

Who Invests Overseas and Why?

POSC 1020 – Introduction to International Relations

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Puzzle(s) for Today

Overseas investment tops about \$5 trillion a year. What's happening here and why is this international relations?



So What Happened?

The international system is still feeling the effects of the subprime mortgage crises. Factors:

- Subprime mortgages
- Bursting of the housing bubble
- New financial products (i.e. credit-default swaps)
- Toxic assets
- Credit freezes
- Bank panics

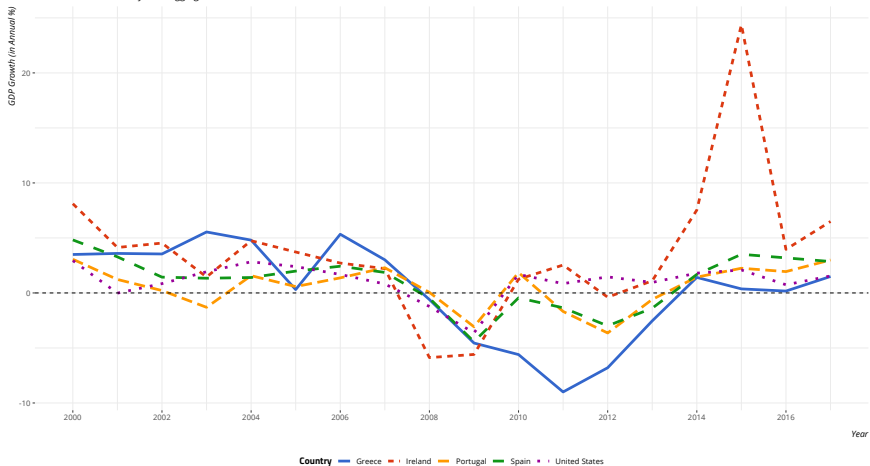
The Crisis in Europe

This was a disaster in the U.S. and worse in the Eurozone.

- Greece, Ireland, Portugal, and Spain borrowed heavily from rest of Europe to finance housing boom.
- When that collapsed, those governments ran large deficits by borrowing abroad.
- However, those governments threatened default, which would've rocked all of Europe.

The 2007 Financial Crisis Rocked GDP Growth in These Five Prominent Countries

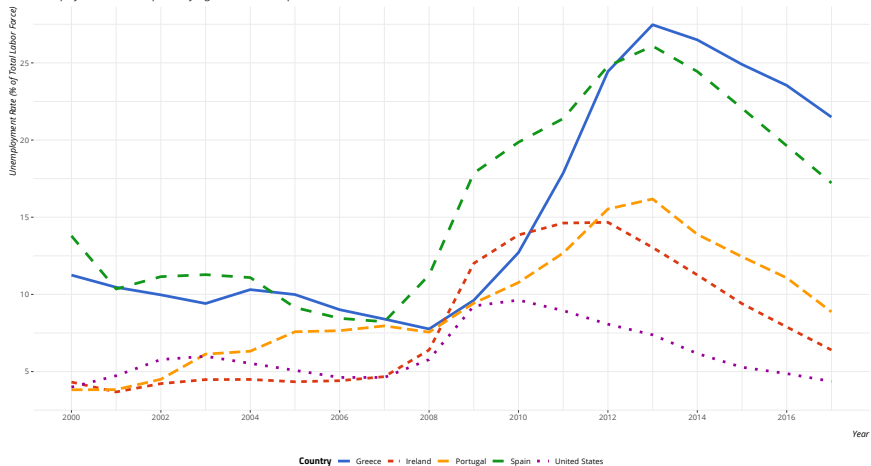
These countries are only now digging themselves from the most severe effects of that crisis.



Data: World Bank National Accounts Data

Unemployment Spiked in These Five Countries as a Result of the 2007 Financial Crisis

Unemployment is still conspicuously high in Greece and Spain.



Data: International Labour Organization via World Bank API

The Crisis in Europe

Europe negotiated bailouts, but with austerity measures.

- Unemployment tripled in countries like Greece and Ireland.
- In Greece: GDP contracted by 20%.

This led to a lot of anti-EU establishment that still puts the continent in a precarious position.

- i.e. international finance has huge IR implications.

How and Why Do People Invest Overseas?

There are generally two types of foreign investments: portfolio and direct.

- Portfolio: simple investment with no management input.
 - Sovereign lending constitutes a big chunk of portfolio investment.
- Foreign direct investment (FDI): direct investors maintain managerial control over foreign operation.
 - Think of your BMW plant in Spartanburg, or Michelin plant in Greenville.

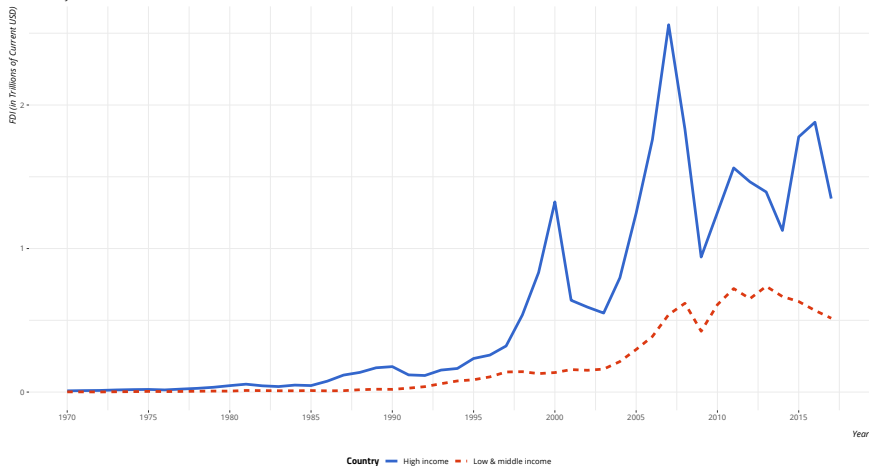
Why Invest Abroad?

Simple: profit, and a higher rate of return.

- Countries lacking in capital will pay a higher interest for capital investments.
- Ability to invest in resources not available in home/capital-rich country.
- Certainly differences in business environment matter too.

FDI in Developing Countries Gets Our Attention but Most FDI is Between Rich Countries

FDI everywhere took a hit after the 2007 financial crisis for obvious reasons.



Data: IMF Balance of Payments Database via World Bank API

The Risks of Foreign Investment

Foreign investment brings a unique risk separate from domestic investment.

- Sovereign risk: more difficult to enforce debt collection in a foreign jurisdiction.
- Foreign investors don't enjoy the same rights as national borrowers.

Why Borrow?

Borrowing is usually quite popular within borrowing countries, at least early.

- More capital = cheaper to borrow.
- Allows for more government spending without taxation.

However, that ends when it's time to pay up.

- Governments usually service their debts through unpopular austerity measures.

So What's the Problem?

Borrowing is contentious largely because of the **moral hazard**.

- i.e. banks view their profits as private and expect their losses to become public.

This certainly explains Wall Street's line of thinking.

The Role of the IMF

The IMF helps manage the international monetary system.

- Cooperation through an IGO to guarantee monetary stability.
- Countries contribute to fund, from which they can draw during a crisis.
- Loans are provided with low interest rates but with policy strings attached.

Benefits of the IMF

- IMF facilitates relations between borrowers and lenders.
- Produces agreements where they might not otherwise exist.
- Helps signal creditworthiness for would-be borrowers.

Criticisms of the IMF

IMF does disaster management, but not a lot of disaster prevention. Recent crises:

- Mexico (1982, 1988, 1994)
- East Asia (1997)
- Brazil (1998)
- Russia (1998)
- Argentina (2001)

In fact, Argentina defaulted on \$93 billion of its debt and still hasn't repayed.

Additional Criticisms of the IMF

IMF negotiations are less than “democratic.”

- Routinely, ordinary citizens bear the costs of adjustment.

The World Bank

The World Bank is another BWI to facilitate international finance.

- Gets most of its money from borrowing on other financial markets, typically at low rates.
- Provides concessional lending below market rates.
- Typically “project-focused” and invested in poorer countries.

Concessional lending is less controversial than private FDI, but debt is still debt.

Multinational Corporations (MNCs)

MNCs constitute one of the major institutional players in international finance. Types of FDI:

- Green field: build a new factory from the ground up (e.g. Michelin in Greenville)
- Mergers and acquisitions (e.g. Anheuser-Busch InBev)
- Joint ventures (i.e. shared ownership)

Why Do MNCs Invest Abroad?

Again, simple: profit, and a higher rate of return.

- Minimize factor costs and search for low-labor.
- Take advantage of permissive tax environments
- Take advantage of supply chains that are simply unavailable
 - i.e. good luck getting an iPhone produced in the U.S.

Problems of MNC Investment

MNCs generate profit and economic activity is good. But:

- Not a development panacea.
- Capital is more mobile than labor.
- Related problem of immigration.

Further, FDI is not well-regulated at the international level like trade is.

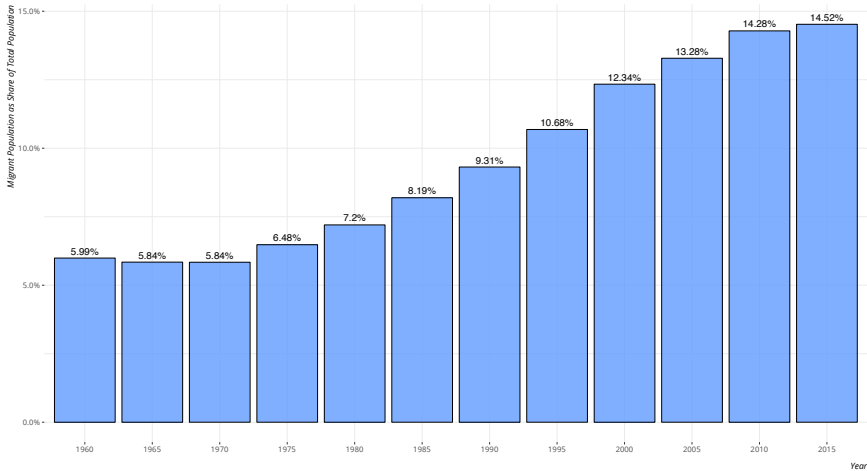
A Brief Aside on Immigration



Labor is a factor of production after all...

About 15% of the U.S. Population was Born in Another Country

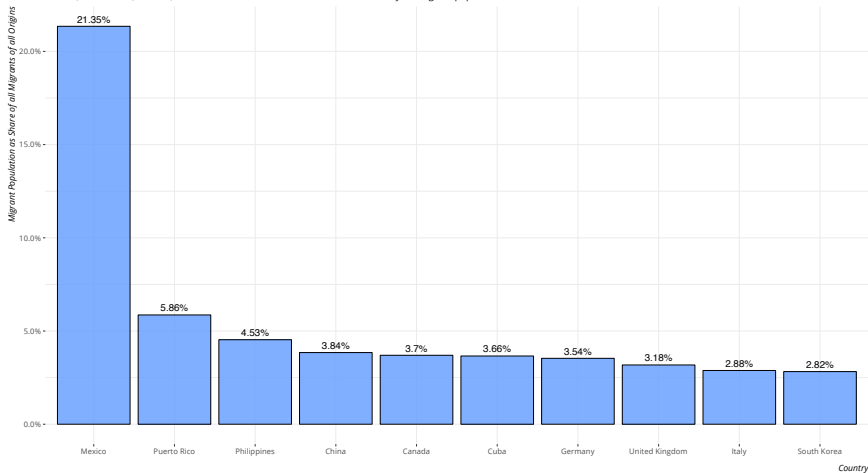
The trend has accelerated around the time the 'Boomers' started to approach retirement age and as globalization increased after the Cold War.



Data: United Nations Population Division, Trends in Total Migrant Stock: 2012 Revision (via World Bank)

U.S. Migration is Mostly Regional and Mexico Accounts for Just Under a Quarter of It

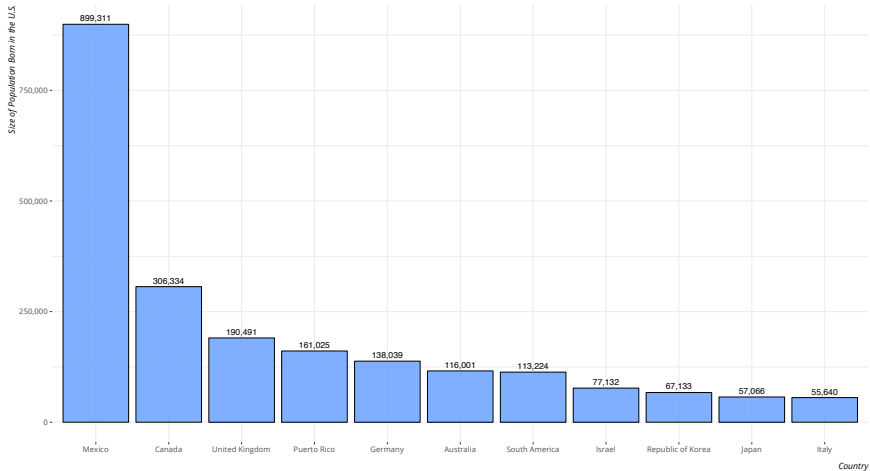
Mexico, Puerto Rico, Canada, and Cuba combine for about 33% of the U.S.' mid-year migrant population in 2017.



Data: United Nations Population Division (DESA)

Likewise: Most U.S. Migration is Local or to Familiar/Friendly Countries

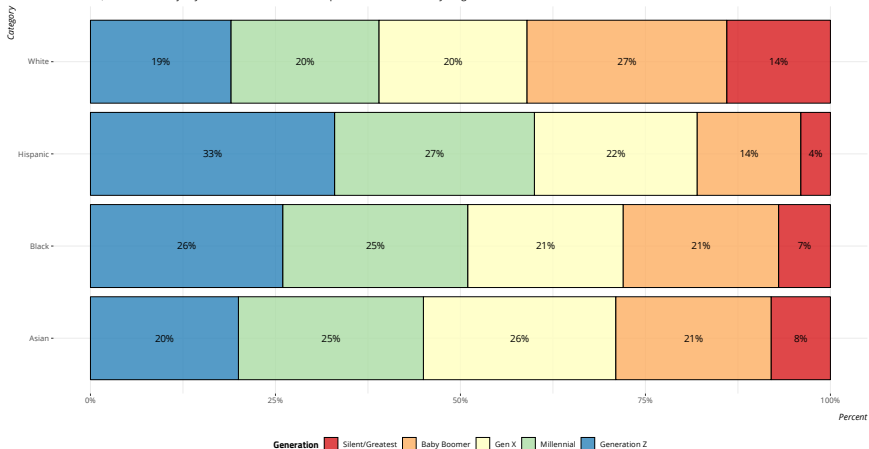
Generally, U.S. migration follows to places where FDI is abundant.



Data: United Nations Population Division (DESA)

(Non-Hispanic) White People Are Around 62% of the U.S. Population But They're Getting Older

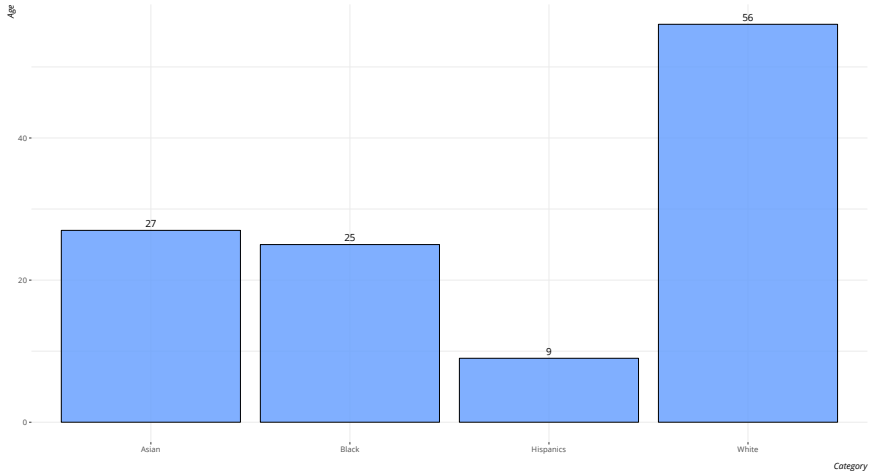
Meanwhile, more than a majority of African-Americans and Hispanics are Millennials or younger.



Data: 2014 American Community Survey, via Pew Research Center Analysis
<http://www.pewhispanic.org/2016/04/20/the-nations-latino-population-is-defined-by-its-youth/>
Note: categories rounded to sum to 100% for convenience.

The Modal (i.e. Most Common) Age for a White Person in the U.S. is 56. For Hispanics: 9.

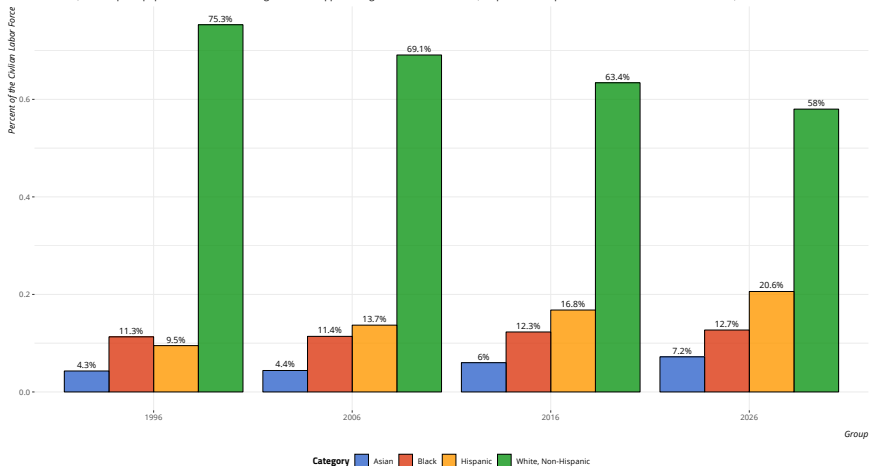
Only about a third of all Hispanics are foreign born but they comprise a large part of the low-skilled labor population.



Data: U.S. Census 2016 estimate

The BLS Expects White, Non-Hispanics as Percentage of Civilian Labor Force to Decrease 23% From 1996 to 2026

The white, non-Hispanic population is concentrated generations approaching retirement. Meanwhile, Hispanics are expected to become 20% of the labor force, a 115% increase from 1996.



Data: Employment Projections program, Bureau of Labor Statistics. Source: <https://www.bls.gov/emp/tables/civilian-labor-force-detail.htm>

Conclusion

International finance is an incredible opportunity, but not an unmitigated blessing.

- Foreign loans are a boon to developing countries but bring eventual harsh costs.
- FDI brings major investments but with some constraints.

A lot of good has come from increased international finance, but it's all still bargaining.

Table of Contents

Introduction

Why Invest Overseas, and How?

- The International Monetary Fund

- The World Bank

- Multinational Corporations

Conclusion