

# International Investment



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# Principal categories of international investment

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- Commercial loans
  - Primarily take the form of bank loans issued to foreign businesses or governments
- Official flows
  - Generally refer to the forms of development assistance that developed nations give to developing ones
- Foreign direct investment
  - International investment in which the investor obtains a lasting interest in an enterprise in another country
- Foreign portfolio investment
  - Investment more easily traded, may be less permanent, and do not represent a controlling stake in an enterprise

# Definition of direct investment

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- Foreign direct investment (FDI) occurs when a firm invests directly in new facilities to produce and/or market in a foreign country
- FDI is investment in which the investor obtains a lasting interest in an enterprise in another country
- Technically, the threshold for FDI is ownership of “10 percent or more of the ordinary shares or voting power” of a business entity
- Once a firm undertakes FDI it becomes a multinational enterprise
- FDI includes all kinds of capital contributions, such as the purchases of stocks, as well as the reinvestment of earnings by a wholly owned company incorporated abroad and the lending of funds to a foreign subsidiary or branch

# Example of foreign direct investment

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- Hungry Dragon Toys, a Chinese company, is sitting on a lot of cash. The company's board of directors decides to take some of that money and purchase Cooperative Chemical, a plastics company in New Jersey. Hungry Dragon, a foreign investor, now owns a U.S. subsidiary company. Hungry Dragon's ownership of Cooperative Chemical is substantial and more likely to be long term. Hungry Dragon is unlikely to sell if the U.S. economy faces a temporary downturn. Therefore, FDI is considered as relatively stable form of international investment.

# Definition of portfolio investment

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- Cross-border transactions and positions involving equity or debt securities, other than those included in direct investment or reserve assets
- The characteristic feature of portfolio investment is their negotiability
  - Their legal ownership is readily transferable from one unit to another unit by delivery or endorsement
- Negotiable instruments are designed to be traded on organized markets
- Can be bought and sold, which makes them an efficient, flexible way of raising and investing money
- Comes from many diverse sources such as a small company's pension or through mutual funds held by individuals

# Example of foreign portfolio investment

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- John Yamashita, a Japanese citizen, purchases one hundred shares of stock in General Motors (GM). John now owns part of a U.S. corporation, the shares of which are part of his personal investment portfolio. John is eligible to receive dividend payments from GM, participate in shareholder decisions, or sell the stock for a profit/loss. John's share of GM is very minor, and his chief concern is not the long-term profitability of the company but the short-term value of his stock. He might therefore sell his share quickly if the share price goes up or down significantly. Hence, portfolio investment is usually more volatile than FDI.

# Distinction between direct and portfolio investment

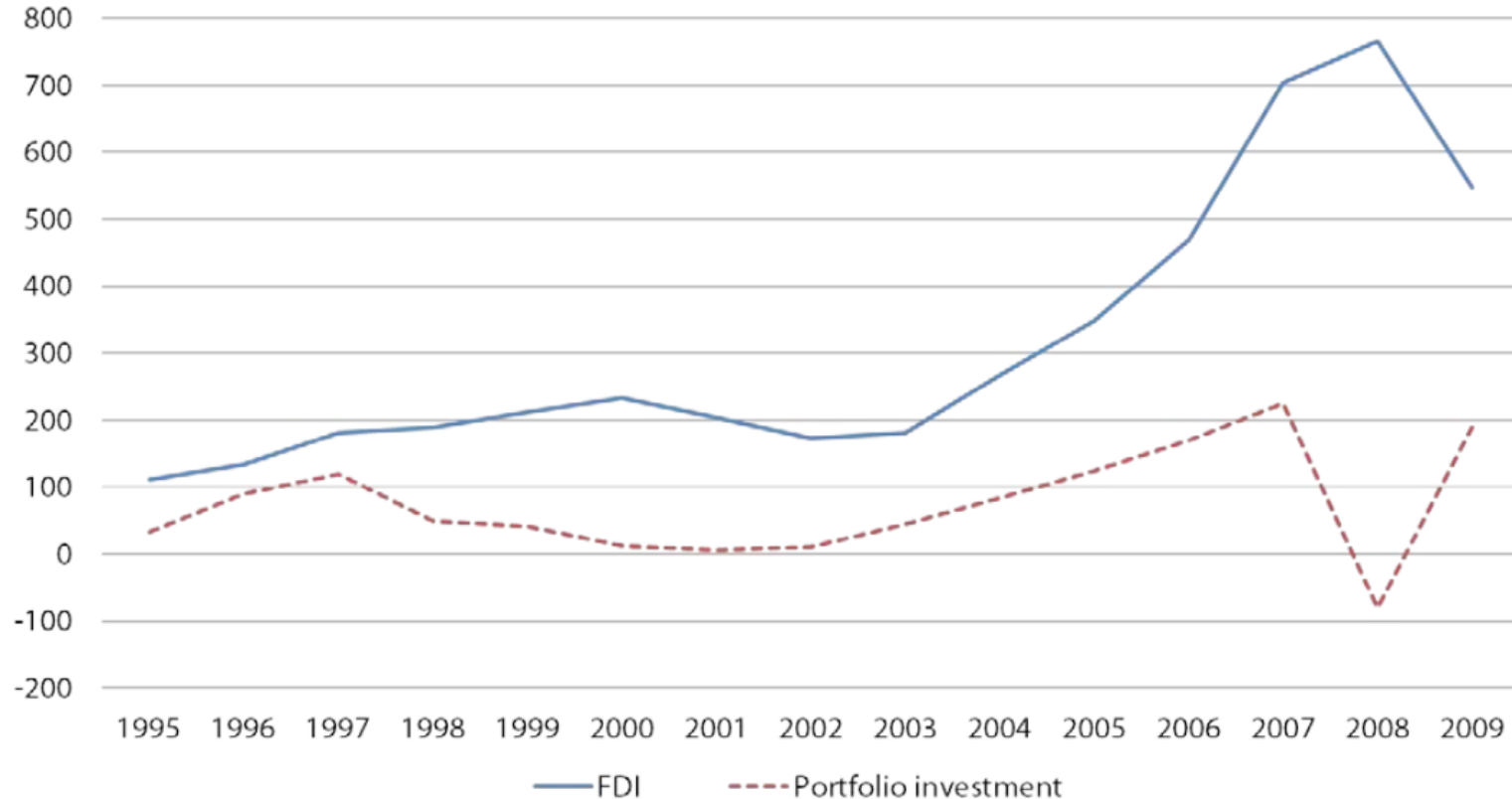


Foreign direct investment	Foreign portfolio investment
Long-term investment	Generally short-term investment
Investment in physical assets	Investment in financial assets
Aim is to increase enterprise capacity or productivity or change management control	Aim is to increase capital availability
Leads to technology transfer, access to markets and management inputs	Results in only capital inflows
Flows into the primary market	Flows into the secondary market
Does not tend to be speculative	Tends to be speculative
Direct impact on employment and wages	No direct impact on employment and wages
Abiding interest in management	Fleeting interest in management

# Composition of private capital flows (bil. USD)



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# Forms of foreign direct investment

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- Acquisition of existing company
  - Purchase an existing company in the foreign country
  - Can be done through privatization, sell of to competitor, or merger
  - E.g. Starbucks purchases an existing UK firm “British Coffee” and sells coffee/tea/desserts under the name “Starbucks”
- Establishment of new company
  - Usually in the form of Greenfield investment
  - Set up a new company “from the ground up” in the foreign country
  - Hyundai invests money in Czechia and builds a new plant to produce cars

# Forms of foreign direct investment

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- **Subsidiary**
  - Company in the foreign country is entirely controlled/owned by one single company
  - Full competencies and decision power
  - Usually slightly different name than maternal company
  - Independent book-keeping, profit taxed in host country
- **Branch**
  - Organizational unit in the maternal company's structure
  - Limited competencies and decision power
  - Similar name like maternal company
  - Unified book-keeping with maternal company, profit taxed in home country

# Forms of foreign direct investment

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- Joint venture
  - Occurs when two or more companies together form a new company in the host country
  - Each of the participants is responsible for profits, losses and costs associated with it
  - The venture is its own entity, separate and apart from the participants' other business interests
  - In the international context, usually occurs when one (or more) foreign company and one (or more) local company join to form a new company

# Horizontal foreign direct investment

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- Investment in the “same” industry as a firm operates in at home
- Reasons for horizontal FDI
  - Transportation costs
  - Market imperfections
    - Impediments to exporting
    - Impediments to sale of know-how
  - Strategic behavior
  - Product life cycle
  - Location specific advantages

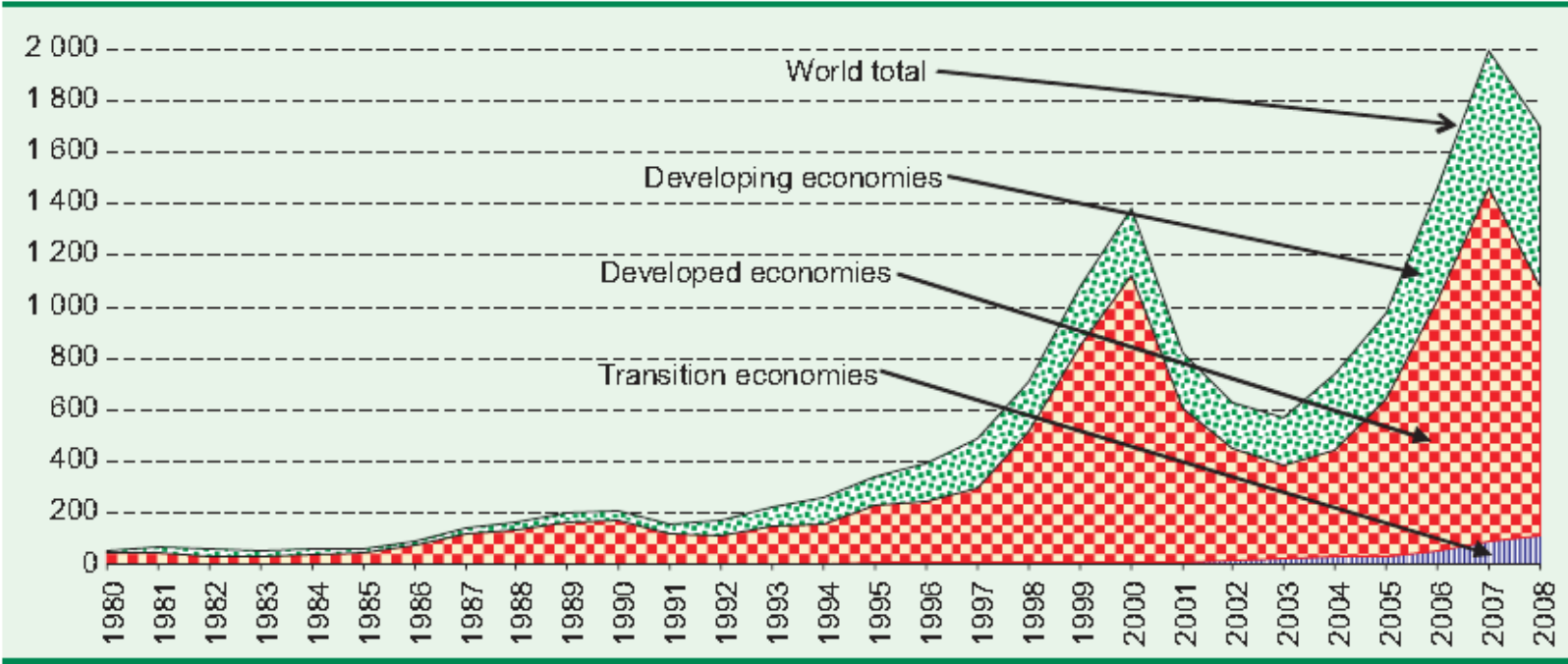
# Vertical foreign direct investment

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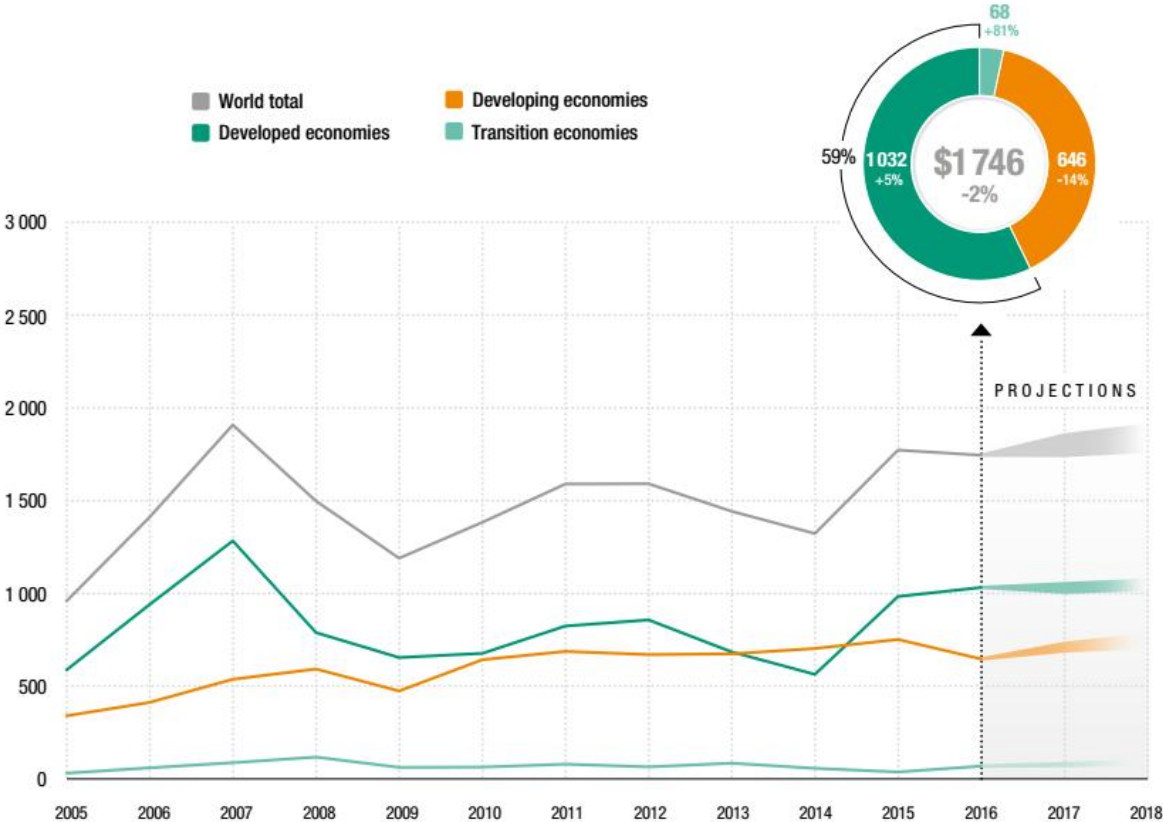
- Investment in a downstream supplier (backward) or upstream purchaser (forward) as compared to the business that the firm operates in its home country
  - Backward investment is more common than forward
- Reasons for vertical foreign direct investment
  - Strategic behavior
  - Market imperfections
    - Impediments to know-how
    - Investments in specialized assets

# Foreign direct investment inflows 1980-2008 (bil. USD)

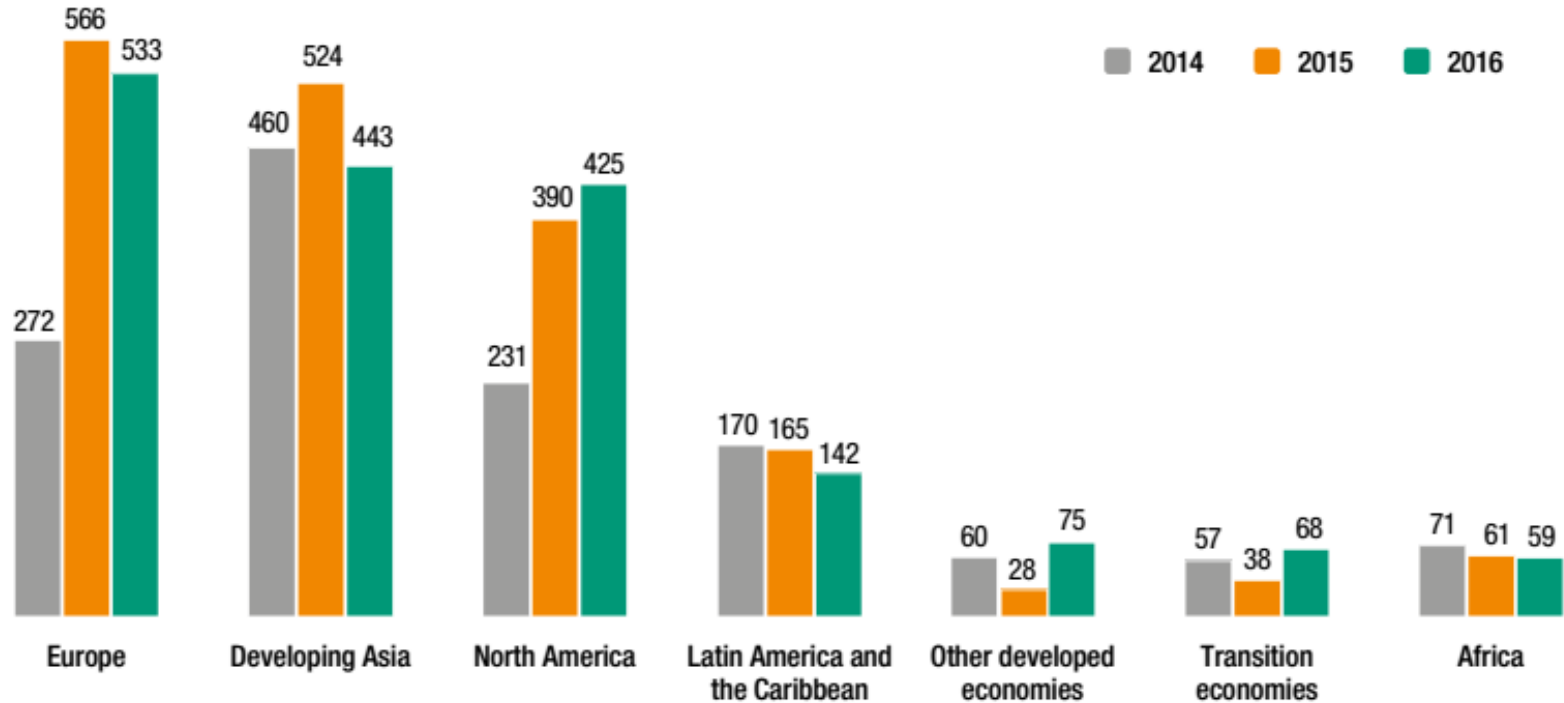


Source: UNCTAD FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and UNCTAD Secretariat estimates.

# Foreign direct investment inflows 2005-2018 (bil. USD)

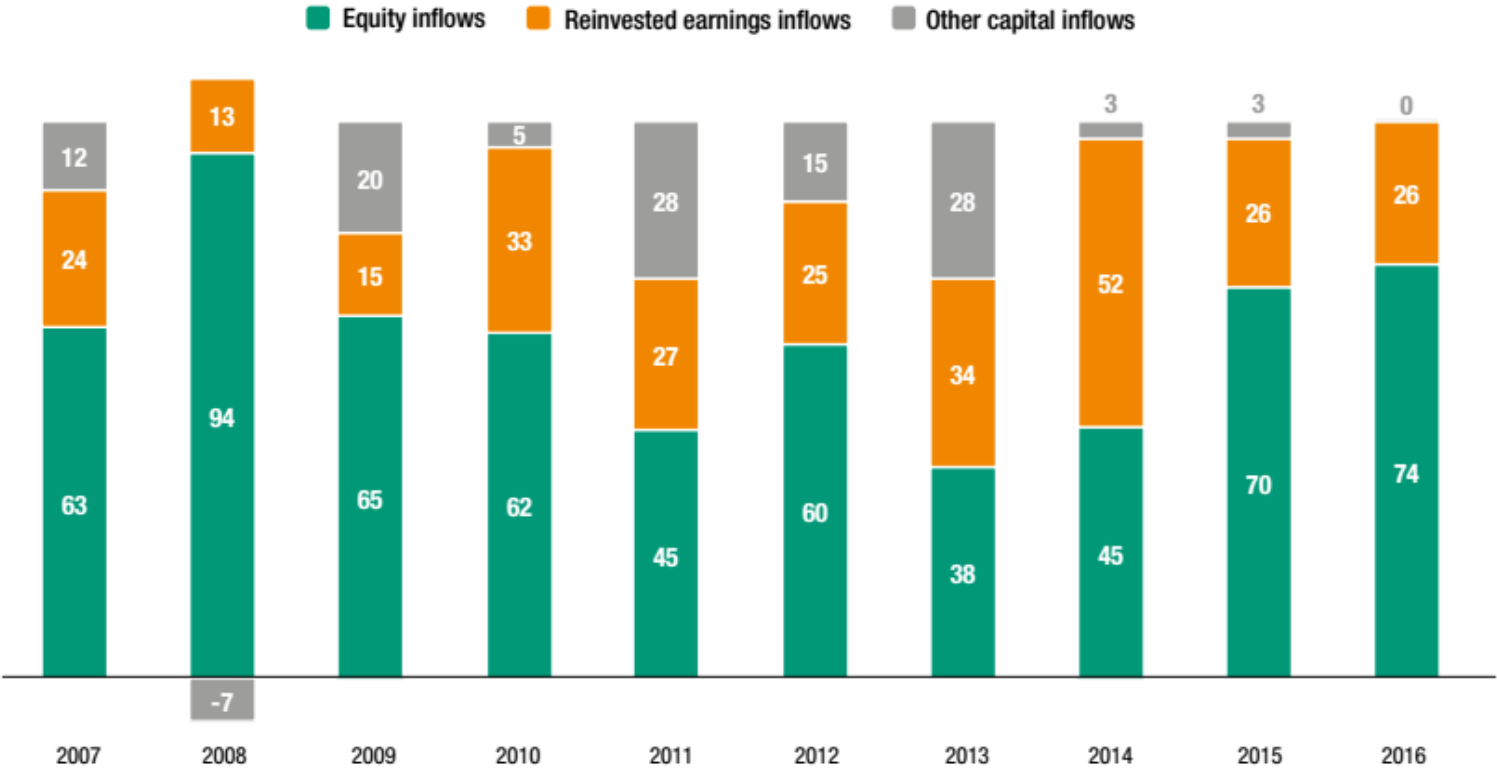


# FDI inflows by region 2014-2016 (bil. USD)





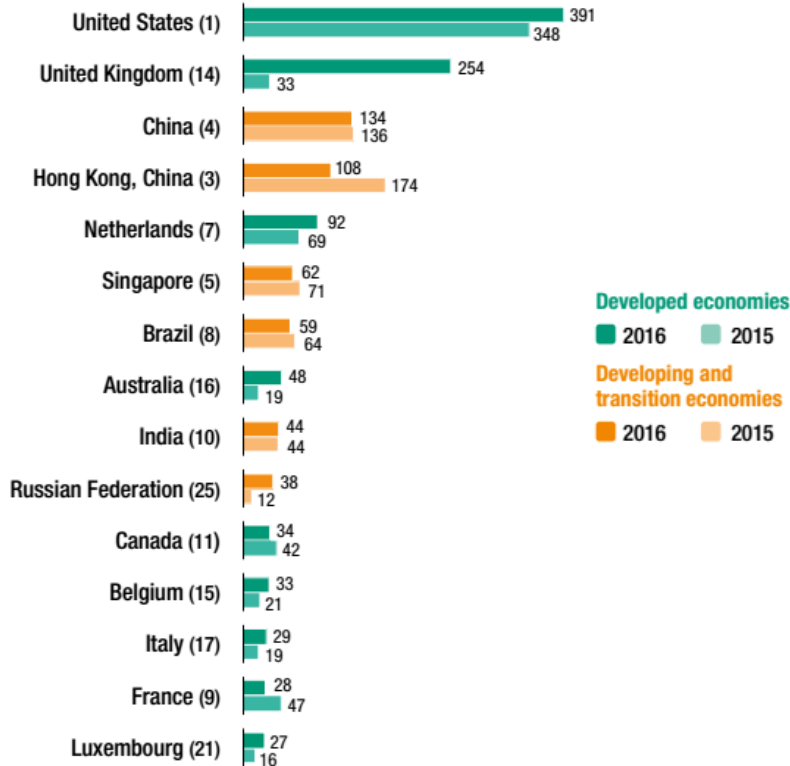
# FDI inflows by component 2007-2016 (in %)



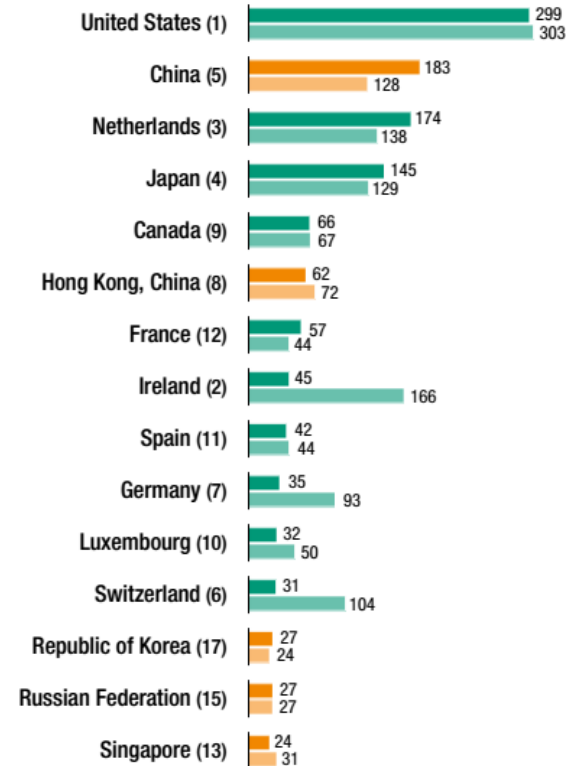
# FDI inflows top 15 host and home economies (bil. USD)



(x) = 2015 ranking



(x) = 2015 ranking



# Political economy of foreign direct investment

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- Radical view
  - “Imperialist” extraction of host country wealth
  - Implication: Always bad for the host country
- Free market
  - Different countries have different comparative advantages; best to allow countries to engage activities for which they do so most efficiently
  - Implication: Always good when countries are specializing in activities for which they have a comparative advantage
- Pragmatic nationalism
  - Belief that FDI has costs and benefits, and whether to engage in FDI depends on whether the benefits exceed the cost
  - What are the costs and benefits to the host country?

# Benefits to the host country

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- Resource transfer effects
  - Capital: MNE invests capital in foreign markets
  - Technology: Research supports that MNEs do transfer technology when they invest in a foreign country
  - Management: When MNEs invest and manage in a foreign country, they often transfer management skills to the host country's workforce
- Employment effects
  - MNEs, by investing in foreign countries, can create employment opportunities for the local workforce
  - But: Acquisition vs. Greenfield Investment

# Benefits to the host country

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- Balance of payments effects
  - FDI can have beneficial and negative effects on a country's balance of payment.
    - Initial capital inflow
    - Substitute for imports
    - Inflow of payments from export of goods and services
- Effect on competition
  - Efficient functioning of markets require adequate level of competition between producers

# Costs to the host country

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- Adverse effects on competition
  - MNEs may have “too much” power and kill off competition
- Adverse effects on balance of payments
  - After initial inflow of capital, subsequent outflow of capital from the earnings of the FDI
  - FDI may import inputs from abroad
- National sovereignty and autonomy
  - Key decisions that affect the host country’s economy may be made by a foreign parent that has no real commitment to the host country

# Benefits and costs to the home country

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- Benefits
  - Stream of income from foreign earnings
  - FDI may import intermediate goods or inputs for production from the home country, creating jobs
  - MNEs may learn skills from exposure to foreign countries
- Costs
  - Initial capital outflow (but often set off by future stream of foreign earnings)
  - Current account suffers if FDI is to serve home market from low-cost production location
  - Current account suffers if FDI is a substitute for direct export
  - FDI a substitute for domestic production

# Factors stimulating foreign direct investment

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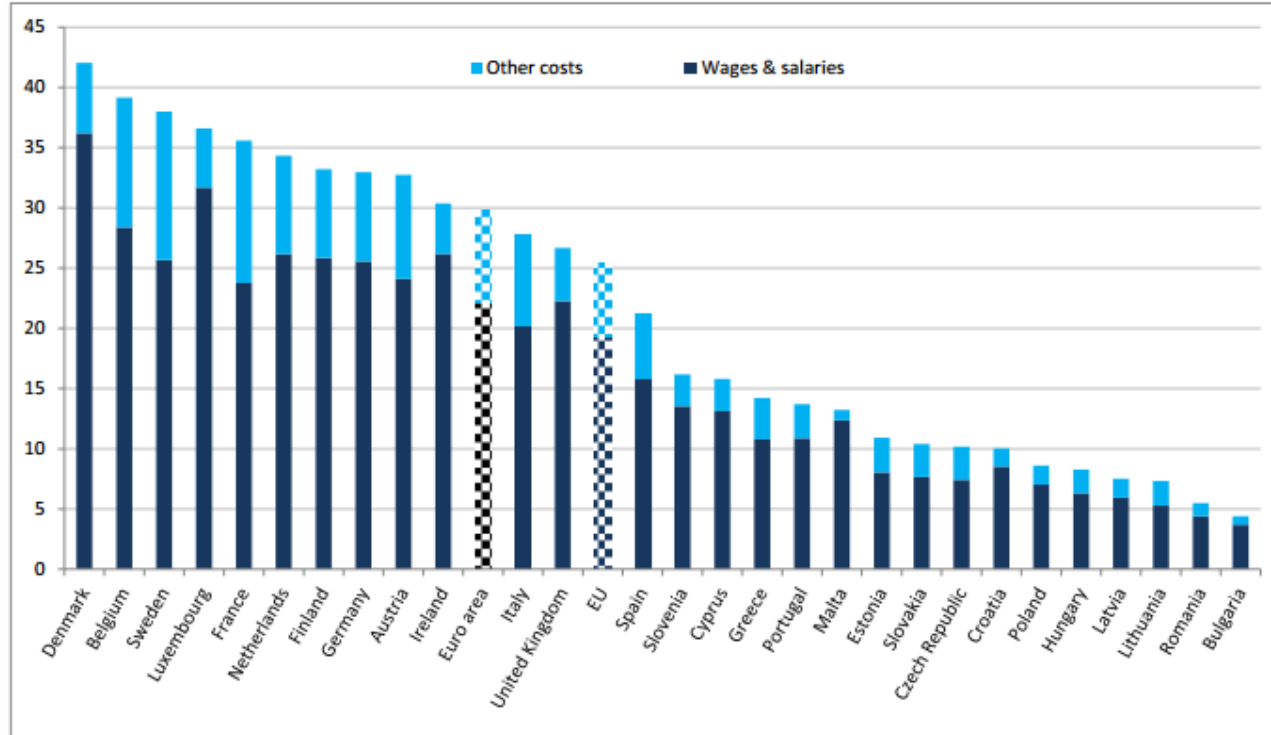
- Cheaper production factors
- Reduction of foreign trade costs
- Better tax system
- Reduction of foreign exchange risk
- Diversification of inputs, outputs, profit
- Better legal system
- Following of business partners
- Host country government incentives and subsidies



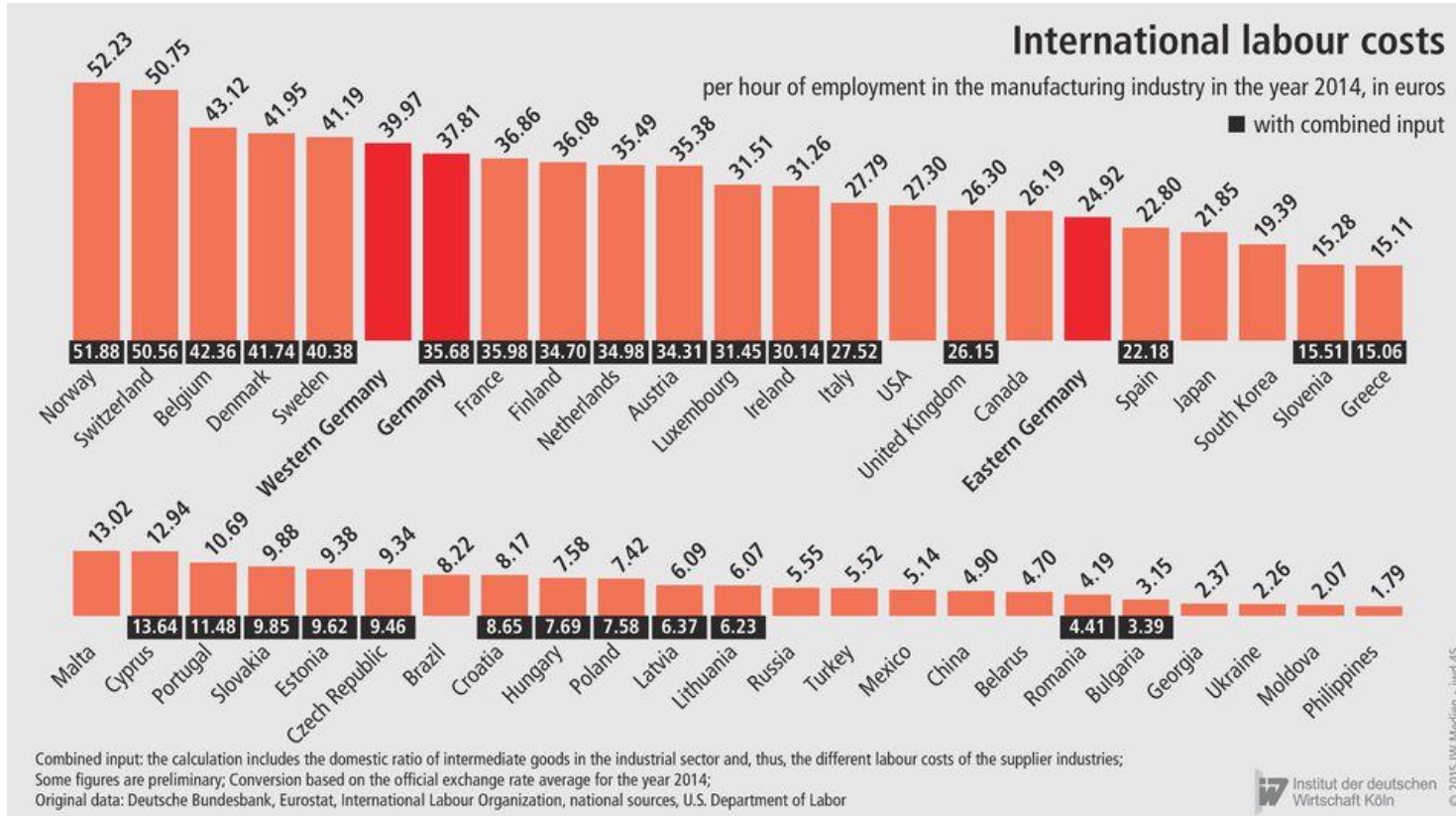
# Labor costs in the EU



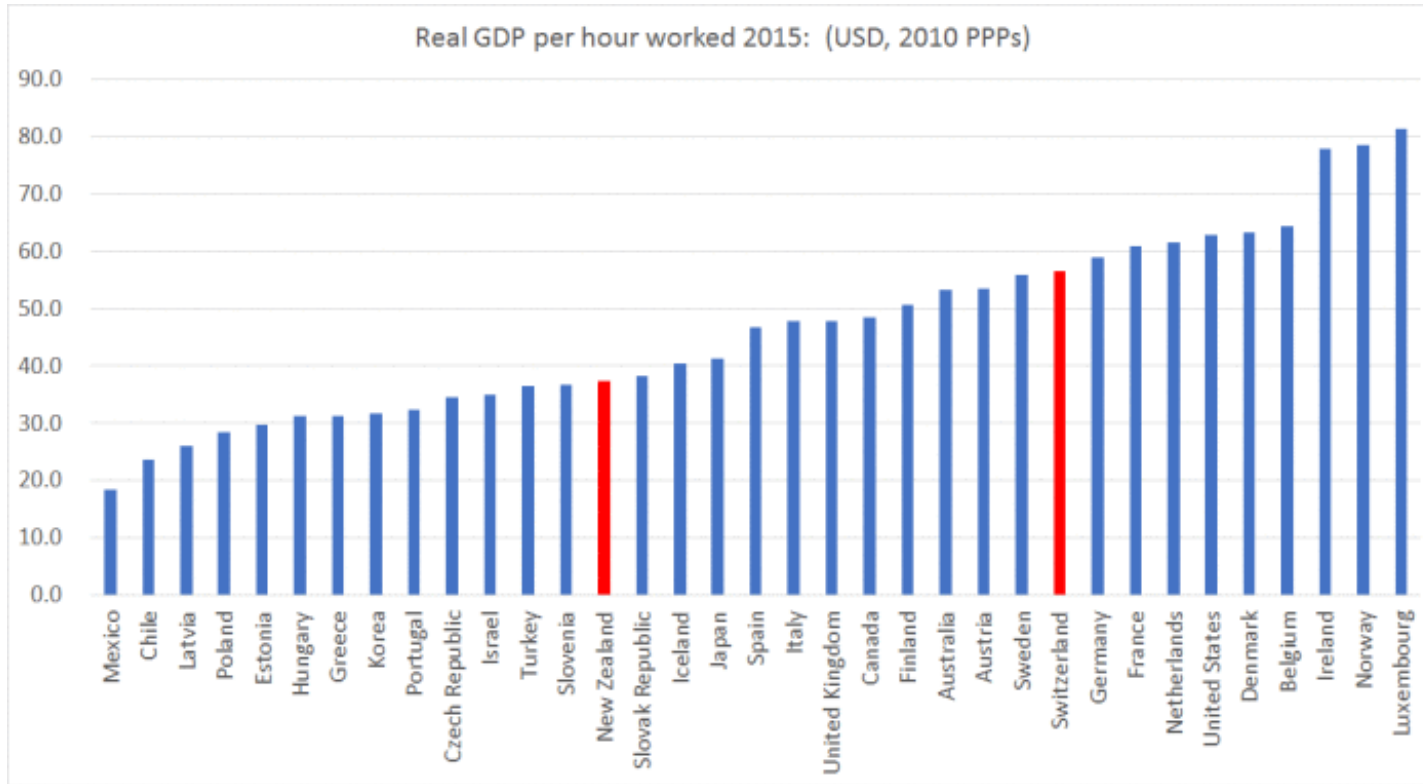
Hourly labour costs for the whole economy in €, 2016  
(enterprises with 10 or more employees)



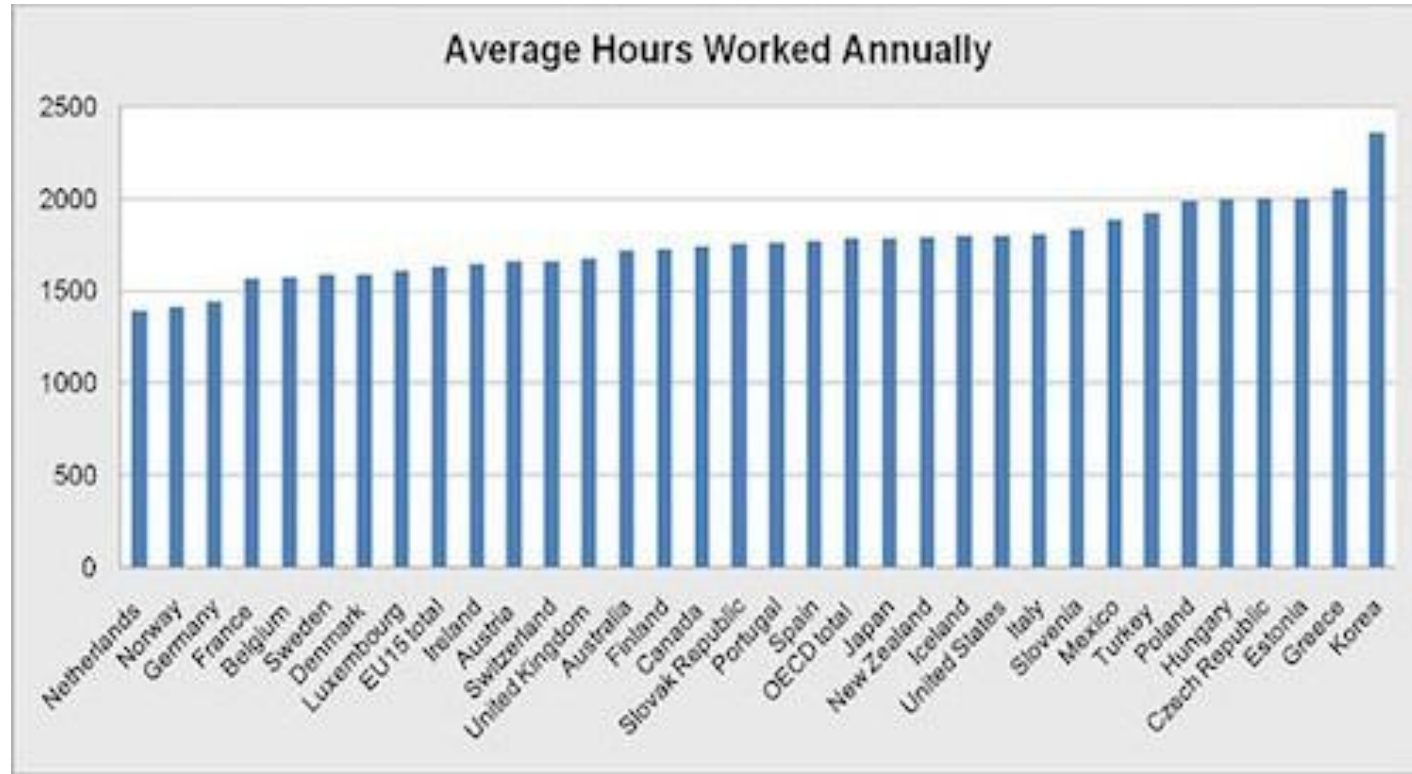
# International labor costs



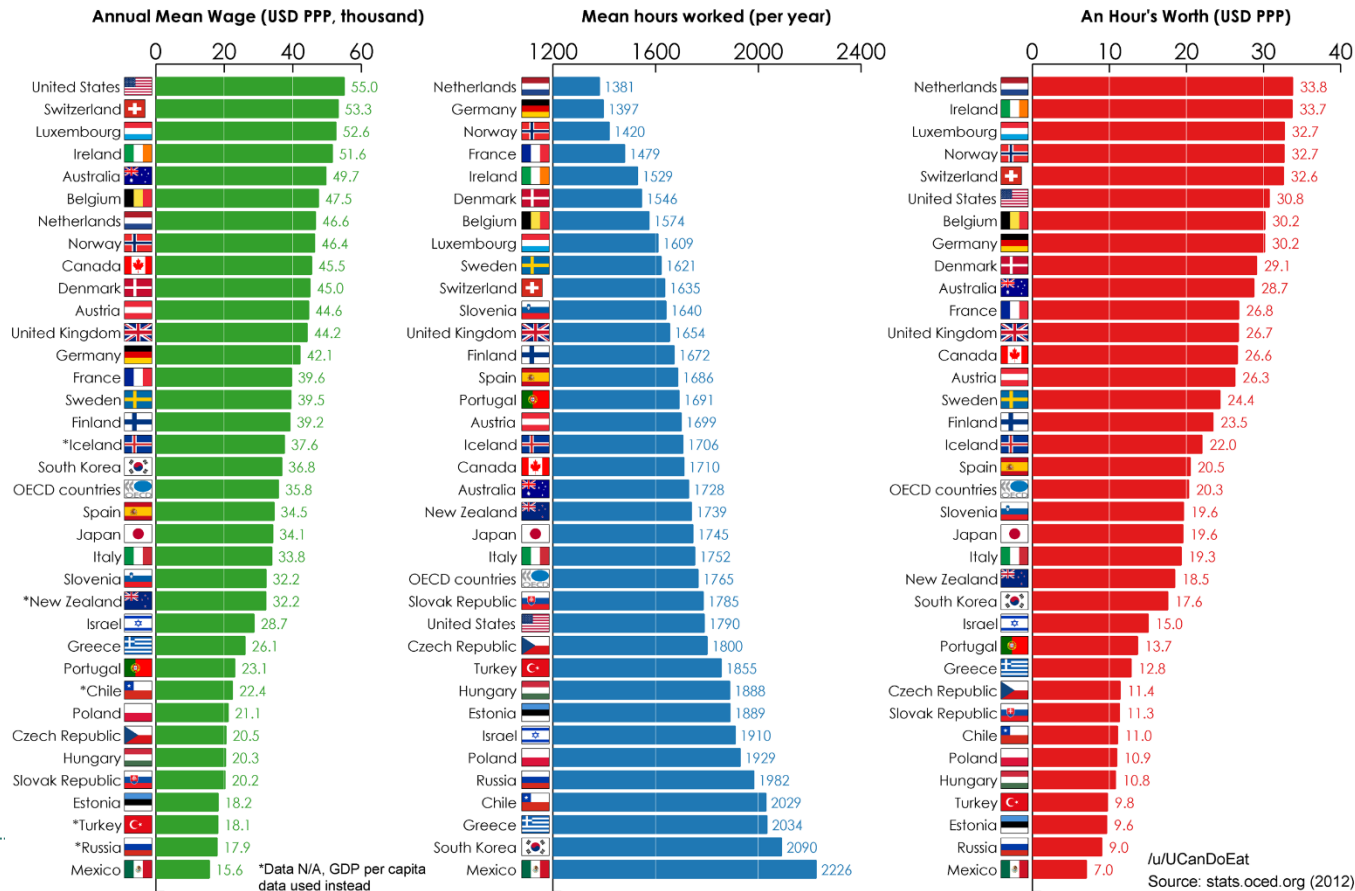
# Productivity of labor



# Annual working hours (2012)



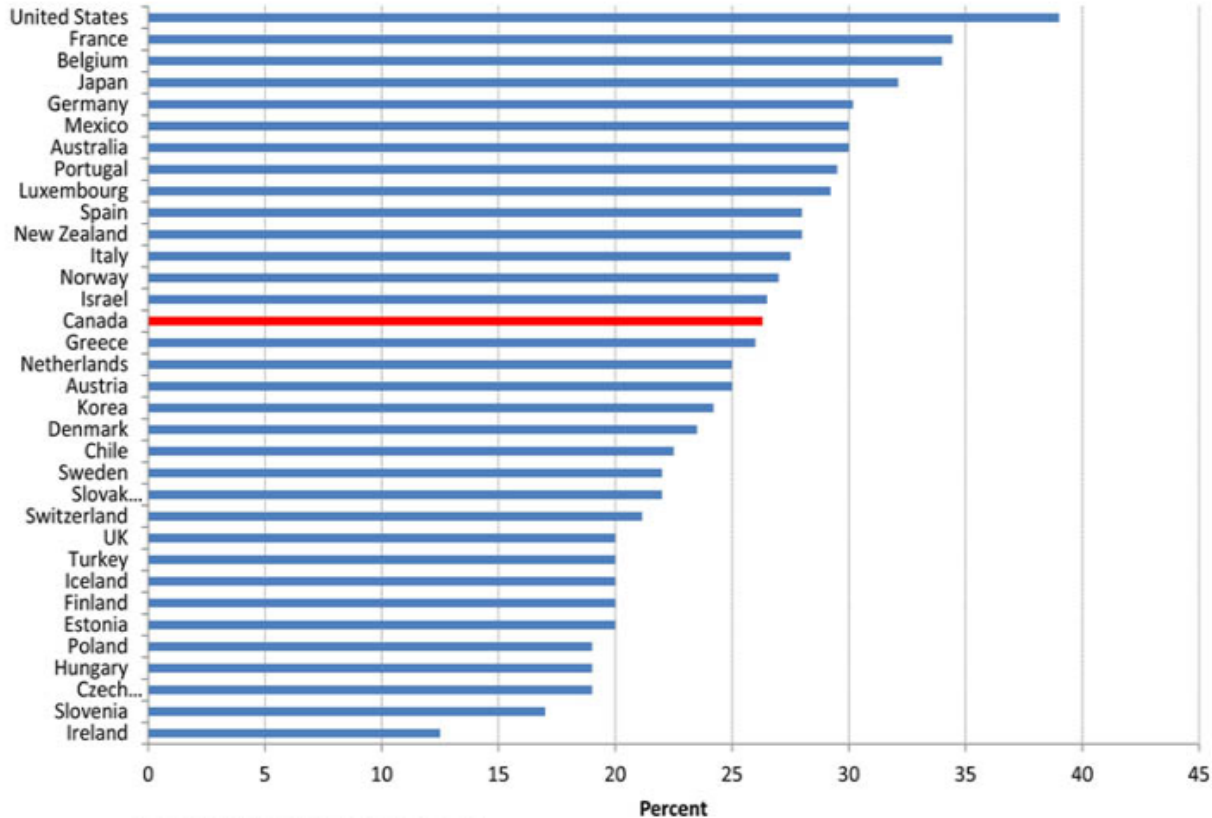
# Worth of one working hour (2012)



# Corporate tax rates (combined) in OECD countries (2015)



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# Following business partners in automobile industry



# Foreign direct investment risks – political

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- Economical expectations and reality
- Success of economical proposals of government
- Political instability and terrorism
- Foreign conflicts
- Corruption in government
- Importance of army and church in politics
- Power of legal tradition
- Conflicts between nationalities and minorities, civic war
- Development of political system
- Quality of bureaucratic system



# Foreign direct investment risks – economic and financial

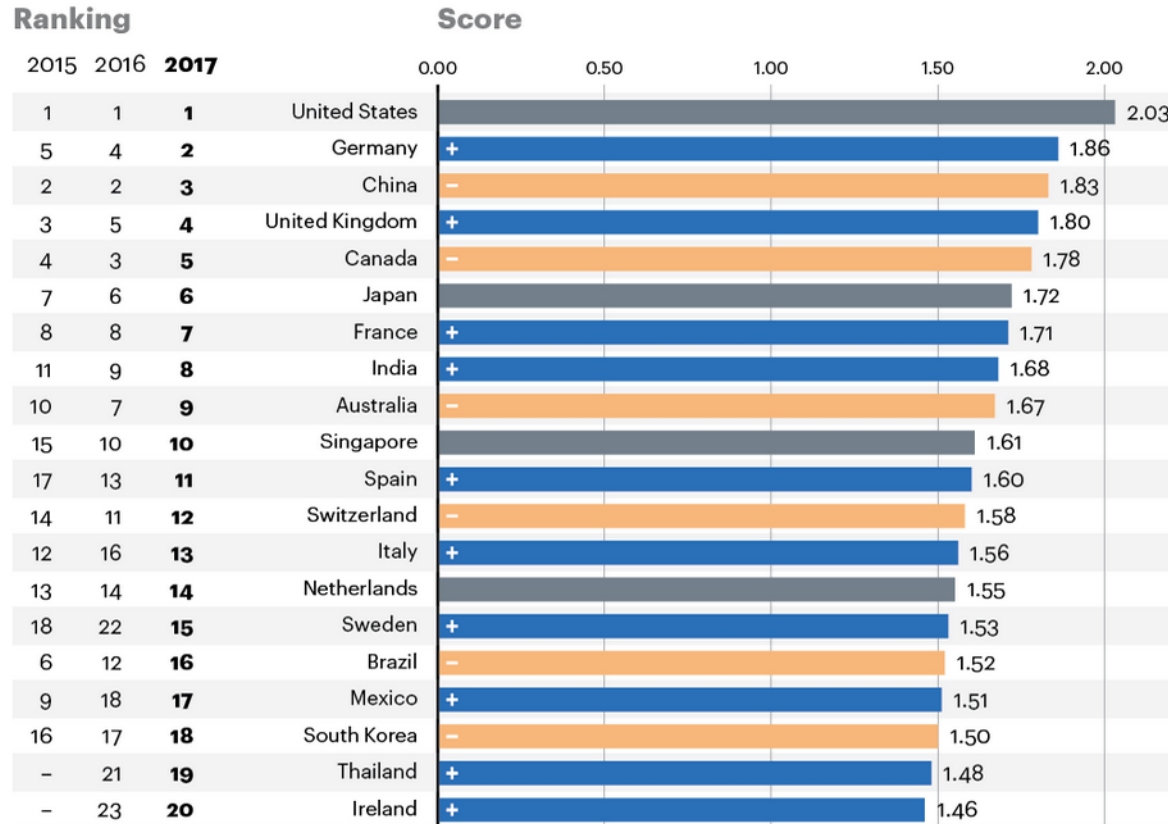
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- Insolvency or unfavorable structure of debt
- Delay of payable supplying loans
- Governments non acceptance of its liabilities
- Losses of foreign exchange control
- Expropriation of private investments
- Inflation risk
- Ratio of debt service to annual export
- Covering of one month import by net foreign currency reserves
- Payment discipline of importers
- Share of goods and services export on current balance amount
- Percentage difference between official and „black“ exchange rate

# A.T. Kearney FDI confidence index



# Ernst & Young FDI attractiveness in Europe



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Top 20 destination countries by FDI projects

	2015	2016		Percentage Change (2016 vs. 2015)
United Kingdom	1,065	1,144	↑	7%
Germany	946	1,063	↑	12%
France	598	779	↑	30%
Spain	248	308	↑	24%
Poland	211	256	↑	21%
Netherlands	219	207	↓	-5%
Russia	201	205	↑	2%
Belgium	211	200	↓	-5%
Ireland	127	141	↑	11%
Turkey	134	138	↑	3%
Finland	105	133	↑	27%
Romania	98	132	↑	35%
Czech Republic	70	110	↑	57%
Hungary	94	107	↑	14%
Sweden	51	90	↑	76%
Italy	55	89	↑	62%
Switzerland	90	88	↓	-2%
Denmark	63	72	↑	14%
Slovakia	54	70	↑	30%
Portugal	47	59	↑	26%
Others	396	454	↑	15%
<b>Total</b>	<b>5,083</b>	<b>5,845</b>	<b>↑</b>	<b>15%</b>

Top 20 destination countries by FDI job creation

	2015	2016		Percentage Change (2016 vs. 2015)
United Kingdom	42,336	43,165	↑	2%
Poland	19,651	22,074	↑	12%
Germany	17,126	19,961	↑	17%
Romania	12,746	17,545	↑	38%
France	13,639	16,980	↑	24%
Serbia	10,631	16,396	↑	54%
Russia	13,672	15,064	↑	10%
Czech Republic	9,332	14,292	↑	53%
Spain	7,126	12,969	↑	82%
Hungary	11,741	12,450	↑	6%
Ireland	10,772	8,535	↓	-21%
Slovakia	9,564	8,308	↓	-13%
Turkey	2,971	7,179	↑	142%
Austria	1,357	4,759	↑	251%
Ukraine	850	4,547	↑	435%
Bulgaria	3,598	3,959	↑	10%
Switzerland	1,391	3,416	↑	146%
Belgium	3,168	3,309	↑	4%
Moldova	1,000	3,200	↑	220%
Italy	1,383	2,654	↑	92%
Others	23,612	18,911	↓	-20%
<b>Total</b>	<b>217,666</b>	<b>259,673</b>	<b>↑</b>	<b>19%</b>

Source: EY European Investment Monitor (EIM), 2017.



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***THANK YOU FOR YOUR  
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