operations to the US dealers that it acquired)
FOUR TYPES OF FDI

- By combining Ownership specific advantages, Internalization specific advantages and Location specific advantages, we get the “eclectic” approach to FDI - the so called OLI paradigm of international production.

- The typology of FDI was developed by Jere R. Behrman, Professor of Economics at University of Pennsylvania, to explain the different objectives of FDI:
  - Resource seeking FDI
  - Market seeking FDI
  - Efficiency seeking (global sourcing FDI)
  - Strategic asset/capabilities seeking FDI
RESOURCE SEEKING FDI

- To seek and secure natural resources e.g. minerals, raw materials
- Upstream investments
MARKET SEEKING FDI

- To identify and exploit new markets for the firms' finished products
- Requires easy production expansion and thus economies of scale
- Preferably similar taste among consumers
EFFICIENCY SEEKING FDI

- To restructure its existing investments so as to achieve an efficient allocation of international economic activity of the firm
  - International specialization whereby firms seek to benefit from differences in product and factor prices and to diversify risk
  - Global sourcing – resource saving and improved efficiency by rationalizing the structure of their global activities
  - Optimizing the supply/value chain
STRATEGIC ASSET/CAPABILITIES SEEKING FDI

- TNCs pursue strategic operations through the purchase of existing firms and/or assets in order to protect ownership-specific advantages in order to sustain or advance its global competitive position
  - Acquisition of key established local firms
  - Acquisition of local capabilities including R&D, knowledge and human capital
  - Acquisition of market knowledge
  - Preempting market entrance by competitors
  - Preempting the acquisition by local firms by competitors

- Modality: mergers and acquisitions (M&A)
VARIOUS FOREIGN MARKET ENTRY MODES: WHERE TRADE MEETS FDI

- Export
- Licensing/Franchising
- FDI
  - Joint venture/Alliances
  - Cross border M&A
  - Greenfield FDI
## EXPORT

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<tr>
<th>Mode</th>
<th>Advantages</th>
<th>Disadvantages</th>
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| Export (to supply foreign demand from home production) | • Little of no investment required  
• International learning experience at relatively low costs | • Cost and risks associated with transportation  
• Disruptive trade barriers |

- In the short and medium run, it is more likely that export contributes more to a potential cost advantage through economies of scale, and efficient use of resources, than for a greenfield investment project in foreign countries.

- Example: Korean steel companies prefer to export steel to Europe and Latin America, rather than setting up local plants.

- Nature of the product: sometimes only export is feasible, sometimes only FDI.

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**LICENSING/FRANCHISING**

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<th>Mode</th>
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| Licensing/franchising: to grant an independent foreign firm the use of an intangible property, a trademark or other asset, for an agreed-on compensation | • Licensee/franchisee takes the political and economic risk  
• Requires little time, resources and knowledge about the foreign market | • Dependence on licensee/franchisee  
• Risk of creating a competitor |

- It looks an ideal way of internationalizing in the short run, but reality learns that it requires significant coordination efforts, to avoid often seen escalations

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## JOINT VENTURE/ALLIANCES

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| Joint venture: enterprise with separate legal identity established by two or more companies joining temporarily to undertake a particular project. (equity and non-equity) | • Knowledge of local market is available  
• Shared risks  
• Joint R&D | • Loss of control  
• Potential conflict of interest, especially over time |
|   | • JV sometimes is legal requirement to enter a market |   |
|   | • Alliance does not involve the establishment of a new enterprise |   |
|   | • Toyota Production Systems is a network of Toyota and its suppliers which is widely regarded as one of the best practice example of an alliance network |   |
## CROSS BORDER M&A

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<tr>
<td>Cross-border M&amp;A</td>
<td>• Quick access to the market&lt;br&gt;• Benefit from existing clients and sales channels</td>
<td>• Difficult to find the right target&lt;br&gt;• Possible governmental intervention / politics&lt;br&gt;• Management challenge – high risk of conflicts</td>
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<td>To establish a wholly owned affiliate by acquiring (or merging with) an existing firm in a foreign market</td>
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- Contrary to greenfield FDI, this type of entry mode is preferred when time is of the essence. However finding the right acquisition partner requires an in-depth due diligence, with sometime unexpected outcomes.

- Nevertheless, this option allows for a high degree of control and ownership and secures an immediate access to the local market.
## GREENFIELD FDI

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<th>Disadvantages</th>
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| Greenfield FDI: To establish from scratch an entire operation in another country | • Full ownership and control  
• Strong signal to customers and other stakeholders  
• Incentive potential  
• Circumvent duties | • Significant investment costs  
• Requires time, resources and knowledge about local market  
• Management control foreign operations |

- If there are significant advantages in accessing less expensive inputs such as labour, raw materials supply, energy, etc. greenfield FDI may be preferred mode of entry

- Textile and electronic companies invested heavily in Asia-Pacific to profit from lower labour costs. Philip Morris invested in Russian Federation to benefit from lower cost levels and avoid high import duties to serve the Russian market

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DETERMINANTS OF FDI
THREE CATEGORIES OF DETERMINANTS

- **Home country economic conditions and policies:** market size, growth prospects, rate of return, level of urbanization/industrialization, labour costs and productivity, human capital, physical infrastructure, macroeconomic fundamentals (taxes, inflation, exchange rates, external debt, etc.), pro-active outward FDI policy

- **Host country economic conditions and policies:** promotion of private ownership, efficient financial market, trade policies/free trade policy/regional trade agreements, FDI policies, perception of country risk, legal framework, and quality of bureaucracy

- **TNC strategies:** risk perceptions and location decisions
HOME AND HOST COUNTRY LINK BETWEEN FDI AND COMPETITIVENESS: MUTUALLY REINFORCING

Higher levels of competitiveness push both inward and outward FDI!
MICHAEL PORTER’S DETERMINANTS OF NATIONAL COMPETITIVENESS

- **Factor conditions**: the nation's position in factors of production necessary to compete in a given industry (traditional and advanced)
- **Demand conditions**: the nature and size of home demand for the industry's product or service (quantity and quality)
- **Related and supporting industries**: the presence or absence in the country of supplier industries and related industries that are internationally competitive
- **Firm strategy, structure and rivalry**: the context in which firms are created, organized and managed as well as the nature of domestic rivalry
TWO BASIC SETS OF DETERMINANTS OF FDI

Firm/industry determinants
- Securing market access
- Securing access to labour and natural resources
- Access to suppliers
- Following a sourcing strategy
- Staying ahead of competition
- Lowering production costs
- Gaining access to technology and skills

Host-country determinants
- Political & economic stability
- Favouring FDI policies
- Adequate infrastructure & services
- Adequate skill and (trainable) labour base
- Good supplier networks & services
- Streamlined procedures
UNDERSTANDING THE CORPORATE INVESTMENT PROCESS

**Phase 1**
- Define project and goals
- Business requirements
  - Project definition & understanding of strategy
    - Determine geographic scope
    - Selection of location factors
    - Weighting location criteria

**Phase 2**
- Project assumptions

**Phase 3**
- Input cost model
- Set up cost model
- Cost differentials between locations
- Sensitivity analysis
- Exploration of incentives

**Phase 4**
- Resources for site visits
- Prepare site visits
- Prepare discussions with relevant governments and service providers
- Incentive negotiations

**Phase 5**
- Define real estate objectives and accommodation needs
- Real estate transaction and acquisition support

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**Location Screening, modeling & benchmarking**
- Analysis and comparison of locations
  - Data gathering
  - Build model for location analysis
  - Present rankings of locations
  - Sensitivity analysis
  - Exploration of incentives

**Cost comparison**
- Comparison of costs
- Set up cost model
- Cost differentials between locations

**Community Evaluations**
- Site visits
- Present rankings of locations
- Sensitivity analysis
- Exploration of incentives

**Implementation**
- Real estate transaction and acquisition support

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MAIN FOREIGN INVESTORS’ DECISION-MAKING FACTORS

- Regulations/Laws
  - Taxation/tariffs
  - Ownership rules
  - Hiring practices
  - Legal frameworks
  - Investment incentives
  - Intellectual property protection

- Finance
  - Repatriation of funds
  - Access to finance
  - Investment costs
  - Currency risk
  - Credit assessment

- Commercial Practices
  - Role and influence of large banks
  - Role and influence of large corporations
  - Business culture
  - Attitude to profit
  - Preferential relationships

- Culture
  - Behaviour
  - Religion
  - Labour practices
  - Attitude to foreigners

- Political/Economic Security
- Logistics/Distance
- Market/Profitability
WHAT MOTIVATES FDI?
THE INITIAL IMPETUS

Primary reasons:
- Reduction of operating/production costs
- Proximity to cluster base/supply chain
- Broad-based market penetration

Secondary reasons:
- Procurement of essential raw materials
- Access to unique technology or skills
- Reaction to, or anticipation of, competition
SURVEY RESULTS ON FDI DETERMINANTS

- Both surveys indicate that both economic and political fundamentals are pre-requisites in order to attract FDI.
GENERAL MOST IMPORTANT FACTORS FOR ATTRACTING FDI

- Open economy, high growth (e.g. China, India)
- Rule of law and economic policy coherence (e.g. Singapore, Thailand)
- Political and economic stability (e.g. China, Singapore)
- Cheap and productive labour (e.g. ASEAN, China, India)
- Natural resources (e.g. Indonesia, Azerbaijan, Kazakhstan)
- Large market (e.g. China, India, Indonesia, AFTA)
- Physical, financial and technological Infrastructure facilities (e.g. Singapore, Hong Kong, Thailand)
- Access to markets and trade facilitation (cross-border zones and areas, e.g. AIA, growth triangles)
- Investment protection and promotion (especially important in mining industry)
- Good governance, quality of institutions and absence of red tape (Hong Kong, Singapore)
FDI DETERMINANTS DEPEND ON TYPE AND SECTOR

- Sectoral FDI: natural resources and agriculture, manufacturing (costs and productivity of labour; exchange rates, infrastructure), services (liberalization level), high technology (level of IPR protection)

- Vertical FDI (difference in factor prices) vs. horizontal FDI (trade costs)

- Efficiency-seeking: strength of domestic SMEs and competitive advantages to minimize costs along the supply chain

- Market-seeking: size of market (purchasing power, rising middle class, high growth)

- Resource-seeking: availability of scarce resources, investment protection, political stability

- Strategic-asset seeking: market presence
POSITIVE DETERMINANTS OF FDI IN MYANMAR

- Political change towards democratization
- Member of ASEAN
- Availability of plenty natural resources, oil and gas
- English speaking abundant labour
- Role of Aung San Suu Kyi (positive image)
- Adoption of Investment Law
- Promising domestic market/increased consumer demand for quality
- Cheap labour (garments)
LIMITATIONS AND CHALLENGES FOR FDI IN MYANMAR

- Economic policy uncertainty
- Slow government decision-making
- Role of Aung San Suu Kyi (too much concentration of decision-making)
- Regulatory uncertainty/implementation capacity
- High cost of real estate
- Lacking infrastructure
- Lacking domestic partners of sufficient capability
- Skills of labour not sufficient in more value-added sectors
- Civil strife and unrest continues
- Image problem
- Institutional approval process (MIC) change with the change in government
- Declining exchange rate
- Worsening market conditions for Myanmar traditional products
QUESTIONS FOR DISCUSSION

- What do you think are the most important types and forms of FDI in your country? How important is greenfield investment in your total FDI inflows?
- Does the type and form of FDI differ across localities in your country (e.g. provinces, cities, special economic zones, border areas, etc.)?
- What do you think are the main attractions of FDI to invest in your country/locality? What are the main determinants of FDI in your country/locality?
- Does your country have specific rules and regulations for FDI on the basis of nationality of the investor? Have you encountered difficulties in ascertaining nationality?
- To what extent is round-tripping a problem in your country? Is it being addressed?
- Referring to the determinants of national competitive advantage, which of the four is the strongest in your country and which is the weakest? To what extent you think your country has overall competitive advantage?
- Do you think FDI in your country contributes to sustainable development? Is FDI itself sustainable?
Your questions please?
CONTACT DETAILS – UNESCAP

UNESCAP
The United Nations Building
Rajadamnern Nok Avenue
Bangkok 10200
Thailand

T: (66-2) 288-1234
F: (66-2) 288-1000
W: http://www.unescap.org/contact

Consulting Partner

Investment Consulting Associates (ICA)
H.J.E Wenckebachweg 210
1086 AS Amsterdam
The Netherlands

T: +31 20 217 0115
F: +31 20 462 3535
E: info@ic-associates.com
W: www.ic-associates.com