

LONG TERM STRUCTURE OF THE WORLD FOREIGN DIRECT INVESTMENT BY COMPONENTS AND ITS MAIN DETERMINANTS

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Abstract

Foreign direct investments are undertaken by various institutions (mostly transnational corporations, but also by sovereign wealth funds, private equity firms or by state-owned enterprises) through investment in equity capital, internal corporate loans and through reinvested earnings. In the last twenty years, the financing structure has changed: while by 2007, the investments of transnational corporations in equity capital is always at least 50 per cent, in the following years have seen a steady decline in this component of foreign direct investment. On the other hand, since 2008, the share of reinvested earnings on equity foreign direct investment kept growing and in the years 2010 to 2014, reinvested earnings accounted for the most prevalent form of equity. The paper will focus on examining the factors that play a major role in deciding of transnational corporations on the specific form of foreign direct investments, ie. their decisions between investments in equity capital, reinvested earnings and intra-company loans. We will also address the question whether the trends in the component structure of global foreign direct investment are observable even within groups of countries, particularly in the group of investors from developed and developing economies.

Key words: foreign direct investment, equity capital, reinvested earnings, intra-company loans.

JEL Code: D21, D29, F21, F23

Introduction

Foreign direct investments (FDI) do reflect the general trends in the world economy. They are one of the phenomena of globalization: as globalization began to pick up momentum in the 60-ies and 70-ies of the 20th century, FDI grew at the same time and in comparison with the year 1970, their flow in 2007, when FDI reached its peak, increased about 150 times. The economic crisis 2008 – 2009 contributed to the change in many aspects of FDI. The role of

developing economies as recipients of FDI has increased and their transnational corporations' (TNCs) activity in investing abroad has also significantly grown. There is a diversification of the institutional structure of international investors: Besides traditional investors - transnational corporations – become foreign direct investors collective investment institutions (private equity firms, mutual funds, hedge funds, etc.), sovereign wealth funds, and state-owned TNCs. There is a change in FDI components' structure for the benefit of reinvested profits; some TNCs reduce the volume of their foreign assets through divestments.

FDI includes the following three components: 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. It comprises equity in branches, all shares in subsidiaries and associates (except non-participating, preferred shares that are treated as debt securities and included under direct investment, debt instruments); and other contributions of an equity nature. Ownership of equity is usually evidenced by shares, stocks, participations, depositary receipts or similar documents (OECD, 2009). Investment in equity capital (mostly through international M&As) have a long-term character, because they are made in order to obtain and possibly expand production capacity abroad and thus are usually the result of careful deliberation and decision-making of a parent company. Equity shares influence the cost of capital, the level of investment, the degree of technology transfer, and the distribution of gains from FDI. Furthermore, a TNC's equity position determines the extent to which the TNC can control its subsidiary and protect the integrity of the TNC's assets (Asiedu & Esfahani, 2001). 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. Since reinvestment means raising additional capital in the subsidiary in the host country, would be the cost of a potential relocation of a branch in another country high, rationally behaving TNC does not intend to do that. That's why reinvestment can be seen as a gradual penetration of branches into the economy of the host country (Lundan, 2006). Reinvested earnings are included in direct investment income because the earnings of the direct investment enterprise are deemed to be the income of the direct investor. TNC when deciding whether income from FDI reinvest or repatriate it in the form of dividends, examines whether there are better investment opportunities abroad than in the home country, and what profitability of foreign affiliates could be realized (these factors would encourage reinvestment). Repatriation of profits affects expectations about future exchange rate changes, the nature of corporate governance and taxation of foreign branch income (Lundan, 2006). There is fairly broad

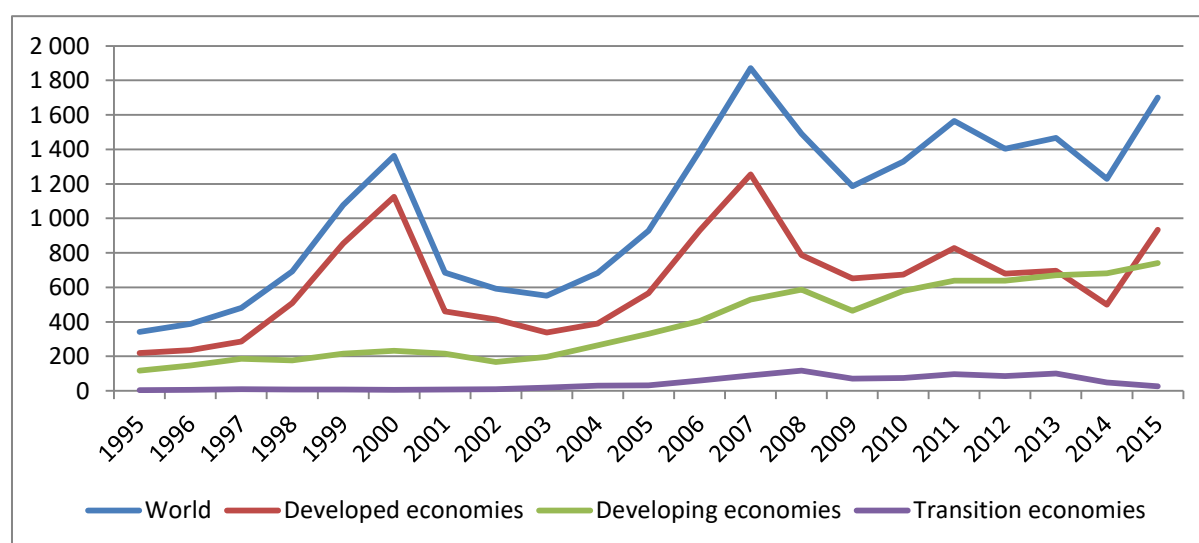
literature on the effects of taxation on the choice between reinvestment and repatriation as well as on the choice of specific forms of repatriation of profits (eg. Desai, Foley & Hines, 2004 and 2006; Desai, Foley & Forbes, 2006; Devereux & Griffith, 2003 and others), which demonstrates the significant impact of taxation on dividend and loyalty payments and on intra-company borrowings. Intra-company loans or intra-company debt transactions refer to short- or long-term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises.

The paper will start with the brief characteristics of FDI flows in the last twenty years. Then it will focus on FDI component structure description and on examining the factors that play a major role in deciding of transnational corporations about the specific form of foreign direct investments, ie. when deciding between investments in equity capital, reinvested earnings and intra-company loans. We will also address the question whether the trends in the component structure of global foreign direct investment are observable even within groups of countries, particularly in the group of investors from developed and developing economies.

1 FDI in the last twenty years

As shown in Figure 1, at the beginning of the period 1995 to 2000 the volume of FDI inflows grew slowly, but in 1998 and 1999 achieved this growth 43.8 respectively. 55.4 per cent, to then in 2000 slowed down to 28per cent. In 2000, FDI flow reached record levels: more than USD1.3 trillion. The main drivers of this development were M&As, which was reflected in the geographical structure: an average of almost 3/4 of FDI inflows went to developed countries and only 1/4 to developing economies. An important impetus for FDI inflows were

Fig. 1: FDI Inflows, 1995 – 2015 (USD billions)



Source: Own graph based on www.unctad.org/fdistatistics, UNCTAD (2016)

growing integration processes within the EU. Huge FDI inflows into Central and Eastern Europe was strongly influenced by privatization. Geographical structure reflects the pressure to improve efficiency TNCs due to increased competition, technological development and liberalization of trade and of national policies towards FDI.

In the period 2001 - 2003 FDI inflows to developed and developing economies declined. The main macroeconomic causes of the decline of FDI inflows in the three years was the slowing of economic activity in major industrial economies and a sharp decrease in their stock market activity due to falling stock market valuations, what contributed to a slump in international M&As, which dragged growth of FDI in previous periods. Microeconomic factors were lower corporate profitability, lower ability or willingness of TNCs to finance FDI through intra-company loans, and slowdown in corporate restructuring. Its role also played the institutional factor in the form of a decline in privatization projects. The higher level of uncertainty and higher perceived political risk due to the terrorist attacks of September 11, 2001, may have lead some international investors to place planned investments on hold or to cancel them. Since privatization opportunities in the countries of Southeast Europe remained open and because the price of oil and natural gas were high among the countries of South Eastern Europe and the Commonwealth of Independent States (CIS) inflows in the period 2001-2003 grew, by 132 per cent.

In the period 2004 - 2007 the global FDI inflows increased by 174% and in 2007 reached historically high levels (almost USD1872 billion). At the beginning of the period FDI growth was driven by inflows of FDI to developing and transition economies, which was influenced by efforts to increase the efficiency of companies expanding production in emerging markets, and to realize economies of scale. Another reason was higher prices of natural resources, whose deposits are found mainly in developing economies. For three years growing cross-border M&As were largely driven by continued economic growth, increased corporate profits, low interest rates, increase in stock prices and FDI policy liberalization. Specific factors were larger and easier possibilities for privatization in the new EU countries, their FDI incentives, weakening the USD, stock exchange and financial market developments, high commodity prices or creation of the euro area.

Period 2008 - 2015 is strongly affected by the economic crisis 2008 - 2009, which hit mainly developed countries and their foreign direct investment. Between 2007 and 2009, FDI inflows declined in developed countries by 48 per cent. 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 and between 2007 and 2008

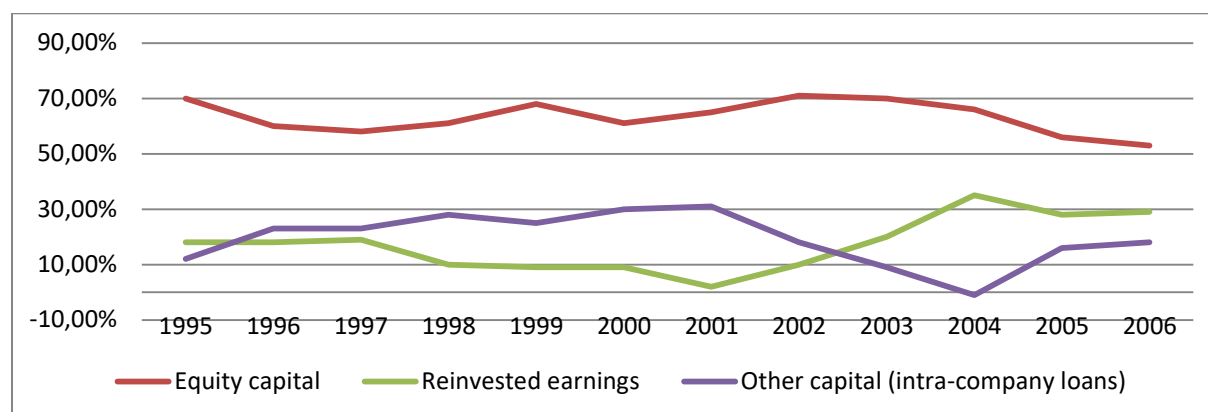
FDI inflows increased by 10.8 per cent and 32 per cent respectively. In 2009 the global financial and economic crisis has had a dampening effect also on FDI inflows to these economies which reflected the time lag associated with the initial economic downturn and following decrease in developed economies markets. Development of FDI inflows in the years 2010 - 2015 differs significantly between groups of countries. While FDI inflows to developed countries has been uneven, reflecting the economic uncertainty, weak economic growth and geopolitical risks, FDI inflows to developing economies continued to grow. In 2014 the share of FDI inflow to developing economies was even higher 55.5 per cent) than to developed economies (40.6 per cent). Growth of FDI inflows into the transition economies in the years 2010 - 2013 was followed by the sharp fall, mainly caused by regional conflicts and a significant drop in commodity prices on world markets.

2 FDI by components

Foreign direct investments are represented by three components: investments in equity capital, reinvested earnings and other capital investments (especially intra-company loans). Monitoring the development of these three components in the long term, comprehensive and comparable is complicated because not all countries collect data for each of these components. For this reason reported data on FDI are not fully comparable across countries. This concerns data on reinvested earnings in particular because their collection depends on company surveys. Due to that data on reinvested earnings are unreported by many countries. Another problem is the fact that till 2010 the data are available about the component structure of inward FDI while from 2007 are available data on the components of FDI outflows, which emphasizes the role of investors. The following description of the development of FDI components in the period 1995 - 2006 will be based on FDI inflows and in the period 2007 - 2014 on FDI outflows.

As it is evident from Figure 2, the largest component of FDI was in the period from 1995 to 2006 investment in equity capital. Their average share in FDI accounted for 63.5 per cent and was relatively stable, while the other two components have fluctuated, reaching an average of 17.3 per cent (reinvested earnings), and 19.3 per cent respectively (intra-company loans). The size of FDI inflows through the equity capital during these twelve years differed between countries and years (for example, in 1997, the investments in equity capital in Germany represented 27 per cent, while in 2003 it was 168 per cent; more than 100 per cent is due to negative values of the other components of FDI). The share of intra-company

Figure 2: Share of different financing components in world FDI inflows, 1995 – 2006 (Per cent)



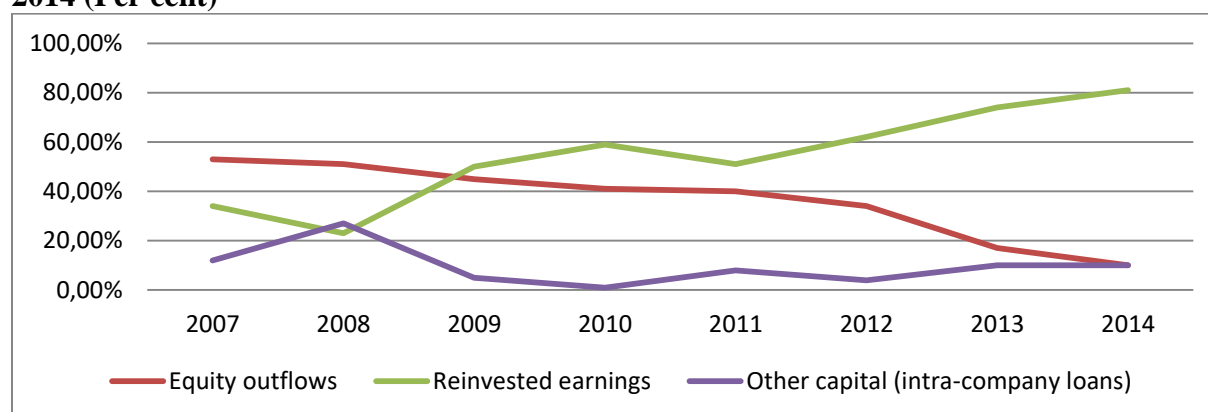
Source: Own graph based on calculations and estimates from UNCTAD (2005, 2010) data

Note: Based on data only for countries for which all three components of FDI inflows were available. This number ranges from 66 to 110 economies and it accounts for an average of 87% of total FDI inflows.

loans in the period 2001 - 2004 declined mainly due to repatriation of large volumes of loans by TNCs from their foreign branches. This is especially true for the US and Germany, which have been seen negative flows of intra-company loans. To a lesser extent experienced negative inflow of intra-company loans due to their massive repatriation Australia, Japan, the Netherlands, Portugal, and Hong-Kong. The share of intra-company loans varies due to differences in the structural aspects of the host and home countries. In order to limit the impact of economic slowdown in 2000 – 2001 many TNCs reduced their intra-company loans instead of selling off their assets in host countries. The growth of reinvested earnings in the years 2001 – 2004 is related to negative flows of intra-company loans. Like the other two components of FDI also the importance of reinvested profits varies between countries. For example, in 2003, most countries showed positive FDI inflows in the form of reinvested earnings. But Germany and France recorded negative reinvested earnings, meaning that foreign affiliates' activities in Germany and France resulted in losses which indicated a reduction or disinvestment of accumulated FDI. Around 30 per cent of reinvested profits in FDI inflows during 2004-2006 reflect growing corporate profits.

Period 2007 - 2014 shows the structure of FDI outflow in very different years: in 2007, when FDI reached historic highs, and during the deepest post-war economic crisis in the years 2008 - 2009. The development of components outflow of FDI shows two graphs, separately for investors from developed economies and investors from developing economies. When looking at the development of the share of equity investment in FDI outflow in the period 2007 - 2014 it is clear that they cease to be unambiguous major component of FDI. In

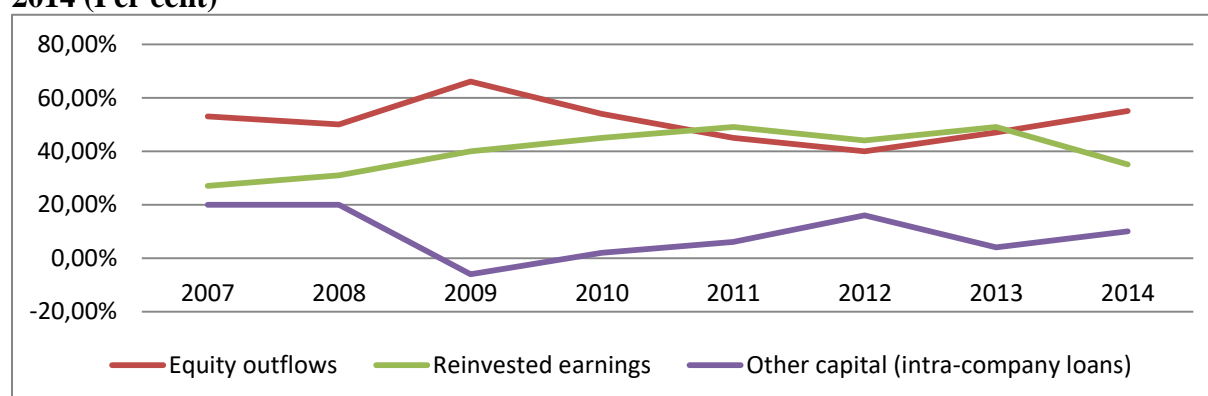
Figure 3: Share of FDI outflow components for selected developed countries*, 2007 – 2014 (Per cent)



Source: Own graph based on data in UNCTAD (2014, 2015) 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

Figure 4: Share of FDI outflow components for selected developing countries*, 2007 – 2014 (Per cent)



Source: Own graph based on data in UNCTAD (2014, 2015) data

*Economies included are Algeria, Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bahrain, Bangladesh, Barbados, Belize, the Plurinational State of Bolivia, Botswana, Brazil, Cambodia, Cabo Verde, Chile, Costa Rica, Curaçao, Dominica, El Salvador, Fiji, Grenada, Guatemala, Honduras, Hong Kong (China), India, Indonesia, the Republic of Korea, Kuwait, Lesotho, Malawi, Mexico, Mongolia, Montserrat, Morocco, Namibia, Nicaragua, Nigeria, Pakistan, Panama, the Philippines, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Samoa, Sao Tome and Principe, Seychelles, Singapore, Sint Maarten, South Africa, Sri Lanka, the State of Palestine, Suriname, Swaziland, Taiwan Province of China, Thailand, Trinidad and Tobago, Turkey, Uganda, Uruguay, the Bolivarian Republic of Venezuela and Viet Nam.

developed countries, investments in equity represent the predominant form of capital investments till 2009; then their share is still declining. While in 2007 the share of equity in FDI outflows from developed countries 53 per cent, in 2014 it was only 10 per cent. A significantly increased (except in 2008) reinvested earnings; their share in FDI outflows from developed countries grew from 34 per cent in 2007 to 81 per cent in 2014. FDI outflows from developing countries have until 2011 the predominant form of investment in equity capital, then the share of equity capital and reinvested earnings was similar and in 2014, these two shares together retreated. FDI by investors from developing economies into equity capital

accounted on average for the whole period 51 per cent, while reinvested profits 40 per cent. Average FDI outflow in the form of intra-company loans in both groups of countries was similar (9.6 per cent for developed economies and 9.25 per cent for developing economies).

34 per cent share of reinvestments in FDI in 2007 was enabled by increasing economic performance of firms as a result of economic growth. Rising profits of TNCs' parent companies created sources of funding international expansion and offset the declining resources from banks, which have found themselves in the sub-prime crisis. In 2008 and 2009, the volume of global FDI fell, and with it, all three of its components. The economic crisis has reduced the ability of TNCs to invest abroad (whether from their own resources or those of the banks or the stock markets) as well as their willingness to invest due to stronger perceived risk and uncertainty. Foreign affiliates of TNCs amounted lower profits and consequently reduced the amount of the reinvested part. Restructuring of the parent companies were sometimes accompanied by divestments in the form of repatriated investment, repayments of outstanding loans by foreign affiliates or reverse payments, which led to a decline or even negative movement in net capital flows from the parent company to foreign affiliates. As a result, intra-company capital flows from TNCs to their foreign affiliates declined, or turned negative.

As already mentioned, investments in equity capital are result of strategic decisions of TNCs and have long-term character; therefore, the decline of their share in FDI among investors from developed countries for the period 2007 - 2014 shows their uncertain expectations in the long term, and their disbelief in the future economic growth. The huge increase in the share of reinvested earnings in FDI does not automatically mean that the profit is invested in the creation, expansion or improvement of productive assets in the host country. Investors may give non-repatriated part of the profit side and wait for better investment opportunities, or it may be used to finance other activities. Other factors of retained earnings can be decisions on the level of financial leverage of the firm, cash accumulation for planned investments, fiscal considerations (e.g. to defer tax liabilities upon repatriation of profits), TNCs effort to profit from changes in exchange rates or local asset price rises, etc.

3 The main factors of the structure of FDI by component

The decision by a TNC to finance an investment in productive assets in a host country through an increase in equity capital, a loan, or by using income earned in the host country is driven by a wide range of factors. As can be apparent from the foregoing description of the development of FDI in the last twenty years, and a description of the development of the

structure of FDI by component, the main factors FDI structure by components are economic growth, the profitability of foreign affiliates, tax factors, interest rate differentials, exchange rate volatility, and some others.

Investments in equity are often associated with long-term strategic plans of TNCs, whose factor is investor confidence in the economic growth of the host country and also in its political stability. TNC's equity position determines the extent to which the TNC can control its subsidiary and protect the integrity of the TNC's assets (Asiedu & Esfahani, 2001). High degree of equity ownership can help capability building and retention in subsidiaries, resulting in their better performance.

Reinvestments are preferred when in the host country there are more favorable macroeconomic conditions than in the home country, and if a foreign branch profitability is higher than profitability in the home country. While the comparison of macroeconomic indicators based on objective statistical data is unambiguous, with corporate data on profitability can be the comparison between countries stumble upon the use of different accounting standards, different disclosure requirements or use of transfer pricing. Profitability of foreign affiliates is affected by such factors as market size, purchasing power, skilled labour force, industry-specific factors, country-specific factors, etc. The impetus for reinvestment in the host country may be the fact that the profitability of foreign branches is significantly influenced by company-specific assets (transferred from the parent company or existing in the form of tangible or non-tangible assets in the subsidiary in the host country). When thinking about reinvestment do play a role expectations of future changes in exchange rates. If investors expect the depreciation of the currency of the host country, they favour reinvestment before the eventual repatriation of profits.

The use of intra-company loans is part of the financial management of the TNCs, and is influenced by liquidity demand and tax and interest rate differentials considerations. For example, if the interest on a loan received in a country with low taxes, but the payment of interest is deductible (as an expense) in the country with high taxation, TNCs can save on taxes by taking advantage of intra-company loan. Empirical studies of tax differentials have shown that low taxes in the US compared with the parent country TNCs, investing in US, reduce the incentive to finance activities in the US through intra-company loans (Desai, Foley & Hines, 2004). Tax differentials study in Germany showed that high taxes in Germany cause the foreign investors invest in Germany through the use of intra-company loans (Ramb & Weichenrieder, 2005). Other factors influencing the size of the share of intra-company loans in FDI, it can be profitability of TNC (the improved profitability can motivate repayments of

loans by foreign affiliates to parent companies), exchange rate volatility (low value of USD can facilitate the repayment of USD-denominated debt), etc.

Choosing between FDI through equity or debt financing is affected by the fact that in most countries, interest expenses are deductible for corporate tax purposes while dividends have to be paid out of net-of-tax corporate income. Most tax systems thus favour debt finance over equity finance. TNCs must decide about the allocation of their debts to the parent firm and the subsidiaries across all countries in which they operate. As a consequence, the financial structure of a multinational firm is expected to reflect the tax systems of all the countries where it operates.

Conclusion

Over the last twenty years the development of global FDI reflected the economic growth; the volume of FDI inflows increased nearly fivefold. Until 2009 investment in equity capital was predominant component of FDI; since 2009, become the dominant component of FDI reinvested profits. This is due to the fact that corporate profits are rising, companies have a relatively large cash reserves and they look for where to place them. In the world of fragile global economy, deceleration in some large emerging market economies, elevated geopolitical risks and regional tensions is for TNCs a way to use these resources, reinvest profits or to hold large cash reserves in the form of retained earnings. Given the fact that foreign affiliates hold a significant amount of retained earnings on their balance sheets, reinvested earnings play an important role in determining the level of FDI flows.

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