Foreign Direct Investment

International Finance 1

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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 political economy?

Why Invest Overseas, and How?

How and Why Do People Invest Overseas?

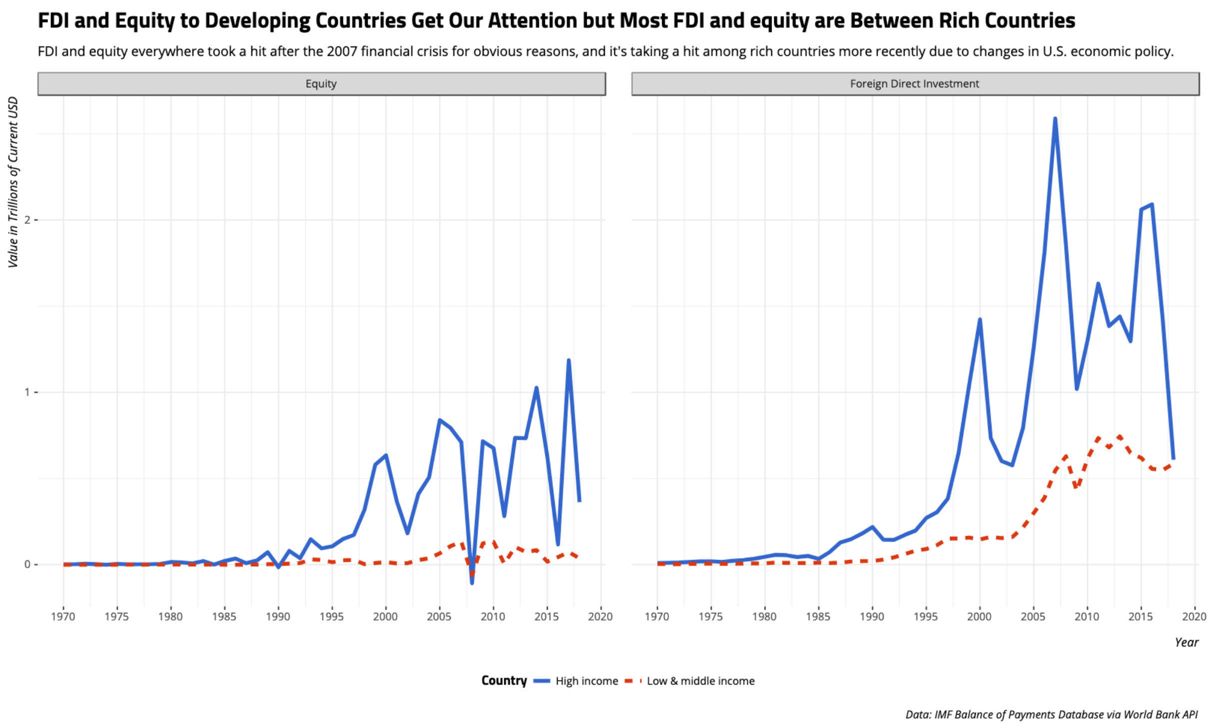
There are generally two types of foreign investments: portfolio and direct.

- 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 a BMW plant in Spartanburg, SC, or Michelin plant in Greenville, SC.

Why Invest Overseas, and How?

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 and Equity to Developing Countries Get Our Attention but Most FDI and equity are Between Rich Countries
FDI and equity everywhere took a hit after the 2007 financial crisis for obvious reasons, and it's taking a hit among rich countries more recently due to changes in U.S. economic policy.
Equity
Foreign Direct Investment
Value in Trillions of Current USD
Year
Country
High income
Low & middle income
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.

Multinational Corporations (MNCs)

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

- Greenfield: build a new factory from the ground up (e.g. Michelin in South Carolina)
- 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.