FOREIGN DIRECT INVESTMENT – THE CHANGING PICTURE

Bronislava Hořejší

Abstract

The main actors in foreign direct investment as one of the phenomena of globalization of the economy, are for the decades developed countries. This fact was reflected in some of the concepts of foreign direct investments (FDI), such as The Product Life Cycle (Vernon, 1966) or The Eclectic Paradigm (Dunning, 1988). Dunning himself in this context speaks of the old paradigm of development (Dunning, 2006). At the end of the 20th century, however, a number of changes, whether economic - administrative nature (decrease of barriers to international trade and investment), the major technological changes (development of the microprocessor and subsequently the development of telecommunications and transport technologies) and policy changes occur. The old paradigm of development is proving to be very narrow and does not reflect the institutional infrastructure and social capital, which seem to be essential for current development. Through these key determinants developing countries can increase their effectiveness, usage of their resources and access to international markets. In this post I will focus on the changing structure of global foreign direct investment, and whether it occurs in the context of the active role of developing countries.

Key words: foreign direct investment, old development paradigm, OLI paradigm, developed countries, developing countries

JEL Code: D21, D29, F21, F23

1 From "International firm" to "Transnational Firm"

The rapid development of the internationalization of production in the 1960s, 20. century has been accompanied by an effort of economists to express in theory changing the nature, the scope, forms and legal organization of institutions, dealing with business on an international scale. At that time, frequently used the term "international corporation", reflecting the fact that in its international expansion, the company used the same methods, processes, and laws, as in the parent ("national") country (hence the "inter-national"). The result of this theoretical concept of the international firm, as well as of the actual way of management international activities of a firm was a relatively strong emphasis on parent country (ethnocentrism) – see e.g. (Perlmutter, 1969 or Vernon, 1966).

In the seventies of the last century began to more fully use the term "multinational corporation” (MNC), because it more accurately reflected the changing nature of international business: the decentralization of decision-making and control on the level of many national entities (subsidiaries or branches – hence the "multi-national "), and in the same time their link through common strategies. According to Dunning (Dunning, 1971) "The concept of multinational producing enterprise…/is defined/ simply as an enterprise, which owns or controls producing facilities ... in more than one country". When defining a multinational corporation in addition to making the business in more countries were also highlighted the factors of the firm´s size (more than USD100 million sales per year) and the diverse nature of ownership (from private through the cooperative to the State).

The great expansion of the activities of multinational companies in the 1980s, 20. century, whether with regard to the number of countries where firms do establish their international activities, the amount of sales, the size of the economic and political influence, and connecting all of this common strategy were reflected in increasingly used the term "transnational corporation" (TNC), highlighting the fact that in many ways can such a company outgrow and overlap national States.

TNCs have become major players in world affairs, because due to their flexibility and territorial division of the global value chain their relationship to the mother country can be relaxed. Numerous international organizations (e.g. OECD, or UNCTAD) today exclusively use the concept of transnational corporations and the term will also be used in the following text. If we consider only equity mode of a firm's international expansion, we start from the definition of foreign direct investment OECD and define the TNC as a corporation that is resident in one economy (mother country) and has continued permanent participation in an entity which is resident in another economy (host country). This continued participation is primarily represented by a long-term relationship between the parent entity and the host country and by significant influence on the management of foreign affiliates. UNCTAD in its regular annual FDI analysis is based on the following definitions: “Transnational corporations (TNCs) are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A parent enterprise is defined as an enterprise that controls assets of other entities in countries other than its home country, usually by owning a certain equity capital stake. An equity capital stake of 10% or more of the ordinary shares or voting power for an incorporated enterprise, or its equivalent for an unincorporated enterprise, is normally considered as the threshold for the control of assets“. (UNCTAD, 2003)

Development of TNC in the 21st century reflected the general trends in the world economy. The economic crisis is changing the structure of equity investments for the benefit of reinvested profits, some TNC reduce the volume of its foreign assets through divestments and used to a greater extent than before non-equity modes of entry into the economies of host countries (contractual agreements in the form of licencing, franchising, concessions, management contracts, strategic alliances, contract manufacturing, contract farming or mining, etc.). There is significant growth in activity of TNCs based in developing countries: since 2002, there is the trend of relative decline in the share of developed countries in global FDI outflows and the growth of developing countries. In 2002, developing countries accounted for an outflow of FDI approximately 7%, in 2013 it was 39% (including FDI from transition economies). One of the reasons for this trend are undoubtedly the economic problems of developed countries (since 2007 this trend promotes stronger). With regard to the long-term trend and the strengthening of the years 2011 - 2013 it is clear that the reasons should be sought elsewhere.

2 The basic causes of the existence of transnational corporations.

Let us recall briefly the basic impulses that lead firms to invest abroad. According to some authors (Hymer, 1976 and Caves, 1971) consist causes FDI in possession of a monopolistic advantages (e.g. technology, exclusive access to the necessary factors of production, economies of scale, product differentiation or control distribution systems), which is used in international expansion.

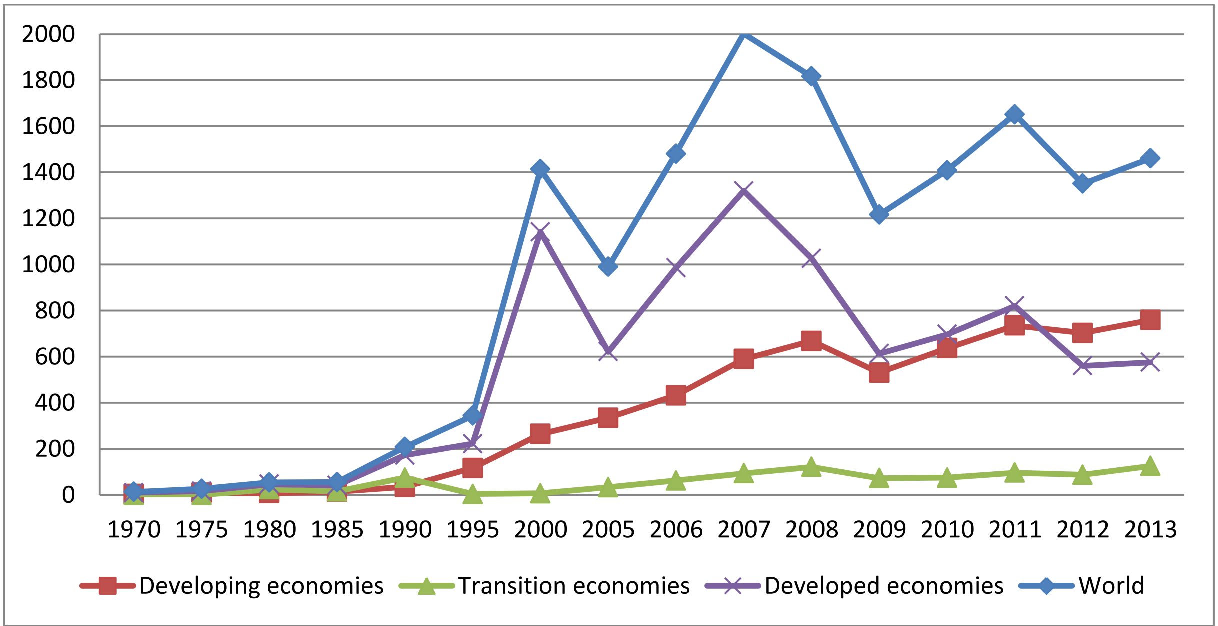
According to the theory of transaction costs (e.g. Buckley and Cason, 1976) may be foreign direct investment associated with the ownership of some monopolistic advantages. The only requirement is that the hierarchical coordination should be less expensive than the price coordination. Transnational companies use a hierarchy to eliminate or reduce transaction costs, since they can organize some interactions that cannot be realized by the market. Foreign direct investment is thus possible within the transaction cost theory understood as the internalization of markets. Transaction cost theory is used to answer the question of the most appropriate forms of international expansion of the company: foreign direct investment and transnational firm occur when, due to high transaction costs in the markets for inputs hierarchical coordination is more efficient.

In the eighties came Dunning (Dunning, 1988) with the eclectic paradigm, whereby the company's international expansion is realized in the form of foreign direct investment if three conditions are fulfilled. The firm must have ownership advantages (e.g. technology or know-how to coordinate their assets in the mother country with assets in the host country more effectively than potential or actual foreign competitors); in the host country it must identify the location advantage (e.g. comparative advantage, political stability, investment incentives, etc.) and FDI must result in a reduction or elimination of firm´s transaction costs - in other words, there must be an advantage of internalization. According to the initial letters of the three advantages (ownership-location-internalization), this concept is referred to as the OLI and is one of the widely accepted theoretical approach to the TNC.

3 Changing the geographic structure of FDI

Since the 60's of last century until 2008, the hegemony of foreign direct investment was developed countries. The global economic crisis and the inability to completely break free from the fragility of economic growth and instability, and also political uncertainty and investor concerns of policy measures towards FDI caused the volume of FDI from developed countries in the years 2007 - 2009 and 2011 - 2012 declined and only slightly grew in the period 2009 - 2011 and 2012 - 2013 period.

Fig.1 Global FDI inflow 1970 – 2013 (billions of USD)



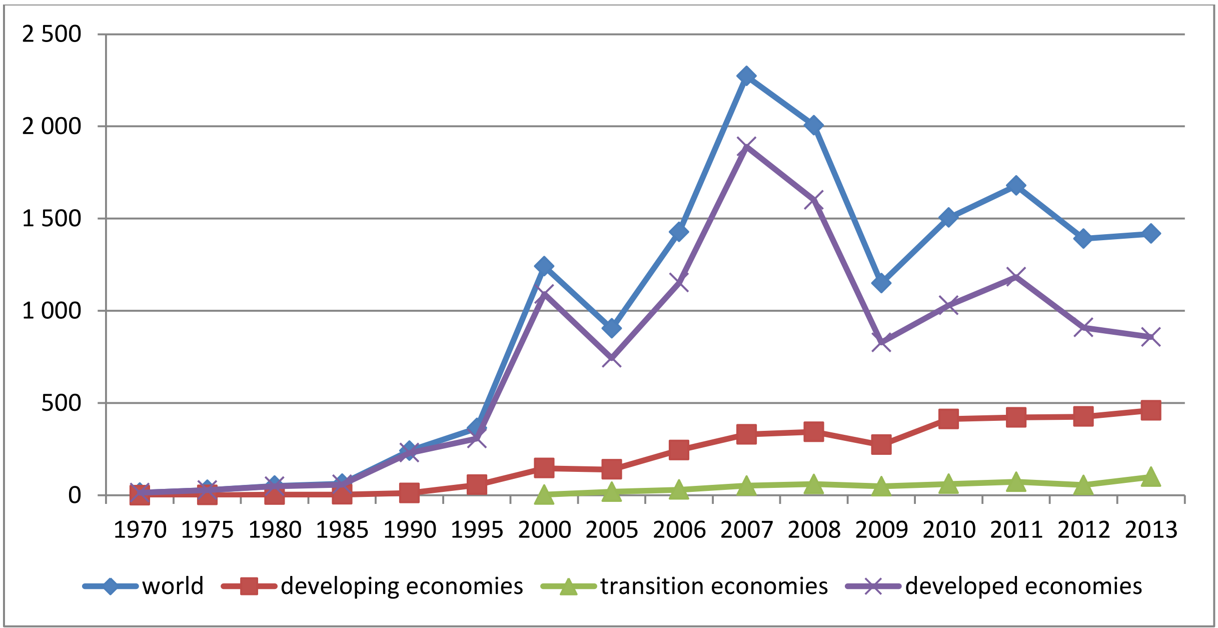
Source: own graph based on http://unctadstat.unctad.org/TableViewer/tableView.aspx wir 2013, Global investment trends monitor No.16, April 2014 (data for 2013year estimated)

As it is evident from Figure 1, there is a fundamental change in the old paradigm of development in the form of the growing importance of developing countries in global FDI. In 2012, for the first time in the history, FDI flows to developing countries were greater than to developed countries, and this trend continued in 2013. A certain role was played by the fact that FDI inflows to developed countries declined quite dramatically.

In 1995 the inflow to developing countries represented 34% of global FDI, into developed countries 64.5% FDI and in transition economies 1% of FDI. In 2007, the share of developed countries as recipients of FDI increased to 65.8% and the share of developing countries as targets for FDI decreased to 29.4% (with a rising share of transition economies to 4.6%). In 2013 flowed to developed countries, 39.4% of global FDI, to developing countries 52% and to transition economies 8.6% of FDI.

Changing the position of the developing countries is evident from their growing foreign investment activity in developed, developing and transition economies. Global FDI outflow in the period 1970 – 2013 is presented in Figure 2.

Fig.2 Global FDI outflow 1970 – 2013 (billions of USD)



Source: own graph based on http://unctadstat.unctad.org/TableViewer/tableView.aspx, wir 2013,Global investment trends monitor No.16, April 2014 (data for 2013year estimated)

As it is evident from Figure 2, FDI from developed countries between 2007 and 2013 on average decreased (in 2013 reached a level of only 55% in 2007). The share of investors from developed countries in global FDI outflow declined from 83% in 2007 to 60.5% in 2013. TNC were waiting for clearer signals about economic growth, pulling their investments from abroad or reinvested abroad part of their incomes and restructured their foreign assets. After a deep decline in incomes from FDI between 2008 and 2009 due to the global financial and economic crisis it occurred in the following years their significant re-growth and became an important source of FDI.

A closer look at the group of developed countries shows that The United States maintains its position as the largest investor, despite the downward trend (outward FDI in 2013 accounted for 86% of FDI invested by U.S. investors abroad in 2007). TNCs´ investments from EU countries in the period 2007 - 2013 have dramatically decreased; estimated outflow in 2013 represents only 20% of the amount invested outside the EU in 2007. European TNCs, mainly operating in the financial sector, divested their abroad assets. Grim trend of developed countries slowed outward FDI of Japan, which in the period 2007 - 2013 with two exceptions still grew and in 2013 were 83% higher than in 2007. Regarding the structure of FDI outflows from developed countries in the period 2007-2013 there is evident reduction of the share of equity outflows (from 52% in 2007 to 23% in 2013) and increasing the share of reinvested earnings (from 35% in 2007 to a record 67% in 2013).

In the years 2007 - 2013 there is a relative growth of FDI outflows from developing countries. While in 2007, investors from developing countries participated in global FDI outflows 14.5%, in 2013 it was already 32.4%. The growth of power and importance of investors from developing and transition economies evidenced by their representation among the world's biggest investors: in 2012 came eight of the twenty largest investors in developing and transition economies. In 2013 appeared seven investors from developing countries in the group of twenty biggest investors. Four investors from developing and transition countries belonged to the group of six largest global investors. When structured view of FDI in developing countries shows that in Africa, investors from developing and transition economies, promote a greater extent than investors from developed countries. The outflow of FDI from Africa between 2011 and 2012 almost tripled and in 2013 over the previous year it increased by 57%. It also increases the volume of intra-African investments. Also, FDI of Asian TNCs are steadily increasing (in the last seven years; they declined slightly in 2009 alone); in the different sub-regions are different trends that we will not address. Among the largest Asian investors in foreign countries are China (nearly fourfold outward FDI increase between 2007 and 2013), Hong Kong, Republic of Korea, Malaysia, Singapore, Thailand, India and Kuwait.

TNCs´ investment from transition economies between 2007 and 2013 doubled (from USD 52billions on billions estimated USD100). The strongest investor is Russia, which in 2012 accounted for 92% of FDI outflows from transition economies. Reported greenfield investments abroad increased (between 2012-13 by 87%); the question is whether there will be the realization of all of them, inter alia as a result of the political situation.

Developing countries foreign expansion is associated with a substantial change in the ownership structure: through M&As TNCs from developing countries gain developed countries' foreign affiliates in developing and transition economies. TNCs from developing countries accounted for 56% of global M&As and in a group of twenty leading international M&A investors was twelve investors from developing and transition economies. 72% of the gross cross-border M&As by TNC from developing countries represented acquisitions in other developing and transition economies; 50% of them were purchases of foreign TNCs´ affiliates in developed countries (UNCTAD, 2014).

4 Development paradigm shift

The traditional paradigm of development was based on the idea that developing countries are similar to developed countries, with the difference that they are at an earlier stage of development. Let us now look at the above two changes to the traditional development paradigm, i.e. the growth of developing countries, as FDI destination countries (from 29.4% in 2007 to 52% in 2013) and to increase the share of investors from developing countries in the global FDI outflow (from 14.5% in 2007 to 32.4% in 2013), using Dunning´s eclectic approach.

In the past, ownership advantage as a result of economic and technological development of the parent country possessed firms from developed countries. It then explained the strong flow of FDI from developed to developing countries in the second half of the 20th century. The growing share of TNCs from developing countries in global FDI outflow shows that ownership advantage may not be a necessary condition, since even without the exclusive ownership of specific assets may be the implementation of location advantage and internalization advantage sufficient reason for FDI and thus the formation of TNC. In addition, a number of firms from developing countries managed to gain ownership advantages either in the form of exclusive technology and the firm-specific advantages. These firm specific advantages due to the relatively smaller cultural and institutional distance thrived better use when investing in other developing countries. The above mentioned change in ownership structure, where developing countries are buying developed countries' foreign affiliates is the result of efforts to acquire ownership advantage, especially in the area of strategic assets (this is evident in the extractive industry in particular) and intangible assets (acquisition of strong brand names such as HSBC or Société Générale in the banking sector).

Locational advantages are usually associated with the quality and price of labour, natural resources, market size, scope and quality of infrastructure, taxes, incentives, presence of suppliers, functional institutions, stability of legal and political environment. Locational advantages of investments in developing countries are often represented by lower labour costs, access to natural resources, size of local and regional market and return on investment. Extremely cheap labour in a number of low-income Asian countries (and poor functioning of institutions, often not defending basic human rights of local workers) remains one of the causes of FDI inflows. Many developing countries, however, seeks to attract FDI with high added value, which requires on their part to raise the level of education, especially in engineering, technology and science. In a broader context, it is about building human capital as the sum of knowledge, abilities, skills and experience. Given the high financial and time demands the creation of human capital in developing countries appears to be one of the main obstacles complicating the achievement of the advantages of localization by foreign investors. The inflow of FDI might be positively stimulated by liberalization of local labour markets and their flexibility - for example, quick and easy retrieval of work and residence permits for foreign workers. These processes are often rigid, unqualified and associated with corruption due to sufficiently dysfunctional institutions.

Investors often seek to enlarge markets through FDI (market-seeking incentive for FDI). For investors it is relevant as the market size as its openness; small countries by their disadvantage in this area addressed through the establishment of regional groupings or free trade areas. Examples include APEC (Asia-Pacific Economic Cooperation), ASEAN (Association of Southeast Asian Nations), COMESA (Common Market for Eastern and Southern Africa), GCC (Gulf Cooperation Council), TPP (Trans-Pacific Partnership Agreement), etc. Regional integration might be more effective if the grouping adopts a common regulatory framework or develops regional transport and communications networks. For instance, the East African Community has created a market of 130 million people with a combined GDP of over USD70 billion (UNCTAD 2012). In 2013 at least 110 countries were involved in 22 regional negotiations (UNCTAD 2013).

Locational advantages of investing in developing countries also lies in the fact that FDI rates of return used to be higher than those in developed economies. In 2006 – 2011 the global average rate of return on FDI was 7.0 per cent, the average inward rate for developed economies was 5.1 per cent. In contrast, the average rates for developing and transition economies were 9.2 per cent and 12.9 per cent, respectively (UNCTAD, 2013). This is due to, inter alia, the fact that FDI directed to the extraction and processing of natural resources that are associated with the highest rate of return[1]. In assessing the rate of return FDI is necessary to bear in mind the fact that the rate of return reflects the risk undergone by investors.

Targets of investors from developing countries may be affected by the nature of ownership, i.e. whether it is a state controlled entity (sovereign wealth funds, SWF and state-owned enterprises, SOE) or private equity funds. The aim of the first-named is not always profit maximization resp. rate of return, but it may prefer long-term strategic goals. As a result of ongoing globalization, the goals of private and government investors converge - for example, SWF are investors in private equity funds. Large market power of state - owned enterprises and their good financial situation are the source of their investment expansion abroad; in 2012 was their share in the global M&As greater than their share in the total number of TNC (UNCTAD, 2013).

Locational advantage may be represented by accommodating conditions, attracting FDI into the country. Looking at the economic policy, focused on liberalizing foreign investment inflows on the one hand and on the restrictive resp. regulating FDI inflow on the other hand in the period 2000 - 2007 it is a clear trend of increasing caution of governments, particularly with respect to investment in sectors deemed strategic. While in 2000, 94% accepted economic policy measures towards FDI were positive (and only 6% negative, i.e. regulating and restricting the inflow of FDI), in 2012 the ratio changed to 75% liberal economic policies to 25% restrictive investment policies.

Localization aspect contributing to the rising flow of investments from developing to developing countries may be their cultural affinities: investors expect similar behaviour in host country markets they are used in the domestic markets. This cultural affinity (knowledge of suppliers and demanders behaviour patterns) may also benefit investors from developing countries to investors from developed countries.

The quality of institutions is currently together with the level of infrastructure development considered key location factors FDI. In particular, this is about the fight against corruption, for the rule of law and its enforcement, protection of intellectual property, open

[1] Note: among the twenty countries with the highest rate of return on inward FDI is the only developed country found itself Czech Republic (with 13% rate of return at 16 to 19 spot together with Bolivia, the Russian Federation and Zambia).

access to transparent information, etc. Political instability, open conflicts and low levels of health care are among the institutional factors that discourage foreign investors. The institutional environment in developing countries can improve thanks to the activity of international institutions such as the WTO or UNCTAD (downward pressure on tariffs, support of international investment agreements, etc.). Overcoming institutional distance (understood as the difference between indicators of institutional quality in the parent and the host country) will require a longer time.

Conclusion

As a result of the qualitative development of the technology, the liberalisation of international trade, the political changes and the development of an institutional environment the barriers for international business decrease. Major international investors are not only transnational corporations, but there are new strong players, represented by the State-owned transnational corporations, sovereign wealth funds or private equity funds (mainly offshore financial centres and special purpose entities). The position of developing countries in the global economy is changing: first, it markedly increases their role as recipients of FDI and secondly, developing countries TNCs´ activity in investing abroad is significantly growing. It increases the volume of FDI flows among developing countries (so called South-South investments). There is a change in equity FDI structure and to a much greater extent than before new forms of FDI, so-called contractual forms of investment abroad are used to expand abroad. Changes in the global investment environment that have taken place over the past seven years, can be permanent or temporary, which is largely influenced on one hand by how quickly developed countries get back on a strong growth trajectory; on the other hand by whether the developing countries make use of the opportunity, take institutional and structural measures and will be able to continue to promote their active role in the world economy.

References

Buckley, P. J. & Casson, M. C. (1976). *The Future of the Multinational Enterprise.* London: Macmillan.

Caves, R. E. (1971). International corporations: the industrial economics of direct foreign investment, *Economica*, *38*, 1 - 27.

Dunning, J. H. (1988). The eclectic paradigm of international production: an update and some possible extensions, *Journal of International Business Studies*, *19*, *1*, 1 – 31.

Dunning, J. H. (2006). Towards a new paradigm of development: implications for the determinants of international business, *Transnational Corporations 15.1*, 174 – 227.

Dunning, J. H. ed. (1971). *The Multinational Enterprise*. London, p. 16

Hymer, S. (1976). *The International Operations of National Firms: a Study of Direct Foreign Investment.* Cambridge, Mass.: MIT Press.

Perlmutter, H. V. (1969). The Tortuous Evolution of Multinational Enterprises. *Columbia Journal of World Business, 4*, 9 – 18

Vernon, R. (1966). International Investments and International Trade in the Product Life Cycle, *Quarterly Journal of Economics, 80, 2*, 190–207.

http://unctadstat.unctad.org/TableViewer/tableView.aspx

http://unctadstat.unctad.org/TableViewer/tableView.aspx

UNCTAD, 2003. *World Investment Report 2003: FDI Policies for Development: National and International Perspectives.* 231.

UNCTAD 2012. *Transnational Corporations, 21, 1*, 48

UNCTAD, 2013. *World Investment Report 2013:Global Value Chains: Investment and Trade for Development.*

UNCTAD, 2014. *Global Investment Trends Monitor. 16.*

Contact

Bronislava Hořejší

Škoda Auto Vysoká škola, o.p.s.

Na Karmeli 1457, 293 01 Mladá Boleslav

bronislava.horejsi@savs.cz