Foreign Direct Investment

Risk, Return and Host Country's Strategy

Surendra Pradhan

Abstract

Foreign Direct Investment (FDI) is the outcome of the mutual interest of multinational firms and host countries. While multinational firms with the expectation of earning relatively higher rate of return on their investments, invest in foreign markets, such investments have proved to be playing an important role in the development of economy. This paper examines the various aspects of FDI from investing firms as well as from receiving countries' point of views. The paper mainly focuses on the risk and return from firms' perspective and on the strategies to attract FDI from host countries' point of view. An examination of stockholders' responses to the announcement of FDI in emerging markets shows their positive responses as indicated by the risk adjusted rate of return higher than the expected on investments during the period surrounding the announcements. The higher rate of return is, in fact, the result of existing market opportunities combined with the host country's policies towards FDI. This paper has four parts: part I is the introduction on globalization of market and dominance of FDI; part II examines the risk adjusted rate of return on FDI in emerging markets; part III deals with the international risk exposure; and part IV prescribes a model for determining a required level of incentives and/or disincentives to be offered for investing firms to consider investment in the country.

Keywords: Globalization, Foreign Direct Investment

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Part I

Introduction

I-A. Globalization of Market

The recent trend of market liberalization has opened many national markets for international businesses. As a result of open door policy in many countries, multinational firms have expanded their production, distribution and research facilities wherever permitted and economically feasible, thus moving towards a global scale of operation. Market opportunities in developed, developing, and newly emerging markets provide lucrative incentives for multinational firms to invest. For example, Toyota, Honda, Sony, General Motors, and Singer, just to note a few, have expanded their research, production and distribution networks all over the world. The developments in the global market indicate that the international business is growing rapidly in terms of market size as well as geographical diversification. International trade now accounts for one-third of the total global output. The total volume of foreign exchange trading which exceeds a trillion dollars per day indicates that international transactions are taking place at a very fast pace especially in the last quarter of the Twentieth

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century. The end of the Twentieth century has already marked a tremendous growth of international investments, trade, and financial transactions along with the integration and openness of international markets. The trend is clearly toward global scale production and marketing.

The emergence of global scale production and marketing has created a keen competition in both domestic and international markets. In reality, it has forced the domestic firms to face competition from internationally operating firms. The domestic firms are left with no choice but to be efficient and competitive or face the risk of being driven out of the market. Domestic business firms especially in developing countries have been provided full or partial protection against foreign competition for many years. They have been given opportunities to develop their potential competitiveness for a considerable length of time in many countries. In the interest of a nation, firms, and consumers, economists agree that such protection should not be extended forever. Many governments now realize that the time has come for them to face the reality of global open market competition. For example, China has freed hundreds of domestic firms from state control letting them to compete with international companies. The reality in today's business world is that no national market is immune to international competition, and domestic firms face a serious challenge from international competition.

As a matter of fact, the positive contribution of this development is that it not only forces the domestic firms to improve their production technology, be cost effective and competitive, but also benefits domestic consumers in terms of cost and quality of goods and services. Further, this process will provide opportunities to domestic firms to enter into international markets and help balance the country's international trade. The negative side of this development is that it may make domestic firms dependent on international factors. However, it is proven in the world that the benefits outweigh some of the negative side effects. Experiences of many open market countries indicate that the growing international competition has paved the highway to international markets and fostered technological advancement. Hong Kong, Singapore, and many developed countries present clear examples of such cases.

I-B. Dominance of Foreign Direct Investment

The growing trend of capital and labor movement across the border has made it possible to put together the globally most inexpensive capital, the appropriate managerial skill, inexpensive labor and supplies and the most appropriate technology at the places where they can be most productively utilized to produce goods and services most efficiently and economically. This is one of the reasons that foreign direct investments, in both size and regional coverage, have grown rapidly in the later part of the Twentieth century.

Studies in this area indicate that opportunities for higher rate of return, global market share, accessibility to production inputs, foreign government import restrictions, opening of new markets and invitation for foreign investments with rewarding incentives are the leading reasons for multinational firms to prefer FDI over other forms of international business. China received more than 100 foreign investment projects in just one year in 1992 and the growing trend continues. India has liberalized its policies on foreign investment, foreign exchange, duties and taxes, and attracted many American, European, and Japanese companies. Russia turned into a complete free-market economy and has extensively welcomed foreign investments. Multinational firms are pouring investments in Asian and Pacific-rim countries to ensure their presence in the burgeoning markets. Japan is slowly diverting investments from matured industrialized countries to growing Asian

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markets. China has been the recipient of a flood of Japanese yen, German mark, and US dollar. The trend shows that global FDI is increasing year by year and the international mobility of factors (capital, labor, and technology) and products has made a significant contribution on many fronts: in providing business opportunities to international investors and entrepreneurs, in utilizing resources productively, and in lowering the cost of production along with better quality and services.

Good or bad, national markets are now international and the global movement of factors of production, products and services is the reality.

I-C. Foreign Direct Investment - A Mutual Interest

"Why does a country invite foreign investments, and why do multinational firms invest in foreign countries?" Despite the reality that foreign investments are exposed to political risk, currency risk, and other complexities, foreign investments dominate the world business. The rationale behind this growth of foreign investments lies in the mutual interest of countries lacking adequate capital and appropriate technologies and multinational investors seeking market opportunities. Both the host countries and investing firms expect to benefit from foreign ventures; otherwise, host governments will not invite foreign firms and business firms will not invest in foreign countries. Countries invite foreign investments mainly for the sake of developing production sites and facilities, building infrastructure, and productively utilizing national resources. On the other hand multinational firms have their own interests in foreign investments. The main objective of any business firm is to maximize the firm's market value for which they take various strategic actions including foreign investments. To achieve this objective, firms continuously explore new markets, ways to lower cost of production, minimize risk, and exploit any market opportunities. Foreign investments provide some or all of these opportunities.

Multinational corporations are in a position to explore (i) where the labor and raw materials are inexpensive, (ii) where inexpensive capital can be raised and (iii) where their technology can best fit. Therefore, it is obvious why and where they invest. In this respect, our study of shareholder wealth effects of foreign direct investments in Asian markets[1] and emerging markets[2] show that such investments do reflect relatively higher rate of returns indicating higher premium for international risk. The present study is a two-dimensional study - (i) evaluation of risk-return from investing firm's perspective, and (ii) host country's strategy to attract foreign investment.

Part II

Foreign Direct Investment in Emerging Markets

II-A. Trends in Foreign Direct Investment

The fourth quarter of the Twentieth century has been an era of heavy foreign direct investment (FDI). FDI grew by $214 billion in 1991 alone, whereas the total growth for the fifteen-year period from 1975-1989 was only $200 billion. The trend is continuing with a significant increase in foreign investment flows to newly emerging markets. Potential opportunities in new markets as well as existing old markets have significantly widened the dimension of international investments. The fast growth in FDI reflects that international investments command a higher rate of return than comparable domestic investments. Since capital investment project decisions, both domestic and foreign, have significant effects on the firms' value, they are closely monitored by stock market participants, and the stock trading and pricing in the market are presumed to be dependent on the available information

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concerning such projects. Under an efficient market condition, responses to any major managerial decisions are quickly reflected into the stock prices of the investing firms. The process of price adjustment for new information is a function of investors' perceptions of projects' risks and returns. The price adjustment actually takes place as investors discount the expected cash flows from projects at a risk-adjusted rate appropriate for the projects' perceived risk level.

II-B. Related Past Studies

Past studies examining the reasons for foreign direct investments indicate that foreign direct investments are the result of economic opportunities based upon certain competitive advantages and ownership qualities of the investing firms. Some of the studies in this area examine a particular form of investments, such as acquisition, expansion in the existing markets, or new markets (Doukas and Travlos (1988); investments classified by geographical boundaries (Pradhan and Wort (1996); investments in a particular country of interest (Crutchley, Guo, and Hansen (1991) and (Chen, Hu, and Shieh (1991). While past studies have examined the shareholders' wealth effects from different dimensions, the present study by Pradhan, Wort, and Hsiao (PWH 1997) focuses on financial outcomes for shareholders from investments in emerging markets.

Doukas and Travlos found positive abnormal returns as a result of foreign acquisitions in countries in which the firms were not operating before. Crutchley, Guo, and Hansen and Chen, Hu, and Shieh examined the effects of joint venture announcements on stock price with reference to investments in Japan and China respectively. Both studies showed positive abnormal returns (about 1% in the case of Japan and about .52% in the case of China) as a result of the announcements. However, in an examination of 136 foreign investment announcements during the period 1971-86 around the world, Pradhan, Wort, and Strickland (1991) found significant negative excess returns for firms making such decisions. The study by Pradhan and Wort examined the wealth effect for shareholders by classifying foreign investments by geographical boundaries into Asian markets and rest of the world. The results of their study indicate insignificant positive abnormal returns for investments in Asian markets while indicating significant negative abnormal returns for rest of the world. All these studies have interestingly shown shareholders' positive and negative reactions to different categories of foreign direct investments.

II-C. Data

The sample data set used in the study (PWH 1997) includes cases involving investment announcements in the countries defined as emerging markets during the period of 15 years from 1980 to 1994. The list of emerging markets used in this study is based on 31 countries included in the emerging markets list in The Emerging Stock Market Fact Book.[3]

The preliminary data set includes announcement dates, investing firms' names and names of countries of 240 foreign investment announcements reported in the National Newspaper Index, e.g., *Wall Street Journal* (WSJ), *New York Times, Los Angeles Times, The Asian Wall Street Journal, The Atalanta Constitution, The Boston Globe, The Chicago Tribune, The Financial Times, The Washington Post* during the time period from 1980 through 1994. After removing all the contaminating news events on and surrounding the event dates and the events with missing and incomplete data on CRSP, a usuable sample set of 187 announcements was finalized and used for the analysis. The breakdown of total sample is presented in the Table 1.

For the analysis of effects of FDI

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announcements on stock prices, the data on daily stock returns for investing firms and a market proxy were taken from the Center for Research in Security Prices (CRSP) tapes.

II-D. Methodology

The methodology used in this study (PWH 1997) to analyze the event effects on stock returns is based on Brown and Warner (1985). A single index market model is assumed to adequately represent the return generating process from the common stock securities of the firms making announcements of major plans. Assuming semi-strong efficient markets for common stocks, the impact of a publicly announced event can be measured by abnormal returns on stocks. In the study (PWH 1997), the firm's actual stock return performance during the analysis period is compared to the market model prediction adjusted for market-related risk and for the overall movement of the market during the same period. The residual differences between the actual and predicted returns are considered to be abnormal returns. They are averaged across the sample and cumulated over time. The average abnormal residual return is considered as the net impact of FDI announcements in the portfolio context.

Estimation Period

In order to adjust for the individual firm's risk and the daily movement of the stock market index during the analysis period (t = -10 to +6), data from the preanalysis period (280 trading days beginning from t = -300 to t = -20) are used in the ordinary least squares (OLS) regression to estimate the market model parameters, alpha and beta.

Using market and security returns for the estimation period, the parameters of the market model are estimated. Accordingly, the returns for firms are generated and the expected return of each security, given the market return, is estimated as follows:

where,

Rit = the return on security I for period t

Rmt = the return on the market portfolio for period t

= the Y intercept indicating excess return on security I

= the estimated measure of relative risk of security i.

= the residual term

In this model, return Rit has a systematic component (bi) which is linearly related to the return on the stock market portfolio of assets (Rmt) and an unsystematic component (eit) which is independent of Rmt.

Since Rit represents the return on security, the abnormal return due to any unanticipated event for any given security I for the event day t is represented by the residual. Thus, for a given security I, the market model residual is its measure of abnormal performance at time period t. Since the expected value of the residual is zero, we can examine the effect of the announcement of a firm- specific unexpected event by testing to see if the abnormal return on the event day is significantly different from zero.

Table 1

	No. of Emerging Markets	No. of Non-Emerging Developing Markets	No. of Non-Emerging Developed Markets	Total No. Cases
Preliminary Sample	97	46	97	240
Final Sample	76	40	71	187

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II-E. Results

The analytical event effect testing was conducted for the sample sets of emerging, non-emerging developed, non-emerging developing, and total of non-emerging markets. The results for each set of sample indicate a nonsignificant change in stock returns particularly on the event day. The only significant changes found were on day t=2 for emerging markets and total sample. Although this finding is consistent with the findings of many of the past studies on FDI, it seems that there is a time lag in market response to FDI announcements as indicated by the non-significant excess return on announcement day. However, the significant positive result two days after the announcement is interesting to note, and it may be delayed response on the part of stockholders due to some time lag in gathering information on foreign markets. On the whole, the overall results indicate stockholders' capitalization of the expected benefits from the FDI decisions in emerging markets.

Part III

International Investment Risk - A Bitter Pill to Swallow for Multinational Investors

III-A. Exposure of International Risk

The multinational investment has grown considerably both in size and diversification but not without substantial degree of risk exposure. International business is exposed to many types of risk arising from various sources such as foreign market system, political instability, social and religious inherent, national economic condition, and foreign exchange system. These risks can be classified into (a) economic risk, (b) currency risk, (c) market risk, and (d) political risk. The potential financial effect of these risks for multinational firms is considerably very high and they cannot be left unaccounted for in foreign investment decisions.

The relevancy of these risks for foreign firms is analyzed in terms of their potential effects on the operating profitability. As a matter of fact, whether or not these risks affect a firm's profitability depends on the type of industry, nature of business, and also firm's nationality. While poor economic condition, currency instability, and uncertainty in market condition may be relevant for all business firms, political risk is unique to firm's characteristics. In the context of foreign investment, political risk refers to any political, social, and religious events or actions at national or local level that adversely affect the business operation and profitability. Although all four types of risk mentioned above are equally important to account for in FDI decisions, political risk has serious financial impact.

III-B. Historical Evidences

The political risk arises mainly from governmental and institutional behavior towards business firms. The governmental source refers to the covert and overt behavior of the ruling government as well as opposition parties against foreign business. The government policies, attitude and actions taken in the past and likely to take in the future indicate a potential political risk in the country. The institutional source, on the other hand, refers to the objective, belief and behavior of social institutions as well as public sentiment towards foreign business, which also indicate a presence of political risk in the country.

Some form of government interference or actions against foreign firms, political instability, and economic and social crisis is common in many countries. Past evidences of political and social events in different countries provide examples of potential political risk for international business. The following historical evidences provide a basis to identify relevant sources of political risk. These evidences are grouped into five categories: 1. Political Disturbances; 2. Uncertain Policies;

3. Government Actions; 4. Anti-foreign Sentiments; and 5. Home-host Country Relation.

1. Political Disturbances

Political instability, public violence and civil war may indicate the presence of a situation with potential effects on foreign businesses. For example,

- The Tiananmen Squire event in China in 1989 was a strong negative signal to foreign investors.
- On February 23, 1991, Thai military toppled premier Choonhavan's elected government and imposed martial law. This was followed by political protest and riots resulting in loss of lives and property damages.
- Political changes in Russia (1992-93), and troubles in Yugoslavia (since 1991) have sent a mixed signal and cautioned foreign investors.
- Political violence in Nepal (1991) and continued political crisis have created an unfavorable environment for foreign direct investment.
- Unstable government: Frequent changes of ruling government in Italy, Japan, India, Nepal and many other countries indicate a certain degree of uncertainty in the country. There were five Prime Ministers in Japan, and three in Nepal in three years from 1992 to 1995.
- Religious and racial violence in India, Ireland, South Africa, the United States have some potential impact on foreign businesses.

2. Uncertain Policies

Unexpected changes in policies on tax, foreign exchange, trade, and foreign investment are the indications of uncertain business environment that could impact the business firms and increase the level of risk for foreign firms. Generally the economic policies are changed or modified when governments and political systems are changed. The effect of unforeseeable changes in government policies may range from mild to severe depending on the magnitude of financial impact on the business.

3. Government Actions

Unpredictable actions against foreign firms create potential political risk. The magnitude of these actions can range from mild to severe, and they can be selective or general. The examples of government actions against foreign firms can be found in many countries. The following are noteworthy:

- Chile expropriated the affiliates of Ford, ITT and Dupont in 1971.
- Peru expropriated some US firms in 1968 and 1974, and nationalized Belco Petroleum Company in 1985 for the reason the company refused to accept the new condition requiring reinvestment of its profit in new exploration and production.
- France, Venezuela, Mexico and India nationalized some of the industries in the past.
- IBM was indirectly forced to cease its operation in India in 1977 because of the government's demand for 51% local ownership. During the same period, Coca Cola had to leave India because of the government demand for disclosure of coke formula.
- Iran expropriated many foreign firms in 1979-82.
- On February 2, 1990, the US President

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ordered a Chinese-owned corporation to sell its interest in MamCo of Seattle.

- Immediately after the change of the government in Maharastra state of India, the new government canceled the Enron's Dhabol project that was later negotiated at a substantial concession (1995).

4. Anti-Foreign Sentiments

This is another source of political risk whose magnitude generally heightens during the economic downturn in the country.

- Instances of public violence and terrorism against foreign firms and kidnapping of foreign business executives are occasionally noted in some countries.
- Violence against Korean business firms in Los Angles riots in 1992 was actually sparked by a different issue.
- Public disgruntlement with Japanese business involvement in the United States during the time of recession (1989-91) was noticeably strong.
- Anti-Kentucky Fried Chicken campaign by anti-foreign investment group in India in 1995 was nothing but the social resistance for specific type of FDI.
- Buy homemade sentiment in many countries is the social and political manifest when the local companies suffer as a result of foreign competition.

5. Home-Host Country Relation

This source is generally present between the countries ruled under different political systems. However, disagreement in the matter of trade is seen as a national strategy.

Political tension between countries in the matters of political issues, trade balance, human rights, market openness, etc., are on and off for many countries. For example, there has been occasional disagreement between the United States and Japan, China, India on political and trade issues.

The past events cited here are the examples of potential sources of political risk for foreign business firms. But do all of them indicate a presence of political risk for foreign investments in those countries? Are they relevant for foreign firms? The answer is "not necessarily". Political risk from business perspective is viewed as the host government or public interference over the operation of foreign firms. In typical cases, it arises as a result of potential conflict between corporate goals and the national aspirations of the host government, opposition parties, and religious and social institutions.

Political risk will be an accountable risk for a firm if and only if such a risk has potential effect on the operation and in the repatriation of profit and capital; otherwise, it would be improper to consider such risk as the risk for the company. Therefore, a country may be politically risky for some projects while it may not be so for other projects. For example, a country may have a hard line policy towards an industry and a liberal policy towards other industries. Similarly, some countries may discriminate against foreign firms for their country of origin. Also, the industries may be treated differently on the basis of national importance. Generally, the projects that belong to key industries and the projects that are critical to national economy and defense are more vulnerable than others. In the past, such industries were nationalized in many countries.

Part IV

Host Country's Strategy

IV-A. Foreign Direct Investment Incentives - Why?

Political risk discourages foreign firms, and

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clearly they shy away from the country if the country is a bagful of problems and politically unfavorable. However, despite problems and risk, foreign direct investments have become a popular mode of conducting international business. The reason is clearly the mutual interest of investing firms and hosting countries. As a matter of fact, it is not a zero-sum game where one party gains at the cost of the other party rather it is a win-win deal for both the parties. The fact of the matter is that foreign investments flow to those countries where the project return on investment is higher than investors' required risk-adjusted rate of return. For example, why flow of foreign investment is high in India and China, but not in Nepal? The answer is clearly the market opportunities and higher rate of return on investments. If the expected rate of return covers adequate risk premium for all types of risk including political risk, investors will not hesitate to invest no matter what type of risk is involved. The examples of foreign investments in Russia, China, and India indicate the investors' willingness to trade off risk for return. If the risk is high, the expected premium has to be high enough to lure foreign investors. If the market does not provide enough premiums, it will be necessary for the government to provide enough incentives to compensate the deficiency. This suggests that the required level of incentives to attract foreign investors depends on market system, political situation, foreign exchange system, and overall economic condition of the country. Whether or not a package of incentives being offered can effectively attract investments depends on the value of incentive package from the investors' point of view, not on the basis of the cost of incentives to governments.

IV-B. Common Types of FDI Incentives

Governments use some form of marketing techniques to attract foreign companies. They treat multinational companies just the way business firms do to their customers. Just like business firms advertise and offer discounts or other incentives to promote sales, governments offer many kinds of monetary incentives (such as cash grant and training or employment allowances) and fiscal incentives (such as tax exemptions and tariff protection) in order to attract foreign investments. The most common types of incentives offered in many countries include:

- Direct cash grants (capital grants)
- Employment grants and training allowances
- Subsidies on land and building purchases
- Interest subsidies
- Tariff protection
- Exemption of imports and export duties
- Exemption of income taxes, dividend and capital gain taxes
- Guarantee for currency conversion
- Guarantee for profit and capital repatriation

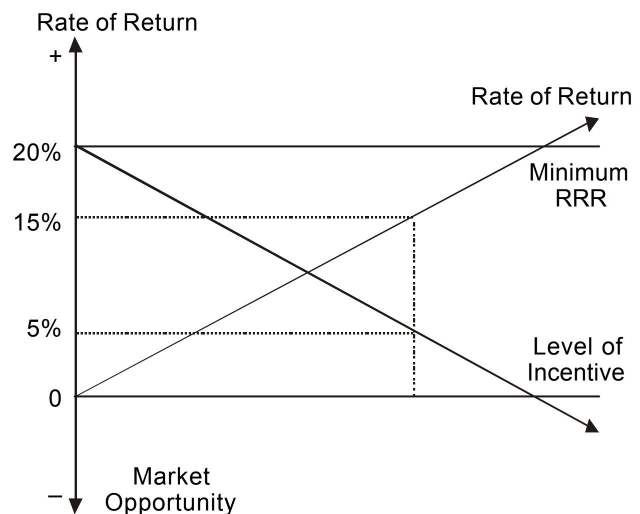
Incentive packages are designed objectively in such a way that they not only compensate the shortage of premium but also stimulate investments in specific industries and regions as per national preference. Government may discriminately use varieties of incentives making some of them industry specific and some other location specific. The purpose of using discriminatory incentives is to boost investments in preferential industries and/or to develop certain regions of the country. It is also a common practice to lodge some disincentives in the package of incentives with the intention of offsetting the cost of incentives and/or controlling the flow, type, and size of investments.

IV-C. How Much Incentive to Offer

Countries design incentive packages differently for different industries and projects based on what they expect to benefit in return. Generally in many cases, incentive packages are found to be strategically formulated in such a way that the benefits exceed the cost of incentives. This is an ideal approach from countries' point of view, but it could be one-sided deal. In order to achieve the objective of offering incentives, the other side (the investors) has to be convinced that the value of incentive package is adequate to attain their risk-adjusted rate of return. It must be noted that an incentive package designed solely on the basis of host country's cost may or may not be effective to attract foreign investors because the value of such package may not be adequate to compensate the shortage of operating premium for the overall risk exposure. Investors evaluate the package of incentives as a compensation for the disadvantages and risk they will have to assume. From their point of view, if the measured value of compensation combined with operating risk premium is not enough to reach their minimum required rate of return, they will not consider the country for investment. The type and quality of foreign investments a country can attract depend upon the market opportunity and level of incentives in that country. Therefore, the incentives should be packaged in such a way that its benefits exceed costs to host countries and its value adds up to at least investors' required risk premium for the level of risk involved.

How much incentive should a host country offer in order to attract foreign direct investment? It depends on numerous micro and macroeconomic factors and socio-political environment. The host countrie's policy on FDI does affect the rate of return and it is expected to be discounted by stockholders. Therefore, it is important for host-countries to formulate a strategy of incentives and/or disincentives that meets the investing firms' risk adjusted required rate of return. In order to successfully lure foreign investors, a very high, average, or low level of incentives may be required depending on the market opportunities available and socio-political condition in the country. In some cases, there may not need any induced incentives if the market opportunities are highly lucrative, or even negative incentives may be desirable in such cases. Therefore, it should be based on the level of incentives that will make up at least the difference between investors' required risk-adjusted rate of return and the market opportunity rate as illustrated in the following model (MIM).

MINIMUM INCENTIVE MODEL



For example, if the investors' required risk-adjusted rate of return in a country is 20% and the market opportunity provides only 15%, there is a shortage of 5%. Unless the value of incentive package is equal to or more than 5%, no investor will consider the country for investment. Thus, whether a country should offer a high, average, low, or negative incentive depends upon the expected rate of return on investment in that country which in turn depends on the market opportunity. Countries like the United States and Japan may need to offer a very little or no incentives, whereas the

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countries like Zaire, Angola, Ethiopia may need a very high incentive to attract foreign investments except in some sectors with abundant indigenous resources. China, Russia, and India would not have been successful in attracting foreign investments without appropriate levels of incentives. Even developed countries such as Germany, France, Italy, and many others do offer incentives to match the international average rate of return.

In a way, the foreign direct investment is no different from a marriage between a boy and a girl, and an appropriate analogy of incentive package would be a marriage proposal from the boy's side. The proposal must be pleasing to a girl and she must accept it in order for the marriage to take place successfully. One can speculate if and when the boy can find a bride he likes in the absence of appealing reward on his part. This reminds me of a boy saying that his marriage is fifty percent settled. When asked about the other fifty percent, he replies that he is ready but he has not found a girl. This is exactly where the problem of some of the developing countries lies in attracting quality investments in desired quantity. It should also be noted that mismatched marriage of odd couples quickly end up into divorce. No one should venture to marry unless he or she finds a matching partner.

An effective incentive package is the one that is designed from the investors' perspective. A country seeking foreign investments is a seller trying to sell site or location to customers (investors) who always expect more than their money's worth.

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