Chapter 13

Direct Foreign Investment

Lecture Outline

Motives for Direct Foreign Investment (DFI)
  Revenue-Related Motives
  Cost-Related Motives
  Comparing Benefits of DFI Among Countries
  Comparing Benefits of DFI Over Time

Benefits of International Diversification
  Diversification Analysis of International Projects
  Diversification Among Countries

Decisions Subsequent to DFI

Host Government Views of DFI
  Incentives to Encourage DFI
  Barriers to DFI
  Government-Imposed Conditions to Engage in DFI

Impact of the Direct Foreign Investment Decision on an MNC’s Value
**Chapter Theme**

The main purpose of this chapter is to illustrate why MNCs often use DFI and to suggest the various factors involved in the DFI decision. The specifics involved in quantifying costs and benefits of DFI are discussed in the following chapter. Thus, this chapter should be covered in general terms as to the costs and benefits of DFI. The chapter implicitly suggests that each firm may benefit from DFI by capitalizing on some unique perceived advantages of the foreign market. Yet, all DFI decisions relate to the MNC’s overall risk and return objectives.

**Topics to Stimulate Class Discussions**

1. Why would a large advanced MNC consider DFI in some less developed country?

2. Assume that you produce plastic computer pieces for computer companies. The pieces require very little technology. Where would you like to establish DFI? (The point of this question is to force consideration of various characteristics that are incorporated in a DFI decision.)

3. What factors would be considered when deciding whether a subsidiary should reinvest earnings or remit them to the parent?

4. The DFI decision is related to marketing, finance, and management. What is the role of each area in the DFI decision? (This question is not explicitly covered in the text but allows students to consider the differences in disciplines as related to the broad corporate function of DFI.)

5. Do you think DFI is primarily intended to reduce production costs or increase sales? Discuss.

**POINT/COUNTER-POINT:**

**Should MNCs Avoid DFI in Countries with Liberal Child Labor Laws?**

POINT: Yes. An MNC should maintain its hiring standards, regardless of what country it is in. Even if a foreign country allows children to work, an MNC should not lower its standards. Although the MNC forgoes the use of low-cost labor, it maintains its global credibility.

COUNTER-POINT: No. An MNC will not only benefit its shareholders, but will create employment for some children who need support. The MNC can provide reasonable working conditions and perhaps may even offer educational programs for its employees.

WHO IS CORRECT? Use the Internet to learn more about this issue. Which argument do you support? Offer your own opinion on this issue.

ANSWER: This is a well-documented controversy which generates interesting discussion. Some students will likely support the point while others will support the counter-point. There are some obvious issues that an MNC would need to consider, such as:

- How old does an employee have to be?
- Should it attempt to hire older workers first?
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- What wage is reasonable for a child?
- Are there any child labor laws enforced by the country?

Answers to End of Chapter Questions

1. Motives for DFI. Describe some potential benefits to an MNC as a result of direct foreign investment (DFI). Elaborate on each type of benefit. Which motives for DFI do you think encouraged Nike to expand its footwear production in Latin America?

ANSWER: See the text exhibit in this chapter for a complete summary of the potential benefits.

Regarding Nike’s motives, Latin America offers additional sources of demand, as Latin American consumers have shown an interest in Nike footwear (this is partially due to increased marketing targeted to Latin American markets). Second, Nike may be able to produce their athletic footwear at relatively low costs in some Latin American countries, as the production is labor-intensive and wages are low. Third, Nike may benefit from economies of scale by producing a large amount and exporting the additional shoes for sale to nearby countries. Fourth, the expansion into Latin America allows Nike to further diversify its business internationally.

2. Impact of a Weak Currency on Feasibility of DFI. Packer, Inc., a U.S. producer of computer disks, plans to establish a subsidiary in Mexico in order to penetrate the Mexican market. Packer’s executives believe that the Mexican peso’s value is relatively strong and will weaken against the dollar over time. If their expectations about the peso value are correct, how will this affect the feasibility of the project? Explain.

ANSWER: If the peso’s value is relatively strong now, Packer Inc. will incur high costs of establishing a Mexican subsidiary. In addition, if the peso weakens, future remitted earnings by the subsidiary to the parent will be converted to fewer dollars. Packer will be adversely affected by the exchange rate movements (although the project may still be feasible).

3. DFI to Achieve Economies of Scale. Bear Co. and Viking, Inc., are automobile manufacturers that desire to benefit from economies of scale. Bear Co. has decided to establish distributorship subsidiaries in various countries, while Viking, Inc., has decided to establish manufacturing subsidiaries in various countries. Which firm is more likely to benefit from economies of scale?

ANSWER: Bear Company is likely to benefit because it is maintaining all of its manufacturing in one area. If Viking Inc. spreads its production facilities, it will incur higher fixed costs of machinery.

4. DFI to Reduce Cash Flow Volatility. Raider Chemical Co. and Ram, Inc., had similar intentions to reduce the volatility of their cash flows. Raider implemented a long-range plan to establish 40 percent of its business in Canada. Ram, Inc., implemented a long-range plan to establish 30 percent of its business in Europe and Asia, scattered among 12 different countries. Which company will more effectively reduce cash flow volatility once the plans are achieved?

ANSWER: Ram Inc. would likely be more effective because its international business is spread across several major countries, while Raider Chemical Company is concentrated in only one foreign country whose business cycles are related to the U.S.
5. **Impact of Import Restrictions.** If the United States imposed long-term restrictions on imports, would the amount of DFI by non-U.S. MNCs in the United States increase, decrease, or be unchanged? Explain.

**ANSWER:** It would likely increase because the foreign firms would need to replace their exporting business with DFI in order to maintain their business in the U.S.

6. **Capitalizing on Low-Cost Labor.** Some MNCs establish a manufacturing facility where there is a relatively low cost of labor. Yet, they sometimes close the facility later because the cost advantage dissipates. Why do you think the relative cost advantage of these countries is reduced over time? (Ignore possible exchange rate effects.)

**ANSWER:** As MNCs capitalize on low cost labor, they may create a strong demand for labor, which can cause labor shortages and increased wage rates, thereby reducing any cost advantage.

7. **Opportunities in Less Developed Countries.** Offer your opinion on why economies of some less developed countries with strict restrictions on international trade and DFI are somewhat independent from economies of other countries. Why would MNCs desire to enter such countries? If these countries relaxed their restrictions, would their economies continue to be independent of other economies? Explain.

**ANSWER:** Countries that are unrelated to other economies are desirable because business in these countries would not be subject to existing business cycles in other countries. Consequently, an MNC’s overall cash flow may be more stable. However, a typical reason why these countries’ economies are independent of other economies is government restrictions on international trade and DFI. Thus, their economies are insulated from other countries. Yet, this means that while these countries may be desirable to MNCs, they may also be off limits to MNCs. If the governments of these countries loosen restrictions, the MNCs could enter these countries, but the economies of these countries could no longer be as insulated from the rest of the world.

8. **Effects of September 11.** In August 2001, Ohio Inc. considered establishing a manufacturing plant in central Asia, which would be used to cover its exports to Japan and Hong Kong. The cost of labor was very low in central Asia. On September 11, 2001, the terrorist attacks on the U.S. caused Ohio to reassess the potential cost savings. Why would the estimated expenses of the plant increase after the terrorist attacks?

**ANSWER:** The plant would be more exposed to the threat of a terrorist attack, because of increased friction between the U.S. and some regions in central Asia. There may be expenses associated with security to ensure the safety of the employees. The cost of insuring the plant would also be higher.

9. **DFI Strategy.** Bronco Corp. has decided to establish a subsidiary in Taiwan that will produce stereos and sell them there. It expects that its cost of producing these stereos will be one-third the cost of producing them in the United States. Assuming that its production cost estimates are accurate, is Bronco’s strategy sensible? Explain.

**ANSWER:** No. Bronco Corporation recognized an advantage of producing stereos in Taiwan versus the U.S. Yet, this is only an advantage if Bronco sells the stereos produced in Taiwan to the U.S. market. All of Bronco’s competition in the Taiwan market will have the same production
costs as Bronco’s Taiwan subsidiary, so Bronco would not have an advantage in the Taiwan market.

10. **Risk Resulting from International Business.** This chapter concentrates on possible benefits to a firm that increases its international business.

   a. What are some risks of international business that may not exist for local business?

   ANSWER: Some of the more common risks of DFI are a government takeover and changing tax laws. There are additional risks (discussed in other chapters) such as currency restrictions, high probability of war, and declining economic conditions.

   b. What does this chapter reveal about the relationship between an MNC’s degree of international business and its risk?

   ANSWER: Firms with more international business can reduce risk with diversification. Thus, firms could reduce their risk by increasing their degree of international business. However, there are some exceptions. A firm that pursues substantial international business in one country may increase its risk, especially if it does not fully understand the consumers and government laws in that country. In general, a firm becomes exposed to some types of risk that may not have existed before it pursued international business, but the diversification benefits may offset these types of risk.

11. **Motives for DFI.** Starter Corp. of New Haven, Connecticut, produces sportswear that is licensed by professional sports teams. It recently decided to expand in Europe. What are the potential benefits for this firm from using DFI?

   ANSWER: The primary reason would be to attract new sources of demand. This type of sportswear is much more popular in the U.S., but the U.S. market is possibly saturated. The European market offers new sources of demand because European people have not been exposed to this type of sportswear.

12. **Disney’s DFI Motives.** What potential benefits do you think were most important in the decision of the Walt Disney Co. to build a theme park in France?

   ANSWER: There is no simple answer to this question, but the question usually leads to an interesting discussion. Some of the more likely motives as related to those discussed in this chapter are:

   a. New sources of demand—another theme park in the U.S. would have less potential, since U.S. tourists are willing to travel to California or Florida to see the theme parks.

   b. Economies of scale should result from the new theme park, because much of the costs associated with planning a theme park have already been incurred. Also, the sales of Disney toys will increase, allowing for additional economies of scale in production.

   c. French labor may not necessarily be less costly than U.S. labor, but there may be a cost advantage to the land in France (due to land subsidies provided by the French government).
d. Exploit monopolistic advantages—there are other theme parks in Europe. Yet, some tourists may feel that no other theme park is an adequate substitute for Disney. Thus, Disney can now attract tourists who are unwilling to travel to the U.S.

e. Diversification—the Disney theme parks in the U.S. have experienced reduced sales when the dollar is strong because foreign tourism in the U.S. declines. A theme park in France may appeal to tourists who decide not to travel to the U.S. when the dollar is strong (euro is weak). In fact, it may even attract more tourists from the U.S. when the dollar is strong.

13. DFI Strategy. Once an MNC establishes a subsidiary, DFI remains an ongoing decision. What does this statement mean?

ANSWER: The subsidiary established due to DFI will generate earnings that are to be either reinvested in the host country or remitted to the parent. This reflects a continuous DFI decision of whether to expand in the host country.

14. Host Government Incentives for DFI. Why would foreign governments provide MNCs with incentives to undertake DFI there?

ANSWER: Foreign governments sometimes expect that DFI will provide needed employment or technology for a country. For these reasons, they may provide incentives to encourage DFI.

Advanced Questions

15. DFI Strategy. J.C. Penney has recognized numerous opportunities to expand in foreign countries and has assessed many foreign markets, including Brazil, Greece, Mexico, Portugal, Singapore, and Thailand. It has opened new stores in Europe, Asia, and Latin America. In each case, the firm was aware that it did not have sufficient understanding of the culture of each country that it had targeted. Consequently, it engaged in joint ventures with local partners who knew the preference of the local customers.

a. What comparative advantage does J.C. Penney have when establishing a store in a foreign country, relative to an independent variety store?

ANSWER: J.C. Penney has name recognition, which could result in customer trust, and therefore a stronger demand for its products. It also has marketing expertise that it applies to each store. It also has economies of scale, because it could buy its products in bulk and distribute the products to the stores that need those products.

b. Why might the overall risk of J.C. Penney decrease or increase as a result of its recent global expansion?

ANSWER: Its risk may decrease because it has a strategy that allows it to utilize its expertise, while relying on foreign expertise for part of the business that requires knowledge about foreign cultures. Also, it has created more international diversification by spreading its store throughout more foreign markets, so that its overall performance is not as heavily influenced by U.S. economic conditions.
Its risk could have increased if it selected local partners in the foreign countries that do not properly apply their knowledge of the local culture when making decisions about the types of products that the store should carry.

c. J.C. Penney has been more cautious about entering China. Explain the potential obstacles associated with entering China.

ANSWER: Obstacles include high inflation in China, difficulties in converting foreign currency, difficulties in efficiently distributing products across stores, and the lack of disposable income for many China residents.

16. DFI Location Decision. Decko Co. is a U.S. firm with a Chinese subsidiary that produces cell phones in China and sells them in Japan. This subsidiary pays its wages and its rent in Chinese yuan, which is stable against the dollar. The cell phones sold to Japan are denominated in Japanese yen. Assume that Decko Co. expects that the Chinese yuan will continue to stay stable against the dollar. The subsidiary’s main goal is to generate profits for itself and it reinvests the profits. It does not plan to remit any funds to the U.S. parent.

a. Assume that the Japanese yen strengthens against the U.S. dollar over time. How would this be expected to affect the profits earned by the Chinese subsidiary?

b. If Decko Co. had established its subsidiary in Tokyo, Japan instead of China, would its subsidiary’s profits be more exposed or less exposed to exchange rate risk?

c. Why do you think that Decko Co. established the subsidiary in China instead of Japan? Assume no major country risk barriers.

d. If the Chinese subsidiary needs to borrow money to finance its expansion and wants to reduce its exchange rate risk, should it borrow U.S. dollars, Chinese yuan, or Japanese yen?

ANSWER:

a. If the yen appreciates against the dollar, it appreciates against the yuan (assuming the yuan is stable against the dollar), which results in higher yuan cash flows to the Chinese subsidiary.

b. If the subsidiary was established in Tokyo, Japan, it would be less exposed to exchange rate risk.

c. Decko Co. may have established the subsidiary in order to take advantage of the low-cost labor in China.

d. If the subsidiary needs to borrow money, it should borrow Japanese yen, because its revenues are also denominated in yen.

Solution to Continuing Case Problem: Blades, Inc.

1. Identify and discuss some of the benefits that Blades, Inc., could obtain from DFI.

ANSWER: First, since Blades’ growth potential in the United States is limited, it could utilize Thailand in order to attract new sources of demand, especially since the growth potential in future years is high. Second, Blades is able to generate higher profit margins in Thailand than in the U.S. Third, raw materials are less expensive in Thailand than they are in the U.S. Fourth, by expanding its operations to Thailand, Blades is more diversified and reduces its exposure to the U.S. economy.
2. Do you think Blades should wait until next year to undertake DFI in Thailand? What is the tradeoff if Blades undertakes the DFI now?

ANSWER: If Blades undertakes the direct foreign investment now, the initial outlay required will be relatively low due to the recent economic conditions in Thailand and due to the depreciation of the baht. However, if economic conditions do not improve within the next year, Blades may not generate the expected return on its Thai investment and may have to sell its Thai operations at a loss. If Blades waits until next year to make its decision, economic conditions may have improved and there may be less uncertainty associated with the investment. However, if economic conditions in Thailand do improve, the initial outlay required to invest in Thailand will have increased. Furthermore, Blades’ competitors may already be established in Thailand next year, which would make it harder for Blades to gain market share there.

3. Do you think Blades should renew its agreement with the Thai retailer for another three years? What is the tradeoff if Blades renews the agreement?

ANSWER: If Blades renews the agreement with the Thai retailer, it will have to maintain the relatively low prices it charges the Thai retailer. It may be able to charge higher prices by establishing its own distribution channels. If economic conditions in Thailand improve, demand for Blades’ products in Thailand will likely be strong, and Blades would probably generate higher profit margins by using its own distribution channels. However, if economic conditions in Thailand continue to deteriorate, the agreement would be an advantage for Blades, as it guarantees the sale of a minimum number of products sold each year.

4. Assume a high level of unemployment in Thailand and a unique production process employed by Blades, Inc. How do you think the Thai government would view the establishment of a subsidiary in Thailand by firms such as Blades? Do you think the Thai government would be more or less supportive if firms such as Blades acquired existing businesses in Thailand? Why?

ANSWER: Given a high level of unemployment in Thailand and a unique production process employed by Blades to manufacture roller blades, the Thai government would be faced with a tradeoff if Blades would like to establish a subsidiary in Thailand. On the one hand, locally owned businesses in Thailand may lose business because of the new competition, which may increase the level of unemployment in Thailand. Conversely, if a firm such as Blades acquires an existing business in Thailand, the level of unemployment in Thailand may be reduced if the firm employs local labor. Furthermore, if the Thai government requires Blades to share its technology, other Thai firms may benefit. Thus, the Thai government would probably be more supportive of firms that acquire existing firms as opposed to those establishing a subsidiary in Thailand, assuming that the acquisition was not intended to downsize the target.
Solution to Supplemental Case: Blues Corporation

Some possible answers are provided below, although there is no perfect solution to the issues introduced. The main objective of this case is to stimulate discussion and force students to create their own concerns about entering Eastern Europe. Students must learn that some ventures could easily backfire.

a. Blues Corporation should not immediately jump at the opportunity unless it considers the following information. First, while the labor cost is low today, it may increase over time as East and West German economies become more integrated. Second, while the East German facility is inefficient, the potential to remove the inefficiencies may be limited by the government. For example, the government may require that all workers at the facility remain employed. Third, there is much uncertainty about the restrictions that could be enforced as conditions of ownership in East Germany, such as high taxes and environmental restrictions. These factors must be accounted for.

b. While the competition appears overpriced, Blues Corp. must consider how that may change in the long run. Some of the government-owned businesses may be privatized over time, which would likely increase efficiency and reduce prices. Therefore, competition could become more intense in the near future. Blues Corp. could attempt to capitalize on the East European markets by exporting from its West German subsidiary. However, it may not be worthwhile to use a heavy promotion program unless it believes that it can attain a reasonable market share even when some of the competition may reduce prices in the future.

c. Blues Corp. should not forgo its established U.S. business as a means of pursuing business in East Germany. The risks are high. Blues Corp. could test the East German market by exporting without requiring a major amount of funds. If it decides to make a major investment in an East German facility or promotion program, it should wait until it can raise funds by some means other than divesting U.S. assets.

Small Business Dilemma

Direct Foreign Investment Decision by the Sports Exports Company

1. Given the information provided here, what are the advantages to Jim of establishing the firm in the United Kingdom?

   ANSWER: One advantage is that most of the expenses of the firm would be denominated in the same currency (pounds) as the currency that is received when selling the goods. A second advantage is that there would be less delays when transporting the goods from the point of production to the distributor because the point of production would be in the same country as the distributor. A third possible advantage is that the firm would avoid any potential trade restrictions by producing the goods in the country where they are to be sold.

2. Given the specific information provided here, what are the disadvantages to Jim of establishing the firm in the United Kingdom?

   ANSWER: One disadvantage is that Jim would incur new expenses associated with establishing a firm in the United Kingdom. He presently uses his garage and a warehouse to produce and store
footballs. The new expense of establishing a firm in the United Kingdom may outweigh all the possible advantages. Another disadvantage is that Jim may not be able to monitor the firm’s business unless he moves to the United Kingdom.