

Readings in International Economics

Autumn 2011 – Winter2012

Foreign direct investment (FDI) in emerging economies

6 December 2011

Overview of last week's class

- Rise of financial openness since the early 1990s (“financial globalization”)
- Four types of foreign capital flows: FDI, foreign portfolio investment, cross-border foreign bank loans, foreign aid
- **The freedom of foreign capital flows and financial crises in emerging economies in the 1990s**
- The 1990s crises
 - (1) The 1994 Mexican crisis
 - (2) The 1997-1998 East Asian crisis
 - (3) The 1998 Russian crisis

Comparison of 1980s and 1990s crises

The 1980s debt crisis (Latin America)	The 1997 East Asian crisis (“twin crisis”)
<u>Cause</u> : excessive government spending financed by printing money or by external borrowing	<u>Cause</u> : excessive private sector spending financed by external borrowing
<u>Types of foreign capital</u> : cross-border foreign bank loans	<u>Types of foreign capital</u> : FDI, cross-border foreign bank loans, foreign portfolio investment
<u>Trigger</u> : fears of high inflation or currency depreciation → capital flight → inability to repay external public debt (default)	<u>Trigger</u> : sudden withdrawal of foreign capital → inability to repay external private debt
<u>Asset bubbles</u> : unlikely	<u>Asset bubbles</u> : very likely

The 1997 East Asian crisis: two kinds of mismatches

- **Currency mismatch**

- ☆ East Asian banks/companies had borrowed in US\$ but lent/invested in the respective national currencies (for example, in Korean won)

- ☆ Won depreciation led to a higher debt repayment burden → bankruptcies, bad loans

- **Maturity mismatch**

- ☆ East Asian banks/companies had borrowed short-term but lent/invested long-term

- ☆ Repayment demands by foreign banks/investors led to a huge USD liquidity shortage problem → won depreciation, IMF bailout



**China and India were relatively
unaffected by the 1997 crisis**

**BECAUSE THEY DELAYED THE OPENING TO
FOREIGN PORTFOLIO CAPITAL INFLOWS (“CAPITAL
ACCOUNT LIBERALIZATION”)**

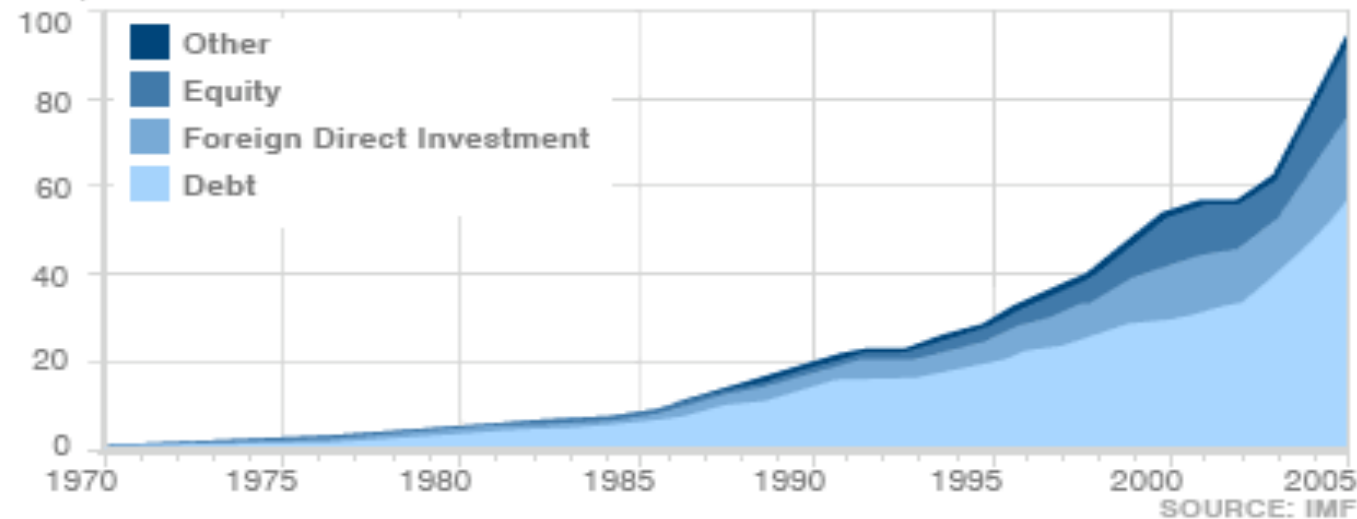
FDI: main terms

- “Home country”: the origin (source) of the FDI
- “Host country”: the destination of the FDI
- IMF’s definition of FDI: “an investment made with the objective to acquire a *lasting management interest* in an enterprise of the host country”
- “Lasting management interest”: a significant influence (or effective control) on the management of that enterprise
- At least 10% of the capital (or the voting rights)
- **Inward FDI (inflows) and outward FDI (outflows) → net FDI inflows**

Rapid growth of FDI since the latter half of 1980s

GLOBAL MONEY FLOWS

Total Cross-Border Financial Assets
US \$trillions



FOREIGN DIRECT INVESTMENT BY MULINATIONALS

US \$billions

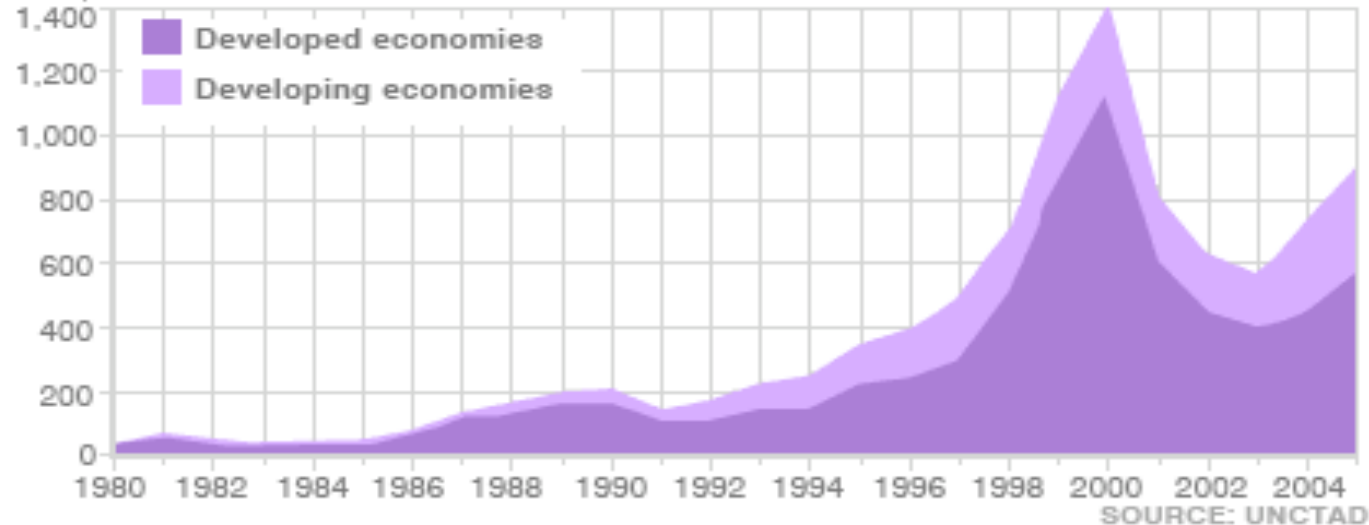
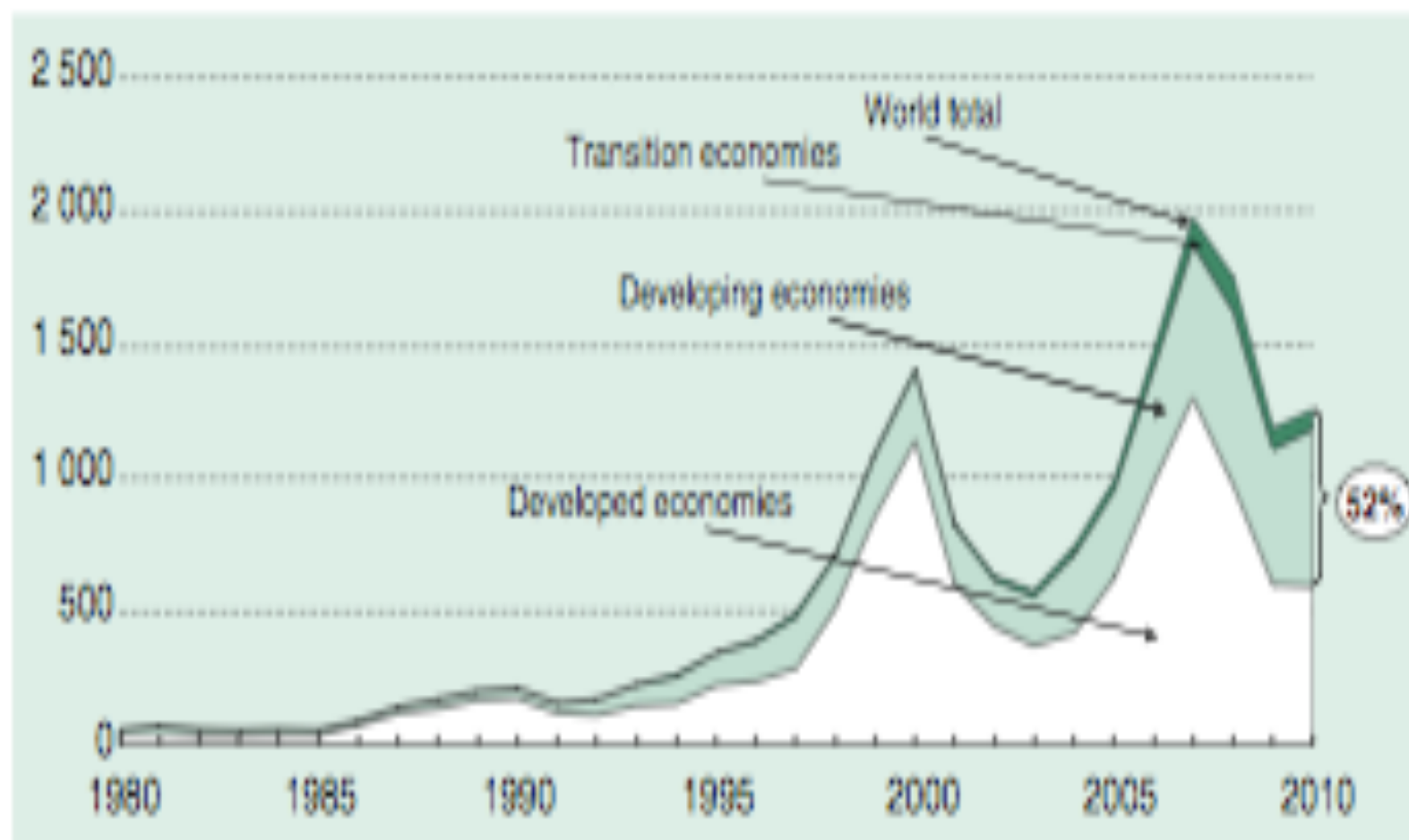
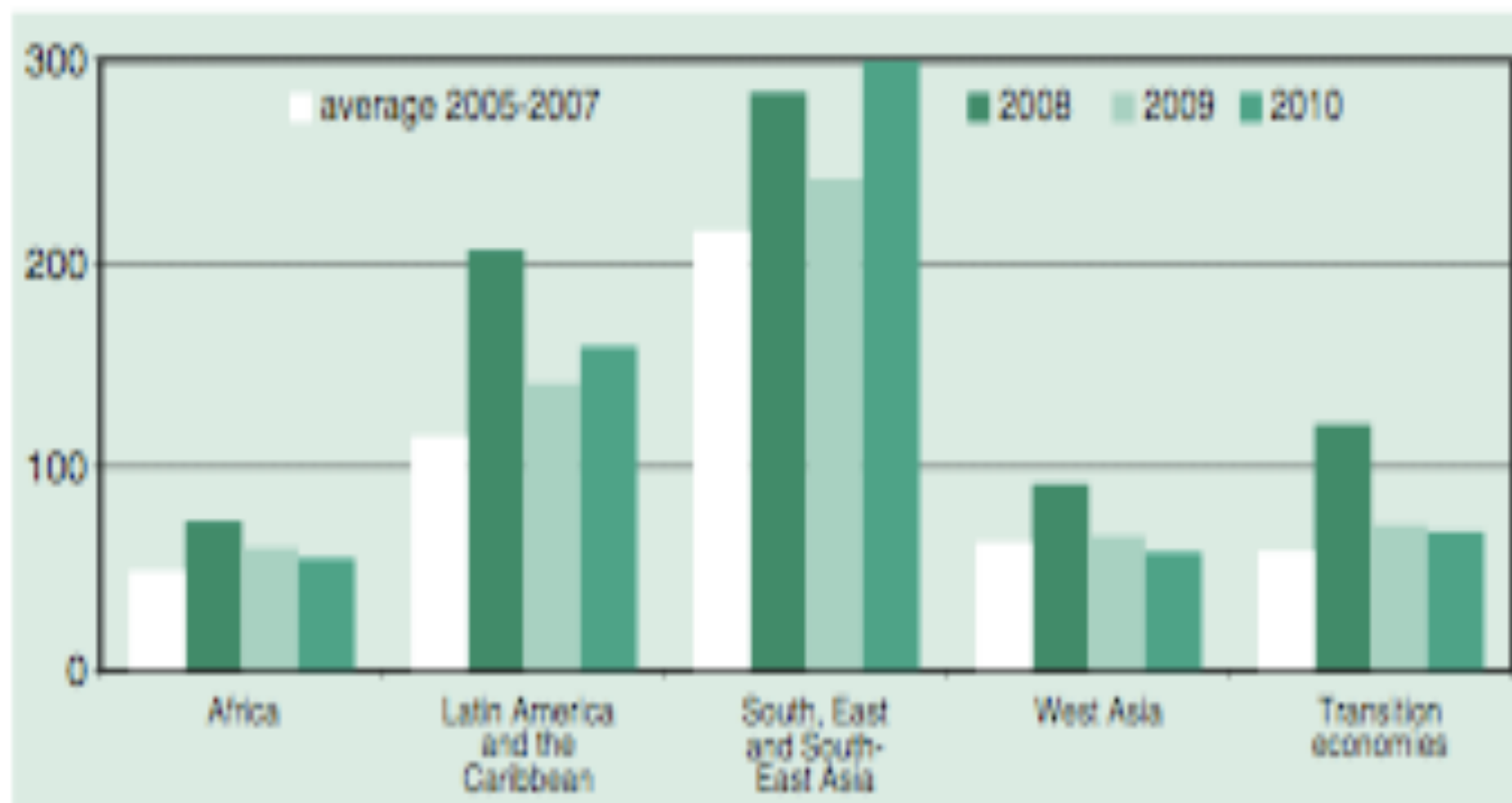


Figure I.3. FDI inflows, global and by group of economies, 1980–2010
(Billions of dollars)



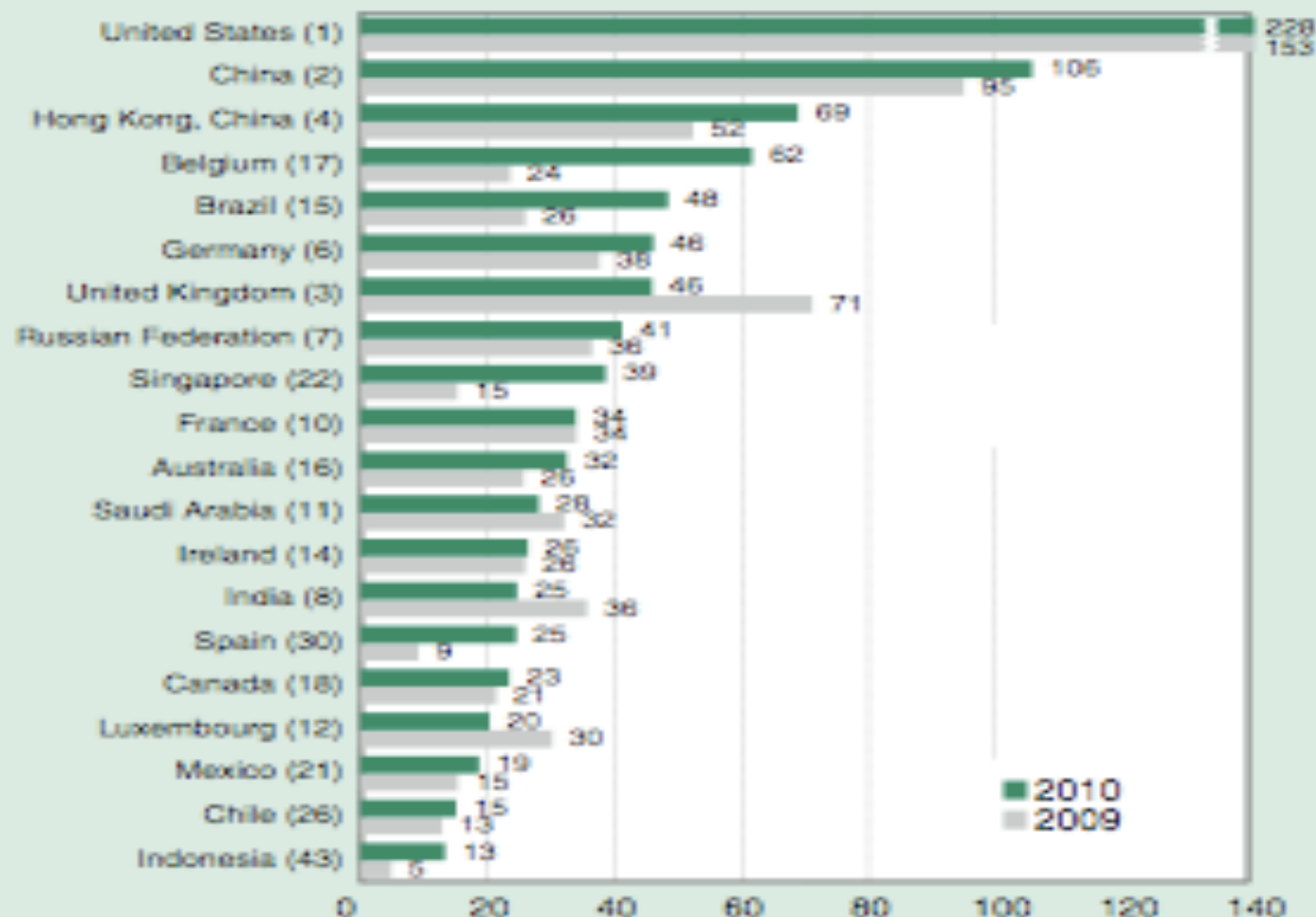
Source: UNCTAD, based on annex table I.1 and the FDI/TNC database (www.unctad.org/fdistatistics).

Figure I.6. FDI inflows to developing and transition economies, by region, average of 2005–2007 and 2008 to 2010
(Billions of dollars)



Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics).

Figure I.4. Global FDI inflows, top 20 host economies, 2009 and 2010 *
 (Billions of dollars)

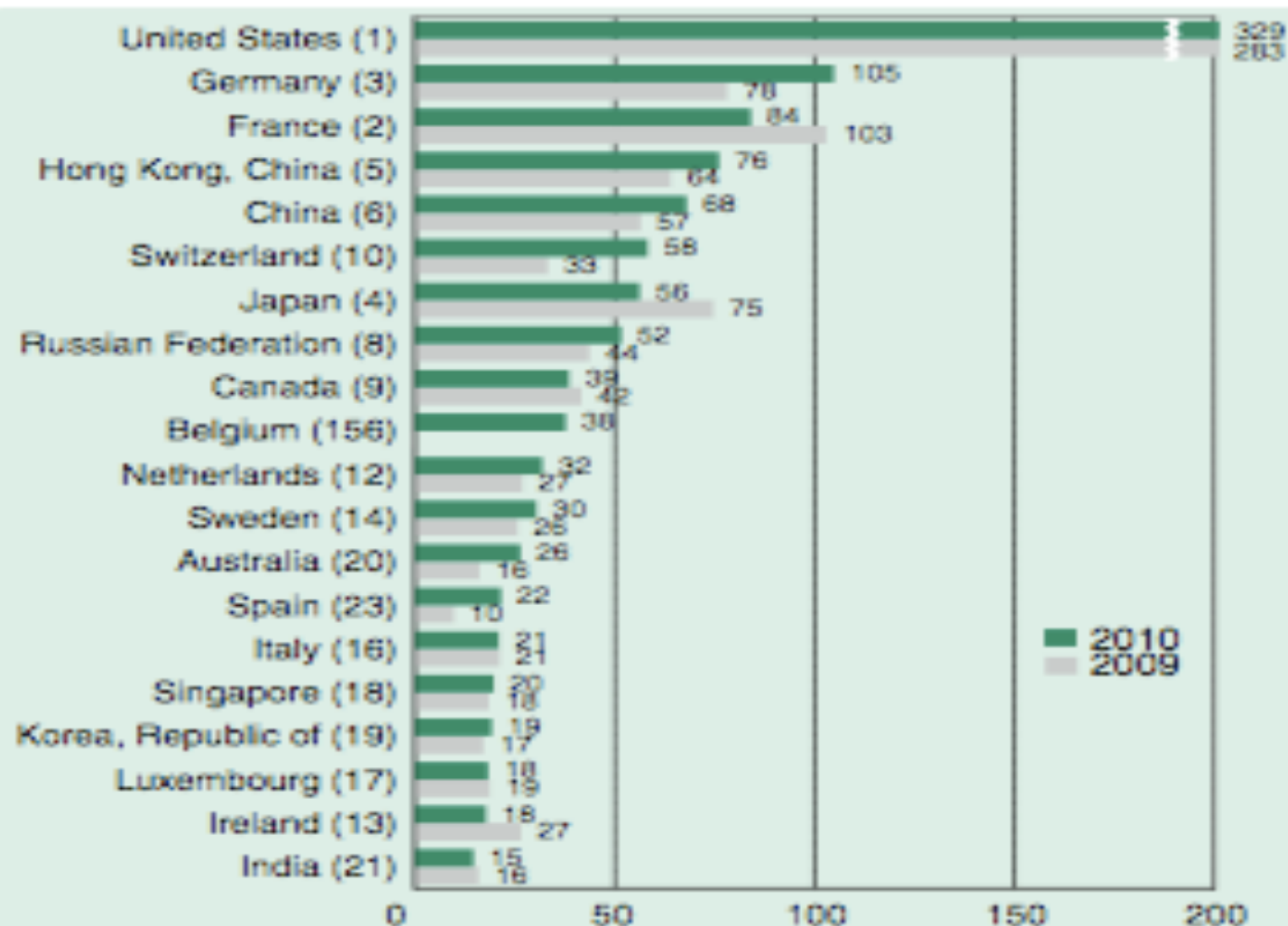


Source: UNCTAD, based on annex table L.1 and the FDI/TNC database (www.unctad.org/fdistatistics).

* Ranked on the basis of the magnitude of 2010 FDI inflows.

Note: The number in bracket after the name of the country refers to the ranking in 2009. British Virgin Islands, which ranked 12th in 2010, is excluded from the list.

Figure I.9. Global FDI outflows, top 20 home economies, 2009 and 2010*
 (Billions of dollars)



Source: UNCTAD, based on annex table I.1 and the FDI/TNC database (www.unctad.org/fdistatistics).

* Ranked on the basis of the magnitude of 2010 FDI outflows.

Note: The number in bracket after the name of the country refers to the ranking in 2009. British Virgin Islands, which ranked 16th in 2010, is excluded from the list.

MNCs/TNCs: main terms

- Multinational (MNCs) or transnational corporations (TNCs): “incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates”
- Parent enterprise: “an enterprise that controls assets of other entities in countries other than its home country, usually by owning a certain equity capital stake”
- Foreign affiliates: subsidiaries, associates, and branches
- **Difference between subsidiaries and associates**

Transnationality and internationalization indexes (TNI, II)

- According to UNCTAD's World Investment Report (2009), about 79,000 TNCs in 2007
- **Transnationality index (TNI)**: calculated as the average of the following three ratios
- (1) foreign assets to total assets, (2) foreign sales to total sales, and (3) foreign employment to total employment
- **"Internationalization index" (II)**: calculated as the number of foreign affiliates divided by the number of all affiliates

The world's top 3 non-financial MNCs by foreign assets (2007)

According to UNCTAD (WIR, 2009):

1. General Electric (US): \$420,300 mln. (out of \$795,337)
2. Vodafone Group (UK): \$230,600 mln. (out of \$254,948)
3. Royal Dutch Shell (Netherlands & UK): \$196,828 (out of \$269,470)
6. Toyota Motor (Japan): \$153,406 mln. (out of \$284,722)

- But the ranking by TNI is different

General Electric (51.4%): number 76

Vodafone Group (87%): number 6

Royal Dutch Shell (71.3%): number 35

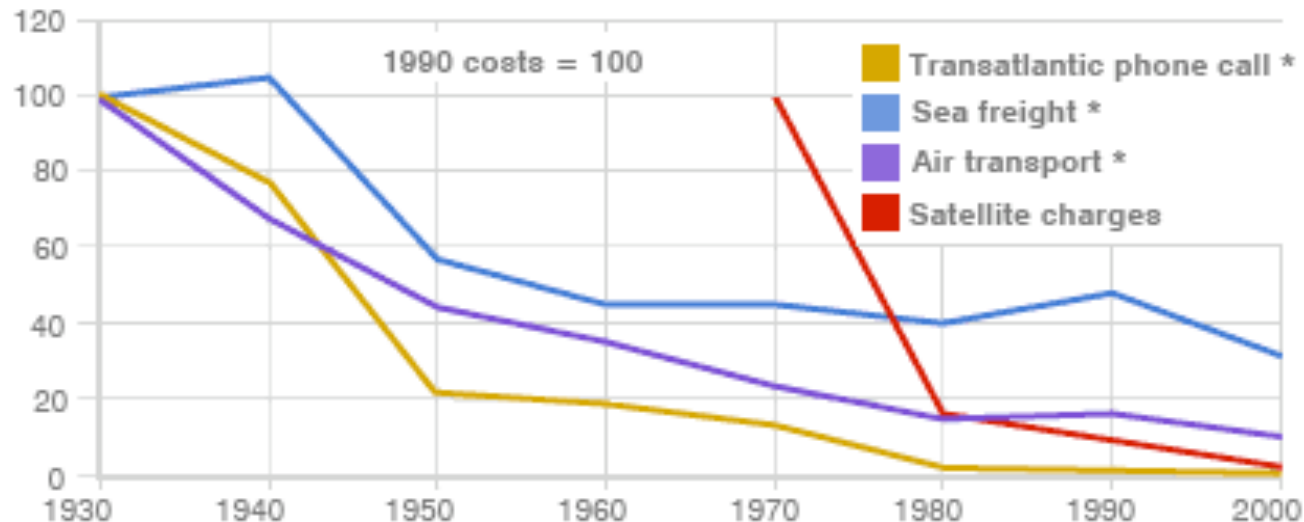
Toyota Motor (51.9%): number 75

The world's top 10 non-financial MNCs by TNI (2007)

- 1. Xstrata (UK; mining): 94.1%
- 2. Linde (Germany; chemicals): 89.5%
- 3. ArcelorMittal (Luxemburg; metals): 89.4%

Rapid growth of MNCs since 1980s

FALLING TRANSPORT AND COMMUNICATION COSTS



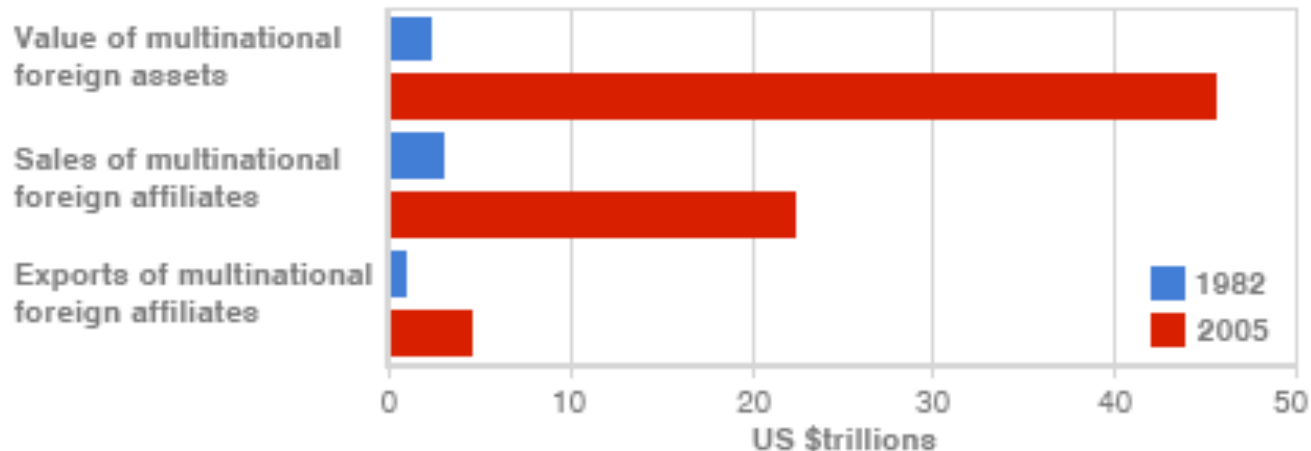
* Cost of three minute telephone call from New York to London

* Average ocean freight and port charges per short ton of import and export cargo

* Average air transport revenue per passenger mile

SOURCE: HM Treasury

GROWTH OF MULTINATIONAL FOREIGN OPERATIONS



SOURCE: UNCTAD

Components of FDI

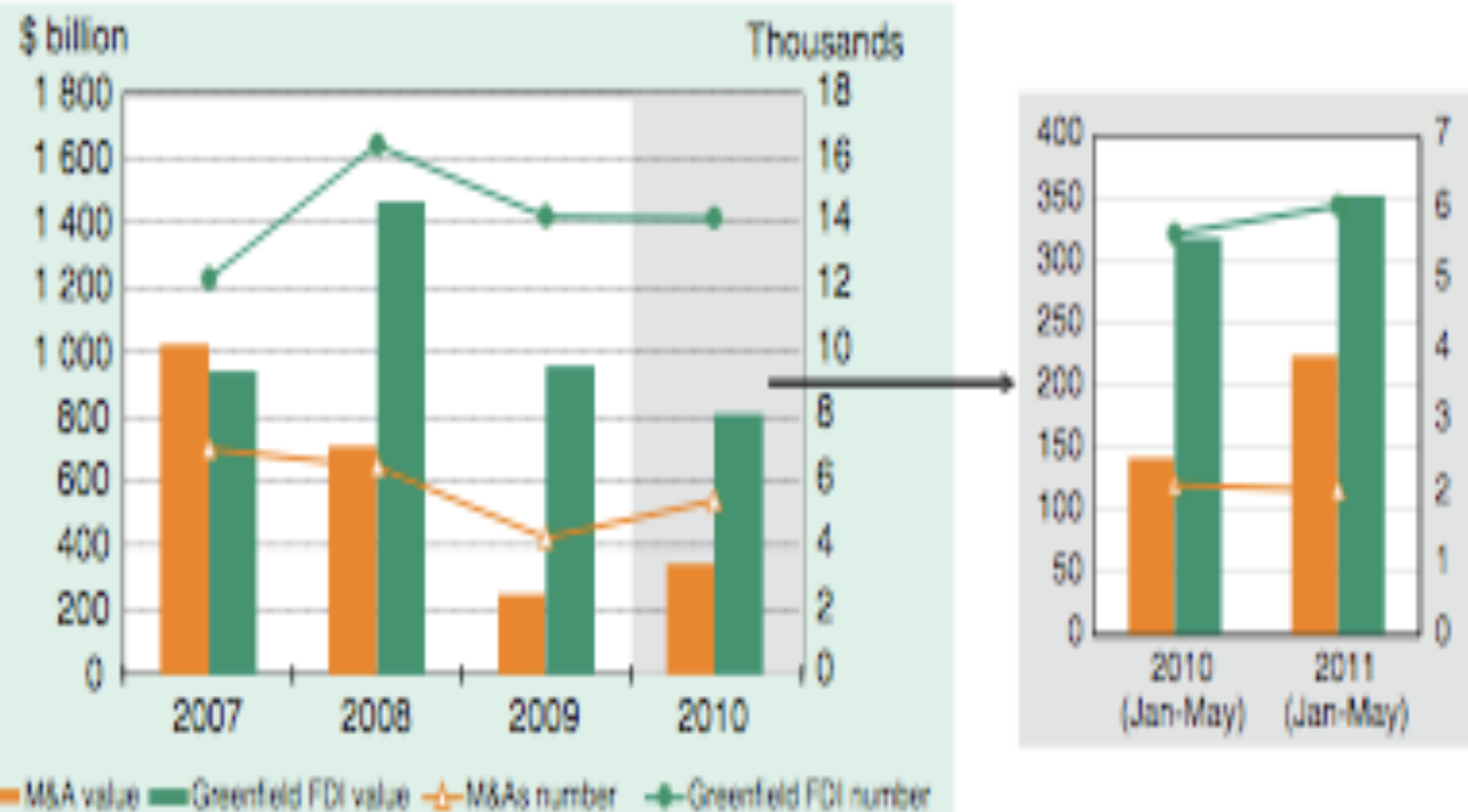
(1) Equity acquisition*: purchase of the shares of an enterprise in the host country (the foreign affiliate) by the foreign direct investor (the parent)

*** Acquisition of the shares of an existing enterprise (cross-border M&A), greenfield FDI, or participation in JVs**

(2) Reinvested profit: part of the retained earnings of the foreign affiliate (which is not paid as dividends and/or not remitted to the parent)

(3) Loans from the parent: short- or long-term borrowing by the foreign affiliate

Figure I.11. Value and number of cross-border M&As and greenfield FDI projects, 2007–May 2011



Source: UNCTAD, based on UNCTAD cross-border M&A database and information from the *Financial Times* Ltd, fDi Markets (www.fdimarkets.com).

Note: Data for value of greenfield FDI projects refer to estimated amounts of capital investment.

Main directions of global FDI flows

#1: Developed countries → Developed countries (North-North)

#2: Developed countries → Developing and emerging countries (North-South)

#3: Developing and emerging countries → Developed countries (South-North)

#4: “Developing and emerging countries → Developing and emerging countries” (South-South)

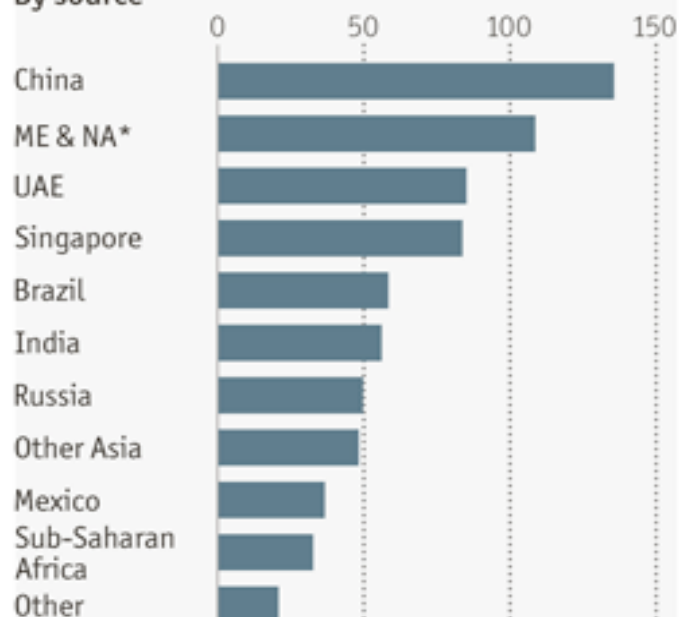
- #1 and #2 account for the biggest part of global FDI flows, but recently #3 and #4 have been rapidly increasing
- For example, Indian outward FDI → UK; or Chinese outward FDI → ASEAN, Latin America and Africa

Uphill rush

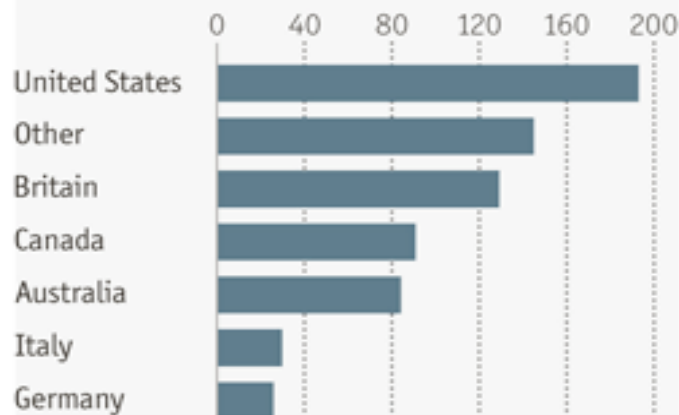
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Cross-border M&A deals from emerging world to rich world
2000-10

By source



By destination



*Middle East & North Africa excluding United Arab Emirates (UAE)

Source: World Bank

Motives for FDI (from the home country's perspective)

What do parents want?

- I. Higher sales growth and larger market share (**“market-seeking FDI”**)
- II. Higher profits thanks to lower labor costs or financial incentives in the host country (**“efficiency-seeking FDI”**)
- III. Access to natural resources (**“resource-seeking FDI”**)

Other motives: to avoid high import tariffs or non-tariff barriers in the host country, to imitate the “first-movers”, to follow important customers/business partners

Factors influencing FDI location decisions

Main FDI determinants

- Macroeconomic and political stability
- Reliability of infrastructure (e.g. electricity, water, transportation, telecommunications, etc.)
- Stable and favorable tax regime
- Openness to trade and foreign capital (for example, membership in WTO and EU)
- Availability of relatively cheap and skilled labor
- Business environment (the costs of doing business)
- Geographical and cultural proximity

Motives for FDI (from the host country's perspective)

- What are the benefits of FDI for developing and emerging countries?

(1) New physical and human capital

(2) Transfer of new technologies and new management skills

(3) Increase of the volume of exports

(4) Improvement of the structure of exports (“industrial upgrading”)

(5) Spillovers of knowledge and productivity to domestic firms

Competition among developing/ emerging countries for FDI

- Due to the perceived benefits of FDI for host countries, many developing and emerging economies compete with each other to attract FDI
- Results: (1) reforms to improve their business environment; (2) financial incentives, including lower corporate taxes to lure foreign investors
- “The flat tax” in Eastern Europe: 19% in Slovakia, 16% in Romania (but recently increased to 20%), 10% in Bulgaria, 16% in Hungary, etc.
- A criticism against tax competition → a “race to the bottom” because, due to the lower corporate and income tax rates, all governments collect relatively less tax revenues; therefore, all of them are worse off (similar to the prisoner’s dilemma)

Japanese FDI in East Asia

“The flying geese” theory (Akamatsu, 1962)

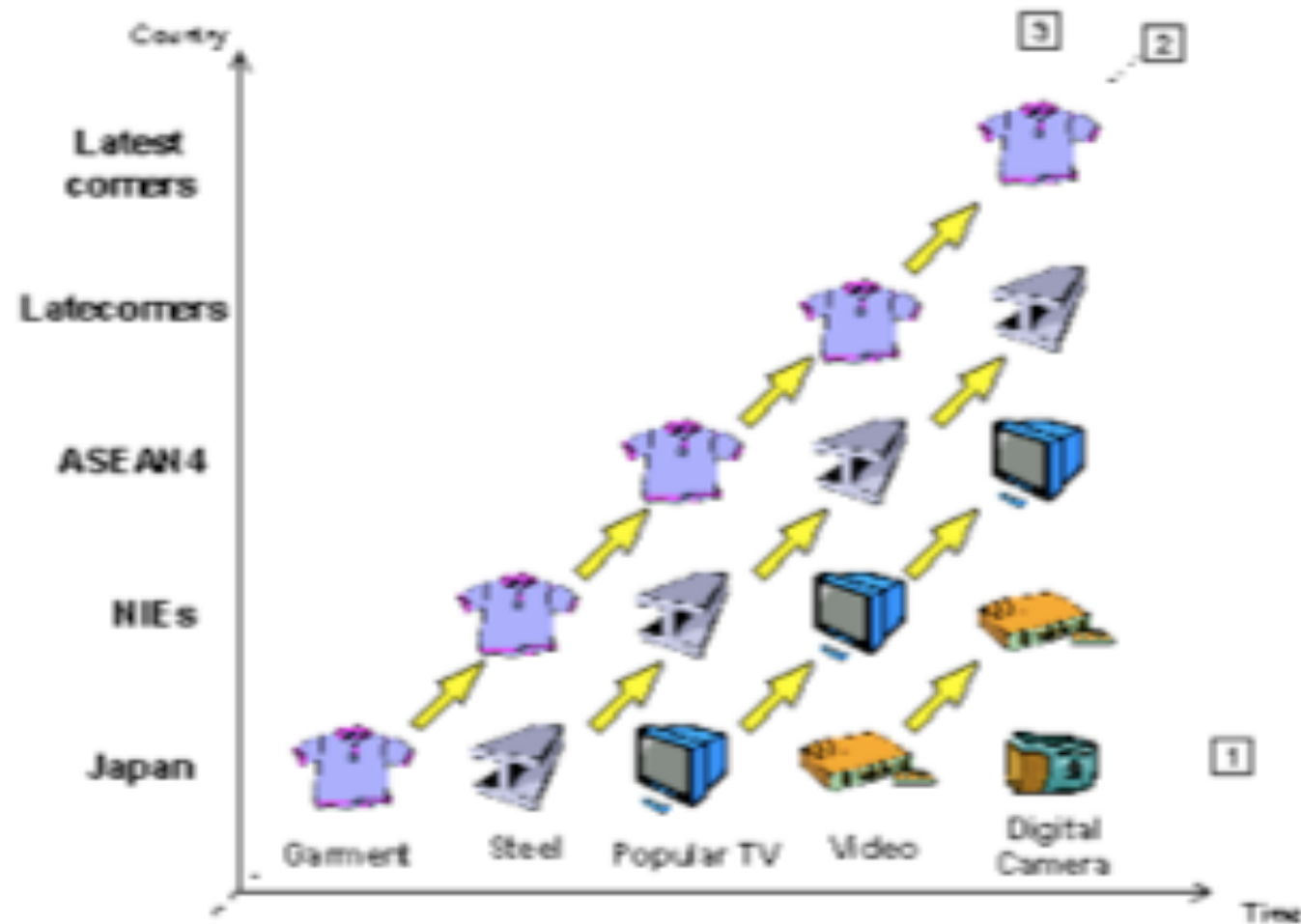
雁行型經濟發展

- With the advance of industrialization in the home country (Japan), labor-intensive production was transferred via FDI to a group of host countries (NIEs)
- After reaching a higher level of economic development, the NIEs group also transferred labor-intensive production to a group of host countries (ASEAN-4), and so on
- The first goose (Japan) was followed by a second group of geese (NIEs), later by a third group (ASEAN-4), and then by a fourth one (China, Vietnam)

The geese fly in a V formation



The flying geese pattern in East Asia



Passing industries from the first bird to the second bird, and so on. FDI by multinational corporations (MNCs) is the agent of this industrial transfer.

Questions for discussion

- Although FDI is usually accepted positively in the developing/emerging economies, could you think of certain demerits of FDI?
- Why have some countries like China, India and Russia established restrictions on FDI in particular industrial sectors (in the case of India, retail trading, mining, real estate, etc.)?
- Can too much FDI be a bad thing? Is it the size of FDI that matters?
- Imagine that you have to convince foreigners to invest in your country. What kind of arguments (or “selling points”) are you going to use?