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1. LEARNING OUTCOMES

After studying this module, you shall be able to

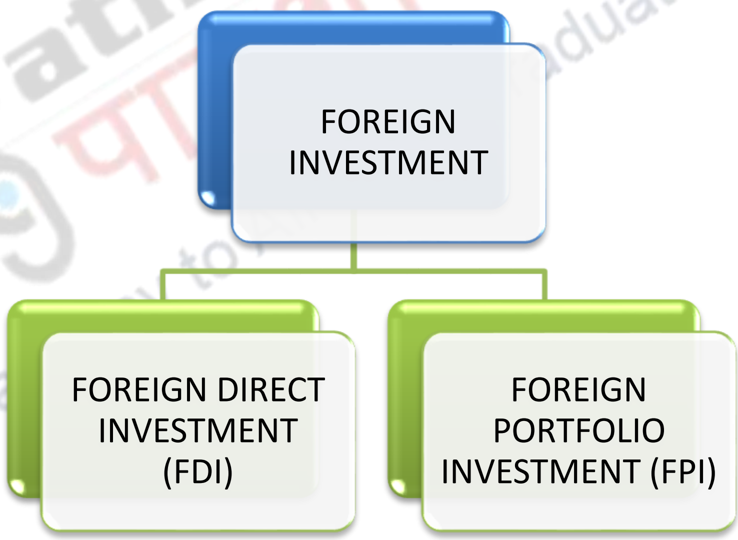
1. Know about the types of capital flows.
2. Understand the difference between FDI and FPI.
3. Evaluate the benefits and costs of foreign direct investment (FDI).
4. Understand the various types of FDI.
5. Know about the global trends in FDI.

2. INTRODUCTION

Economic liberalization and globalization have paved the way for greater investment flows between countries. This in turn has substantially increased the role of international investment in trade, global production and employment generation. The tremendous growth in cross border flows of investment has spurred tremendous economic growth across the globe.

3.TYPES OF INVESTMENT FLOWS

Foreign investment involves flow of capital from one economy to another in barter for crucial ownership stakes in domestic companies or other domestic assets. Broadly, there are two types of foreign investment, namely, foreign direct investment (FDI) and portfolio investment.



3.1 FOREIGN DIRECT INVESTMENT

Foreign direct investment is defined as cross-border investment which an entity becomes resident economy in another economy with the aim of obtaining a lasting interest and control.This type of investment helps the investor to acquire an effective voice in the management of the firm. It generally takes the form of acquiring a stake in an existing enterprise in the foreign country or starting a subsidiary to expand the operations of an existing enterprise of that country. FDI facilitates the transfer of technology, know-how, skills and expertise between countries and also helps to create long lasting links between economies.

FDI can be carried by individuals as well as enterprises. Because FDI cannot be easily liquidated, therefore it is governed by a number of considerations like economic prospects, trade policy, market size, functioning and efficiency of local markets, human capital, restrictions on repatriations of earnings etc.

FDI has always been linked to improvement in economic growth and development in the host countries which has led to the evolution of global competition to attract FDI. Many countries are now furnishing a wide spectrum of incentives to the foreign investor like tariff concessions, tax holidays, R&D support, infrastructure improvements, financial subsidies, low tax rates etc.

3.2 FOREIGN PORTFOLIO INVESTMENT

Foreign portfolio investment involves investment in foreign financial assets like stocks, bonds, commodities etc. This type of investment is not made with the intention of acquiring a controlling interest in the issuing company. Typically, this type of investment is short term in nature and is made to take advantage of favorable changes in exchange rates or to earn short term profits on interest rate differences.It provides the investor with an opportunity to diversify their portfolios and better manage the associated risk.

Foreign portfolio investment can also help to strengthen the domestic capital markets by enhancing the liquidity and can also contribute to improving their functioning. This in turn will lead to optimal allocation of capital and resources in the domestic economy. For an emerging economy, foreign portfolio investment can prove to be a significant contributor to its development, creating significant wealth.

Foreign portfolio investment is also referred to as hot money because of its tendency to move in and out of markets in the blink of an eye.

4. FOREIGN DIRECT INVESTMENT (FDI) VS. FOREIGN PORTFOLIO INVESTMENT (FPI)

Although both FDI and FPI bring the much needed capital into a country and fuelup the process of economic development, yet there are a lot of differences between these two forms of investment. Some of them have been listed below:

- FDI is long term investment in real or physical assets like plant equipment, factories, buildings etc., whereas FPI is the short term investment in the financial assets like bonds, stocks which are denominated in terms of currency of issuing company's domestic economy.
- FDI is made with an intention of acquiring controlling interest or participation in the management of foreign enterprise, whereas the investors making portfolio investment doesn't seek management control. It is made with the sole objective of making profit.
- It is very difficult to sell off or pull out FDI, whereas one can easily sell off the securities and pull out the portfolio investment.
- Due to the ease with which FPI can be liquidated, they are much more volatile than FDI. The moment the investment environment turns unfavorable or the economic situation of the foreign country detoriates, the portfolio investors sell off their securities.

5. COSTS AND BENEFITS OF FDI

When FDI flows from one nation to another, it creates benefits for both the home and host nation. But just as there are two sides to a coin, FDI also has some costs associated with it.

5.1 BENEFITS FOR THE HOME COUNTRY

- The repatriation of income from foreign earnings can improve the home country's balance of payment situation.
- FDI might lead import of raw materials or intermediate goods from home country for production, which would further lead to employment generation.
- The home country also benefits in terms of acquiring knowledge and skills from operating abroad.

5.2 COSTS TO THE HOME COUNTRY

- The outflow of factors of production like skilled manpower, professionals, experts and capital can hinder home country's growth and development.
- The BOP account of the home country also suffers on three counts:
  1. Initial capital outflow.
  2. If MNE invests abroad to take advantage of low cost location and then sells back the goods produced in the foreign location to home country, then this will lead to increase in home country's imports.
  3. If the foreign operation results in substitution of domestic exports, then the decrease in home country's exports will again adversely affect the balance of payment.
- If the MNE decides to conduct foreign operations with the intention of shutting down home country's operation, then the home country will suffer in terms of unemployment.

5.3 BENEFITS TO THE HOST COUNTRY

- FDI brings in the stock of capital, advanced technology, management skills and expertise to the host economy, thereby speeding up the pace of economic growth and development. Moreover, the host economy also gains an access to continued research and development of the home economy.
- FDI also helps to generate employment opportunities in the host country. The employment of labour force in MNE results in increased income levels and increased demand. This is turn helps to create more jobs. MNEs also train the labour force which helps to create a pool of trained personnel in the host economy.
- The inflow of capital helps to improve the host country's balance of payments. At the same time, if FDI can also improve the balance of payments if it results in reduction in imports or export promotion.
- FDI also results in availability of large variety of good quality products at lower prices, thereby increasing consumer welfare. It also leads to the creation of a more competitive business environment in the host economy.

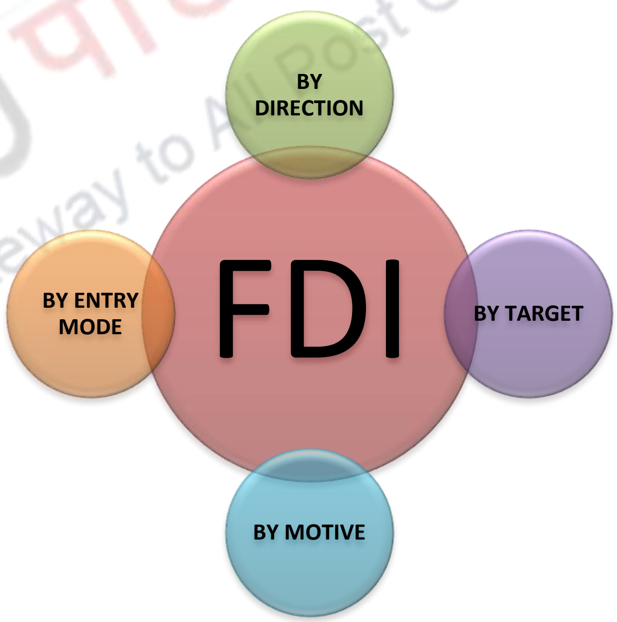
5.4 COSTS TO THE HOST COUNTRY

- Foreign investment can result in deterioration of host country's balance of payments on account of repatriation of profits, payment of dividends, interests, royalty etc. If the foreign operations require imports of raw materials from the home economy, then this will again affect the balance of payments negatively.

- MNEs because of their big size of operations, large economic powerand greater financial resources can destroy competition, eliminate local producers and hamper the growth of native industries. With their operations spread across countries and effective supply chains, they are able to reap economies of scale which the local producers cannot compete with.
- If the MNE is able to monopolize the market, then they charge higher prices for the products, which hamper the interests of consumers.
- FDI also results in increased economic interdependence between host and home economy which leads to reduction in the degree of control that host governments exert over their economies.

6. TYPES OF FDI

FDI can be classified into four broad categories which are as follows:



6.1 BY DIRECTION: On the basis of direction of flow of funds, FDI can be classified into two types.

- ***INWARD FDI:*** Inward FDI takes place when foreign capital is invested in local resources.

- ***OUTWARD FDI:*** Outward FDI takes place when local capital is invested in foreign resources.

6.2 BY TARGET: On the basis of target, FDI can be classified into two types.

- ***HORIZONTAL FDI:***This type of FDI involves manufacturing the same products or the services in a host country as firms do at home.
  Example: Ford's investment in India to manufacture cars to serve the Indian market is an example of Horizontal FDI.

- ***VERTICAL FDI:*** Investment in the upstream or downstream operations is referred to as vertical FDI.
  1. **Backward Vertical FDI-** When MNE invests abroad to manufacture intermediate goods or inputs for its domestic operations, it is referred to as backward vertical FDI.
     Example: Automobile company like Honda acquiring a tyre manufacturer or a steel manufacturer in USA.
     Most of the backward vertical FDI takes place in extractive industries like petroleum and minerals.

  2. **Forward Vertical FDI-**When MNE invests in a foreign market to market its home-made products, it is known to as forward vertical integration.
     Example: Automobile companies like Honda acquiring a car dealer in USA or establishing its own sales outlets.

6.3 BY MOTIVE: On the basis of motive of investment, FDI can be categorized into 4 types.

- ***RESOURCE SEEKING FDI:*** When investment is made in a foreign location to take advantage of natural resources like minerals, cheap labour, or some other asset, then the investment is said to be resource seeking.Usually, this type of investment is made to acquire resources that are either unavailable or are available at very high cost in the home country and most of the output from this type of investment is exported. So this type of FDI is likely to promote exports in the host economy.

Example: ExxonMobil's investment in middle east countries like Saudi Arabia, Qatar, Abu Dhabi and Kuwait is resource seeking.

- ***MARKET SEEKING FDI:*** Market-seeking FDI engulfs investing in a host country market in order to directly serve that market with local production and distribution rather than through exporting. The basic motive behind this type of FDI is to circumvent the trade barriers of the host countries so as to gain access to large overseas market and to reap the benefits of economies of scale. Usually, this type of investment is made in countries where customer base is large and per capita income is high.Market seeking FDI displaces exports from home country.

  Example: General Motors investment in India to offer products under the Chevrolet brand is an example of market seeking FDI because cars manufactured in India are sold there.

- ***EFFECIENCY SEEKING FDI:*** Efficiency-seeking FDI engulfs investing in foreign operations to produce cost-effective and competitive global production networks. The main motive behind this type of investment is to take advantage of differences in institutional arrangements, market structures, cost differences between locations, quality of infrastructure etc. so as to produce the products at relatively low cost. This type of FDI is also likely to promote host country's exports.

- ***STRATEGIC ASSET SEEKING FDI:*** This type of investment involves investing in foreign country to acquire strategic assets like innovative technology; management expertise etc. in order to strengthen firm's global competitiveness. This type of FDI results in the MNE acquiring local firms or forming strategic alliance with local firms in the host country.

6.4 BY ENTRY MODE: On the basis of entry mode, FDI can be classified into two types.

- ***GREENFIELD INVESTMENT:*** This type of investment involves establishment of wholly new operational facilities from scratch in the host country. Greenfield investment helps to generate new jobs and boost the production capacity of the host nation. This is why many host nations offer incentives like tax breaks, subsidies etc. in an attempt to attract Greenfield investments. This type of investment enables the investor to exert greater degree of control over all the aspects of business.

Example- German luxury car maker Mercedes Benz started its own manufacturing plant in Pune to launch its products in India.

- ***MERGERS AND ACQUISITIONS:*** Mergers and Acquisitions account for a very large share of FDI.

  - ***Mergers:***Cross border merger occurswhen two or more independent business entities which are resident in different countries combine their assets and operations to form a new and separate legal entity.

  - ***Acquisitions***: Acquisition is said to take place when the control of local firms' assets, liabilities and operations is transferred to a foreign firm as a result of which the local firm becomes foreign firm's affiliate. Acquisitions can be hostile or friendly. Further, acquisition can be minority (10% to 49%), majority (50% to 99%) or full outright stake (100%).

    Example: Hindalcoindustries, a subsidiary of Aditya Birla group, engaged in aluminum manufacturing business acquired Canadian based firm Novelis Inc.

- ***Why firms tend to prefer Merger and acquisitions over Greenfield investments?***
  - ✓ Quicker to execute
  - ✓ Provides ready access to local market know how.
  - ✓ Helps to eliminate potential competitor
  - ✓ Provides access to local firm's strategic assets like customer relationships, distribution and production systems, trademarks etc.

7. GLOBAL TRENDS IN FDI

FDI has grown considerably in its importance and has registered phenomenal growth over the years. The composition of FDI has also undergone several changes.

7.1 GLOBAL TRENDS IN FDI INFLOWS

- The global FDI inflows grew from $13.346 billion in 1970 to $207.36 billion in 1990 and further to $1408.53 billion in 2010. However in 2012 the global FDI inflows fell by 18% from $1651.51 billion in 2011 to $1350.92 billion in 2012.
- In 1970 to 1991, the FDI inflows were concentrated in a handful of developed countries like US, Canada, UK and Japan. In 1974, the developed economies received 90% of global FDI inflows. This trend now has undergone change with developing economies accounting for 52% of global FDI inflows.
- The absolute amount of FDI inflows going to developing economies has also shown a rising trend, for instance, it has increased $34.762 billion in 1990 to $702.82 billion in 2012. Within the group of developing economies, the countries which are relatively developed have received the major chunk of FDI inflows. Very little FDI has gone to low income countries except for China and India.
- Among, the top 20 host economies in 2012, US saw the biggest inflow of FDI amounting to $167.62 billion. China bagged the second place receiving FDI inflows to the tune of $121 billion. Three developing economies namely, China, Hong Kong and Brazil ranked among the 5 largest recipients in the world. India bagged 15th place receiving FDI inflow of $26 billion.
- China has been able to attract large FDI inflows because of its favorable political environment plus large market size coupled with impressive rate of economic growth. In 2012, the absolute amount of FDI inflows to developed countries fell sharply, for instance, for US it fell from $227 billion to $168 billion. Similar trend was observed in case of European developed economies. However, with the improvement in the macroeconomic parameters, the FDI inflows are expected to show a rising trend in the years to come.

7.2 GLOBAL TRENDS IN FDI OUTFLOWS

- The global FDI outflows have also grown over the years from $14.15 billion in 1970 to $234 billion in 1990 and further to $2272 billion in 2007. But then it gradually fell down in the subsequent years and reached $1504 billion in 2010. In 2012, the figure stood at $1390 billion down from $1678 billion in 2011, a fall of 17%.
- From 1970 to 1990, developed economies accounted for more than 90% of global FDI outflows, for instance, in 1970, 99.6% of global FDI outflows were from developed economies. This trend has undergone some change since 1990. In 2012, developing economies accounted for 31% of global FDI outflows. This trend indicates that developing economies are now emerging as major investors.
- While the FDI outflows from developing economies went up slightly from $422 billion in 2011 to $426 billion in 2012, the situation was reverse for developed economies. The FDI outflows from developed economies went down from $1183 billion in 2011 to $909 billion in 2012.
- Among the developing world, Asian countries accounted for three fourth of the FDI outflows from developing countries. The major chunk of FDI outflows among Asian countries has been from China. FDI outflows from some developing economies like Thailand, Malaysia, Turkey and Republic of Korea rose in 2012. On the other hand, FDI outflows from India, Hong Kong and Singapore declined in 2012 from 2011 levels. US again accounted for largest FDI outflows in 2012, followed by Japan. China emerged as the world's third largest investor, followed by Hong Kong.

8. SUMMARY

- Foreign investment involves flow of capital from one economy to another in exchange
for significant ownership stakes in domestic companies or other domestic assets. The two types of foreign investment are foreign direct investment (FDI) and foreign portfolio investment.
- FDI is defined as cross-border investment which an entity in one economy makes in an enterprise resident in another economy with the objective of obtaining a lasting interest and control. It is made with long term perspective.
- Foreign portfolio investment involves investment in foreign financial assets like stocks, bonds, commodities etc. with no intention of acquiring a controlling interest in the issuing company.
- Although, both FDI and FPI bring capital in the host economy, but they are different in terms of volatility, intention with which they are made and liquidity
- The benefits of FDI to home country include improvement in the balance of payment through repatriation of profits; employment generation and acquiring knowledge and skills from operating abroad.
- The cost of FDI to home country includes outflow of factors of production; adverse effects on balance on payments due to initial capital outflow and export substitution; and loss of jobs if MNE decides to shut down its business in home country.
- The benefits of FDI to host country includes supply of capital, advanced technology, management skills; improvement in the balance of payments due to capital inflow; creation of employment opportunities for local workforce; and increasing consumer welfare by making large variety of good available at affordable prices.
- The cost of FDI to host country includes adverse impact on balance of payment due to repatriation of income; destruction of competition and perceived loss of economic independence.
- FDI can be categorized into four broad categories. On the basis of direction; inward FDI and outward FDI. Keeping target as a base; horizontal FDI and vertical FDI. On the basis of motive; resource seeking FDI, market seeking FDI, efficiency seeking FDI and strategic asset seeking FDI. And on the basis of entry mode, Greenfield investment and merger and acquisitions.
- The global FDI inflows have shown a rising trend. In 2012, US saw the biggest inflow of FDI. And three developing economies namely, China, Hong Kong and Brazil ranked among the 5 largest recipients in the world.
- The global FDI outflows have also shown phenomenal growth over the years. US again accounted for largest FDI outflows in 2012, followed by Japan, China and Hong Kong.