International Financial Accounting and Policy

Foreign Direct Investments & International Business

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Foreign Direct Investment

- What is FDI?
  - FDI is the net transfer of funds to purchase and acquire physical capital, such as factories and machines
    - E.g. Nissan a Japanese firm building a car factory in the UK
    - Nestle a Switzerland company setting up a manufacturing plant in New Zealand
- FDI Definition?
  - "Foreign direct investment are the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor.
  - It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments." (World Bank)

FDI net inflows / outflows
What is FDI net inflows / outflows?
FDI net inflows are the value of inward direct investment made by non-resident investors in the reporting economy. This is usually reported for a given year.
Inward investment stock
This is the total accumulated level of foreign direct investment in a country.

Reasons firms engage in FDI
Take advantage of lower labour costs in other countries
E.g. India is one of biggest recipients of FDI, where labour costs are much lower than in Developed Countries.
Take advantage of proximity to raw materials rather than transport them around the world.
Avoid tariff barriers and other non-tariff barriers to trade.
Reduce transport costs.
Eg: By producing cars in UK, Nissan has lower transport costs for selling to UK market.
Opportunities for using local knowledge to help tap into domestic markets.
Eg: By investing in a foreign country and working with local workers, a multinational can gain a better insight into what works well for local markets.

Advantages of FDI
- Capital inflows create higher output and jobs.
- Capital inflows can help finance a current account deficit.
- Long term capital inflows are more sustainable than short term portfolio inflows.
  - Eg. In a credit crunch, banks can easily withdraw portfolio investment, but capital investment is less prone to sudden withdrawals.
- Recipient country can benefit from improved knowledge and expertise of foreign multinational.
- Investment from abroad could lead to higher wages and improved working conditions,
  - Eg: The MNCs are conscious of their public image of working conditions in developing economies.

Potential Problems of FDI
- Gives multinationals controlling rights within foreign countries. Critics argue powerful MNCs can use their financial clout to influence local politics to gain favourable laws and regulations.
- FDI may be a convenient way to bypass local environmental laws. Developing countries may be tempted to compete on reducing environmental regulation to attract the necessary FDI.
- FDI does not always benefit recipient countries as it enables foreign multinationals to gain from ownership of raw materials, with little evidence of wealth being distributed throughout society.
- Multinationals have been criticised for poor working conditions in foreign factories
  - Eg: Apple's factories in China

Benefits of Multinational Corporations
• Create wealth and jobs around the world. Inward investment by multinationals offer much needed foreign currency for developing economies. They also create jobs.
• Their size and scale of operation enables them to benefit from economies of scale enabling lower average costs and prices for consumers.
• Large profits can be used for research & development.
- Oil exploration
- Drug manufacturers
• Ensure minimum standards. The success of multinationals is often because consumers like to buy goods and services where they can rely on minimum standards.

Criticisms of Multinational Corporations
• Companies are often interested in profit at the expense of the consumer. Multinational companies often have monopoly power which enables them to make excess profit.
• Their market dominance makes it difficult for local small firms to thrive.
• In developing economies, big multinationals can use their economies of scale to push local firms out of business.
• In the pursuit of profit, multinational companies often contribute to pollution and use of non renewable resources which is putting the environment under threat.
• MNCs have been criticised for using 'slave labour'

International Trade

International trade is the exchange of goods and services between countries. This type of trade gives rise to a world economy, in which prices, or supply and demand, affect and are affected by global events.

Advantages of International Trade

• Optimal use of natural resources:
- Each country can concentrate on production of those goods for which its resources are best suited. Wastage of resources is avoided.
• Availability of all types of goods:
- It enables a country to obtain goods which it cannot produce or which it is not producing due to higher costs, by importing at lower costs.
• Specialisation:
• Goods can be produced at a comparatively low cost due to advantages of division of labour.

Advantages of International Trade
• Advantages of large-scale production:
- Goods are produced not only for home consumption but for export to other countries also. Nations of the world can dispose of goods which they have in surplus in the international markets.
• Increase in efficiency:
- Due to international competition, the producers in a country attempt to produce better quality goods and at the minimum possible cost.
• Development of the means of transport and communication:
- International trade requires the best means of transport and communication.
• Exchange of technical know-how and establishment of new industries:
- Underdeveloped countries can establish and develop new industries with the machinery, equipment and technical know-how imported from developed countries.

Disadvantages of International Trade
• Impediment in the Development of Home Industries:
- It poses a threat to the survival of infant industries at home. Due to foreign competition and unrestricted imports, the upcoming industries in the country may collapse.
• Economic Dependence:
- The underdeveloped countries have to depend upon the developed ones for their economic development. Such reliance often leads to economic misus
• Political Dependence:
- International trade often encourages slavery. It impairs economic independence which endangers political dependence.
• Mis-utilisation of Natural Resources:
- Excessive exports may exhaust the natural resources of a country in a shorter span of time than it would have been otherwise.

Disadvantages of International Trade

- Import of Harmful Goods:
- Import of spurious drugs, luxury articles, etc. adversely affects the economy and well-being of the people.
- Storage of Goods:
- Eg: India has been exporting sugar to earn foreign trade exchange; hence the exalting prices of sugar in the country.
- Danger to International Peace:
- International trade gives an opportunity to foreign agents to settle down in the country which ultimately endangers its internal peace.

Factors Contributing to Rapid Growth of International Business

- Increase in and expansion of technology
- Liberalization of cross-border trade and resource movements
- Development of services that support international business
- Growing consumer pressures
- Increased global competition
- Changing political situations
- Expanded cross-national cooperation

Thank you!