Question #69724 Economics / Macroeconomics

Explain how net foreign investment measures the international flow of capital and how it can influence the market of goods and services, labour market and financial market.

Hint: Provide possible examples or case studies.

Foreign investment involves capital flows from one country to another, granting extensive ownership stakes in domestic companies and assets. Foreign investment denotes that foreigners have an active role in management as a part of their investment. A modern trend leans toward globalization, where multinational firms have investments in a variety of countries.

Foreign investments can be made by individuals, but are most often endeavors pursued by companies and corporations with substantial assets looking to expand their reach. As globalization increases, more and more companies have branches in countries around the world. For some companies, opening new manufacturing and production plants in a different country is attractive because of the opportunities for cheaper production, labor and lower or fewer taxes.

Foreign direct investment takes many forms in actual practice but is generally classified as either a vertical, horizontal or conglomerate investment.

A vertical direct investment is one where the investor adds foreign activities to an existing business, such as in the case of an American auto manufacturer establishing dealerships or acquiring a parts supply business in a foreign country.

Horizontal direct investment is perhaps the most common form. In horizontal investments, a business already existing in one country merely establishes the same business operations in a foreign country, such as in the case of a fast food franchise based in the United States opening restaurant locations in China. Horizontal direct investment is also referred to as greenfield entry into a foreign market.

The conglomerate type of direct investment, the least common form, is where an existing company in one country adds an unrelated business operation in a foreign country. This is a particularly challenging form of direct investment, since it requires simultaneously establishing a new business and establishing it in a foreign country. An example of conglomerate direct investment might be an insurance firm opening a resort park in a foreign country.

When a country's imports exceed its exports, it has a current account deficit. Its foreign trading partners who hold net monetary claims can continue to hold their claims as monetary deposits or currency, or they can use the money to buy other financial assets, real property, or equities (stocks) in the trade-deficit country. Net capital flows comprise the sum of these monetary, financial, real property, and equity claims. Capital flows move in the opposite direction to the goods and services trade claims that give rise to them. Thus, a country with a current account deficit necessarily has a capital account surplus. In BALANCE-OF-PAYMENTS accounting terms, the current-account balance, which is the total balance of internationally traded goods and services, is just offset by the capital-account balance, which is the total balance of claims that domestic investors and foreign investors have acquired in newly invested financial, real property, and equity assets in each others' countries. While all the above statements are true by definition of the accounting terms, the data on international trade and financial flows are generally riddled with errors, generally because of undercounting. Therefore, the international capital and trade data contain a balancing error term called "net errors and omissions."

Trade imbalances are financed by offsetting capital and financial flows, which generate changes in net foreign assets. These payments can be any combination of the following:

- capital investments
- portfolio investments in either debt or equity securities

• direct investment in domestic firms (FDI) including start-ups
• changes in international reserves

As Table shows, industrial countries financed their current account balances primarily with financial flows other than direct investment or reserve flows. Indeed, while the industrial countries were importing capital in the form of other financial flows, they were at the same time exporting capital as investors in the form of foreign direct investment (outflow of capital indicated by minus sign). The flow of net direct investment from industrial countries averaged −$115 billion during the nine years shown in Table and was directed primarily to developing countries. These capital outflows were an important component of financing investment in the LDCs, where the foreign direct investment inflows averaged $154 billion, positive numbers indicating an inflow.

The difference between the industrial country outflow and the developing country inflow was primarily due to foreign direct investment in the United States, which averaged −$36 billion; that is, investors in LDCs were making substantial investments in the United States, much of it reflecting capital flight from insecure financial markets in LDCs to the greater security of PROPERTY RIGHTS in industrial countries. Because financial claims may be short term or long term, real or financial, the key to development is to raise long-term investments as a percentage of capital inflows into LDCs.10 Foreign direct investment—distinguished from portfolio investment by the investor's substantial ownership share (>10 percent)—implies a greater commitment to a long-term interest in the investment project and an active interest in managing the project. While the United States has been, along with developing countries, the major recipient of direct investment inflows, it is also a major supplier of foreign direct investment.

As Table shows, flows of net investment from industrial countries to LDCs were substantial and were a major impulse to their growth; however, much of industrial and developing country investment was funneled to the United States. Of these capital flows from LDCs to the United States, a substantial share has been purchases of U.S. government debt taken up by LDCs as reserve assets; LDCs' central banks buy and hold a great amount of U.S. debt as international reserves to back their domestic currencies. Purchases of such reserve assets, primarily short-term U.S. Treasury bills, amounted to more than $1 trillion during 1997–2003, with $340 billion in 2003 alone.

The non-U.S. industrial countries—particularly France, JAPAN, the Netherlands, Switzerland, and the United Kingdom—have been the primary net investors; these five countries supplied the largest part of direct investment during the period 1995–2003, equivalent to 76 percent of the annual net direct investment of all LDCs over this period. The distribution of this net foreign direct investment (inflows) was not uniform across LDCs. Almost half of total net direct investment in developing countries was invested in three LDCs: China with 26 percent, Brazil with 13 percent, and Mexico with 8 percent. At the other end of the spectrum, the countries of sub-Saharan Africa accounted, in total, for only 5 percent of total direct investment in LDCs.

Over the past two hundred years, the world's dominant international investors have been the Western European nations, particularly the United Kingdom, the Netherlands, and Switzerland. Capital from these countries was invested in their own and other European colonies and in other developing nations, first in the Western Hemisphere and, more recently, worldwide, particularly in China and Brazil. During the nineteenth century, the British financed the transcontinental railroads in the United States and Canada and built vast agricultural plantations in Africa and Asia. Today, Great Britain and the Netherlands remain, as they have from colonial times, among the largest direct investors in the United States: Britain is largest, followed by Japan, Germany, the Netherlands, and France. After World War I, the United States emerged as the world's predominant direct investor and, in gross terms, remains so. As of 2003, U.S. foreign direct assets were more than twice those of the United Kingdom, the next largest asset holder at $2.7 trillion, while U.S. foreign direct

investment liabilities were $2.4 trillion, implying a net FDI position of $300 billion. During the past two decades, the United Kingdom again became the world's largest net foreign direct investor, with about $600 billion in net holdings at exchange rates prevailing in 2003. Following the United Kingdom in order are the United States, Japan, Switzerland, and the Netherlands. As Figure 4shows, foreign direct investment flows have cumulated to huge international holdings by these five principal investors.

Table 1 Current Account Financing ($ Billions)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Industrial Countries									
Current Account Balance Financing	42	33	73	−41	−186	−292	−249	−276	−314
Net foreign direct investment	−106	−115	−133	−153	−172	18	−100	−77	−202
Reserves	−78	−77	−23	7	−40	−45	−27	−66	−166
Other financial and capital flows	162	205	168	73	282	413	394	496	714
Net errors and omissions	−20	−47	−84	114	116	−93	−18	−77	−32
LDCs									
Current Account Balance Financing	−104	−88	−81	−51	52	136	94	148	245
Net foreign direct investment	103	120	155	165	191	169	179	136	141
Reserves	−112	−112	−83	−48	−110	−127	−129	−204	−340
Other financial and capital flows	140	100	50	−29	−94	−149	−122	−86	−85
Net errors and omissions	−28	−20	−41	−37	−38	−30	−22	5	39

Notes: Capital flows indicate investments and borrowings of all terms, ranging from currency holdings and short-term lending to long-term bonds or equity investments. Capital inflows (borrowings and investments) are indicated by positive numbers while capital outflows (lending and investments) are indicated by negative numbers.

International capital flows have increased dramatically over time, despite a temporary contraction during the global crisis. Gross cross-border capital flows rose from about 5% of world GDP in the mid- 1990s to about 20% in 2007, or about three times faster than world trade flows. The contraction affected mainly international banking flows among advanced economies and subsequently spread to other countries and asset classes. Capital flows have rebounded since the spring of 2009, driven by a bounce-back in portfolio investment from advanced to emergingmarket economies and increasingly among emerging-market economies. International capital movements can support long-term growth but are not without short-term risks. The long-term benefits arise from an efficient allocation of saving and investment between surplus and deficit countries.

Sources:

http://www.econlib.org/library/Enc/InternationalCapitalFlows.html

https://www.oecd.org/economy/48972216.pdf

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