What Is Direct Investment?

Investors often seek profits from a long-term stake in a foreign operation

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FOREIGN INVESTORS can have myriad motivations for seeking to earn profits in another country. But they have fundamentally two core choices when deciding how to deploy their capital.

They can make a portfolio investment, buying stocks or bonds, say, often with the idea of making a short-term speculative financial gain without becoming actively engaged in the day-to-day running of the enterprise in which they invest.

Or they can choose the long-haul, hands-on approach—investing in an enterprise in another economy with the objective of gaining control or exerting significant influence over management of the firm (which usually involves a stake of at least 10 percent of a company's stock). In the most extreme case, investors may build new facilities from scratch, maintaining full control over operations.

It is the intent of lasting interest that is the crucial component of direct investment. A portfolio investor can sell a stock or bond quickly—whether to cement a gain or avoid a loss. Most corporations entering a foreign market through direct investment expect to substantially influence or control the management of the enterprise over the long haul.

Faces of investment

A number of factors influence a company's decision to engage in direct investment, including analysis of the trade costs with a foreign country. If these costs—including tariffs (taxes on imports), trade barriers such as quotas, and transportation—are higher than the cost, including the costs of production abroad, of establishing presence in the foreign country, the business will maximize its profits through direct investment.

Companies may invest with the idea of producing components that become part of a bigger product. An automaker may invest in a plant to build transmissions that are shipped to a final assembly plant in another country. This so-called vertical direct investment accounts for most of the investment by advanced economies in developing ones. The cost advantages associated with investing in a foreign country—and in many cases performing only a portion of the production process in that country—drive such investment. Abundant or unique natural resources or low labor costs influence the decision to move production overseas and import intermediate or final products from subsidiaries in host economies to the parent company's country (intrafirm trade).

A company may also invest in a foreign country by duplicating there its home country manufacturing processes. This may be done to supply goods or services to a foreign market. That's called horizontal direct investment. In countries with tariffs or other barriers to imports, a foreign firm may find that setting up local operations allows it to circumvent the barriers. Even though trade taxes have been falling over the years, such tariff jumping is still a common way to enter markets where the greatest benefit of direct investment is access to the local market. Another factor driving horizontal direct investment, specifically between advanced economies, is access to a pool of skilled employees and technology. In contrast to vertical direct investment, horizontal direct investment is likely to compete directly with local firms for local market share.

Of course investment need not be purely horizontal or vertical. A foreign subsidiary may provide goods to the parent company and receive services from the headquarters—a clear example of vertical direct investment. But the same subsidiary may also supply the local market, as part of the parent company's horizontal direct investment strategy.

Direct investment takes different shapes and forms. A company may enter a foreign market through so-called greenfield direct investment, in which the direct investor provides funds to build a new factory, distribution facility, or store, for example, to establish its presence in the host country.

But a company might also choose brownfield direct investment. Instead of establishing a new presence the company invests in or takes over an existing local company. Brownfield investment means acquiring existing facilities, suppliers, and operations—and often the brand itself.

Local effects

Countries may encourage inward direct investment to improve their finances. Firms that set up operations in host countries are subject to local tax laws and often significantly boost the host country's tax revenues. Direct investment can also help a country's balance of payments. Because portfolio investments can be volatile, a country's financial circumstances could worsen if investors suddenly withdrew their funds. Direct investment, on the other hand, is a more stable contributor to a country's financial structure. Direct investors do not wish to take actions to undermine the value or sustainability of their investments.

Other positive effects associated with inward direct investment include increased employment, improved productivity, technology and knowledge transfer, and overall economic growth. Increased competition from foreign firms, whether new or acquired, often forces competitors to increase their productivity so that they don't go out of business. Suppliers and service providers to the direct investment enterprise may also increase their productivity, often because the investor requires higher-volume or higher-quality orders. The increase in volume and variability of products and services in the economy leads to overall improvement in the market's quality and size.

Host countries also benefit from a transfer of knowledge and technology, which often stems from workforce turnover. Incoming firms frequently offer more training opportunities than local employers. This knowledge is later transferred to local companies when trained employees leave the foreign enterprise for local businesses. In addition, there may be some incidental spillover of knowledge through informal networks, when employees exchange ideas and opinions about their workplace practices.

But direct investment may not always be viewed positively from a host country perspective. Because productive companies engage in direct investment, the increased competition they provide may force the least productive local companies out of business. Opponents of direct investment argue that foreign, especially brownfield, investment is a simple ownership transfer that does not generate new jobs. Some critics, moreover, point to the risk of a sudden reversal of the direct investment and a fire sale of assets, drastically reducing their value and, in extreme cases, forcing facilities to close and companies to lay off workers. Direct investment is often restricted in certain companies and industries, such as those involving sensitive high-technology products and in defense-related companies.

Because direct investment depends on the host country's decision to attract and accommodate investments, foreign companies often maintain close relations with the local authorities. This entanglement of business and politics may have an adverse effect on the host country. Perhaps the most common argument against direct investment is the potential power and political influence of foreign investors. The leverage investors have over policymakers becomes troublesome when a foreign company gains significant control over a sector of the economy or becomes a critical, or even the largest, employer in the market.

Attracting direct investment

Despite the potential problems of unregulated direct investment, governments of both advanced and developing economies tend to actively seek foreign investors and the capital they bring.

Advanced economies attract direct investment because of their stable policies, pool of skilled workers, and sizable markets. Developing economies are more interested in greenfield investment, which creates new facilities and jobs. Governments often set up special economic zones, provide the property for construction of facilities, and offer generous tax incentives or subsidies to attract capital. These special economic zones, if properly designed, allow industries to concentrate in one geographic area, often placing suppliers close to buyers and providing the necessary infrastructure to meet investors' requirements.

Countries with a comparative advantage, such as favorable policies or a significant pool of skilled workers, frequently develop investment-promotion programs, which can include marketing campaigns, information offices, and even bilateral negotiations between governments and foreign firms. Unlike the tax and other fiscal incentives offered to foreign investors, information campaigns do not erode tax revenues from direct investment.

The overwhelming share of direct investment occurs among advanced economies.

According to the IMF (2014), 63 percent of global direct investment occurs between advanced economies and 20 percent is between advanced and emerging market economies (including low-income countries). Six percent is between emerging market economies, and 11 percent of total direct investment flows from emerging market to advanced economies.

That the overwhelming share of direct investment occurs among advanced economies may seem counterintuitive. But given the large size of these economies, it stands to reason that horizontal direct investment in which advanced economies access pools of skilled workers, advanced technology, and large markets in other advanced economies dominates global direct investment.

Data on direct investment can be hard to interpret because of investments in tax havens. The level of investment in these countries is large, but investors tend to have no physical presence there. Given the pass-through nature of these investments, the usual costs and benefits associated with direct investment, other than collection of fees and taxes, do not apply.

Foreign direct investors may, as their critics claim, buy out domestic assets, pushing local firms out of business or imposing their policies on governments. But the overall benefits to both host and investing economies from foreign direct investment significantly outweigh the costs. Capital inflows from foreign direct investors help finance a country's spending—on investment, for example—and increase tax revenue, create jobs, and produce other positive spillovers for the host economy. FD

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