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Foreign Direct Investment

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Foreign direct investment (FDI) refers to firms' investments in foreign countries, where new production and other physical facilities are built in order to conduct new business operations, for example the selling and servicing of the firms' products.

FDI projects will encounter many international business (IB) risks; these include political and economic risks, cultural risks, and foreign exchange risks. For example, many western oil companies recently ceased operation in the war-torn African and Middle East countries and have taken huge financial losses; and western exporters to Russia have similarly suffered losses because of the recent rapid decline in the value of the Russian ruble against western currencies. Firms from two countries with different cultures sometimes find it financially profitable to form a jointly owned firm; this is often termed an "international joint venture" (IJV). But an IJV may suffer cultural risk. For example, intercountry cultural differences have been a source of failure for large IJVs like Daimler-Chrysler (*Economist*, 2000). The presence of these risks requires the firms that invest in FDIs to generate much higher returns from FDIs than from domestic investments.

One classical business decision problem for firms that consider resorting to FDIs is how to organize their ownership structures. In particular, should they create a fully owned subsidiary (SUB), or should they find a local partner and form an IJV? In general, a foreign investing firm's ownership share is thought to reflect its overall bargaining power in the market. Research also suggests that firms investing in FDIs are typically driven by their superior capacity in research and development (R&D), management, and endowments in natural resources ([Daniels, Radebaugh, and Sullivan, 2013](#)) and hence they often choose to have SUBs as their preferred ownership form.

In general, the firms with the most bargaining power choose SUBs rather than IJVs, since SUBs allow foreign parents to protect their intellectual property rights (IPR) better and make management decisions faster than IJVs ([Farge and Wells, 1982](#); [Nakamura, 2005](#)). IJVs are established by foreign firms in need of local partners to help them run their FDI operations and by local firms that seek to learn about foreign management practices and

technologies. As IJVs mature, their partner firms' needs and circumstances change over time, eroding the original reasons for maintaining these IJVs. Hence IJVs are generally unstable and often end up with one partner buying out the other's rights ([Nakamura, Shaver, and Yeung, 1996](#)). For this reason, IJVs have been likened to marriages.

IJVs face the risk of potential spillovers of their technology to their IJV partners. When the host country requires FDIs to be jointly owned with local firms and the local partner firms to have access to foreign parent firm technologies (as China does), then foreign firms face decision problems of whether or not to go ahead with establishing FDIs in that country and, if they do, of how they should protect their IPRs against potentially competing local partner firms, including host country government firms.

While firms invest globally for their growth, a large fraction of the FDI flows take place among developed countries, where the protection of IPRs, contracts, and other legal rights related to FDIs is well established, IB risks are limited and better understood, and the purchasing power is high ([OECD, 2014](#)). While powerful western firms with much bargaining power can establish SUBs in low-cost countries, owning FDIs still comes with significant IB risks, which may jeopardize the potential returns.

Some profitable western firms – such as Apple, Arm, Qualcomm, and Nike – have introduced foreign operations without ownership, which still realize most of the advantages that SUBs provide. While their industries vary (though most are in the semiconductor business), these western firms (called “fabless firms”) were able to have foreign firms set up for them production operations, mostly assembly, in low-cost countries. Although they outsource production to low-cost foreign assembly firms, western firms still control and monitor designs by selecting the makers of main parts, the production processes, and the IPR management. For example, Apple outsources assembly operations to the Taiwanese Foxconn company, which assembles Apple's iPhones, iPads and other products in China. Foxconn has similar outsourcing contracts with Apple's competitors. Proper IPR management by Foxconn is essential for these multiple outsourcing contracts to be viable over time.

Western fabless firms suffer little from the ownership risk of FDI facilities while they benefit from focusing on what they regard as the most profitable parts of firm operation: design, R&D, marketing and sales, and other head office functions. From their perspective, production is not profitable, and hence is to be outsourced. For FDIs without ownership to be successful, fabless firms need reliable and low-cost foreign assemblers such as Foxconn, which can produce efficiently while protecting multiple firms' IPR.

Since fabless firms do not own fixed facilities, they can be footloose and can shift production among nations for reasons related to costs, as Nike shifted primary production sites over time from Japan to Korea to China to Vietnam, and so on. Outsourcing contracts involving relatively low-tech products (e.g., appliances) were known for a long time, but current trends to outsource production processes involving advanced technology products appear to have opened up new opportunities for firms that contemplate profitable foreign investment.

The impacts of FDIs on wages, employment, and economic development in host countries have attracted much research. In developed countries, the primary benefits of FDIs consist of newly created employment. However, in developing countries there are additional benefits, such as technology transfer and economic development. China's policy of forcing the transfer of technology from foreign parent firms to local partners through IJV agreements has been effective, though such technology spillover benefits seem to be mostly limited to the large-scale automated assembly operations of the semiconductor and other manufacturing industries.

The impacts of FDIs in low-wage countries on home-country wages and employment in the investing firms have been generally negative, since these FDIs replaced old production operations at home without adding new and higher wage employment ([Freeman, 1995](#)). However, managing global FDIs requires the investing firms to

develop new management skills at home, and wage increases for these skill enhancements have been observed in the case of Japanese workers at home ([Hayami, Nakamura, and Nakamura, 2012](#)).

SEE ALSO: [Economic Development](#)

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