Lecture 12: Foreign Investment (1)

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Today’s Plan

• Housekeeping
• Reading Quiz

• Today’s topic:
  • Foreign Investment
  • We’re going to talk both government perspective and firm perspective
Housekeeping

- Midterms come back Thursday
- Outline of the course:
  - Trade
  - Foreign Investment
  - Money and Finance
  - Foreign Aid, Migration
Reading Quiz(1)

• What is the title of the subsection I assigned?
  • A. The World is Flat
  • B. Foreign Investment 101
  • C. Investment and Development
  • D. The Golden Straightjacket
  • E. Investments and Consequences
  • F. The Race to the Bottom
Reading Quiz(2)

• What/Who is the electronic herd?
  • A. Government regulators
  • B. Foreign investors -- especially bond traders
  • C. Casual internet users
  • D. Hackers
  • E. All of the above
Not a Quiz

• What affect did the time limit have on your ability to perform well on the midterm?
  • A. No effect (I had enough time)
  • B. A small effect
  • C. A large effect
  • D. Armageddon
Categories of Foreign Investment

- Foreign direct investment
  - You (partially) control the enterprise you’re investing in
- Portfolio investment (no control)
  - Stocks
  - Bonds: i.e. loans to firms (sold at auction)
  - Bank loans
- Sovereign debt (government bonds)
Hot Capital

- Hot capital is capital investors can pull out quickly when they get scared.
  - Volatility

- Includes:
  - Stocks
  - Short term loans
    - i.e. Short-term bonds (both private and government)

- These investors make money off of:
  - Interest rate differentials across countries
  - Currency speculation
Cold Capital: Foreign Direct Investment

• Actually control the business in question
• Tends to be a long term investment
  • b/c it's harder to find buyers for entire companies
• This makes firm especially vulnerable to political risk (i.e. war, expropriation)
  • Obsolescing bargain (discuss later)

• Firms invest overseas to:
  • Seek factors of production (land, labor, natural resources)
  • Seek markets
Multinational Enterprises (MNEs)

- Vertical diversification
  - Different steps of the development/production/sales process occur in different locations
  - Economies of scale
  - International specialization

- Horizontal diversification
  - Produce the same good/service in several locations
  - Avoid tariffs, shipping costs
  - Customize product to local market
Checking Understanding

• Apple designs iPhones in Cupertino, manufactures them in China, and makes components in several other countries. This is an example of:
  • A. Vertical Integration
  • B. Horizontal Integration
Mode of Entry Choice

Say Anheuser-Busch wants to sell Budweiser in Canada. It can:

A. Build a brewery in Wisconsin, and ship the Bud to Canada for sale (export)
   - Economies of scale
   - But face tariffs and shipping costs

B. Build a brewery in Canada, sell in Canada (FDI)
   - No shipping costs
   - But lose economies of scale, and exposed to political risks
   - “Sunk Costs”

C. License a Canadian company to make and sell Bud in Canada (licensing)
   - Loss of quality control (brand risk)
   - Requires capable local partner
Mode of Entry Choice: Checking Understanding

• If Canadian tariffs on beer went up, it would:
  • A. Make exporting a worse strategy
  • B. Make FDI a worse strategy
  • C. Make licensing a worse strategy
  • D. B&C
Mode of Entry Choice: Checking Understanding

- If economies of scale are very high, it is best to:
  - A. Manufacture in only one country and export from there
  - B. License production to partners in as many countries as possible
  - C. Build factories in as many countries as possible (FDI)
  - D. All of the above
Direct investment position of the United States on an historical cost basis, 2007*

<table>
<thead>
<tr>
<th>Country</th>
<th>U.S. DIRECT INVESTMENT ABROAD</th>
<th>FOREIGN DIRECT INVESTMENT IN U.S</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount (billions of dollars)</td>
<td>Percentage</td>
</tr>
<tr>
<td>Canada</td>
<td>257.1</td>
<td>9.2</td>
</tr>
<tr>
<td>Europe</td>
<td>1,551.2</td>
<td>55.6</td>
</tr>
<tr>
<td>Latin America</td>
<td>472.0</td>
<td>16.9</td>
</tr>
<tr>
<td>Africa</td>
<td>27.8</td>
<td>1.0</td>
</tr>
<tr>
<td>Middle East</td>
<td>29.4</td>
<td>1.0</td>
</tr>
<tr>
<td>Asia and Pacific</td>
<td>453.9</td>
<td>16.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,791.4</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

*Historical-cost valuation is based on the time the investment occurred, with no adjustment for price changes.
The Obsolescing Bargain

- Year 1: A mining firm signs a contract with a government
  - The government offers good terms to attract the investment
- Years 2-5: the firm spends millions developing the mine
- Year 6: The government “renegotiates” the contract
  - Or just nationalizes the mine
  - “Expropriation”

- Obsolescing bargains are a much more general phenomenon
  - For example, disarmament of rebel groups following a ceasefire
Expropriation is Out of Style

• The archetypical nationalizations occurred following leftist takeovers in the 1960s-1980s.
• These events have high reputational costs
  • Also, damage bilateral relations with investor’s home country
• Bilateral Investment Treaties protect investors
  • Many free trade agreements also have investment chapters
• So countries often have to pay damages following expropriations
Creeping Expropriation

• Creeping Expropriation: Adverse changes in tax rates or regulations that reduce the value of a firm’s invested assets

• This is a REALLY broad category
  • Includes Transfer Risk

• In other, I break things up between:
  • Policy risk
  • Bureaucratic risk
  • Risk of Political Violence