

Geely Goes Global

opening case

Zhejiang Geely Holding Group Co., Ltd. (often referred to as Geely) is a Chinese auto manufacturer that started in 1986 as a manufacturer of refrigerators. Founded by Li Shufu, an energetic entrepreneur and car enthusiast, the Hangzhou-based company did not enter the automobile business until 1987. Today, it is the second largest private automobile manufacturer in China's booming car market.

Li Shufu reportedly has a great appreciation for design. He scrapped three iterations of poorly designed and built models before finally arriving at one that met his expectations, a four-door subcompact sedan introduced in 2002 known as the Ziyaojun (Free Cruiser in English). In a clear sign that Geely had yet to develop its own design and engineering skills, the car was actually designed by the South Korean firm Daewoo Motors.

It was around this time that Li started to think about owning Volvo, his personal favorite car maker. Based in Sweden, Volvo had been acquired by Ford Motor Company in 1999 for \$6.45 billion. Li got his chance in 2009 when Ford, battered by the great recession that had hammered the auto market in the United States and Europe, announced that it would sell many of its specialty car brands, including Volvo. In 2010, Geely reached an agreement to purchase Volvo for \$1.8 billion. At the time this was the largest overseas acquisition by a Chinese automobile maker.

Many observers had low expectations for the acquisition, but they have been proved wrong. The marriage of Volvo's brand and engineering design skills with Geely's manufacturing capabilities has proved to be a winning combination. Today Volvo cars are still engineered, designed, and tested in Gothenburg Sweden, but they are manufactured at three plants in China and one in South Carolina.

China has emerged as a major market for the Volvo, where the brand is valued for its safety and elegance. The company's aim is to produce the safest car on the road that handles well under any roadside conditions. Geely has pledged to produce a "death-proof" car by 2020, with a commitment that no one should be seriously injured or killed in a new Volvo. The technologies required to achieve this include auto steering, adaptive cruise control, and pedestrian and animal detection for collision warnings and avoidance, all technologies that are being developed in Gothenburg.

The proof of the strategy is in the sales figures. In 2017, sales rose 7 percent year-on-year to a new record high. All regions contributed to the nearly 600,000 units sold, with performance in the Asia Pacific region growing by more than 20 percent on the back of record sales in China, now the largest market for the Volvo brand.

Emboldened by its success with Volvo, Geely is now making more foreign investments. In 2017, it acquired a controlling stake in the British sports car manufacturer Lotus Cars, a 49.9 percent stake in Proton, Malaysia's largest car company, and minority stakes in the Swedish Truck Company, the Volvo Group (the one time parent of Volvo Cars), and Daimler Benz. ●

Sources: Pamela Ambler, "Volvo and Geely: The Unlikely Marriage of Swedish Tech and Chinese Manufacturing," *Forbes*, January 23, 2018; Sui-Lee Wee, "Geely Buys Stake in Volvo Trucks," *The New York Times*, December 27, 2017; "Volvo Cars Sales Rise to Fresh Record," *Reuters*, January 4, 2018.

Introduction

Foreign direct investment (FDI) occurs when a firm invests directly in facilities to produce or market a good or service in a foreign country. According to the U.S. Department of Commerce, FDI occurs whenever a U.S. citizen, organization, or affiliated group takes an interest of 10 percent or more in a foreign business entity. Once a firm undertakes FDI, it becomes a multinational enterprise. The investment by Geely in Volvo discussed in the opening case is an example of FDI. While much FDI takes the form greenfield ventures—building up subsidiaries from scratch—acquisitions are also an important vehicle for foreign investment.

This chapter begins by looking at the importance of FDI in the world economy. Next, we review the theories that have been used to explain why enterprises undertake foreign direct investment. These theories can explain why Geely acquired Volvo. Geely needed Volvo's engineering design skills and access to a powerful brand like Volvo. Although Geely perhaps could have built these skills and the associated brand equity internally, it was quicker (and probably cheaper in this instance) to acquire Volvo. The foreign investment, by combining Geely's manufacturing capabilities with Volvo's design engineering skills and brand, has enabled Geely to transform itself from a little-known Chinese automobile company into a global player in the luxury car segment. After discussing theories of FDI, the chapter moves on to look at government policy toward foreign direct investment. The chapter closes with a section on implications of the material discussed in the chapter for management practice.

LO 8-1

Recognize current trends regarding foreign direct investment (FDI) in the world economy.

flow of FDI

The amount of foreign direct investment undertaken over a given time period (normally one year).

stock of FDI

The total accumulated value of foreign-owned assets at a given time.

outflows of FDI

Flow of foreign direct investment out of a country.

inflows of FDI

Flow of foreign direct investment into a country.

Foreign Direct Investment in the World Economy

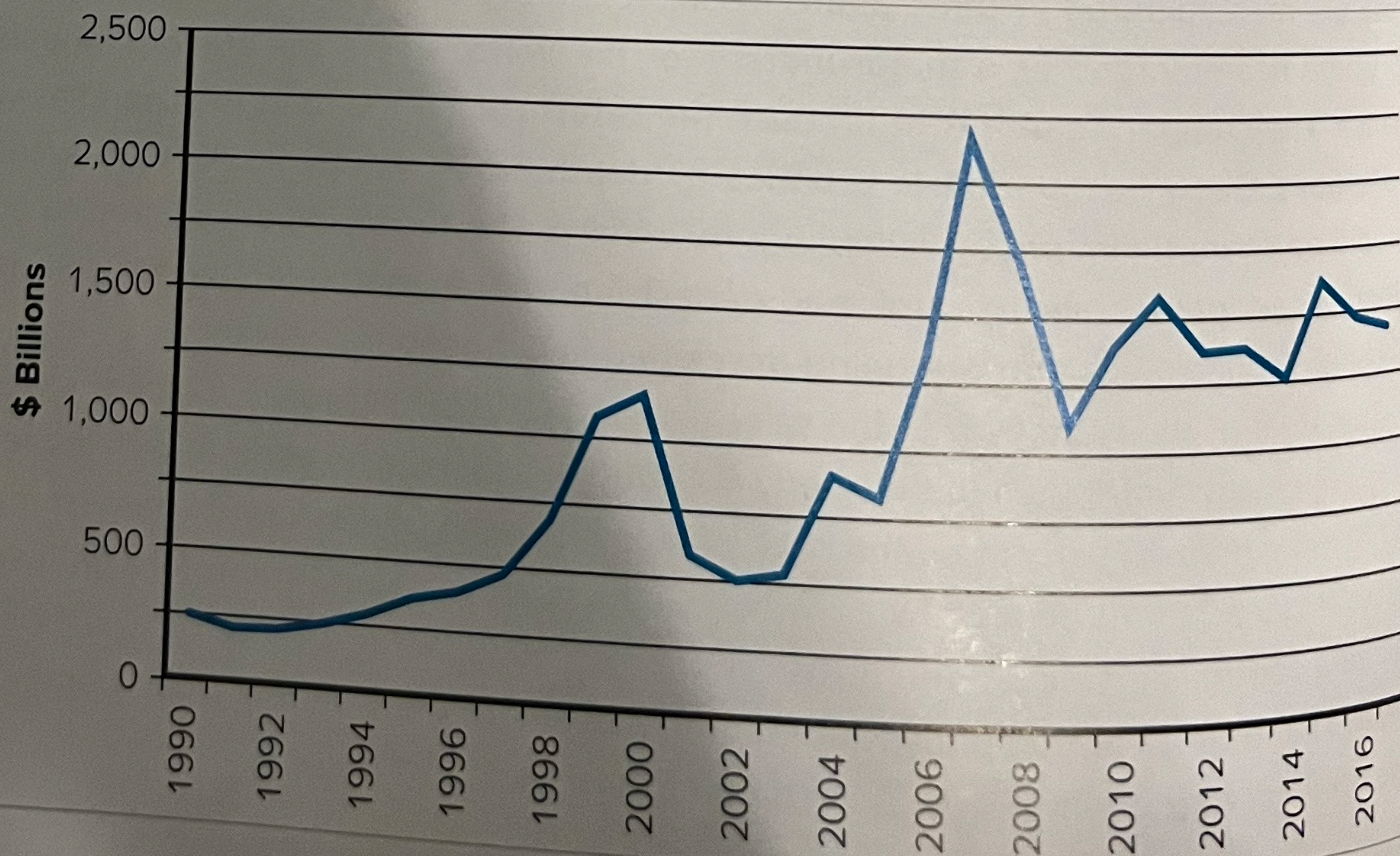
When discussing foreign direct investment, it is important to distinguish between the flow of FDI and the stock of FDI. The **flow of FDI** refers to the amount of FDI undertaken over a given time period (normally a year). The **stock of FDI** refers to the total accumulated value of foreign-owned assets at a given time. We also talk of **outflows of FDI**, meaning the flow of FDI out of a country, and **inflows of FDI**, the flow of FDI into a country.

TRENDS IN FDI The past 25 years have seen a marked increase in both the flow and stock of FDI in the world economy. The average yearly *outflow* of FDI increased from \$250 billion in 1990 to \$1.43 trillion in 2017 (see Figure 8.1).¹ Over the past 25 years, the flow of FDI has accelerated faster than the growth in world trade and world output. For example, between 1990 and 2017, the total flow of FDI from all countries increased around sixfold, while world trade by value grew fourfold and world output by around 60 percent.² As a result of the strong FDI flows, by 2017 the global stock of FDI was about \$32 trillion. The foreign affiliates of multinationals

8.1 FIGURE

FDI outflows, 1990–2017 (\$ billions).

Source: UNCTAD statistical data set, <http://unctadstat.unctad.org>.



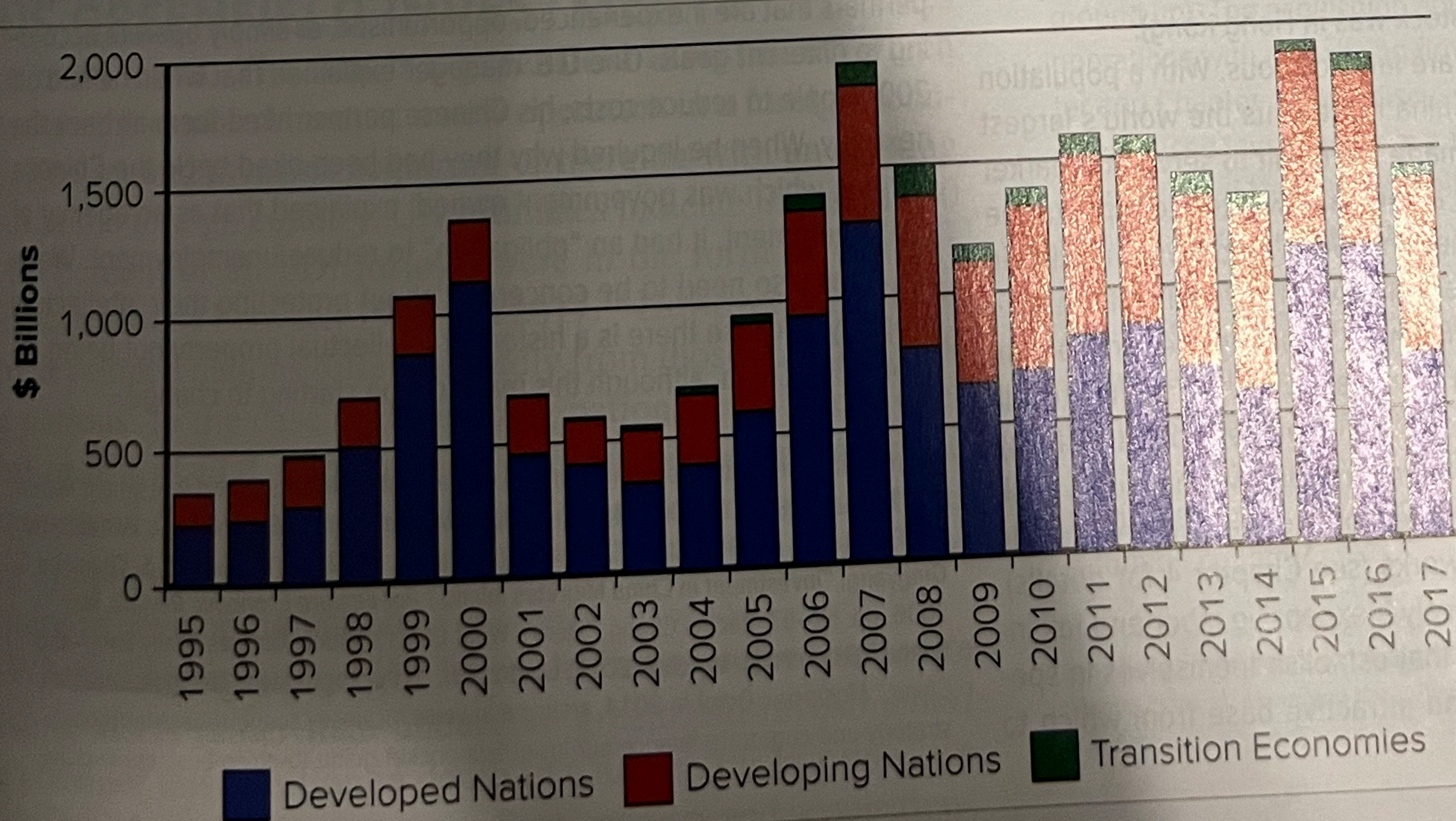
had \$31 trillion in global sales in 2017, compared to \$22.5 trillion in global exports, and accounted for more than one-third of all cross-border trade in goods and services.³ Clearly, by any measure, FDI is a very important phenomenon in the global economy.

FDI has grown more rapidly than world trade and world output for several reasons. First, despite the general decline in trade barriers over the past 30 years, firms still fear protectionist pressures. Executives see FDI as a way of circumventing future trade barriers. Given the rising pressures for protectionism associated with the election of Donald Trump as president in the United States and the decision by the British to leave the European Union, this seems likely to continue for some time. Second, much of the increase in FDI has been driven by the political and economic changes that have been occurring in many of the world's developing nations. The general shift toward democratic political institutions and free market economies that we discussed in Chapter 3 has encouraged FDI. Across much of Asia, eastern Europe, and Latin America, economic growth, economic deregulation, privatization programs that are open to foreign investors, and removal of many restrictions on FDI have made these countries more attractive to foreign multinationals. According to the United Nations, some 90 percent of the 2,700 changes made worldwide between 1992 and 2009 in the laws governing foreign direct investment created a more favorable environment for FDI.⁴

The globalization of the world economy is also having a positive effect on the volume of FDI. Many firms see the whole world as their market, and they are undertaking FDI in an attempt to make sure they have a significant presence in many regions of the world. For example, a third of the revenues and as much as 40 percent of the profits of firms in the S&P 500 index are generated abroad. For reasons that we explore later in this book, many firms now believe it is important to have production facilities close to their major customers. This too creates pressure for greater FDI.

THE DIRECTION OF FDI Historically, most FDI has been directed at the developed nations of the world as firms based in advanced countries invested in the others' markets (see Figure 8.2). During the 1980s and 1990s, the United States was often the favorite target for FDI inflows. The United States has been an attractive target for FDI because of its large and wealthy domestic markets, its dynamic and stable economy, a favorable political environment, and the openness of the country to FDI. Investors include firms based in Great Britain, Japan, Germany, Holland, and France. Inward investment into the United States remained high during the 2000s and stood at \$275 billion in 2017. The developed nations of Europe have also been recipients of significant FDI inflows, principally from the United States and other European nations. In 2017, inward investment into Europe was \$334 billion. The United Kingdom and France have historically been the largest recipients of inward FDI.⁵

Even though developed nations still account for the largest share of FDI inflows, FDI into developing nations and the transition economies of eastern Europe and the old Soviet Union has increased markedly (see Figure 8.2). Most recent inflows into developing nations have been



8.2 FIGURE

FDI inflows by region, 1995–2017 (\$ billions).

Source: UNCTAD statistical data set, <http://unctadstat.unctad.org>.

targeted at the emerging economies of Southeast Asia. Driving much of the increase has been the growing importance of China as a recipient of FDI, which attracted about \$60 billion of FDI in 2004 and rose steadily to hit a record \$136 billion in 2017.⁶ The reasons for the strong flow of investment into China are discussed in the accompanying Country Focus. Latin America is the next most important region in the developing world for FDI inflows. In 2017, total inward investments into this region reached \$151 billion. Brazil has historically been the top recipient of inward FDI in Latin America. In Central America, Mexico has been a big recipient of inward investment thanks to its proximity to the United States and to NAFTA. In 2017, some \$27 billion of investments were made by foreigners in Mexico. At the other end of the scale, Africa has long received the smallest amount of inward investment, \$42 billion in 2017. In recent years, Chinese enterprises have emerged as major investors in Africa, particularly in extraction industries, where they seem to be trying to ensure future supplies of valuable raw materials. The inability of Africa to attract greater investment is in part a reflection of the political unrest, armed conflict, and frequent changes in economic policy in the region.⁷

THE SOURCE OF FDI Since World War II, the United States has consistently been the largest source country for FDI. Other important source countries include the United Kingdom, France, Germany, the Netherlands, and Japan. Collectively, these six countries accounted for 60 percent of all FDI outflows for 1998–2018 (see Figure 8.3). As might be expected, these countries also predominate in rankings of the world's largest multinationals.⁸ These nations dominate

country FOCUS

Foreign Direct Investment in China

Beginning in late 1978, China's leadership decided to move the economy away from a centrally planned socialist system to one that was more market driven. The result has been 40 years of sustained high economic growth rates of around 6–10 percent, compounded annually. This growth attracted substantial foreign investment. Starting from a tiny base, foreign investment increased to an annual average rate of \$2.7 billion between 1985 and 1990 and then surged to \$40 billion annually in the late 1990s, making China the second-biggest recipient of FDI inflows in the world after the United States. The growth has continued, with inward investments into China hitting \$133 billion in 2016 (with another \$108 billion going into Hong Kong). Over the past 20 years, this inflow has resulted in the establishment of more than 300,000 foreign-funded enterprises in China. The total stock of FDI in mainland China grew from almost nothing in 1978 to \$1.35 trillion in 2016 (another \$1.6 trillion of FDI stock was in Hong Kong).

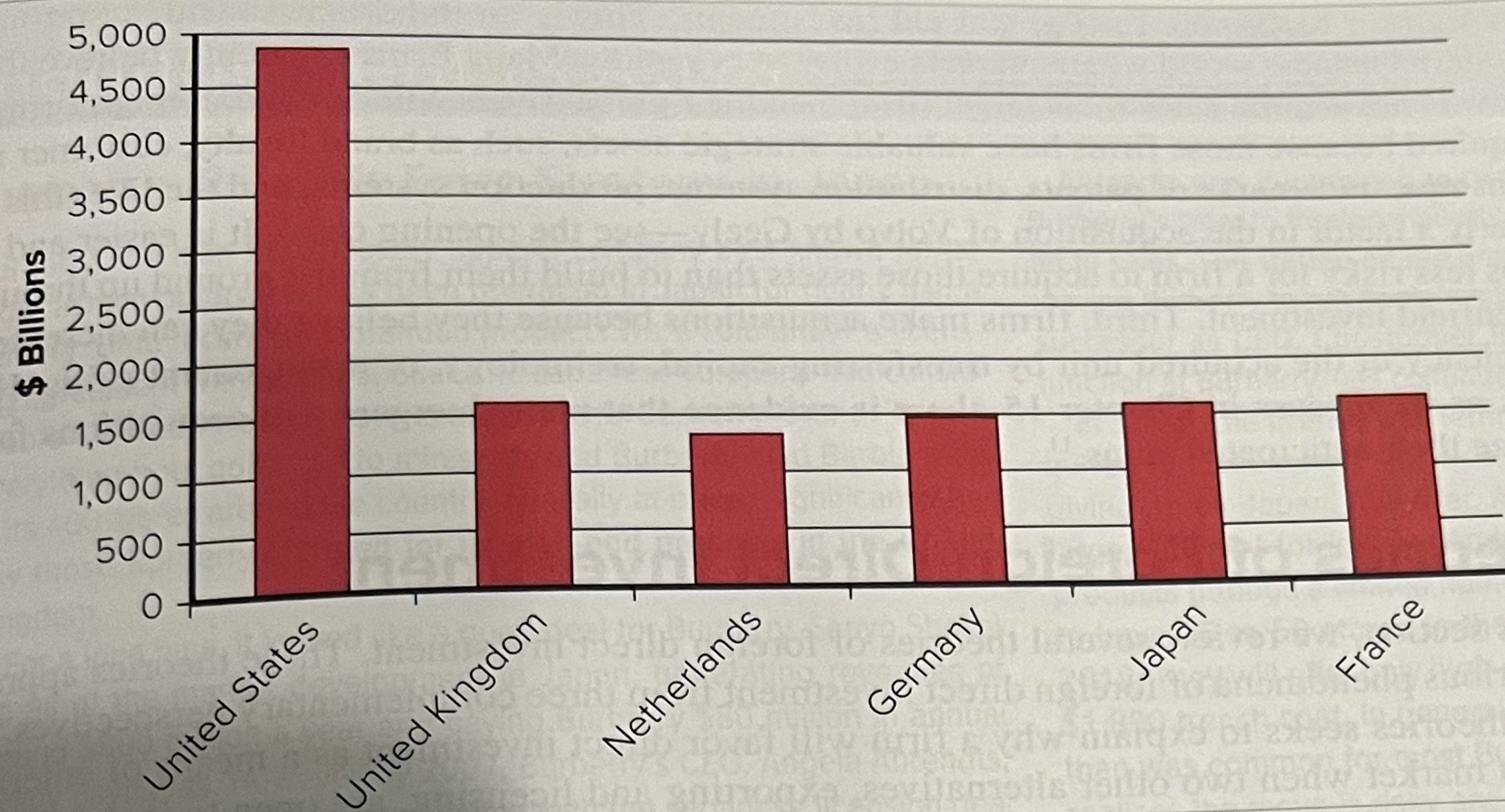
The reasons for this investment are fairly obvious. With a population of more than 1.3 billion people, China represents the world's largest market. Historically, import tariffs made it difficult to serve this market via exports, so FDI was required if a company wanted to tap into the country's huge potential. China joined the World Trade Organization in 2001. As a result, average tariff rates on imports have fallen from 15.4 percent to about 8 percent today. Even so, avoiding the tariff on imports is still a motive for investing in China (at 8 percent, tariffs are still above the average of 3.5 percent found in many developed nations). Notwithstanding tariff rates, many foreign firms believe that doing business in China requires a substantial presence in the country to build *guanxi*, the crucial relationship networks (see Chapter 4 for details). Furthermore, a combination of relatively inexpensive labor and tax incentives, particularly for enterprises that establish themselves in special economic zones, makes China an attractive base from which to

serve Asian or world markets with exports (although rising labor costs in China are now making this less important).

Less obvious, at least to begin with, was how difficult it would be for foreign firms to do business in China. For one thing, despite decades of growth, China still lags far behind developed nations in the wealth and sophistication of its consumer market. This limits opportunities for Western firms. The average annual wage in 2014 was only \$8,655. Moreover, half of the 770 million labor force works in rural areas and only earns around \$2,000 a year. The middle class, which accounts for about 20 percent of the workforce, has an average income of \$12,000 a year, still way below Western levels. Only 0.2 percent of the population earns more than \$50,000 a year.

Other problems include a highly regulated environment, which can make it problematic to conduct business transactions, and shifting tax and regulatory regimes. Then there are problems with local joint-venture partners that are inexperienced, opportunistic, or simply operate according to different goals. One U.S. manager explained that when he laid off 200 people to reduce costs, his Chinese partner hired them all back the next day. When he inquired why they had been hired back, the Chinese partner, which was government owned, explained that as an agency of the government, it had an "obligation" to reduce unemployment. Western firms also need to be concerned about protecting their intellectual property because there is a history of intellectual property not being respected in China, although this may now be starting to change.

Sources: Interviews by the author while in China; United Nations, *World Investment Report*, 2017; Linda Ng and C. Tuan, "Building a Favorable Investment Environment: Evidence for the Facilitation of FDI in China," *The World Economy*, 2002, pp. 1095–114; S. Chan and G. Qingyang, "Investment in China Migrates Inland," *Far Eastern Economic Review*, May 2006, pp. 52–57; Rachel Chang, "Here's What China's Middle Classes Really Earn—and Spend," *Bloomberg*, March 9, 2016; Gordon Orr, "A Pocket Guide to Doing Business in China," *McKinsey*, October 2014, archived at www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/a-pocket-guide-to-doing-business-in-china.



8.3 FIGURE

Cumulative FDI outflows, 1998–2017 (\$ billions).

Source: UNCTAD statistical data set, <http://unctadstat.unctad.org>.

primarily because they were the most developed nations with the largest economies during much of the postwar period and therefore home to many of the largest and best-capitalized enterprises. Many of these countries also had a long history as trading nations and naturally looked to foreign markets to fuel their economic expansion. Thus, it is no surprise that enterprises based there have been at the forefront of foreign investment trends.

That being said, it is noteworthy that Chinese firms have started to emerge as major foreign investors. In 2005, Chinese firms invested some \$12 billion internationally. Since then, the figure has risen steadily, reaching a record \$196 billion in 2016 before declining to \$125 billion in 2017. Firms based in Hong Kong accounted for another \$60 billion of outward FDI in 2016 and \$83 billion in 2017. Much of the outward investment by Chinese firms has been directed at extractive industries in less developed nations (e.g., China has been a major investor in African countries). A major motive for these investments has been to gain access to raw materials, of which China is one of the world's largest consumers. There are signs, however, that Chinese firms are starting to turn their attention to more advanced nations. In 2017, Chinese firms invested \$25 billion in the United States, up from \$146 million in 2003.⁹

THE FORM OF FDI: ACQUISITIONS VERSUS GREENFIELD INVESTMENTS

FDI takes two main forms. The first is a **greenfield investment**, which involves the establishment of a new operation in a foreign country. The second involves acquiring or merging with an existing firm in the foreign country. UN estimates indicate that some 40 to 80 percent of all FDI inflows were in the form of mergers and acquisitions between 1998 and 2017.¹⁰ However, FDI flows into developed nations differ markedly from those into developing nations. In the case of developing nations, only about one-third or less of FDI is in the form of cross-border mergers and acquisitions. The lower percentage of mergers and acquisitions may simply reflect the fact that there are fewer target firms to acquire in developing nations.

When contemplating FDI, when do firms prefer to acquire existing assets rather than undertake greenfield investments? We consider this question in depth in Chapter 15. For now, we can make a few basic observations. First, mergers and acquisitions

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greenfield investment

Establishing a new operation in a foreign country.



Which Is Better, an Acquisition or a Greenfield Investment?

A greenfield investment is an establishment of a new operation in a foreign country (i.e., a parent company starts a new venture in a foreign country by building new production facilities from the ground up). The acquisition approach refers to buying or merging operations with an existing firm in a foreign country. In this chapter and Chapter 13, we discuss reasons for greenfield and acquisition-based investments in a foreign country. While mergers and acquisitions (M&A) are typically quicker to execute than building something from literally the ground up, M&A often fails to gain the advantages expected. The failure rate of M&A is somewhere between 50 and 83 percent. At the same time, the trend shows that both the number of mergers and acquisitions and the sums of money spent on M&A are increasingly consistently every year. If you were making the decision, would you prefer to make a greenfield investment or to engage in either a merger or acquisition in a foreign country?

Source: Y. Weber, C. Oberg, and S. Tarba, "The M&A Paradox: Factors of Success and Failure in Mergers and Acquisitions," *Comprehensive Guide to Mergers & Acquisitions, A: Managing the Critical Success Factors Across Every Stage of the M&A Process* (Upper Saddle River, NJ: FT Press, 2013).

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LO 8-2

Explain the different theories of FDI.

eclectic paradigm

Argument that combining location-specific assets or resource endowments and the firm's own unique assets often requires FDI; it requires the firm to establish production facilities where those foreign assets or resource endowments are located.

exporting

Sale of products produced in one country to residents of another country.

licensing

Occurs when a firm (the licensor) licenses the right to produce its product, use its production processes, or use its brand name or trademark to another firm (the licensee). In return for giving the licensee these rights, the licensor collects a royalty fee on every unit the licensee sells.

are quicker to execute than greenfield investments. This is an important consideration in the modern business world where markets evolve very rapidly. Many firms apparently believe that if they do not acquire a desirable target firm, then their global rivals will. Second, foreign firms are acquired because those firms have valuable strategic assets, such as brand loyalty, customer relationships, trademarks or patents, distribution systems, production systems, and the like (this was clearly a factor in the acquisition of Volvo by Geely—see the opening case). It is easier and perhaps less risky for a firm to acquire those assets than to build them from the ground up through a greenfield investment. Third, firms make acquisitions because they believe they can increase the efficiency of the acquired unit by transferring capital, technology, or management skills. However, as we discuss in Chapter 15, there is evidence that many mergers and acquisitions fail to realize their anticipated gains.¹¹

Theories of Foreign Direct Investment

In this section, we review several theories of foreign direct investment. These theories approach the various phenomena of foreign direct investment from three complementary perspectives. One set of theories seeks to explain why a firm will favor direct investment as a means of entering a foreign market when two other alternatives, exporting and licensing, are open to it. Another set of theories seeks to explain why firms in the same industry often undertake foreign direct investment at the same time and why they favor certain locations over others as targets for foreign direct investment. Put differently, these theories attempt to explain the observed *pattern* of foreign direct investment flows. A third theoretical perspective, known as the **eclectic paradigm**, attempts to combine the two other perspectives into a single holistic explanation of foreign direct investment (this theoretical perspective is *eclectic* because the best aspects of other theories are taken and combined into a single explanation).

WHY FOREIGN DIRECT INVESTMENT?

Why do firms go to the trouble of establishing operations abroad through foreign direct investment when two alternatives, exporting and licensing, are available to them for exploiting the profit opportunities in a foreign market? **Exporting** involves producing goods at home and then shipping them to the receiving country for sale. **Licensing** involves granting a foreign entity (the licensee) the right to produce and sell the firm's product in return for a royalty fee on every unit sold. The question is important, given that a cursory examination of the topic suggests that foreign direct investment may be both expensive and risky compared with exporting and licensing. FDI is expensive because a firm must bear the costs of establishing production facilities in a foreign country or of acquiring a foreign enterprise. FDI is risky because of the problems associated with doing business in a different culture where the rules of the game may be very different. Relative to indigenous firms, there is a greater probability that a foreign firm undertaking FDI in a country for the first time will make costly mistakes due to its ignorance. When a firm exports, it need not bear the costs associated with FDI, and it can reduce the risks associated with selling abroad by using a native sales agent. Similarly, when a firm allows another enterprise to produce its products under license, the licensee bears the costs or risks (e.g., fashion retailer Burberry originally entered Japan via a licensing contract with a Japanese retailer—see the accompanying Management Focus). So why do so many firms apparently prefer FDI over either exporting or licensing? The answer can be found by examining the limitations of exporting and licensing as means for capitalizing on foreign market opportunities.

Limitations of Exporting The viability of exporting physical goods is often constrained by transportation costs and trade barriers. When transportation costs are added to production costs, it becomes unprofitable to ship some products over a large distance. This is particularly true of products that have a low value-to-weight ratio and that can be produced in almost any location. For such products, the attractiveness of exporting decreases, relative to either FDI or licensing. This is the case, for example, with cement. Thus, Cemex, the large Mexican cement maker, has expanded internationally by pursuing FDI, rather than exporting. For products with a high value-to-weight ratio, however, transportation costs are normally a minor component of total landed cost (e.g., electronic components, personal computers, medical

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Burberry Shifts Its Entry Strategy in Japan

Burberry, the icon British luxury apparel company best known for its high-fashion outerwear, has been operating in Japan for nearly half a century. Until recently, its branded products were sold under a licensing agreement with Sanyo Shokai. The Japanese company had considerable discretion as to how it utilized the Burberry brand. It sold everything from golf bags to miniskirts and Burberry-clad Barbie dolls in its 400 stores around the country, typically at prices significantly below those Burberry charged for its high-end products in the United Kingdom.

For a long time, it looked like a good deal for Burberry. Sanyo Shokai did all of the market development in Japan, generating revenues of around \$800 million a year and paying Burberry \$80 million in annual royalty payments. However, by 2007, Burberry's CEO, Angela Ahrendts, was becoming increasingly dissatisfied with the Japanese licensing deal and 22 others like it in countries around the world. In Ahrendts's view, the licensing deals were diluting Burberry's core brand image. Licensees such as Sanyo Shokai were selling a wide range of products at a much lower price point than Burberry charged for products in its own stores. "In luxury," Ahrendts once remarked, "ubiquity will kill you—it means that you're not really luxury anymore." Moreover, with an increasing number of customers buying Burberry products online and on trips to Britain, where the brand was considered very upmarket, Ahrendts felt that it was crucial for Burberry to tightly control its global brand image.

Ahrendts was determined to rein in licensees and regain control of Burberry's sales in foreign markets, even if it meant taking a short-term hit to sales. She started off the process of terminating licensees before leaving Burberry to run Apple's retail division in 2014. Her hand-picked successor as CEO, Christopher Bailey, who rose through the design function at Burberry, has continued to pursue this strategy.

In Japan, the license was terminated in 2015. Sanyo Shokai was required to close nearly 400 licensed Burberry stores. Burberry is not giving up on Japan, however. After all, Japan is the world's second-largest market for luxury goods. Instead, the company will now sell products through a limited number of wholly owned stores. The goal is to have 35 to 50 stores in the most exclusive locations in Japan by 2018. They will offer only high-end products, such as Burberry's classic \$1,800 trench coat. In general, the price point will be 10 times higher than was common for most Burberry products in Japan. The company realizes the move is risky and fully expects sales to initially fall before rising again as it rebuilds its brand, but CEO Bailey argues that the move is absolutely necessary if Burberry is to have a coherent global brand image for its luxury products.

Sources: Kathy Chu and Megumi Fujikawa, "Burberry Gets a Grip on Brand in Japan," *The Wall Street Journal*, August 15–16, 2015; Angela Ahrendts, "Burberry's CEO on Turning an Aging British Icon into a Global Luxury Brand," *Harvard Business Review*, January–February 2013; Tim Blanks, "The Designer Who Would Be CEO," *The Wall Street Journal Magazine*, June 18, 2015; and G. Fasol, "Burberry Solves Its 'Japan Problem,' at Least for Now," *Japan Strategy*, August 19, 2015.

equipment, computer software, etc.) and have little impact on the relative attractiveness of exporting, licensing, and FDI.

Transportation costs aside, some firms undertake foreign direct investment as a response to actual or threatened trade barriers such as import tariffs or quotas. By placing tariffs on imported goods, governments can increase the cost of exporting relative to foreign direct investment and licensing. Similarly, by limiting imports through quotas, governments increase the attractiveness of FDI and licensing. For example, the wave of FDI by Japanese auto companies in the United States that started in the mid 1980s and continues to this day has been partly driven by protectionist threats from Congress and by tariffs on the importation of Japanese vehicles, particularly

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Rankings

Cross-border investments have been ramped up to a relatively large degree in the last decade. Even with the economic downturn that started in 2008, the world continued to see a great deal of foreign direct investment by companies in the last decade. Now, when the economic prosperity is likely to be better, given that we are removed from those downturn days, the expectation is that more foreign direct investment will be considered by companies. On globalEDGE™, there are myriad opportunities to gain more knowledge about foreign direct investment (FDI). The "Rankings"

section is a great starting point (globeedge.msu.edu/global-resources/rankings). In this section, globalEDGE™ features several reports by A.T. Kearney—with one of them squarely centered on foreign direct investment and a "confidence index" for FDI. The companies that participate in the regular study account for more than \$2 trillion in annual global revenue! Which countries are in the top three in the investment confidence index, and do you agree that the three countries are the best ones to invest in if you were running a company?

light trucks (SUVs), which still face a 25 percent import tariff into the United States. For Japanese auto companies, these factors decreased the profitability of exporting and increased that of foreign direct investment. In this context, it is important to understand that trade barriers do not have to be physically in place for FDI to be favored over exporting. Often, the desire to reduce the threat that trade barriers might be imposed is enough to justify foreign direct investment as an alternative to exporting.

internalization theory
Marketing imperfection approach to foreign direct investment.

market imperfections
Imperfections in the operation of the market mechanism.

Limitations of Licensing A branch of economic theory known as **internalization theory** seeks to explain why firms often prefer foreign direct investment over licensing as a strategy for entering foreign markets (this approach is also known as the **market imperfections** approach).¹² According to internalization theory, licensing has three major drawbacks as a strategy for exploiting foreign market opportunities. First, *licensing may result in a firm's giving away valuable technological know-how to a potential foreign competitor*. In a classic example, in the 1960s, RCA licensed its leading-edge color television technology to a number of Japanese companies, including Matsushita and Sony. At the time, RCA saw licensing as a way to earn a good return from its technological know-how in the Japanese market without the costs and risks associated with foreign direct investment. However, Matsushita and Sony quickly assimilated RCA's technology and used it to enter the U.S. market to compete directly against RCA. As a result, RCA was relegated to being a minor player in its home market, while Matsushita and Sony went on to have a much bigger market share.

A second problem is that *licensing does not give a firm the tight control over production, marketing, and strategy in a foreign country that may be required to maximize its profitability*. With licensing, control over production (of a good or a service), marketing, and strategy are granted to a licensee in return for a royalty fee. However, for both strategic and operational reasons, a firm may want to retain control over these functions. One reason for wanting control over the *strategy* of a foreign entity is that a firm might want its foreign subsidiary to price and market very aggressively as a way of keeping a foreign competitor in check. Unlike a wholly owned subsidiary, a licensee would probably not accept such an imposition because it would likely reduce the licensee's profit, or it might even cause the licensee to take a loss. Another reason for wanting control over the *strategy* of a foreign entity is to make sure that the entity does not damage the firm's brand. This was the primary reason fashion retailer Burberry recently terminated its licensing agreement in Japan and switched to a strategy of direct ownership of its own retail stores in the Japanese market (see the Management Focus about Burberry above for details).

One reason for wanting control over the *operations* of a foreign entity is that the firm might wish to take advantage of differences in factor costs across countries, producing only part of its final product in a given country, while importing other parts from where they can be produced at lower cost. Again, a licensee would be unlikely to accept such an arrangement because it would limit the licensee's autonomy. For reasons such as these, when tight control over a foreign entity is desirable, foreign direct investment is preferable to licensing.

A third problem with licensing arises when the firm's competitive advantage is based not as much on its products as on the management, marketing, and manufacturing capabilities that produce those products. The problem here is that *such capabilities are often not amenable to licensing*. While a foreign licensee may be able to physically reproduce the firm's product under license, it often may not be able to do so as efficiently as the firm could itself. As a result, the licensee may not be able to fully exploit the profit potential inherent in a foreign market.

For example, consider Toyota, a company whose competitive advantage in the global auto industry is acknowledged to come from its superior ability to manage the overall process of designing, engineering, manufacturing, and selling automobiles—that is, from its management and organizational capabilities. Indeed, Toyota is credited with pioneering the development of a new production process, known as *lean production*, that enables it to produce higher-quality automobiles at a lower cost than its global rivals.¹³ Although Toyota could license certain products, its real competitive advantage comes from its management and process capabilities. These kinds of skills are difficult to articulate or codify; they certainly cannot be written down in a simple licensing contract. They are organizationwide and have been developed over the years. They are not embodied in any one individual but instead are widely dispersed throughout the company. Put another way, Toyota's skills are embedded in its organizational culture, and culture is

something that cannot be licensed. Thus, if Toyota were to allow a foreign entity to produce its cars under license, the chances are that the entity could not do so as efficiently as could Toyota. In turn, this would limit the ability of the foreign entity to fully develop the market potential of that product. Such reasoning underlies Toyota's preference for direct investment in foreign markets, as opposed to allowing foreign automobile companies to produce its cars under license.

All of this suggests that when one or more of the following conditions holds, markets fail as a mechanism for selling know-how and FDI is more profitable than licensing: (1) when the firm has valuable know-how that cannot be adequately protected by a licensing contract, (2) when the firm needs tight control over a foreign entity to maximize its market share and earnings in that country, and (3) when a firm's skills and know-how are not amenable to licensing.

Advantages of Foreign Direct Investment It follows that a firm will favor foreign direct investment over exporting as an entry strategy when transportation costs or trade barriers make exporting unattractive. Furthermore, the firm will favor foreign direct investment over licensing (or franchising) when it wishes to maintain control over its technological know-how, or over its operations and business strategy, or when the firm's capabilities are simply not amenable to licensing, as may often be the case.

Beyond this, FDI has other "strategic" advantages that are difficult to achieve through licensing or exporting/importing. For example, the opening case describes how the Chinese automobile manufacturer Geely acquired the assets of Volvo from Ford in 2010 in order to gain access to Volvo's design engineering skills and brand equity. In theory, Geely could have licensed in design know-how from Volvo, and/or produced Volvo cars in China under license. In practice, such skills are difficult to articulate or codify and cannot be written down in a simple licensing contract. Thus, acquisition presents itself as a better option. Moreover, the acquisition gave Geely the tight operational control that it wanted over Volvo's manufacturing activities, enabling it to relocate significant production to China, and using that as an export base to serve much of the world market outside of North America (North American demand is served from a production facility in South Carolina).

More generally, gaining technology, productive assets, market share, brand equity, distribution systems, and the like through FDI by purchasing the assets of an established company can all speed up market entry, improve production in the firm's home base, and facilitate the transfer of technology from the acquired company to the acquiring company. We return to this topic in Chapter 13 when we discuss different entry strategies.

THE PATTERN OF FOREIGN DIRECT INVESTMENT Observation suggests that firms in the same industry often undertake foreign direct investment at about the same time. Also, firms tend to direct their investment activities toward the same target markets. The two theories we consider in this section attempt to explain the patterns that we observe in FDI flows.

Strategic Behavior One theory is based on the idea that FDI flows are a reflection of strategic rivalry between firms in the global marketplace. An early variant of this argument was expounded by F. T. Knickerbocker, who looked at the relationship between FDI and rivalry in oligopolistic industries.¹⁴ An **oligopoly** is an industry composed of a limited number of large firms (e.g., an industry in which four firms control 80 percent of a domestic market would be defined as an oligopoly). A critical competitive feature of such industries is interdependence of the major players: What one firm does can have an immediate impact on the major competitors, forcing a response in kind. By cutting prices, one firm in an oligopoly can take market share away from its competitors, forcing them to respond with similar price cuts to retain their market share. Thus, the interdependence between firms in an oligopoly leads to imitative behavior; rivals often quickly imitate what a firm does in an oligopoly.

Imitative behavior can take many forms in an oligopoly. One firm raises prices, and the others follow; one expands capacity, and the rivals imitate lest they be left at a disadvantage in the future. Knickerbocker argued that the same kind of imitative behavior characterizes FDI. Consider an oligopoly in the United States in which three firms—A, B, and C—dominate the market. Firm

oligopoly

An industry composed of a limited number of large firms.

A establishes a subsidiary in France. Firms B and C decide that if successful, this new subsidiary may knock out their export business to France and give a first-mover advantage to firm A. Furthermore, firm A might discover some competitive asset in France that it could repatriate to the United States to torment firms B and C on their native soil. Given these possibilities, firms B and C decide to follow firm A and establish operations in France.

Studies that have looked at FDI by U.S. firms show that firms based in oligopolistic industries tended to imitate each other's FDI.¹⁵ The same phenomenon has been observed with regard to FDI undertaken by Japanese firms.¹⁶ For example, Toyota and Nissan responded to investments by Honda in the United States and Europe by undertaking their own FDI in the United States and Europe. Research has also shown that models of strategic behavior in a global oligopoly can explain the pattern of FDI in the global tire industry.¹⁷

Knickerbocker's theory can be extended to embrace the concept of multipoint competition. **Multipoint competition** arises when two or more enterprises encounter each other in different regional markets, national markets, or industries.¹⁸ Economic theory suggests that rather like chess players jockeying for advantage, firms will try to match each other's moves in different markets to try to hold each other in check. The idea is to ensure that a rival does not gain a commanding position in one market and then use the profits generated there to subsidize competitive attacks in other markets.

Although Knickerbocker's theory and its extensions can help explain imitative FDI behavior by firms in oligopolistic industries, it does not explain why the first firm in an oligopoly decides to undertake FDI rather than to export or license. Internalization theory addresses this phenomenon. The imitative theory also does not address the issue of whether FDI is more efficient than exporting or licensing for expanding abroad. Again, internalization theory addresses the efficiency issue. For these reasons, many economists favor internalization theory as an explanation for FDI, although most would agree that the imitative explanation tells an important part of the story.

THE ECLECTIC PARADIGM The eclectic paradigm has been championed by the late British economist John Dunning.¹⁹ Dunning argues that in addition to the various factors discussed earlier, location-specific advantages are also of considerable importance in explaining both the rationale for and the direction of foreign direct investment. By **location-specific advantages**, Dunning means the advantages that arise from utilizing resource endowments or assets that are tied to a particular foreign location and that a firm finds valuable to combine with its own unique assets (such as the firm's technological, marketing, or management capabilities). Dunning accepts the argument of internalization theory that it is difficult for a firm to license its own unique capabilities and know-how. Therefore, he argues that combining location-specific assets or resource endowments with the firm's own unique capabilities often requires foreign direct investment. That is, it requires the firm to establish production facilities where those foreign assets or resource endowments are located.

An obvious example of Dunning's arguments are natural resources, such as oil and other minerals, which are—by their character—specific to certain locations. Dunning suggests that to exploit such foreign resources, a firm must undertake FDI. Clearly, this explains the FDI undertaken by many of the world's oil companies, which have to invest where oil is located in order to combine their technological and managerial capabilities with this valuable location-specific resource. Another obvious example is valuable human resources, such as low-cost, highly skilled labor. The cost and skill of labor varies from country to country. Because labor is not internationally mobile, according to Dunning it makes sense for a firm to locate production facilities in those countries where the cost and skills of local labor are most suited to its particular production processes.

However, Dunning's theory has implications that go beyond basic resources such as minerals and labor. Consider Silicon Valley, which is the world center for the computer and semiconductor industry. Many of the world's major computer and semiconductor companies—such as Apple Computer, Hewlett-Packard, Oracle, Google, and Intel—are located close to each other in the Silicon Valley region of California. As a result, much of the cutting-edge research and product development in computers and semiconductors occurs there. According to Dunning's arguments, knowledge being generated in Silicon Valley with regard to the design and manufacture of computers and semiconductors is available nowhere else in the world. To be sure, that knowledge is

multipoint competition

Arises when two or more enterprises encounter each other in different regional markets, national markets, or industries.

location-specific advantages

Advantages that arise from using resource endowments or assets that are tied to a particular foreign location and that a firm finds valuable to combine with its own unique assets (such as the firm's technological, marketing, or management know-how).

commercialized as it diffuses throughout the world, but the leading edge of knowledge generation in the computer and semiconductor industries is to be found in Silicon Valley. In Dunning's language, this means that Silicon Valley has a *location-specific advantage* in the generation of knowledge related to the computer and semiconductor industries. In part, this advantage comes from the sheer concentration of intellectual talent in this area, and in part, it arises from a network of informal contacts that allows firms to benefit from each other's knowledge generation. Economists refer to such knowledge "spillovers" as **externalities**, and there is a well-established theory suggesting that firms can benefit from such externalities by locating close to their source.²⁰

Insofar as this is the case, it makes sense for foreign computer and semiconductor firms to invest in research and, perhaps, production facilities so they too can learn about and utilize valuable new knowledge before those based elsewhere, thereby giving them a competitive advantage in the global marketplace.²¹ Evidence suggests that European, Japanese, South Korean, and Taiwanese computer and semiconductor firms are investing in the Silicon Valley region precisely because they wish to benefit from the externalities that arise there.²² Others have argued that direct investment by foreign firms in the U.S. biotechnology industry has been motivated by desire to gain access to the unique location-specific technological knowledge of U.S. biotechnology firms.²³ Dunning's theory, therefore, seems to be a useful addition to those outlined previously because it helps explain how location factors affect the direction of FDI.²⁴

Political Ideology and Foreign Direct Investment

Historically, political ideology toward FDI within a nation has ranged from a dogmatic radical stance that is hostile to all inward FDI at one extreme to an adherence to the noninterventionist principle of free market economics at the other. Between these two extremes is an approach that might be called *pragmatic nationalism*.

THE RADICAL VIEW The radical view traces its roots to Marxist political and economic theory. Radical writers argue that the multinational enterprise (MNE) is an instrument of imperialist domination. They see the MNE as a tool for exploiting host countries to the exclusive benefit of their capitalist-imperialist home countries. They argue that MNEs extract profits from the host country and take them to their home country, giving nothing of value to the host country in exchange. They note, for example, that key technology is tightly controlled by the MNE and that important jobs in the foreign subsidiaries of MNEs go to home-country nationals rather than to citizens of the host country. Because of this, according to the radical view, FDI by the MNEs of advanced capitalist nations keeps the less developed countries of the world relatively backward and dependent on advanced capitalist nations for investment, jobs, and technology. Thus, according to the extreme version of this view, no country should ever permit foreign corporations to undertake FDI because they can never be instruments of economic development, only of economic domination. Where MNEs already exist in a country, they should be immediately nationalized.²⁵

From 1945 until the 1980s, the radical view was very influential in the world economy. Until the collapse of communism between 1989 and 1991, the countries of eastern Europe were



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externalities

Knowledge spillovers.

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LO 8-3

Understand how political ideology shapes a government's attitudes toward FDI.



Are They Friends or Not—India and Pakistan?

For many years, since the partition of British India in 1947 and the creation of India and Pakistan, these two South Asian countries have been involved in numerous wars, border skirmishes, and military stand-offs. The dispute for Kashmir has been the main reason in most interactions, with a notable exception being the Indo-Pakistani War of 1971, when the conflict started because of turmoil in East Pakistan (now called Bangladesh). However, in trying to improve the economic ties between the two nations, India recently announced that it will allow FDI from Pakistan, paving the way for industries from the neighboring country to set up businesses in the growing Indian market. While this is a prime example of how free markets are promoting trade between countries that have not traditionally enjoyed stable political relationships with each other, the question is also on what grounds cross-border interaction is founded. What do you think? Can countries that have been long-standing enemies normalize their relationship simply based on foreign direct investment opportunities?

Source: www.hindustantimes.com.

opposed to FDI. Similarly, communist countries elsewhere—such as China, Cambodia, and Cuba—were all opposed in principle to FDI (although, in practice, the Chinese started to allow FDI in mainland China in the 1970s). Many socialist countries—particularly in Africa, where one of the first actions of many newly independent states was to nationalize foreign-owned enterprises—also embraced the radical position. Countries whose political ideology was more nationalistic than socialist further embraced the radical position. This was true in Iran and India, for example, both of which adopted tough policies restricting FDI and nationalized many foreign-owned enterprises. Iran is a particularly interesting case because its Islamic government, while rejecting Marxist theory, essentially embraced the radical view that FDI by MNEs is an instrument of imperialism.

By the early 1990s, the radical position was in retreat. There seem to be three reasons for this: (1) the collapse of communism in eastern Europe; (2) the generally abysmal economic performance of those countries that embraced the radical position, in addition to a growing belief by many of these countries that FDI can be an important source of technology and jobs and can stimulate economic growth; and (3) the strong economic performance of those developing countries that embraced capitalism rather than radical ideology (e.g., Singapore, Hong Kong, and Taiwan). Despite this, the radical view lingers on in some countries, such as Venezuela, where the government of Hugo Chávez and that of his successor Nicolás Maduro have both viewed foreign multinationals as an instrument of domination.

THE FREE MARKET VIEW

The free market view traces its roots to classical economics and the international trade theories of Adam Smith and David Ricardo (see Chapter 6). The intellectual case for this view has been strengthened by the internalization explanation of FDI. The free market view argues that international production should be distributed among countries according to the theory of comparative advantage. Countries should specialize in the production of those goods and services that they can produce most efficiently. Within this framework, the MNE is an instrument for dispersing the production of goods and services to the most efficient locations around the globe. Viewed this way, FDI by the MNE increases the overall efficiency of the world economy.

Imagine that Dell decided to move assembly operations for many of its personal computers from the United States to Mexico to take advantage of lower labor costs in Mexico. According to the free market view, moves such as this can be seen as increasing the overall efficiency of resource utilization in the world economy. Mexico, due to its lower labor costs, has a comparative advantage in the assembly of PCs. By moving the production of PCs from the United States to Mexico, Dell frees U.S. resources for use in activities in which the United States has a comparative advantage (e.g., the design of computer software, the manufacture of high value-added components such as microprocessors, or basic R&D). Also, consumers benefit because the PCs cost less than they would if they were produced domestically. In addition, Mexico gains from the technology, skills, and capital that the computer company transfers with its FDI. Contrary to the radical view, the free market view stresses that such resource transfers benefit the host country and stimulate its economic growth. Thus, the free market view argues that FDI is a benefit to both the source country and the host country.

PRAGMATIC NATIONALISM

In practice, many countries have adopted neither a radical policy nor a free market policy toward FDI but, instead, a policy that can best be described as pragmatic nationalism.²⁶ The pragmatic nationalist view is that FDI has both benefits and costs. FDI can benefit a host country by bringing capital, skills, technology, and jobs, but those benefits come at a cost. When a foreign company rather than a domestic company produces products, the profits from that investment go abroad. Many countries are also concerned that a foreign-owned manufacturing plant may import many components from its home country, which has negative implications for the host country's balance-of-payments position.

Recognizing this, countries adopting a pragmatic stance pursue policies designed to maximize the national benefits and minimize the national costs. According to this view, FDI should be allowed so long as the benefits outweigh the costs. Japan offers an example of pragmatic nationalism. Until the 1980s, Japan's policy was probably one of the most restrictive among countries adopting a pragmatic nationalist stance. This was due to Japan's perception that direct entry of foreign (especially U.S.) firms with ample managerial resources into the Japanese markets could

hamper the development and growth of its own industry and technology.²⁷ This belief led Japan to block the majority of applications to invest in Japan. However, there were always exceptions to this policy. Firms that had important technology were often permitted to undertake FDI if they insisted that they would neither license their technology to a Japanese firm nor enter into a joint venture with a Japanese enterprise. IBM and Texas Instruments were able to set up wholly owned subsidiaries in Japan by adopting this negotiating position. From the perspective of the Japanese government, the benefits of FDI in such cases—the stimulus that these firms might impart to the Japanese economy—outweighed the perceived costs.

Another aspect of pragmatic nationalism is the tendency to aggressively court FDI believed to be in the national interest by, for example, offering subsidies to foreign MNEs in the form of tax breaks or grants. The countries of the European Union often seem to be competing with each other to attract U.S. and Japanese FDI by offering large tax breaks and subsidies. Britain has been the most successful at attracting Japanese investment in the automobile industry. Nissan, Toyota, and Honda now have major assembly plants in Britain and use the country as their base for serving the rest of Europe—with obvious employment and balance-of-payments benefits for Britain (what happens to these investments if and when Britain exits from the EU remains to be seen). Similarly, within the United States, individual states often compete with each other to attract FDI, offering generous financial incentives in the form of tax breaks to foreign companies looking to set up operations in the country.

SHIFTING IDEOLOGY Recent years have seen a marked decline in the number of countries that adhere to a radical ideology. Although few countries have adopted a pure free market policy stance, an increasing number of countries are gravitating toward the free market end of the spectrum and have liberalized their foreign investment regime. This includes many countries that 30 years ago were firmly in the radical camp (e.g., the former communist countries of eastern Europe, many of the socialist countries of Africa, and India) and several countries that until recently could best be described as pragmatic nationalists with regard to FDI (e.g., Japan, South Korea, Italy, Spain, and most Latin American countries). One result has been the surge in the volume of FDI worldwide, which, as we noted earlier, has been growing faster than world trade. Another result has been an increase in the volume of FDI directed at countries that have liberalized their FDI regimes in the last 20 years, such as China, India, and Vietnam.

As a counterpoint, there is some evidence of a shift to a more hostile approach to foreign direct investment in some nations. Venezuela and Bolivia have become increasingly hostile to foreign direct investment. In 2005 and 2006, the governments of both nations unilaterally rewrote contracts for oil and gas exploration, raising the royalty rate that foreign enterprises had to pay the government for oil and gas extracted in their territories. Following his election victory in 2006, Bolivian president Evo Morales nationalized the nation's gas fields and stated that he would evict foreign firms unless they agreed to pay about 80 percent of their revenues to the state and relinquish production oversight. In some developed nations, there is increasing evidence of hostile reactions to inward FDI as well. In Europe in 2006, there was a hostile political reaction to the attempted takeover of Europe's largest steel company, Arcelor, by Mittal Steel, a global company controlled by the Indian entrepreneur Lakshmi Mittal. In mid-2005, China National Offshore Oil Company withdrew a takeover bid for Unocal of the United States after highly negative reaction in Congress about the proposed takeover of a "strategic asset" by a Chinese company.

Benefits and Costs of FDI

To a greater or lesser degree, many governments can be considered pragmatic nationalists when it comes to FDI. Accordingly, their policy is shaped by a consideration of the costs and benefits of FDI. Here, we explore the benefits and costs of FDI, first from the perspective of a host (receiving) country and then from the perspective of the home (source) country. In the next section, we look at the policy instruments governments use to manage FDI.

HOST-COUNTRY BENEFITS The main benefits of inward FDI for a host country arise from resource-transfer effects, employment effects, balance-of-payments effects, and effects on competition and economic growth.

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Describe the benefits and costs of FDI to home and host countries.

Does Foreign Direct Investment Promote Growth?

There are multiple reasons for companies to make foreign direct investments. Lowering the cost of production, increasing capacity (volume) of production, and strategically locating production facilities to serve world regions are some of the many reasons for FDI by a company. For the host countries that receive the investment by multinational corporations, the logic is that the influx of capital and increase in tax revenues will benefit the host country in the form of new infrastructure, increased knowledge, and general economic development. However, the evidence so far is very mixed on the value of FDI to the host, ranging from beneficial to detrimental. What do you think? Does FDI promote growth in the host country?

Source: L. Alfaro, A. Chanda, S. Kalemli-Ozcan, and S. Sayek, *Does Foreign Direct Investment Promote Growth? Exploring the Role of Financial Markets on Linkages* (Cambridge, MA: Harvard Business School, 2009), www.people.hbs.edu/lalfaro/fdiandlinkages.pdf.

Resource-Transfer Effects Foreign direct investment can make a positive contribution to a host economy by supplying capital, technology, and management resources that would otherwise not be available and thus boost that country's economic growth rate.

With regard to capital, many MNEs, by virtue of their large size and financial strength, have access to financial resources not available to host-country firms. These funds may be available from internal company sources, or, because of their reputation, large MNEs may find it easier to borrow money from capital markets than host-country firms would.

As for technology, you will recall from Chapter 3 that technology can stimulate economic development and industrialization. Technology can take two forms, both of which are valuable. Technology can be incorporated in a production process (e.g., the technology for discovering, extracting, and refining oil), or it can be incorporated in a product (e.g., personal computers). However, many countries lack the research and development resources and skills required to develop their own indigenous product and process technology. This is particularly true in less developed nations. Such

countries must rely on advanced industrialized nations for much of the technology required to stimulate economic growth, and FDI can provide it.

Research supports the view that multinational firms often transfer significant technology when they invest in a foreign country.²⁸ For example, a study of FDI in Sweden found that foreign firms increased both the labor and total factor productivity of Swedish firms that they acquired, suggesting that significant technology transfers had occurred (technology typically boosts productivity).²⁹ Also, a study of FDI by the Organisation for Economic Co-operation and Development (OECD) found that foreign investors invested significant amounts of capital in R&D in the countries in which they had invested, suggesting that not only were they transferring technology to those countries but they may also have been upgrading existing technology or creating new technology in those countries.³⁰

Foreign management skills acquired through FDI may also produce important benefits for the host country. Foreign managers trained in the latest management techniques can often help improve the efficiency of operations in the host country, whether those operations are acquired or greenfield developments. Beneficial spin-off effects may also arise when local personnel who are trained to occupy managerial, financial, and technical posts in the subsidiary of a foreign MNE leave the firm and help establish indigenous firms. Similar benefits

may arise if the superior management skills of a foreign MNE stimulate local suppliers, distributors, and competitors to improve their own management skills.

Employment Effects Another beneficial employment effect claimed for FDI is that it brings jobs to a host country that would otherwise not be created there. The effects of FDI on employment are both direct and indirect. Direct effects arise when a foreign MNE employs a number of host-country citizens. Indirect effects arise when jobs are created in local suppliers as a result of the investment and when jobs are created because of increased local spending by employees of the MNE. The indirect employment effects are often as large as, if not larger than, the direct effects. For example, when Toyota decided to open a new auto plant in France, estimates suggested the plant would create 2,000 direct jobs and perhaps another 2,000 jobs in support industries.³¹

Cynics argue that not all the "new jobs" created by FDI represent net additions in employment. In the case of FDI by Japanese auto



An employee uses a robotic arm to fit a wheel onto a Volkswagen AG Vento automobile on the production line at the Volkswagen India Pvt. plant in Chakan, Maharashtra, India.

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companies in the United States, some argue that the jobs created by this investment have been more than offset by the jobs lost in U.S.-owned auto companies, which have lost market share to their Japanese competitors. As a consequence of such substitution effects, the net number of new jobs created by FDI may not be as great as initially claimed by an MNE. The issue of the likely net gain in employment may be a major negotiating point between an MNE wishing to undertake FDI and the host government.

When FDI takes the form of an acquisition of an established enterprise in the host economy as opposed to a greenfield investment, the immediate effect may be to reduce employment as the multinational tries to restructure the operations of the acquired unit to improve its operating efficiency. However, even in such cases, research suggests that once the initial period of restructuring is over, enterprises acquired by foreign firms tend to increase their employment base at a faster rate than domestic rivals. An OECD study found that foreign firms created new jobs at a faster rate than their domestic counterparts.³²

Balance-of-Payments Effects FDI's effect on a country's balance-of-payments accounts is an important policy issue for most host governments. A country's **balance-of-payments accounts** track both its payments to and its receipts from other countries. Governments normally are concerned when their country is running a deficit on the current account of their balance of payments. The **current account** tracks the export and import of goods and services. A current account deficit, or *trade deficit* as it is often called, arises when a country is importing more goods and services than it is exporting. Governments typically prefer to see a current account surplus rather than a deficit. The only way in which a current account deficit can be supported in the long run is by selling off assets to foreigners (for a detailed explanation of why this is the case, see the appendix to Chapter 6). For example, the persistent U.S. current account deficit since the 1980s has been financed by a steady sale of U.S. assets (stocks, bonds, real estate, and whole corporations) to foreigners. Because national governments invariably dislike seeing the assets of their country fall into foreign hands, they prefer their nation to run a current account surplus. There are two ways in which FDI can help a country achieve this goal.

First, if the FDI is a substitute for imports of goods or services, the effect can be to improve the current account of the host country's balance of payments. Much of the FDI by Japanese automobile companies in the United States and Europe, for example, can be seen as substituting for imports from Japan. Thus, the current account of the U.S. balance of payments has improved somewhat because many Japanese companies are now supplying the U.S. market from production facilities in the United States, as opposed to facilities in Japan. Insofar as this has reduced the need to finance a current account deficit by asset sales to foreigners, the United States has clearly benefited.

A second potential benefit arises when the MNE uses a foreign subsidiary to export goods and services to other countries. According to a UN report, inward FDI by foreign multinationals has been a major driver of export-led economic growth in a number of developing and developed nations.³³ For example, in China exports increased from \$26 billion in 1985 to around \$3 trillion in 2017. Much of this dramatic export growth was due to the presence of foreign multinationals that invested heavily in China.

Effect on Competition and Economic Growth Economic theory tells us that the efficient functioning of markets depends on an adequate level of competition between producers. When FDI takes the form of a greenfield investment, the result is to establish a new enterprise, increasing the number of players in a market and thus consumer choice. In turn, this can increase the level of competition in a national market, thereby driving down prices and increasing the economic welfare of consumers. Increased competition tends to stimulate capital investments by firms in plant, equipment, and R&D as they struggle to gain an edge over their rivals. The long-term results may include increased productivity growth, product and process innovations, and greater economic growth.³⁴ Such beneficial effects seem to have occurred in the South Korean retail sector following the liberalization of FDI regulations in 1996. FDI by large Western discount stores—including Walmart, Costco,

balance-of-payments accounts

National accounts that track both payments to and receipts from foreigners.

current account

In the balance of payments, records transactions involving the export or import of goods and services.

Carrefour, and Tesco—seems to have encouraged indigenous discounters such as E-Mart to improve the efficiency of their own operations. The results have included more competition and lower prices, which benefit South Korean consumers. In a similar vein, the Indian government has been opening up that country's retail sector to FDI, partly because it believes that inward investment by efficient global retailers such as Walmart, Carrefour, and IKEA will provide the competitive stimulus that is necessary to improve the efficiency of India's fragmented retail system.

FDI's impact on competition in domestic markets may be particularly important in the case of services, such as telecommunications, retailing, and many financial services, where exporting is often not an option because the service has to be produced where it is delivered.³⁵ For example, under a 1997 agreement sponsored by the World Trade Organization, 68 countries accounting for more than 90 percent of world telecommunications revenues pledged to start opening their markets to foreign investment and competition and to abide by common rules for fair competition in telecommunications. Before this agreement, most of the world's telecommunications markets were closed to foreign competitors, and in most countries, the market was monopolized by a single carrier, which was often a state-owned enterprise. The agreement has dramatically increased the level of competition in many national telecommunications markets, producing two major benefits. First, inward investment has increased competition and stimulated investment in the modernization of telephone networks around the world, leading to better service. Second, the increased competition has resulted in lower prices.

HOST-COUNTRY COSTS Three costs of FDI concern host countries. They arise from possible adverse effects on competition within the host nation, adverse effects on the balance of payments, and the perceived loss of national sovereignty and autonomy.

Adverse Effects on Competition Host governments sometimes worry that the subsidiaries of foreign MNEs may have greater economic power than indigenous competitors. If it is part of a larger international organization, the foreign MNE may be able to draw on funds generated elsewhere to subsidize its costs in the host market, which could drive indigenous companies out of business and allow the firm to monopolize the market. Once the market is monopolized, the foreign MNE could raise prices above those that would prevail in competitive markets, with harmful effects on the economic welfare of the host nation. This concern tends to be greater in countries that have few large firms of their own (generally, less developed countries). It tends to be a relatively minor concern in most advanced industrialized nations.

In general, while FDI in the form of greenfield investments should increase competition, it is less clear that this is the case when the FDI takes the form of acquisition of an established enterprise in the host nation. Because an acquisition does not result in a net increase in the number of players in a market, the effect on competition may be neutral. When a foreign investor acquires two or more firms in a host country and subsequently merges them, the effect may be to reduce the level of competition in that market, create monopoly power for the foreign firm, reduce consumer choice, and raise prices. For example, in India, Hindustan Lever Ltd., the Indian subsidiary of Unilever, acquired its main local rival, Tata Oil Mills, to assume a dominant position in the bath soap (75 percent) and detergents (30 percent) markets. Hindustan Lever also acquired several local companies in other markets, such as the ice cream makers Dollops, Kwality, and Milkfood. By combining these companies, Hindustan Lever's share of the Indian ice cream market went from zero to 74 percent.³⁶ However, although such cases are of obvious concern, there is little evidence that such developments are widespread. In many nations, domestic competition authorities have the right to review and block any mergers or acquisitions that they view as having a detrimental impact on competition. If such institutions are operating effectively, this should be sufficient to make sure that foreign entities do not monopolize a country's markets.

Adverse Effects on the Balance of Payments The possible adverse effects of FDI on a host country's balance-of-payments position are twofold. First, set against the initial

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capital inflow that comes with FDI must be the subsequent outflow of earnings from the foreign subsidiary to its parent company. Such outflows show up as capital outflow on balance-of-payments accounts. Some governments have responded to such outflows by restricting the amount of earnings that can be repatriated to a foreign subsidiary's home country. A second concern arises when a foreign subsidiary imports a substantial number of its inputs from abroad, which results in a debit on the current account of the host country's balance of payments. One criticism leveled against Japanese-owned auto assembly operations in the United States, for example, is that they tend to import many component parts from Japan. Because of this, the favorable impact of this FDI on the current account of the U.S. balance-of-payments position may not be as great as initially supposed. The Japanese auto companies responded to these criticisms by pledging to purchase 75 percent of their component parts from U.S.-based manufacturers (but not necessarily U.S.-owned manufacturers). When the Japanese auto company Nissan invested in the United Kingdom, Nissan responded to concerns about local content by pledging to increase the proportion of local content to 60 percent and subsequently raising it to more than 80 percent.

Possible Effects on National Sovereignty and Autonomy Some host governments worry that FDI is accompanied by some loss of economic independence. The concern is that key decisions that can affect the host country's economy will be made by a foreign parent that has no real commitment to the host country and over which the host country's government has no real control. Most economists dismiss such concerns as groundless and irrational. Political scientist Robert Reich has noted that such concerns are the product of outmoded thinking because they fail to account for the growing interdependence of the world economy.³⁷ In a world in which firms from all advanced nations are increasingly investing in each other's markets, it is not possible for one country to hold another to "economic ransom" without hurting itself.

HOME-COUNTRY BENEFITS The benefits of FDI to the home (source) country arise from three sources. First, the home country's balance of payments benefits from the inward flow of foreign earnings. FDI can also benefit the home country's balance of payments if the foreign subsidiary creates demands for home-country exports of capital equipment, intermediate goods, complementary products, and the like.

Second, benefits to the home country from outward FDI arise from employment effects. As with the balance of payments, positive employment effects arise when the foreign subsidiary creates demand for home-country exports. Thus, Toyota's investment in auto assembly operations in Europe has benefited both the Japanese balance-of-payments position and employment in Japan, because Toyota imports some component parts for its European-based auto assembly operations directly from Japan.

Third, benefits arise when the home-country MNE learns valuable skills from its exposure to foreign markets that can subsequently be transferred back to the home country. This amounts to a reverse resource-transfer effect. Through its exposure to a foreign market, an MNE can learn about superior management techniques and superior product and process technologies. These resources can then be transferred back to the home country, contributing to the home country's economic growth rate.³⁸

HOME-COUNTRY COSTS Against these benefits must be set the apparent costs of FDI for the home (source) country. The most important concerns center on the balance-of-payments and employment effects of outward FDI. The home



Is FDI a Form of Colonialism or Ethical Investing?

Some critics of globalization suggest that FDI is an advanced form of colonialism that destroys local cultures in developing countries. What these critics say may have some limited validity, but it isn't the whole picture. Take Freeport McMoRan, a U.S.-based mining company with operations in West Papua (the former Irian Jaya), Indonesia, where the world's largest gold, mineral, and copper reserves have been found. Freeport formed a joint venture with the Indonesian government to mine a concession, an isolated tract of land the size of Massachusetts on a remote island, half of which is the country of Papua New Guinea. Freeport has brought education, Internet connections, world-class health care, and the modern world to the isolated local tribes in West Papua, nomadic peoples who wear loincloths and hunt in the forest. Their traditional, subsistence way of life is threatened, while at the same time, they gain from their share of the operation's profits, from their increased health care and education, and from local employment opportunities with FCX. Is this colonialism or a kind of ethical investing?

Source: www.corpwatch.org.

country's balance of payments may suffer in three ways. First, the balance of payments suffers from the initial capital outflow required to finance the FDI. This effect, however, is usually more than offset by the subsequent inflow of foreign earnings. Second, the current account of the balance of payments suffers if the purpose of the foreign investment is to serve the home market from a low-cost production location. Third, the current account of the balance of payments suffers if the FDI is a substitute for direct exports. Thus, insofar as Toyota's assembly operations in the United States are intended to substitute for direct exports from Japan, the current account position of Japan will deteriorate.

With regard to employment effects, the most serious concerns arise when FDI is seen as a substitute for domestic production. This was the case with Toyota's investments in the United States and Europe. One obvious result of such FDI is reduced home-country employment. If the labor market in the home country is already tight, with little unemployment, this concern may not be that great. However, if the home country is suffering from unemployment, concern about the export of jobs may arise. For example, one objection frequently raised by U.S. labor leaders to the free trade pact among the United States, Mexico, and Canada (see Chapter 9) is that the United States would lose hundreds of thousands of jobs as U.S. firms invest in Mexico to take advantage of cheaper labor and then export back to the United States.³⁹

INTERNATIONAL TRADE THEORY AND FDI When assessing the costs and benefits of FDI to the home country, keep in mind the lessons of international trade theory (see Chapter 6). International trade theory tells us that home-country concerns about the negative economic effects of offshore production may be misplaced. The term **offshore production** refers to FDI undertaken to serve the home market. An example would be U.S. automobile companies investing in auto parts production facilities in Mexico. Far from reducing home-country employment, such FDI may actually stimulate economic growth (and hence employment) in the home country by freeing home-country resources to concentrate on activities where the home country has a comparative advantage. In addition, home-country consumers benefit if the price of the particular product falls as a result of the FDI. Also, if a company were prohibited from making such investments on the grounds of negative employment effects while its international competitors reaped the benefits of low-cost production locations, it would undoubtedly lose market share to its international competitors. Under such a scenario, the adverse long-run economic effects for a country would probably outweigh the relatively minor balance-of-payments and employment effects associated with offshore production.

Government Policy Instruments and FDI

We have reviewed the costs and benefits of FDI from the perspective of both home country and host country. We now turn our attention to the policy instruments that home (source) countries and host countries can use to regulate FDI.

HOME-COUNTRY POLICIES Through their choice of policies, home countries can both encourage and restrict FDI by local firms. We look at policies designed to encourage outward FDI first. These include foreign risk insurance, capital assistance, tax incentives, and political pressure. Then we look at policies designed to restrict outward FDI.

Encouraging Outward FDI Many investor nations now have government-backed insurance programs to cover major types of foreign investment risk. The types of risks insurable through these programs include the risks of expropriation (nationalization), war losses, and the inability to transfer profits back home. Such programs are particularly useful in encouraging firms to undertake investments in politically unstable countries.⁴⁰ In addition, several advanced countries also have special funds or banks that make government loans to firms wishing to invest in developing countries. As a further incentive to encourage domestic firms to undertake FDI, many countries have eliminated double taxation of foreign income (i.e., taxation of income in both the host country and the home country). Last, and perhaps most significant, a number of investor countries (including the United States) have used their

offshore production

FDI undertaken to serve the home market.

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Explain the range of policy instruments that governments use to influence FDI.

political influence to persuade host countries to relax their restrictions on inbound FDI. For example, in response to direct U.S. pressure, Japan relaxed many of its formal restrictions on inward FDI. In response to further U.S. pressure, Japan relaxed its informal barriers to inward FDI. One beneficiary of this trend was Toys "R" Us, which, after five years of intensive lobbying by company and U.S. government officials, opened its first retail stores in Japan in December 1991. By 2012, Toys "R" Us had more than 170 stores in Japan, and its Japanese operation, in which Toys "R" Us retained a controlling stake, had a listing on the Japanese stock market. Interestingly, although Toys "R" Us ceased operations in the United States in 2017 due to bankruptcy, it continues to operate in Japan.

Restricting Outward FDI Virtually all investor countries, including the United States, have exercised some control over outward FDI from time to time. One policy has been to limit capital outflows out of concern for the country's balance of payments. From the early 1960s until 1979, for example, Britain had exchange-control regulations that limited the amount of capital a firm could take out of the country. Although the main intent of such policies was to improve the British balance of payments, an important secondary intent was to make it more difficult for British firms to undertake FDI.

In addition, countries have occasionally manipulated tax rules to try to encourage their firms to invest at home. The objective behind such policies is to create jobs at home rather than in other nations. At one time, Britain adopted such policies. The British advanced corporation tax system taxed British companies' foreign earnings at a higher rate than their domestic earnings. This tax code created an incentive for British companies to invest at home.

Finally, countries sometimes prohibit national firms from investing in certain countries for political reasons. Such restrictions can be formal or informal. For example, formal U.S. rules prohibited U.S. firms from investing in countries such as Cuba and Iran, whose political ideology and actions are judged to be contrary to U.S. interests. Similarly, during the 1980s, informal pressure was applied to dissuade U.S. firms from investing in South Africa. In this case, the objective was to pressure South Africa to change its apartheid laws, which happened during the early 1990s.

HOST-COUNTRY POLICIES Host countries adopt policies designed both to restrict and to encourage inward FDI. As noted earlier in this chapter, political ideology has determined the type and scope of these policies in the past. In the last decade of the twentieth century, many countries moved quickly away from adhering to some version of the radical stance and prohibiting much FDI toward a situation where a combination of free market objectives and pragmatic nationalism took hold.

Encouraging Inward FDI It is common for governments to offer incentives to foreign firms to invest in their countries. Such incentives take many forms, but the most common are tax concessions, low-interest loans, and grants or subsidies. Incentives are motivated by a desire to gain from the resource-transfer and employment effects of FDI. They are also motivated by a desire to capture FDI away from other potential host countries. For example, in the mid-1990s, the governments of Britain and France competed with each other on the incentives they offered Toyota to invest in their respective countries. In the United States, state governments often compete with each other to attract FDI. For example, Kentucky offered Toyota an incentive package worth \$147 million to persuade it to build its U.S. automobile assembly plants there. The package included tax breaks, new state spending on infrastructure, and low-interest loans.⁴¹

Restricting Inward FDI Host governments use a wide range of controls to restrict FDI in one way or another. The two most common are ownership restraints and performance requirements. Ownership restraints can take several forms. In some countries, foreign companies are excluded from specific fields. They are excluded from tobacco and mining in Sweden and from the development of certain natural resources in Brazil, Finland, and Morocco. In other industries, foreign ownership may be permitted although a significant proportion of the equity of the subsidiary must be owned by local investors. Foreign ownership is restricted to 25 percent or less of an

airline in the United States. In India, foreign firms were prohibited from owning media businesses until 2001, when the rules were relaxed, allowing foreign firms to purchase up to 26 percent of an Indian newspaper.

The rationale underlying ownership restraints seems to be twofold. First, foreign firms are often excluded from certain sectors on the grounds of national security or competition. Particularly in less developed countries, the feeling seems to be that local firms might not be able to develop unless foreign competition is restricted by a combination of import tariffs and controls on FDI. This is a variant of the infant industry argument discussed in Chapter 7.

Second, ownership restraints seem to be based on a belief that local owners can help maximize the resource-transfer and employment benefits of FDI for the host country. Until the 1980s, the Japanese government prohibited most FDI but allowed joint ventures between Japanese firms and foreign MNEs if the MNE had a valuable technology. The Japanese government clearly believed such an arrangement would speed up the subsequent diffusion of the MNE's valuable technology throughout the Japanese economy.

Performance requirements can also take several forms. Performance requirements are controls over the behavior of the MNE's local subsidiary. The most common performance requirements are related to local content, exports, technology transfer, and local participation in top management. As with certain ownership restrictions, the logic underlying performance requirements is that such rules help maximize the benefits and minimize the costs of FDI for the host country. Many countries employ some form of performance requirements when it suits their objectives. However, performance requirements tend to be more common in less developed countries than in advanced industrialized nations.⁴²

INTERNATIONAL INSTITUTIONS AND THE LIBERALIZATION OF FDI

Until the 1990s, there was no consistent involvement by multinational institutions in the governing of FDI. This changed with the formation of the World Trade Organization in 1995. The WTO embraces the promotion of international trade in services. Because many services have to be produced where they are sold, exporting is not an option (e.g., one cannot export McDonald's hamburgers or consumer banking services). Given this, the WTO has become involved in regulations governing FDI. As might be expected for an institution created to promote free trade, the thrust of the WTO's efforts has been to push for the liberalization of regulations governing FDI, particularly in services. Under the auspices of the WTO, two extensive multinational agreements were reached in 1997 to liberalize trade in telecommunications and financial services. Both these agreements contained detailed clauses that require signatories to liberalize their regulations governing inward FDI, essentially opening their markets to foreign telecommunications and financial services companies. The WTO has had less success trying to initiate talks aimed at establishing a universal set of rules designed to promote the liberalization of FDI. Led by Malaysia and India, developing nations have so far rejected efforts by the WTO to start such discussions.

Focus on Managerial Implications

FDI AND GOVERNMENT POLICY Several implications for business are inherent in the material discussed in this chapter. In this section, we deal first with the implications of the theory and then turn our attention to the implications of government policy.

The Theory of FDI The implications of the theories of FDI for business practice are straightforward. First, the location-specific advantages argument associated with John Dunning does help explain the *direction* of FDI. However, the location-specific advantages argument does not explain *why* firms prefer FDI to licensing or to exporting. In this regard, from both an explanatory and a business perspective, perhaps the most useful theories are those that focus on the limitations of exporting and licensing—that is, internalization theories. These

theories are useful because they suggest that exporting is not an attractive option for firms in countries with high trade barriers. FDI is not an attractive option for firms in countries with high trade barriers because it is more costly and more risky than exporting. Firms for which licensing is a more attractive option are those that (1) have valuable know-how that is difficult to transfer, (2) need tight control over their operations in the host country, and (3) a firm's performance requirements are more important than its need for local content.

1. High-technology industries in which licensing is important and licensing is difficult.
2. Global oligopolies in which firms need to maintain tight control over their operations in the host country.
3. Industries in which coordinated attacks are common and tight control over operations is important (e.g., around the globe to maximize value).

How High
Transportation
Costs are

Is Knowledge
Amenable to
Licensing

Is Tight
Foreign
Requirements

Can Knowledge
Protect
Licensing

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08-6

Discuss the implications for managers of the theory and government policies related to FDI.

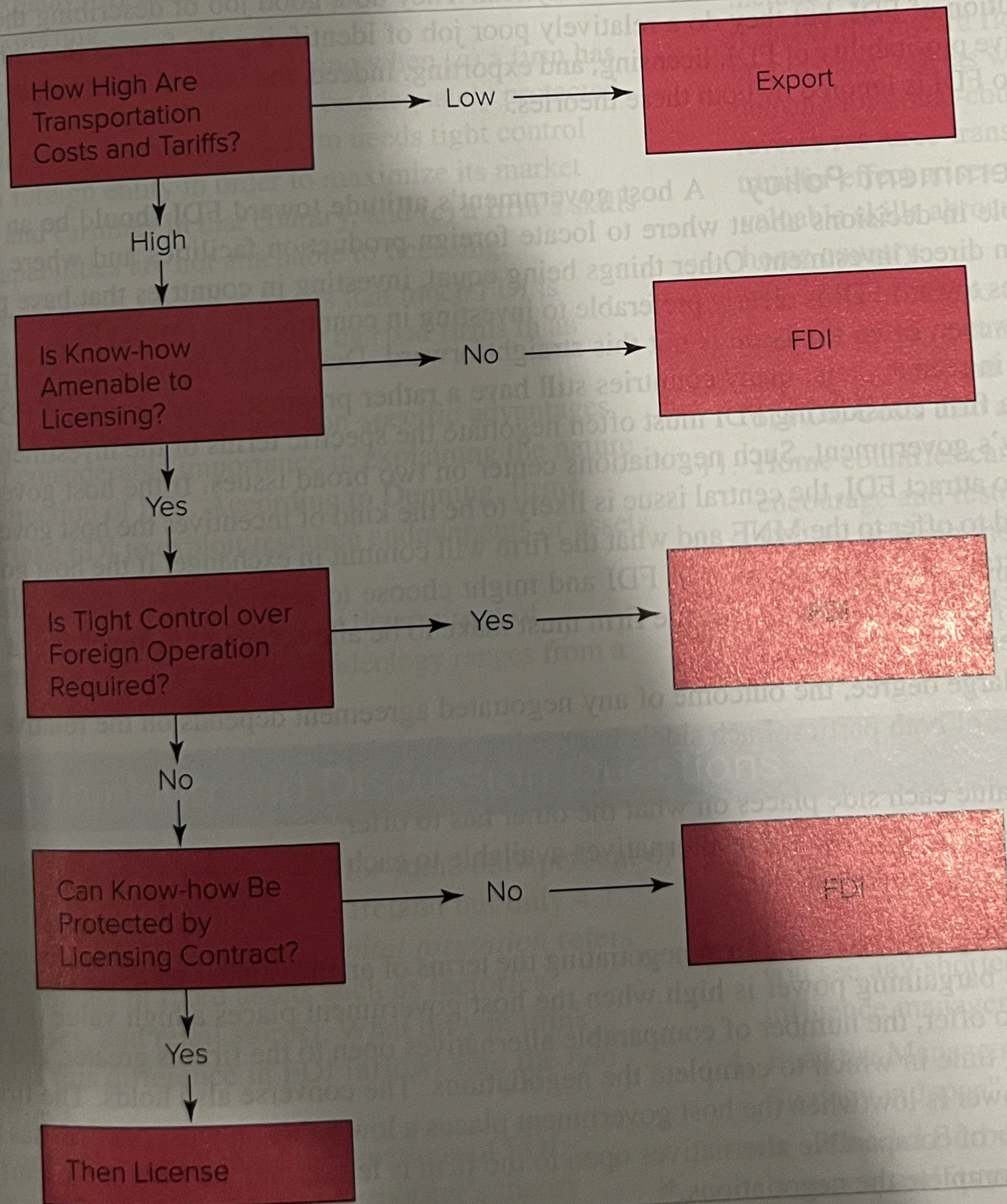
theories are useful because they identify with some precision how the relative profitability of foreign direct investment, exporting, and licensing varies with circumstances. The theories suggest that exporting is preferable to licensing and FDI so long as transportation costs are minor and trade barriers are trivial. As transportation costs or trade barriers increase, exporting becomes unprofitable, and the choice is between FDI and licensing. Because FDI is more costly and more risky than licensing, other things being equal, the theories argue that licensing is preferable to FDI. Other things are seldom equal, however. Although licensing may work, it is not an attractive option when one or more of the following conditions exist: (1) the firm has valuable know-how that cannot be adequately protected by a licensing contract, (2) the firm needs tight control over a foreign entity to maximize its market share and earnings in that country, and (3) a firm's skills and capabilities are not amenable to licensing. Figure 8.4 presents these considerations as a decision tree.

Firms for which licensing is not a good option tend to be clustered in three types of industries:

1. High-technology industries in which protecting firm-specific expertise is of paramount importance and licensing is hazardous.
2. Global oligopolies, in which competitive interdependence requires that multinational firms maintain tight control over foreign operations so that they have the ability to launch coordinated attacks against their global competitors.
3. Industries in which intense cost pressures require that multinational firms maintain tight control over foreign operations (so that they can disperse production to locations around the globe where factor costs are most favorable in order to minimize costs and maximize value).

8.4 FIGURE

A decision framework.



Although empirical evidence is limited, the majority of studies seem to support these conjectures.⁴³ In addition, licensing is not a good option if the competitive advantage of a firm is based upon managerial or marketing knowledge that is embedded in the routines of the firm or the skills of its managers and that is difficult to codify in a "book of blueprints." This would seem to be the case for firms based in a fairly wide range of industries.

Firms for which licensing is a good option tend to be in industries whose conditions are opposite to those just specified. That is, licensing tends to be more common, and more profitable, in fragmented, low-technology industries in which globally dispersed manufacturing is not an option. A good example is the fast-food industry. McDonald's has expanded globally by using a franchising strategy. Franchising is essentially the service-industry version of licensing, although it normally involves much longer-term commitments than licensing. With franchising, the firm licenses its brand name to a foreign firm in return for a percentage of the franchisee's profits. The franchising contract specifies the conditions that the franchisee must fulfill if it is to use the franchisor's brand name. Thus, McDonald's allows foreign firms to use its brand name so long as they agree to run their restaurants on exactly the same lines as McDonald's restaurants elsewhere in the world. This strategy makes sense for McDonald's because (1) like many services, fast food cannot be exported; (2) franchising economizes the costs and risks associated with opening up foreign markets; (3) unlike technological know-how, brand names are relatively easy to protect using a contract; (4) there is no compelling reason for McDonald's to have tight control over franchisees; and (5) McDonald's know-how, in terms of how to run a fast-food restaurant, is amenable to being specified in a written contract (e.g., the contract specifies the details of how to run a McDonald's restaurant).

Finally, it should be noted that the product life-cycle theory and Knickerbocker's theory of FDI tend to be less useful from a business perspective. The problem with these two theories is that they are descriptive rather than analytical. They do a good job of describing the historical evolution of FDI, but they do a relatively poor job of identifying the factors that influence the relative profitability of FDI, licensing, and exporting. Indeed, the issue of licensing as an alternative to FDI is ignored by both these theories.

Government Policy A host government's attitude toward FDI should be an important variable in decisions about where to locate foreign production facilities and where to make a foreign direct investment. Other things being equal, investing in countries that have permissive policies toward FDI is clearly preferable to investing in countries that restrict FDI.

However, often the issue is not this straightforward. Despite the move toward a free market stance in recent years, many countries still have a rather pragmatic stance toward FDI. In such cases, a firm considering FDI must often negotiate the specific terms of the investment with the country's government. Such negotiations center on two broad issues. If the host government is trying to attract FDI, the central issue is likely to be the kind of incentives the host government is prepared to offer to the MNE and what the firm will commit in exchange. If the host government is uncertain about the benefits of FDI and might choose to restrict access, the central issue is likely to be the concessions that the firm must make to be allowed to go forward with a proposed investment.

To a large degree, the outcome of any negotiated agreement depends on the relative bargaining power of both parties. Each side's bargaining power depends on three factors:

- The value each side places on what the other has to offer.
- The number of comparable alternatives available to each side.
- Each party's time horizon.

From the perspective of a firm negotiating the terms of an investment with a host government, the firm's bargaining power is high when the host government places a high value on what the firm has to offer, the number of comparable alternatives open to the firm is greater, and the firm has a long time in which to complete the negotiations. The converse also holds. The firm's bargaining power is low when the host government places a low value on what the firm has to offer, the number of comparable alternatives open to the firm is fewer, and the firm has a short time in which to complete the negotiations.⁴⁴