

FOREIGN DIRECT INVESTMENT (FDI)

Foreign direct investment is investment made by a foreign individual or company in productive capacity of another country. It is the movement of capital across national frontiers in a manner that grants the investor control over the acquired asset.

Foreign Direct Investment is a component of a country's national financial accounts. It is investment of foreign assets into domestic structures, equipment, and organizations. It does not include foreign investment into the stock markets. Foreign direct investment is thought to be more useful to a country than investments in the equity of its companies because equity investments are potentially "hot money" which can leave at the first sign of trouble, whereas FDI is durable and generally useful whether things go well or badly.

Foreign direct investment (FDI) is defined as "investment made to acquire lasting interest in enterprises operating outside of the economy of the investor." The FDI relationship consists of a parent enterprise and a foreign affiliate which together form a transnational corporation (TNC). In order to qualify as FDI the investment must afford the parent enterprise control over its foreign affiliate. The UN defines control in this case as owning 10% or more of the ordinary shares or voting power of an incorporated firm or its equivalent for an unincorporated firm; lower ownership shares are known as portfolio investment.

Types of FDI

By Direction:

- **Inward**
 - Inward foreign direct investment is when foreign capital is invested in local resources.
 - Inward FDI is encouraged by: Tax breaks, subsidies, low interest loans, grants, lifting of certain restrictions. The thought is that the long term gain is worth short term loss of income.
- **Outward**
 - Outward foreign direct investment, sometimes called "direct investment abroad", is when local capital is invested in foreign resources.
 - Outward FDI is encouraged by: Government-backed insurance to cover risk
 - Outward FDI is restricted by: Tax incentives or disincentives on firms that invest outside of the home country or on repatriated profits

By Target:

- **Greenfield Investment:** It is the direct investment in new facilities or the expansion of existing facilities. It is the principal mode of investing in developing countries. Greenfield investments are the primary target of a host nation's promotional efforts because they create new production capacity and jobs, transfer technology and know-how, and can lead to linkages to the global marketplace. The Organization for International Investment cites the benefits of Greenfield investment (or in sourcing) for regional and national economies to include increased employment (often at higher wages than domestic firms); investments in research and development; and additional capital investments. Criticism of the efficiencies obtained from Greenfield investments include the loss of market share for competing domestic firms.

Another criticism of Greenfield investment is that profits are perceived to bypass local economies, and instead flow back entirely to the multinational's home economy. Critics contrast this to local industries whose profits are seen to flow back entirely into the domestic economy.

- **Mergers and Acquisitions:** It occurs when a transfer of existing assets from local firms takes place. Transfers of existing assets from local firms to foreign firms takes place; the primary type of FDI. Cross-border mergers occur when the assets and operation of firms from different countries are combined to establish a new legal entity. Cross-border acquisitions occur when the control of assets and operations is transferred from a local to a foreign company, with the local company becoming an affiliate of the foreign company. Unlike Greenfield investment, acquisitions provide no long term benefits to the local economy-- even in most deals the owners of the local firm are paid in stock from the acquiring firm, meaning that the money from the sale could never reach the local economy. Nevertheless, mergers and acquisitions are a significant form of FDI and until around 1997, accounted for nearly 90% of the FDI flow into the United States. Mergers are the most common way for multinationals to do FDI.

Horizontal FDI

Investment in the same industry abroad as a firm operates in at home.

Vertical FDI

Backward Vertical FDI

Where an industry abroad provides inputs for a firm's domestic production process.

Forward Vertical FDI

Where an industry abroad sells the outputs of a firm's domestic production.

By Motive

FDI can also be categorized based on the motive behind the investment from the perspective of the investing firm:

Resource-Seeking

Investments which seek to acquire factors of production that are more efficient than those obtainable in the home economy of the firm. In some cases, these resources may not be available in the home economy at all (e.g. cheap labor and natural resources). This typifies FDI into developing countries, for example seeking natural resources in the Middle East and Africa, or cheap labor in Southeast Asia and Eastern Europe.

Market-Seeking

Investments which aim at either penetrating new markets or maintaining existing ones. FDI of this kind may also be employed as defensive strategy; it is argued that businesses are more likely to be pushed towards this type of investment out of fear of losing a market rather than discovering a new one. This type of FDI can be characterized by the foreign Mergers and Acquisitions in the 1980's by Accounting, Advertising and Law firms.

Efficiency-Seeking

Investments which firms hope will increase their efficiency by exploiting the benefits of economies of scale and scope, and also those of common ownership. It is suggested that this type of FDI comes after either resource or market seeking investments have been realized, with the expectation that it further increases the profitability of the firm. Typically, this type of FDI is mostly widely practiced between developed economies; especially those within closely integrated markets (e.g. the EU).

Strategic-Asset-Seeking

A tactical investment to prevent the loss of resource to a competitor. Easily compared to that of the oil producers, whom may not need the oil at present, but look to prevent their competitors from having it.

Forbidden Territories:

FDI is not permitted in the following industrial sectors:

- Arms and ammunition.
- Atomic Energy.
- Railway Transport.
- Coal and lignite.
- Mining of iron, manganese, chrome, gypsum, sulphur, gold, diamonds, copper, zinc.

Importance of FDI:

A direct foreign investment allows companies to accomplish several tasks which include:

- Avoiding foreign government pressure for local production.
- Circumventing trade barriers, hidden and otherwise.
- Making the move from domestic export sales to a locally-based national sales office.
- Capability to increase total production capacity.
- Opportunities for co-production, joint ventures with local partners, joint marketing arrangements, licensing, etc;

Basic requirements for companies considering a foreign investment:

Depending on the industry sector and type of business, a foreign direct investment may be an attractive and viable option. With rapid globalization of many industries and vertical integration rapidly taking place on a global level, at a minimum a firm needs to keep abreast of global trends in their industry. From a competitive standpoint, it is important to be aware of whether a company's competitors are expanding into a foreign market and how they are doing that. At the same time, it also becomes important to monitor how globalization is affecting domestic clients. Often, it becomes imperative to follow the expansion of key clients overseas if an active business relationship is to be maintained.

New market access is also another major reason to invest in a foreign country. At some stage, export of product or service reaches a critical mass of amount and cost where foreign production or location begins to be more cost effective. Any decision on investing is thus a combination of a number of key factors including:

- Assessment of internal resources,
- Competitiveness,
- Market analysis
- Market expectations.

From an internal resources standpoint, does the firm have senior management support for the investment and the internal management and system capabilities to support the set up time as well as ongoing management of a foreign subsidiary? Has the company conducted extensive market research involving both the industry, product and local regulations governing foreign investment which will set the broad market parameters for any investment decision? Is there a realistic assessment in place of what resource utilization the investment will entail? Has information on local industry and foreign investment regulations, incentives, profit retention, financing, distribution, and other factors been completely analyzed to determine the most viable vehicle for entering the market (Greenfield, acquisition, merger, joint venture, etc.)? Has a plan been drawn up with reasonable expectations for expansion into the market through that local vehicle? If the foreign economy, industry or foreign investment climate is characterized by government regulation, have the relevant government agencies been contacted and concurred? Have political risk and foreign exchange risk been factored into the business plan?

The Advantages of FDI:

- Jumping the tariff wall (and other non- tariff barriers)
- Securing access to minerals located in the host country
- Lower wage in host developing countries for labor.
- Infrastructure and technology transfer
- Increased Productive efficiency due to competition from multinational subsidiaries
- Improvement in the quality of the factors of production
- Inflow in Investment funds (Benefits to the balance of payments)
- Increase in Exports
- Increase in savings and Investment
- Inflow of equipment
- Technology
- Scarce human capital
- Financial resources

Disadvantages:

- More costly travel/communications abroad.
- Not having a close familiarity with local business tax laws, business scene in general, and
- Various government regulations.
- There are risks such as exchange rate changes, expropriation by the government, and other actions that can be taken against them.
- Language and culture differences
- Higher wages/benefits must be paid to the personnel going abroad.
- Foreign investors are exploiting workers in poor countries and initiating a "race to the bottom" in environmental and labor standards.

The extent to which foreign investment can help or harm the poor largely depend upon what governments and firms choose to do. Many multinational companies voluntarily adopt environmental, social, and governance practices designed precisely to guard against abuse of the environment and the workforce when they invest in developing countries. But governments in developing countries should facilitate and encourage the transfer of this social and environmental practice and maximize the benefits from FDI. A Government keen to ensure FDI is truly pro-poor should follow the following points.

- Clear the way for free entry and exit in domestic markets by creating competition in product and labor markets and incentives to upgrade productivity and to prevent exploitation of consumers and workers.
- Promote education, worker training, and infrastructure to increase domestic capacity to absorb and diffuse good new practices introduced by foreign investors.
- Create a policy framework that encourages the adoption of appropriate social and environmental standards in corporate practices.

Investment in India

Government of India recognizes the key role of Foreign Direct Investment (FDI) in economic development not only as an addition to domestic capital but also as an important source of technology and global best practices. The Government of India has put in place a liberal and transparent FDI policy.

FDI up to 100% is allowed under the automatic route in most sectors/activities. FDI policy in India is reckoned to be among the most liberal in emerging economies. FDI Policy permits FDI up to 100 % from foreign/NRI investor without prior approval in most of the sectors including the services sector under automatic route. FDI in sectors/activities under automatic route does not require any prior approval either by the Government or the RBI.

- India is now the third most favored destination for Foreign Direct Investment (FDI), behind China and the USA, according to an AT Kearney survey that tracked investor confidence among global executives to determine their order of preferences.
- India's share of global FDI flows rose from 1.8 per cent in 1996 to 2.2 per cent in 1997.
- FDI in India in 1997-98 was lower at U.S.\$ 5,025 million compared to U.S.\$ 6,008 million in 1996-97 because of a decline in portfolio investment. Although foreign direct investment (FDI) increased by 18.6 per cent from U.S.\$ 2,696 million in 1996-97 to U.S.\$ 3,197 million in 1997- 98
- International developments continue to affect capital flows into India in 1998-99 as well.
- Mauritius, as in the previous two years, was the dominant source of FDI inflows in 1997- 98. U.S.A. and S. Korea were, respectively, the second and third largest sources of FDI.
- S. Korea increased its flow of investment in India from a meager U.S.\$ 6.3 million in 1996-97 (0.2 per cent of total FDI) to U.S.\$ 333.1 million in 1997-98 (10.4 per cent share).
- There has been a sharp rise in the number of FDI's approved in 2004.
- During the first seven months of 2004, between January and July, Rs 5,220 crore worth of FDI was approved.
- Almost a third share of the investment in India is by NRI.
- According to the latest Reserve Bank of India figures, outflows through various NRI deposits schemes amounted to \$903 million since May 2004, as against net inflows of \$1.2 billion in the corresponding period last year.