GEOGRAPHICAL, INSTITUTIONAL AND OWNERSHIP PATTERNS OF FOREIGN DIRECT INVESTMENT AFTER THE ECONOMIC CRISIS

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Abstract

Foreign direct investment (FDI) as one of the phenomena of globalization do reflect the general trends in the world economy. The economic crisis 2008 – 2009 contributed to the change in many aspects of FDI. Developing countries are more active than before: their role as recipients of FDI has markedly increased and their transnational corporations´ (TNC) activity in investing abroad has also significantly grown. There is a change in equity FDI structure for the benefit of reinvested profits; some TNCs reduce the volume of their foreign assets through divestments and use to a greater extent than before non-equity modes of entry into the economies of host countries. "The last two decades have witnessed a number of dramatic changes in the location of international business activity and of our understanding of its determinants. Globalization, technological advances, the emergence of several new players on the world economic stage, and a new focus on the role of institutions and belief systems in the resource allocation process have been the main triggers for change" (Dunning, 2010). Main changes in the FDI characteristics (geographical structure, FDI forms and institutional structure) will be described in the paper.

Key words: foreign direct investment, mergers and acquisitions, greenfield investment, private equity funds, state-owned enterprises, sovereign wealth funds.

JEL Code: D21, D29, F21, F23

1 Changes in the geographic structure of foreign direct investment

Geographical structure of global FDI over the last more than forty years shows a significant change in the positions of developed and developing countries. When looking at the evolution of FDI inflows in the years 1970 - 2014 it is obvious that until 2009 FDI could be described using some version of Vernon's product life cycle theory (Vernon, R. 1966, 1971). According to this theory, in the first stage of the life cycle a product is sold in the domestic market and foreign demand is served by exports. In the second stage the increase in export is constrained by growing number of barriers (capacity, instruments of trade policy), and therefore - through FDI- are established foreign affiliates in developed economies. In the third stage of its life cycle the product is standardized, meets the demand of domestic consumers as well as the demand in developed economies. In the last stage of product´s life the demand in developed markets decreases and production is shifted to developing economies. As the Table 1 shows, in 1970 71 per cent of global FDI flowed into developed economies while less than one third (28.9 per cent) to developing economies. Until 2008, the share of FDI inflows to developed economies was greater than the share of FDI inflows to developing economies.

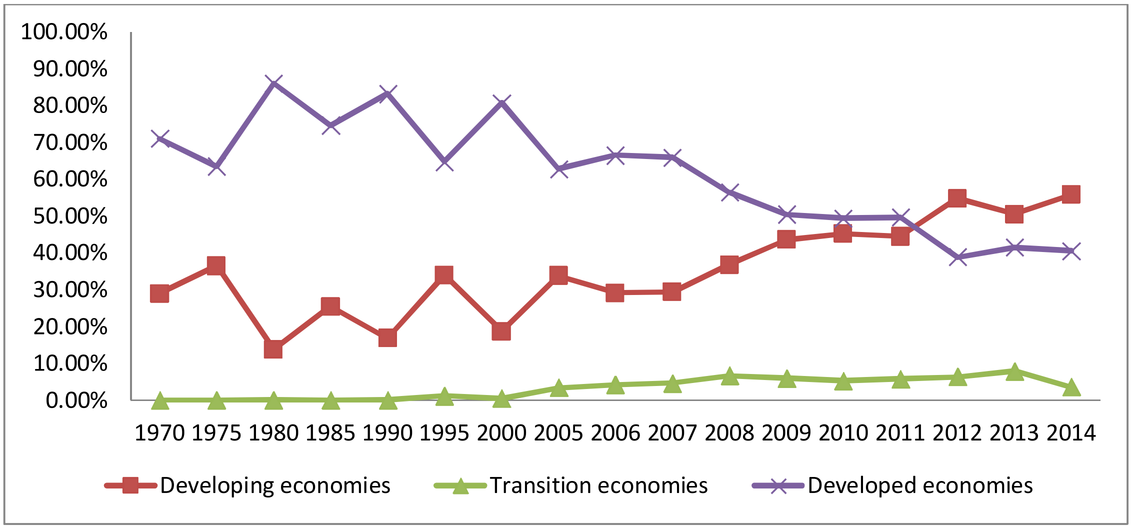
Table 1: FDI Inflows, 1970 – 2014 (billions of USD)

Year	World	Developing economies	Transition economies	Developed economies
1970	13,346	3,854	0	9,491
1975	26,567	9,709	0	16,858
1980	54,068	7,469	24	46,576
1985	55,842	14,165	15	41,663
1990	207,362	34,762	75	172,525
1995	343,544	116,957	4,107	222,48
2000	1413,169	264,543	7,038	1141,588
2005	989,618	334,521	33,612	621,485
2006	1480,587	432,113	62,585	985,888
2007	2002,695	589,43	93,371	1319,893
2008	1816,398	668,439	121,429	1026,531
2009	1216,475	530,289	72,75	613,436
2010	1408,537	637,063	75,056	696,418
2011	1651,511	735,212	96,39	820,008
2012	1330,273	729,449	84,159	516,594
2013	1363,001	689,407	107,967	565,626
2014	1260,001	704,001	45,001	511,001

Source: http://unctadstat.unctad.org/wds/TableViewer/tableView.aspx?ReportId=88, UNCTAD, 2015a (data for 2013 are revised, data for 2014 are estimated). Data in 2013 exclude Caribbean offshore financial centres and FDI flows passing through special purpose entities in Austria, Hungary, Luxembourg and the Netherlands.

With a large generalization, we can say that in the years 2009 - 2011, the share of developed and developing economies in global FDI inflows balanced (and this applies even more if we add capital inflows into the transition economies). Between 2012 and 2014 prevailed FDI inflows to developing economies over the FDI inflows to developed economies. In 2014 it went to developing economies 56 percent of global FDI, while in developed economies, just 40.6 percent. Changing proportion of developed, developing and transition economies in global FDI inflows in 1970 - 2014 years is illustrated in Figure 1.

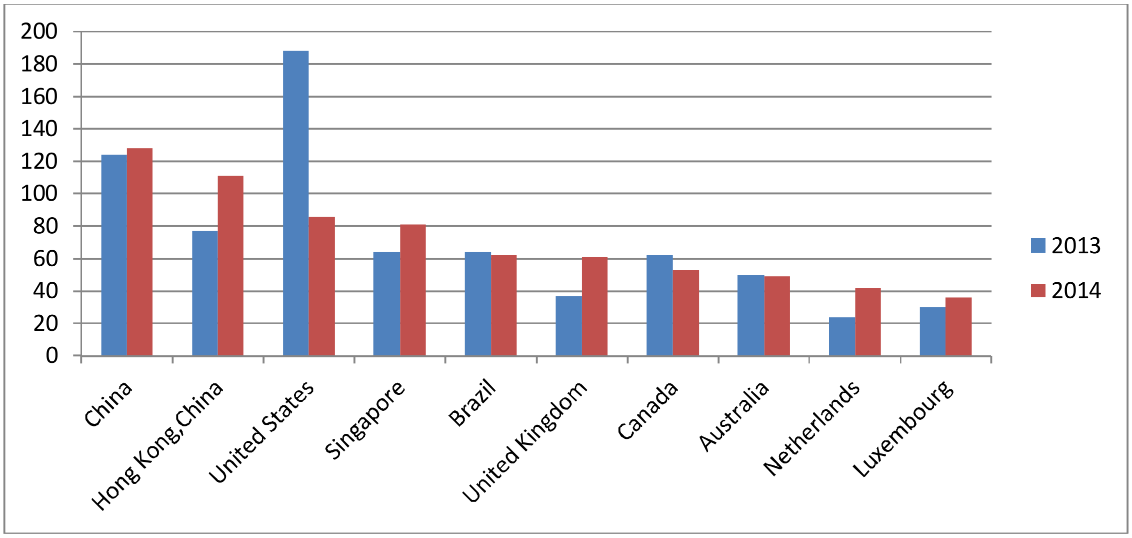
Figure 1: Share of FDI Inflows by group of economies, 1970 – 2013 (Per cent)



Source: Own graph based on Table 1 data

Causes of the current changes in the developing economies position are numerous, the main undoubtedly be regarded as an economic crisis in the years 2008 - 2009, which hit especially the developed economies, and consequently their weak and fragile economic growth. Economic uncertainty and geopolitical risks were behind some mega-transactions, divestments, repayment loans to parent companies and fall of intra-company loans which significantly reduced FDI inflows to developed economies. On the other hand, strong economic growth in developing and transition economies, often supported by high commodity prices, especially oil, has attracted FDI into these groups of economies. Within the developing economies was the most appealing destination for foreign direct investment countries in the Southeast Asia. Huge FDI was directed to China, which in 2013 took in order of global FDI recipients second place behind the USA and in 2014 was even the largest global recipient of FDI (see Figure 2). Figure 2 illustrates the position of developing economies as major recipients of FDI, which is evident from the fact, that in 2014 among the top five FDI recipients in the world, four were developing economies. When searching for the causes of the rising share of developing and transition economies in global FDI inflows could be accepted a critical evaluation of Vernon's theory, highlighting its ethnocentric character, which is not in line with reality, when innovative processes are increasingly developed outside the US; globalization also contributes to simultaneously bringing new products to the markets of developed economies.

Figure 2: Estimated FDI Inflows: top 10 host economies, 2013-2014 (Billions of USD)



Source: own graph based on UNCTAD 2014, 2015a data. FDI estimations are based primarily on quarterly FDI data derived from the directional principle, though there are some countries for which the asset/liability data are used for estimation.

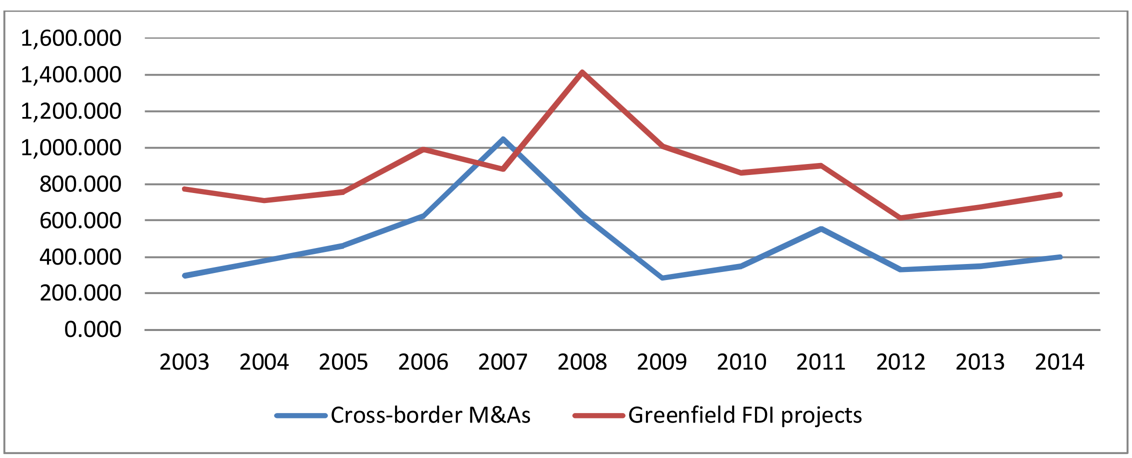
If we briefly mentioned for completeness role transition economies as recipients of FDI, from Table 1 it is clear that in 2014 FDI flows to them more than halved. The largest country in the region is Russian Federation whose position among the biggest world host economies dramatically changed between 2013 and 2014. While in 2013 it was the third largest recipient of global FDI, in 2014 FDI flows to Russian Federation are estimated to have fallen by 70percent. This change was mainly due to the conflict with Ukraine and following sanctions on Russia, due to Russian Federation growth prospects (impacted strongly by fall in petroleum prices) and the exceptional level of FDI inflow reached in 2013.

2 Changes in FDI forms

Companies can invest in production abroad through equity and non-equity FDI. Equity modes of entry are represented by mergers and acquisitions (M&As) and greenfield/brownfield investments. Non-equity forms of FDI enabling firms obtain an effective voice in the management of another abroad business entity can be represented, inter alia, by production sharing agreements, subcontracting, management contracts, licensing, franchising or strategic alliances. Strategic choice between M&As and greenfield investment is influenced by numerous factors, including the intensity of competition in the market of the host country and its level of concentration, transferability of resources (competencies, skills, organizational culture), high barriers to entry, excess capacity, searching for assets embodied in abroad firms, privatization opportunities, etc. This choice can be strongly influenced by fixed costs: The foreign firm prefers a merger to a greenfield investment if the fixed cost of greenfield investment is not too small (Raff, Ryan and Stähler, 2005). The factor supporting cross-border mergers can be economic integration because it may intensify the pre-merger competition in the market, thereby reducing the reservation price of the target firm. In addition, economic integration in the form of lower trade costs may reduce the post-merger business stealing effect as the outside firm chooses exports rather than greenfield investment (Bjorvatn, 2004). An alternative view provides institutional theory, according to which the choice between greenfield investment and M&As affect institutional distance between the investing firm and the host country in terms of differences in political, economic, legal and cultural systems. Due to high distances in institutions, entrants often need local resources such as institutional or market knowledge that is embedded in existing organizations (Meyer and Estrin, 2001) and these can be accessed either by forming a joint venture or by taking over a local firm. A more detailed look reveals that while regulatory distance (i.e. in laws and regulations) increases the propensity for greenfield investment, cognitive distance (widely shared social knowledge and cognitive categories) has diametrically the opposite effect (Ionaşcu, Meyer, Estrin, 2004).

Patterns of M&As and announced greenfield investment projects before the economic crisis and after it shows Figure 3.

Figure 3: The value of cross-border M&A sales and of announced greenfield investment projects, 2003 – 2014 (Billions of USD)

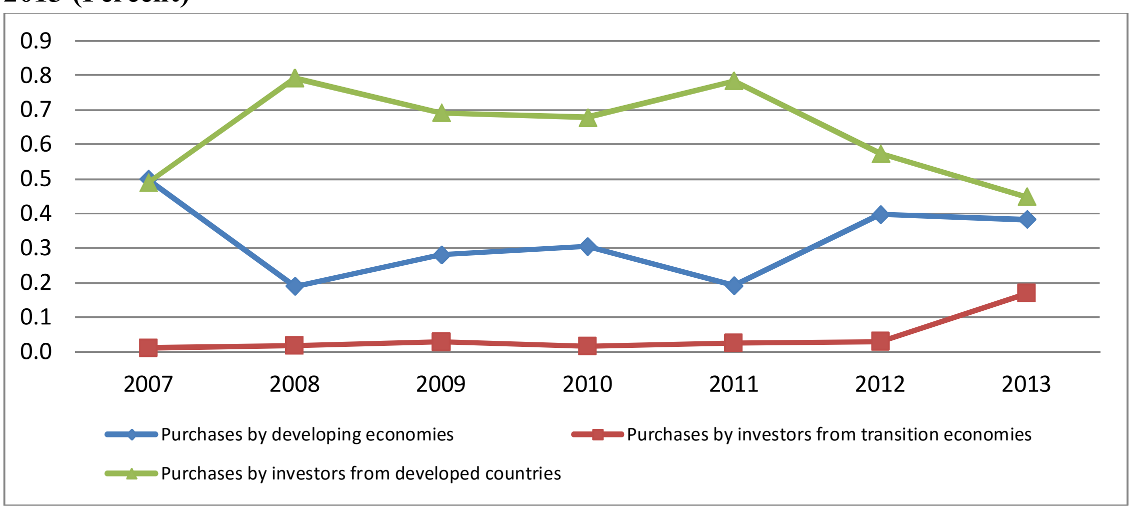


Source: Own graph based on UNCTAD, 2006, 2012, 2014 data and preliminary data for 2014 in UNCTAD, 2015a and 2015b

The level of global M&As reached its peak in 2007, which was significantly influenced by strong economic growth, high profits of TNCs and strong competitive pressures in their home markets. Liquidity crisis in money and debt markets and the persistence of global recession led to a decline in the value of TNCs assets, decrease in demand, reduction of production and investment in fixed capital, etc., which was reflected in a continuing decline of cross-border M&As in 2008 – 2009. Decline in the value of cross-border M&A sales within two years of the economic crisis was enormous: from USD 1 054,085 billion in 2007 to USD 285,396 billion in 2009, i.e. by 73 percent. In 2009 – 2011 period M&As growth was encouraged by the growing value of assets on stock markets and the increased financial capacity of investors (its major driver were some megadeals), while greenfield projects were in a slow decline. The downward trend observed in 2012 in both entry modes reversed in 2013 and 2014, reflecting the improvement of general investment outlook and increasing confidence of global investors.

In 2011 – 2013 period, both FDI greenfield projects and cross-border M&As displayed differentiated patterns among groups of economies: while the values of announced greenfield projects and cross-border M&As in developing and transition economies increased, in developed economies values of both FDI forms declined. As a result, developing and transition economies accounted for historically high shares of the total values of greenfield investment and M&A projects. Figure 4 confirms the growing activity of investors from developing and transition economies

Figure 4: Share of cross-border M&As (net purchases) by group of economies, 2007 – 2013 (Percent)

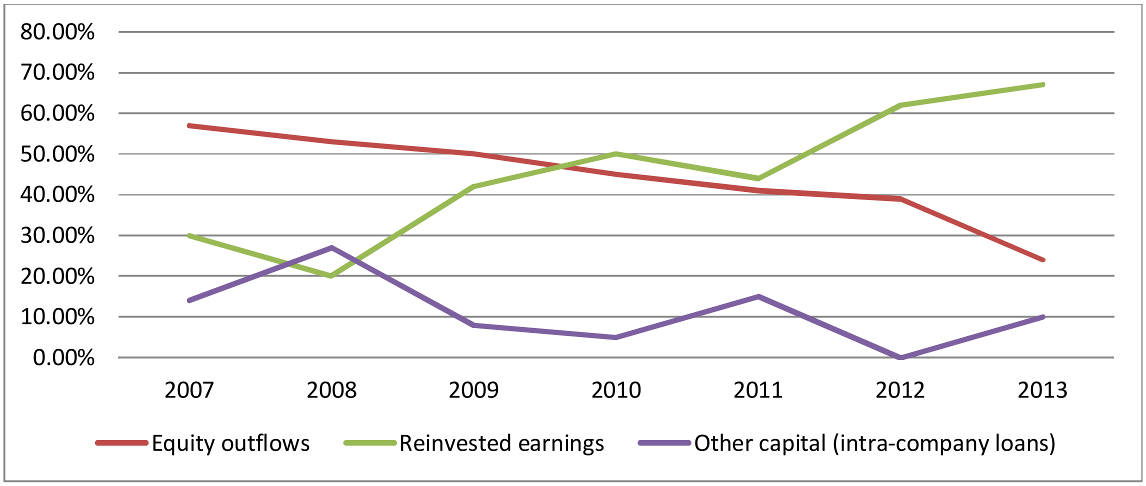


Source: Own calculations and graph based on UNCTAD, 2014a data

M&As purchases by investors from developing and transition economies accounted for 55 percent in 2013. Developing economies were conducting a high share of the acquisitions of developed country foreign affiliates: whereas in 2007 23 percent of acquisitions from developing and transition economies targeted foreign affiliates of developed country corporations, after the crisis this percentage increased quickly, jumping to 30 percent in 2010 and 41per cent in 2011 to half of all acquisitions in 2013 (UNCTAD, 2014a).

Components of equity FDI can be equity capital, reinvested earnings and intra-company loans. Equity capital is the foreign direct investor's purchase of shares of an enterprise in a country other than its own. Reinvested earnings comprise the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by affiliates, or earnings not remitted to the direct investor. Such retained profits by affiliates are reinvested. Intra-company loans or intra-company debt transactions refer to short- or long-term borrowing and lending of funds between direct investors (parent company) and affiliates. TNCs decision on whether to reinvest profits in their foreign branches or download it to headquarters in the mother country, is generally determined by factors that increase the attractiveness of the host country as an investment location, as well as the factors that increase the attractiveness of the alternative of repatriation. The main factors are macroeconomic factors affecting investment opportunities in the host country, the profitability of foreign investment, exchange rates, different systems of corporate governance, the tax treatment of repatriated foreign income, and use of dividend policy as a means of managerial control (Lundan, 2006). Effect of the first of these factors is evident from the Figure 5.

Figure 5: Share of FDI outflow components for selected developed countries* , 2007 – 2013 (Percent)



Source: Own graph based on data in UNCTAD, 2014 data
*Economies included are Belgium, Bulgaria, the Czech Republic, Denmark, Estonia, Germany, Hungary, Japan, Latvia, Lithuania, Luxembourg, the Netherlands, Norway, Poland, Portugal, Sweden, Switzerland, the United Kingdom and the United States

In times of economic crisis the share of equity outflows on equity FDI represented more than 50 percent while the share of reinvested earnings was one third of equity FDI. Since 2008, the share of reinvested earnings on equity FDI kept growing and in the years 2010 to 2013, reinvested earnings accounted for the most prevalent form of equity FDI. Because TNCs from developed economies kept a lot of cash in their foreign affiliates, in 2013 this component of equity FDI reached 67 percent and record level - 81 per cent in 2014 (UNCTAD 2015b).

3 Changes in the institutional structure

The institutional structure of global investors, are recently diversifying. In addition to traditional investors - TNCs - recently promoted, especially through international acquisitions, institutional investors and collective investment institutions. These include, among others, private equity firms and various financial investment funds (mutual funds, hedge funds, etc.) As long as cross-border investments of collective investor exceed the 10 percent equity threshold of the acquired firm, these investments are classified as FDI.

Private equity funds raise major part of their funds from institutional investors (banks, insurance companies, etc.). Their activity concentrates on asset management; they provide the acquired firm organizational and managerial know-how, financial resources and networking and their aim is to sell them after several years to earn profits. Due to the nature of the business majority of private equity funds´ cross-border investment is realized through M&As. Another collective investor who has entered into buyout transactions, are hedge funds. Hedge funds do not concentrate their activities on asset management, but have broad investment mandates. They initially focused on the use of short selling, leverage and derivatives, and later began to expand their equity stakes in stock-listed companies. Private equity funds are much more important for FDI than are hedge funds because they normally obtain a majority of shares or full control and management of the companies they buy, and stay longer (5 to 10 years) than hedge funds. As Table 2 shows, the number and value of M&As transactions by private equity funds and hedge funds, between 1987 and 2013 increased many times; the share of private equity funds and hedge funds on cross-border M&As have increased both in the number of transactions (from 13.5 percent to 24 percent), as in the gross M&As (from 13.7 percent to 21 percent). The share of private equity funds and hedge funds on the net M&As in the period 1996-2013 doubled. In 2013, the unspent funds of private equity firms grew to a record level of USD 1.07 trillion (UNCTAD, 2014). Firms thus did not use funds for investment despite the fact that they could raise more money for leverage owing to quantitative easing and low interest rates. In 2013 private equity funds´ cross-border investment (usually through M&As) was 10 percentage points lower than in the peak year of 2007. Private equity firms are becoming relatively more active in emerging markets, especially in Asia. Private equity funds´ FDI in emerging economies have increased their share from 6 percent in 2007 to 30 percent in 2010 and after two years of decline, the proportion began to grow again (www.unctad.org/fdistatistics). They are also emerging new institutional investors from developing economies (Hong-Kong, China, UAE, China, Singapore, etc.)

Table 2: Cross-border M&As by private equity firms and hedge funds, 1987–2013 (Number of deals and value)

	Number of deals		Gross M&As		Net M&As	
Year	Number	Share in total (%)	Value (USD billion)	Share in total (%)	Value (USD billion)	Share in total (%)
1987	158	13.5	13.4	13.7		
1990	531	15.8	41.0	20.5		
1995	722	13.1	33.6	14.5		
1996	989	16	44	16	18	12
2000	1 478	14	83	6	30	3
2005	1 892	20	209	23	110	20
2006	1 898	18	263	23	118	19
2007	2 108	17	541	31	292	28
2008	2 015	18	444	31	109	17
2009	2 186	24	115	18	70	25
2010	2 280	22	147	19	68	20
2011	2 026	19	161	15	69	12
2012	2 300	23	192	23	67	20
2013	2 043	24	171	21	83	24

Source: UNCTAD, 2006, UNCTAD, 2014

Note: Value on a net basis takes into account divestments by private equity funds. Thus it is calculated as follows: Purchases of companies abroad by private equity funds (-) Sales of foreign affiliates owned by private equity funds. The table includes M&As by hedge and other funds (but not sovereign wealth funds). Private equity firms and hedge funds refer to acquirers as “investors not elsewhere classified”. This classification is based on the Thomson ONE database on M&As.

Individual and collective investment institutions are incorporated investment companies or unincorporated undertakings, and in most cases they are private. A different type of investors are sovereign wealth funds (SWFs). They are established by various governments in order to use the accumulated reserves for expansion abroad. Many SWFs has recently acquired more than a 10 percent share in foreign companies, allowing them to participate significantly on long-term control, so that became the foreign direct investors. SWFs usually have a higher risk tolerance and higher expected returns than traditional official reserves managed by the monetary authorities. Their goal is to manage the portfolio so as to deliver a sustainable flow of income in the future. Investment strategies of SWFs are influenced by the fact that, unlike private equity funds they represent an investment instrument fully controlled by the government of a home country, there is nothing to prevent them from holding stakes in foreign companies for a long time and economic motives of their investments are often complemented by noneconomic ones. Many SWFs therefore prefers investments in domestic public services which are expected to bring greater financial and social benefits and are relevant for sustainable development. The assets of SWFs are huge, and the last two years has grown faster than any other assets of an institutional investor. With regard to the specifics of their investment strategies, FDI is small (corresponding to less than 2 percent of total assets under management) and represented mostly by a few major SWFs. In the years 2000 - 2004 the value of FDI invested by SWFs was very low (about USD 1 billion), then in the years 2005 to 2008 has risen sharply (to USD 22.5 billion), and then until 2013 (except for 2011) declined (to USD 6.7 billion) (UNCTAD, 2014).

Both developed and developing economies do invest abroad through state-owned TNCs, which represent another type of direct foreign investor. These are TNCs, which are at least 10 percent owned by the State or public bodies, or in which the State or public entity is the largest shareholder. Such investors, there are currently around 550 and some of them are among the largest global TNCs. In terms of foreign assets among the top in the ranking of non-financial state-owned TNCs are those ones from developed economies (SDF Suez, Volkswagen Group, ENI, ENEL, ADF, etc.). The fact that the investor is the State, determines the industrial structure of FDI; State-owned TNCs operate mainly in strategic sectors (extractive industries and infrastructure, public utilities) and financial services. In the oil and gas we find large TNCs, owned by the governments of developing and transition economies (eg. Chinese Sinopec and CNOOC, Malaysian Petronas, Brazilian Petrobras, Russian Gazprom, etc.). The estimated value of state-owned TNCs FDI since 2008 continued to decline; in 2013 rose to USD 160 billion. It featured over 11 percent of global FDI. This fact is interesting also because in the total number of TNCs state-owned enterprises accounted for only one percent. The abovementioned increase in estimated FDI by state-owned enterprises have contributed significantly enterprises from developing and transition economies (let's mention here mega-transactions of Chinese CNOOC, which has acquired the Canadian company Nexen for USD 15 billion or Rosneft, which acquired BP's 50 percent interest in

TNK-BP for USD 28 billion). By contrast, foreign investment activity of companies owned by developed countries, was weak, especially due to the weak economic growth in Europe.

Conclusion

Current development of global FDI confirms the trend of increasing role of developing economies as recipients of FDI and increase of their share in FDI inflow. At the same time TNCs from developing economies are becoming important foreign investors: they continue acquiring developed economies foreign affiliates and investing mainly to other developing economies. FDI to and from transition economies declined significantly, reflecting the political instability in the region, low commodity prices and depreciation of the rouble. Developing and transition economies accounted for high shares of the values of greenfield investment and M&As. While TNCs from developing economies invested primarily in equity, outflow FDI from developed economies was represented mainly by reinvested earnings. The investor base is more diversified than before: Increasingly important players in global investments – together with traditional TNCs – have become sovereign wealth funds and private equity firms. Global FDI of state-owned enterprises after the outbreak of the economic crisis were falling; their subsequent growth came mainly at the expense of state-owned enterprises in developing and transition economies, which fared better than the economically developed countries, especially Europe. Further development of global investment could be affected positively by the expected economic growth in developed countries, quantitative easing in the Eurozone and huge resources of private equity firms. Geopolitical factors and low commodity prices can play negative role.

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