International economics

INTERNATIONAL CAPITAL MOBILITY

PART 1

1. General outlook

In the course of globalization, foreign direct investment (FDI) is a widespread phenomenon which is closely related to the process of economic integration.

A central topic concerns the differences in the characteristics between firms that are investing abroad and firms without foreign affiliates. There is a broad consensus in theory that only the most productive firms engage in FDI (Helpman/Melitz/Yeaple 2004; Melitz 2003).

Direct investment is a category of cross-border investment made by a resident in one economy (the direct investor) with the objective of establishing a lasting interest in an enterprise (the direct investment enterprise) that is resident in an economy other than that of the direct investor. The motivation of the direct investor is a strategic long-term relationship with the direct investment enterprise to ensure a significant degree of influence by the direct investor in the management of the direct investment enterprise. The “lasting interest” is evidenced when the direct investor owns at least 10% of the voting power of the direct investment enterprise. Direct investment may also allow the direct investor to gain access to the economy of the direct investment enterprise which it might otherwise be unable to do.

The objectives of direct investment are different from those of portfolio investment whereby investors do not generally expect to influence the management of the enterprise.

Direct investment enterprises are corporations, which may either be subsidiaries, in which over 50% of the voting power is held, or associates, in which between 10% and 50% of the voting power is held, or they may be quasi-corporations such as branches which are effectively 100% owned by their respective parents. The relationship between the direct investor and its direct investment enterprises may be complex and bear little or no relationship to management structures. Direct investment relationships are identified according to the criteria of the Framework for Direct Investment Relationships (FDIR), including both direct and indirect direct investment relationships.

A foreign direct investor is an entity (an institutional unit) resident in one economy that has acquired, either directly or indirectly, at least 10% of the voting power of a corporation (enterprise), or equivalent for an unincorporated enterprise, resident in another economy. A direct investor could be classified to any sector of the economy and could be any of the following:

i) an individual;

ii) a group of related individuals;

iii) an incorporated or unincorporated enterprise;

iv) a public or private enterprise;

v) a group of related enterprises;

vi) a government body;

vii) an estate, trust or other societal organisation; or

viii) any combination of the above.

In the case where two enterprises each own 10% or more of each other's voting power, each is a direct investor in the other.

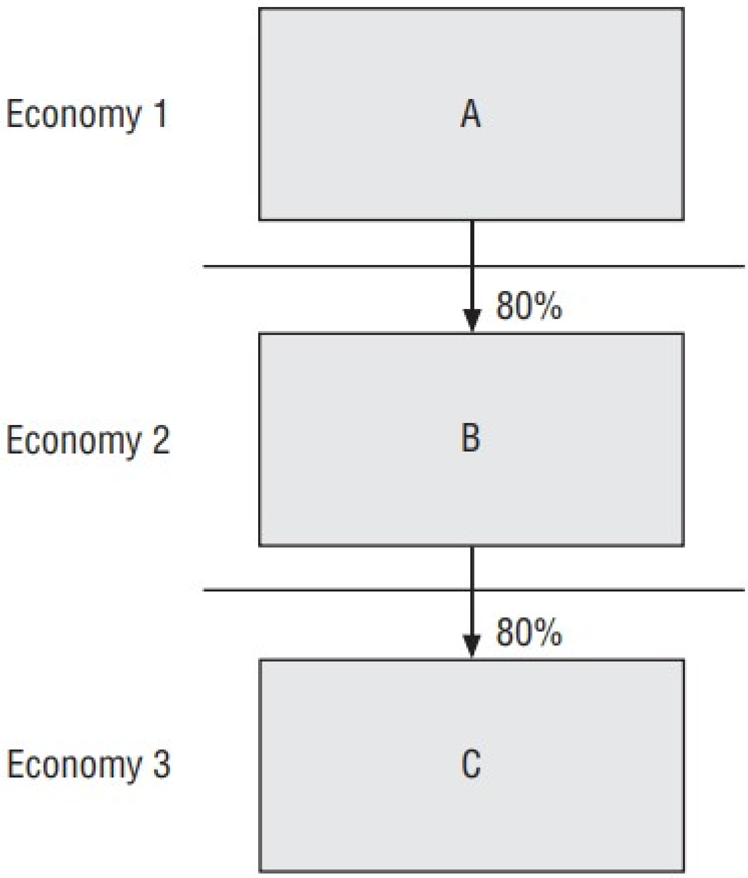
The numerical threshold of ownership of 10% of the voting power determines **the existence of a direct investment relationship between the direct investor and the direct investment enterprise.** An ownership of at least 10% of the voting power of the enterprise is regarded as the necessary evidence that the investor has sufficient influence to have an effective voice in its management. In contrast to some other statistical measures such as those on the Activities of MNEs, direct investment does not require control by the investor (i.e. more than 50% owned by the investor and/or its related enterprises). Direct investors may have direct investment enterprises in one economy or in several economies.

The Framework for Direct Investment Relationships (FDIR) is a generalised methodology for identifying and determining the extent and type of direct investment relationships. In other words, the FDIR allows compilers to determine the population of direct investors and direct investment enterprises to be included in FDI statistics.

For a compiling economy, the FDIR identifies all enterprises related to a particular enterprise whether it is a direct investor or a direct investment enterprise or both. For example, within a group, it is possible that a direct investment enterprise itself owns 10% or more of the voting power of another non-resident enterprise, in which case the direct investment enterprise is itself a direct investor in a further direct investment enterprise. ***The question is therefore whether there is a direct investment relationship between the further enterprise and the original enterprise.***

In Figure 1, enterprises A, B and C are in different economies. Enterprise A owns 80%

of the voting power in enterprise B and is a direct investor in B. Enterprise B, in turn, owns 80% of the voting power in enterprise C and is a direct investor in C. A has control over B, and through its control over B, has indirect control over C. As a result, financial transactions between A and C are also relevant to FDI, even though A directly holds no equity in C, and A and C are therefore considered to be in the direct investment relationship which embraces A, B and C. Financial transactions and positions as well as associated income flows between A, B and C should be included in direct investment statistics.



The FDIR aims at identifying all enterprises over which the investor has significant influence under the 10% voting power criterion for FDI. In this determination, it is necessary to establish whether each enterprise under consideration is a subsidiary, an associate, or is not relevant in FDI – all three categories when combined being exhaustive and individually mutually exclusive. Those enterprises which are subsidiaries or associates are included in the direct investment relationship, while those categorised as not influenced are not included.

Subsidiaries in FDI are described as follows:

i) A subsidiary is an enterprise in which an investor owns more than 50% of its voting power i.e. it is controlled by the investor;

ii) Where an investor and its subsidiaries combined own more than 50% of the voting power of another enterprise, this enterprise is also regarded as a subsidiary of the investor for FDI purposes;

In determining the scope of a direct investment relationship, the degree of influence that may be exercised through controlling links (more than 50% of voting power) is not diminished by the existence of multiple links in an ownership chain.

❖ An enterprise controlled by a subsidiary of an investor or by a group of subsidiaries (which may also include the investor) is itself regarded as a subsidiary for FDI purposes.

❖ However, for clarification, it should be stressed that an enterprise controlled by an associate or any group including an associate is regarded as an associate in the context of FDI.

Associates in FDI are described as follows:

i) An associate is an enterprise in which an investor owns directly at least 10% of the voting power and no more than 50%;

ii) Where an investor and its subsidiaries combined own at least 10% of the voting power of an enterprise but no more than 50%, the enterprise is regarded as an associate of the investor for FDI purposes;

iii) Where an associate, either as an individual or in combination with its subsidiaries, own more than 50% of an enterprise, this enterprise is regarded for FDI purposes as an associate of the higher level investor;

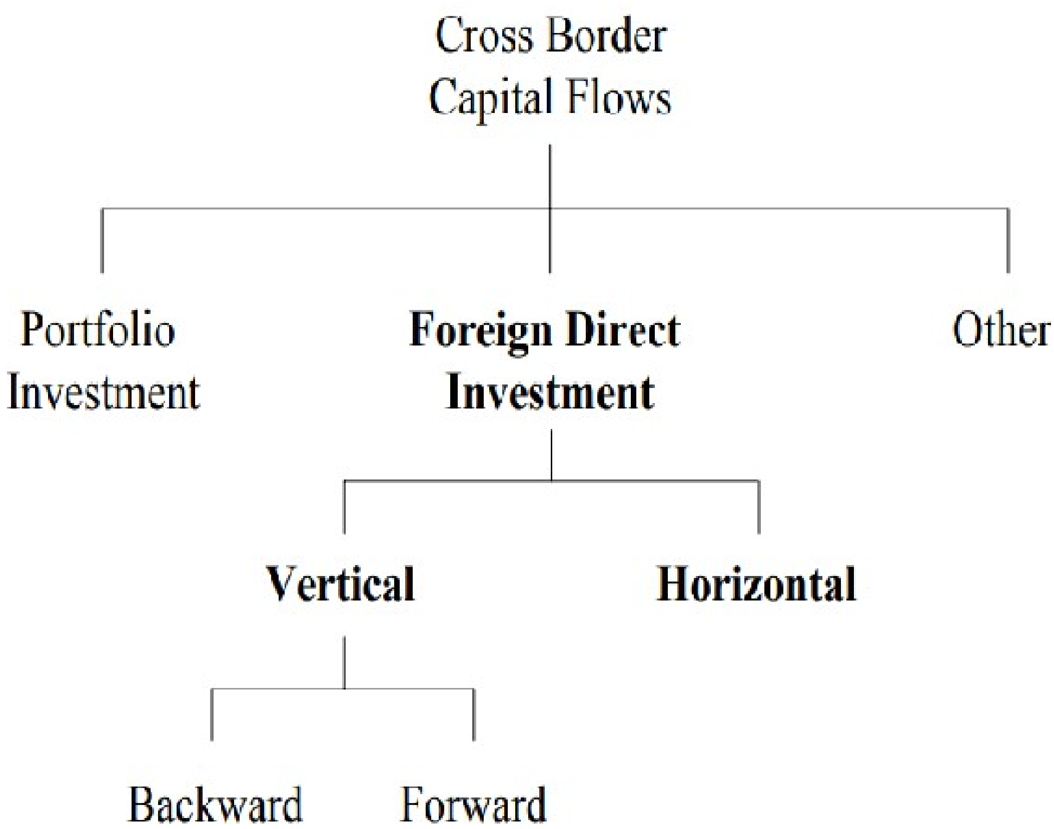
iv) In determining the scope of a direct investment relationship involving associates, the degree of influence that may be exercised through a single or cumulative influencing link (from 10% to 50%) along an ownership chain is diminished by one degree. Thus, an enterprise which is an associate of a subsidiary – or of a group of the investor's subsidiaries (which may include the investor) is regarded as an associate of the investor for FDI purposes.

<u>The following are not relevant in FDI:</u>

i) An enterprise in which an investor owns less than 10% of its voting power is regarded as not influenced by the investor and is therefore out of the scope of the FDIR. However, it should be stressed that a particular investor in a chain of ownership within the FDIR may indirectly hold less than 10% (but more than 0%) of an enterprise's voting power; this enterprise should be included in the FDIR as a subsidiary or an associate of the investor if the relevant criteria are fulfilled e.g. as in the description of associates in the preceding section;

ii) It should be also noted that an enterprise which is an associate of an enterprise associated to an investor is not influenced by this investor in the context of FDI, i.e. it is not regarded as an associate of the investor within the FDIR.

2. Basically, the theory of FDI distinguishes between ***two types of providing capital abroad:*** vertical foreign direct investment (VFDI) and horizontal foreign direct investment (HFDI).



Vertically integrated firms pursue the international fragmentation of the production process for the reason of factor cost savings. Thus, VFDI is connected to the slicing-up of the value-added chain (Krugman 1995), where each production step is performed at the location where the factor needed for production is relatively cheap (Helpman/Krugman 1985). Vertical FDI refers to those multinationals that fragment production process geographically. It is called "vertical" because MNE separates the production chain vertically by outsourcing some production stages abroad. The basic idea behind the analysis of this type of FDI is that a production process consists of multiple stages with different input requirements. If input prices varies across countries, it becomes profitable for the firm to split the production chain.

Furthermore, as shown in Figure 2, vertical ***FDI consists of two groups: backward and forward vertical FDI.*** In case of *backward FDI* multinational enterprise establishes its own supplier of input goods which delivers inputs to the parent company. *Conducting forward FDI,* the firm builds up a foreign affiliate, which draws inputs from the parent company for own production, thus staying after the parent in the production chain.

In contrast, **HFDI is related to a firm's wish** to get access to a new market and typically occurs when it is more profitable for a firm to serve the foreign market by producing in a local plant than by exporting from the company's home country. As a consequence, horizontally integrated multi-plant firms produce the same goods in various countries for local sales. This type of FDI is called "horizontal" because the multinational duplicates the same activities in different countries. Horizontal FDI arises because it is too costly to serve the foreign market by exports due to transportation costs or trade barriers.

Two factors are important for the appearance of horizontal FDI: presence of positive trade costs and firm-level scale economies. The main motivation for horizontal FDI is to avoid transportation costs or to get access to a foreign market which can only be served locally. The horizontal models predict that multinational activities can arise between similar countries.

Indeed, a clear separation between horizontal and vertical FDI is not possible, because in case of horizontal FDI affiliates draw some headquarter services from the parent company, even when the firm duplicates the same production activity in several countries. Thus, each horizontal MNE has some vertical traits.