RISK AND THE FOREIGN DIRECT INVESTMENT - SYNTHETIC APPROACH

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Abstract:

As part of the international economics flows, FDI always puts a mark on the economic development of a country. The internationalization of a company by investments involves a great many risks, from the lowest to the highest level of involvement. On the basis of these considerations one can assess that the country risk is one of the most important pillars that support the process of internationalization of a company by means of foreign direct investments.

Broadly sepaking, country risk is an important component of the overall risk of trading on international levels. In other terms it can be seen as the likelihood of losses resulting from a series of macroeconomic (GDP decline on the long run, inflation increase, economic crises, etc.), social (conflicts between social classes, civil wars, riots, etc.) and political events (wars, territorial claims, conflicts of interest, etc.).

In order to identify the main country risk factors that influence the decision of corporations to invest abroad, AT Kearney (2004) performed an extensive survery among multinational corporations. Those risk factors that were most frequently mentioned included government regulations (64%), country financial risk (60%), currency or interest rate volatility (51%) and political and social disturbance (46%).[11]

The purpose of this article is to highlight a number of important factors that may affect the realization of a foreign direct investment, in other terms to influence "go-no-go" decisions, that is to invest or not to invest. Also, through the analysis of the influence of country risk over FDI one aims at evaluating the relationship between risk and potential gain resulting from conducting the respective business. The purpose of this article is an attempt to identify and develop aspects that outline a number of risk factors of influence over FDI.

Keywords: *country risk, FDI, risk factors, economic relation.*

Clasificare JEL: *P33 International Trade, Finance, Investment, Relations and Aid*

1. Introduction

A.M. Best[*] defines country risk as the risk that country-specific factors could adversely affect an insurer's ability to meet its financial obligations. Country risk is evaluated and factored into all A.M. Best ratings. As part of evaluating country risk, A.M. Best identifies the various factors within a country that may directly or indirectly affect an insurance company. Countries are placed into one of five tiers, ranging from Country Risk Tier 1 (CRT-1), denoting a stable environment with the least amount of risk, to Country Risk Tier 5 (CRT-5) for countries that pose the most risk and, therefore, the greatest challenge to an insurer's financial stability, strength and performance - (Annex no.1).[12]

The assignment of CRTs to score ranges is based on A.M. Best's assertion that the risk in countries can be categorized loosely to provide a basis of comparison, provided that country-by-country differences are acknowledged. Therefore, CRTs can be classified, in a typical scenario, by the following: [13]

[*] A.M. Best was founded in 1899 by Alfred M. Best with the mission to report on the financial stability of insurers and the insurance industry. It is the oldest and most widely recognized provider of ratings, financial data and news with an exclusive insurance industry focus. A.M. Best has offices in the U.S., London, Hong Kong, Dubai, Mexico City and Singapore. View the company's history to learn more about its role in the global insurance industry.

CRT-1: Predictable and transparent political environment, legal system and business infrastructure; sophisticated financial system regulation with deep capital markets; mature insurance industry framework.

CRT-2: Predictable and transparent political environment, legal system and business infrastructure; sufficient financial system regulation; mature insurance industry framework.

CRT-3: Developing political environment, legal system and business infrastructure with developing capital markets; developing insurance regulatory structure.

CRT-4: Relatively unpredictable and nontransparent political, legal and business environment with underdeveloped capital markets; partially to fully inadequate regulatory structure.

CRT-5: Unpredictable and opaque political, legal and business environment with limited or nonexistent capital markets; low human development and social instability; nascent insurance industry.

The country risk is an essential component of the overall risk that characterizes any business party, transaction, investment, etc. This is the result of interaction of the multitude economic, social, policies and financial factors whiche characterize the socio-political and financial-economic environment of the host country. Since the rise and the materialisation of the country risk depends on the complex of events in that country, the person who conducts a business, transaction or investment may not have any control on those events. In conclusion, all he can do is to to forecast events that may influence the actions undertaken and take appropriate measures to protect those actions.

The challenges of direct foreign investments will always be a quite interesting subject for specialists in the field, publications stand proof, having aspects of this field as research themes. By putting in the foreground the analysis of direct foreign investments in the light of the occurrence and manifestation of the country risk, all we do not is to emphasize the importance and the topicality of the study of such themes. I am going to present to you some publications which are based on the two important aspects mentioned above: the country risk and foreign direct investments which have constituted the basis of this study:

1.Kazunobu Hayakawa, Fukunari Kimura, Hyun-Hoon Lee, How does country risk matter for foreign direct investment, Institute of Developing Economies, February 2011;

2. Evica Petrović, Jelena Stanković, Country risk and effects of foreign Direct investment, FACTA UNIVERSITATIS, Series: Economics and Organization Vol. 6, No 1, 2009, pp. 9 - 22, UDC 339.22 (497.11);

3. Duncan H. Meldrum, Country Risk and Foreign Direct Investment, Business economics, the journal of the National Association for business Economists, Basingstoke : Palgrave Macmillan, ISSN 0007-666X, ZDB-ID 9632682. - Vol. 35.2000, 1, p. 33-40;

4.Coplin, William D. and & O'Leary, Michael K., editors, The Handbook of Country and Political Risk Analysis, East Syracuse, New York: Political Risk Services, International Business Communications, 1994;

And the list may continue, the influence of the country risk on foreign direct investment being a theme of great interest for many participants in economic and financial activities on internal and international level.

The purpose of this study consists in outlining an approach to the completion of foreign direct investments in the light of the influence of the country risk assessment.

By this study I am trying to make an introduction to a series of theoretical aspects that emphasize the importance of the influence of the risk by country on foreign direct investment. I also hope that this study to be of help to the future studies on this topic which certainly will never end.

2. Foreign direct investment globally

One of the most important elements that underlie globalization is free movement of capital worldwide, thus in this process particularly complex foreign direct investiţile is one of the most important aspects in the economic development of a country. In both states, which initiates and investment of the receiving states regard the investment as a means of maximising their influence on the effectiveness and cost-efficiency.

Global foreign direct investment (FDI) inflows fell by 16 per cent in 2014 to \$1.23 trillion, down from \$1.47 trillion in 2013. The decline in FDI flows was influenced mainly by the fragility of the global economy, policy uncertainty for investors and elevated geopolitical risks. New investments were also offset by some large divestments. The decline in FDI flows was in contrast to growth in GDP, trade, gross fixed capital formation and employment (table no. 2). [14]

Table no. 2 Growth rates of global GDP, GFCF, trade, employment and FDI, 2008–2016 (Per cent)

Variable	2008	2009	2010	2011	2012	2013	2014	2015*	2016*
GDP	1.5	-2.0	4.1	2.9	2.4	2.5	2.6	2.8	3.1
Trade	3.0	-10.6	12.6	6.8	2.8	3.5	3.4	3.7	4.7
GFCF	3.0	-3.5	5.7	5.5	3.9	3.2	2.9	3.0	4.7
Employment	1.2	1.1	1.2	1.4	1.4	1.4	1.3	1.3	1.2
FDI	-20.4	-20.4	11.9	17.7	-10.3	4.6	-16.3	11.4	8.4
Memorandum									
FDI value (in $ trillions)	1.49	1.19	1.33	1.56	1.40	1.47	1.23	1.37	1.48

Source: UNCTAD, FDI/MNE database for FDI in 2008–2014; United Nations (2015) for GDP; IMF (2015) for GFCF and trade; ILO for employment; and UNCTAD estimates for FDI in 2015–2016.

*Projections.

Note: FDI excludes Caribbean offshore financial centres. GFCF = gross fixed capital formation.

UNCTAD forecasts an upturn in FDI flows to $1.4 trillion in 2015 and beyond ($1.5 trillion in 2016 and $1.7 trillion in 2017) due to growth prospects in the United States, the demand-stimulating effects of lower oil prices and accommodating monetary policy, and continued investment liberalization and promotion measures. Forecasts for macroeconomic fundamentals and continued high levels of profitability and cash reserves among multinational enterprises (MNEs) support the expectation of higher FDI flows. However, a number of economic and political risks, including ongoing uncertainties in the Eurozone, potential spillovers from geopolitical tensions, and persistent vulnerabilities in emerging economies, may disrupt the projected recovery. [14]

The global FDI decline masks regional variations. While developed countries and economies in transition saw a significant decrease, inflows to developing economies remained at historically high levels.

Synthetic, the evolution of foreign direct investment by region is presented as follows:

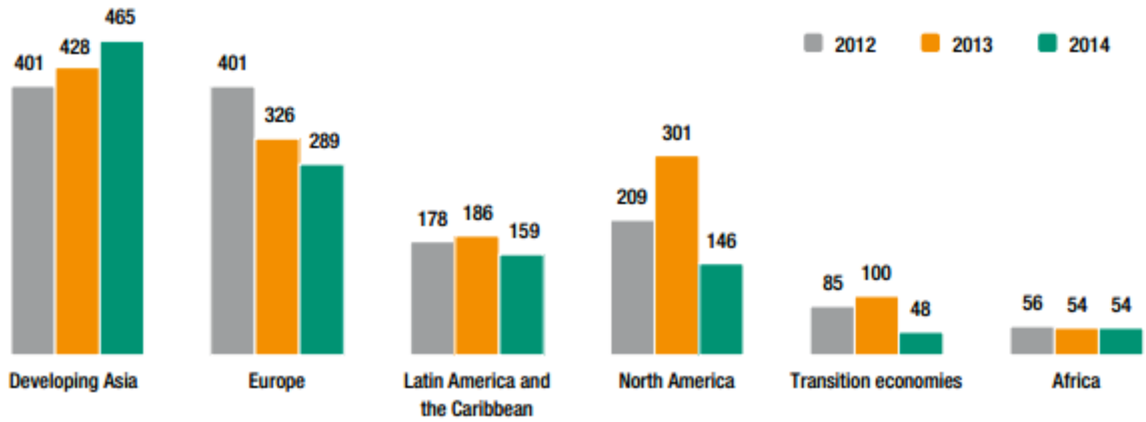

Figure no. 1 FDI inows, by region, 2012–2014 (Billions of dollars)
Source: UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

3. A synthetic approach regarding the connection between country risk and foreign direct investment

Foreign Direct Investments may be defined according to various authors as follows:

a)„ Foreign Direct investments consist in the transfer of an industrial package which comprises capital, technologies, methods of Industrial Organization, managing expertise, marketing expertise, etc. which allow the investor to exercise the right of control over the investment"; [3]

b)" Foreign Direct investments represent the expenditure incurred for the purchase or the creation of economic units, the modernization and expansion of the present and future income, with the purposemof obtaining future income from foreign investors"; [2]

c) The definition of direct foreign investments offerd by the International Monetary Fund is to be found in the Book about balance of payments and in its Supplement. [1] According to that definition, the foreign direct investments is a category of international investments that reflects the purpose of a business entity residing in a country (direct investor) to obtain a long-term collaboration in a company residing in a foreign country (direct investment). [6]

On the basis of the definitions above, we can extract the following aspects:

- the risk factors that influence the foreign direct investments are born in the business environment characterising the host country;
- the events which lead to the rise of country risk are controlled by the Government of the country in which the investment is carried out;
- decisions concerning the achievement of a foreign direct investment in a host country should be taken exclusively on the basis of a solid documentation on the financial and economic and political environment;
- the implementation of investments is made only if they provide a safe profit with a minimum of risks;
- avoiding the losses in the case of the contracting the investment shoul be a constant concern for investing companies and these losses may be: loss of opportunities generated by locking the profits made from the investment made, losses resulting from additional costs arising from the adoption of various actions in order to avoid and reduce the risk of loss arising from the capital invested that once lost can no longer be recovered in the host country.

Unlike an investment in general, representing the costs are for obtaining capital goods, foreign investment foreign elements incorporate a (foreign currency, the location of the place where the goods are sold in a foreign country, mediums, different countries, from contractors etc.). Thus, foreign investments representing capital transfers from one country to another in various forms (direct investments, portfolio investments, etc.). [1]

Country Risk can influence the foreign direct investments by means of the following levers:

- limitation or restriction of the capital
- political, economic or social events (strikes, military conflicts, elections)
- loss of profit caused by economic crisis
- corruption, legislative instability

From the aspect of a domestic company, FDI is one of the instruments for production stimulus, import of know-how, employment growth, infrastructure development, poverty reduction etc. From the aspect of a foreign company, the above mentioned investments can be defined as any form of capital investment in a foreign company, which enables achieving the ownership control. The operating mechanism of FDI considers establishing a subsidiary of parent firm in a foreign country, which can be investor's full ownership or partial foreign ownership. [15]

Table no. 3 Spread of FDI potential effects

	Spread of potential FDI effects			
	Direct		Indirect	
	Positive effects	Negative effects	Positive effects	Negative effects
Quantity	Capital inflow and employment growth in propulsive industries	FDI that take place through Brownfield investments can rationalize and minimize number of working places	New working places throughout linking with suppliers and buyers	Importing from domestic country or moving company to another country
Quality	Contributing to productivity growth	Implementing practice of cutting working places and promotions	Sharing experience and best practices among domestic companies	Lowering salaries if domestic companies decide to compete with low salaries
Location	New and probably better working places in the industries with great unemployment	Contributing to further development of regional centers and strengthening regional inequality	Strengthening companies' determination to migrate from regional centers	Creating local monopoles

Source: http://facta.junis.ni.ac.rs/eao/eao200901/eao200901-02.pdf

As for the economic component of country risk, the analyst must be able to understand the basic components of the economy of the host country, its vulnerabilities; in other words, he must anticipate those factors able to affect the general economic environment. Domestic factors of an economic nature can be chategorized in six main groups generically entitled: A. The condition of national economy; B. Sectorial Factors; C. The size of domestic market; D. The domestic financial situation; E. Geographical factors.

External factors concern the economic relations of the host country with foreign investors They may provide a clear image upon the dependence of the country of the situation in the global economy, on the obligations which the country has assumed to foreign investors, the degree of indebtedness, the level of diversification and the processing of exports, the vulnerability to fluctuations in prices on the world market, the rigidity of the imports, etc. External factors can be chategorized in: F. External trade; G. External degree of indebtedness; H. Foreign investments; I. The balance of payments and the exchange rate. [7]

4. Conclusions

Even though the topic presents only some issues regarding the link between foreign direct investment and the risk of the country, it does not highlight the fact that the issue of direct investments in relation to the risk of the country is simple and easy to understand.

On the contrary, the approach of direct foreign investments is carried out both at national and international level, especially that the volume and structure of foreign direct investment influences the level of development of a country.

Located in attention of researchers for several decades, foreign direct investment still remains a broad research topic, which has not lost its importance, but more in the context of the economic and social realities constantly changing, I consider a perpetual FDI analysis necessary, both in terms of the expected benefits but also of the determinants. [16]

The analysis and evaluation of country risk for FDI involve solving major issues such as: [4]

a) complete and accurate information on current political and economic situation in the host country;

b) detailed analysis of risk factors, and structuring a system of specific indicators;

c) building the country matrix through mathematical modelling of the system of indicators;

d) evaluating and determining the dynamics of country risk or country risk index;

e) formulation, based on the ratings and the country risk index, of strategic alternatives that should also include elements of risk management, etc.

Analysis of country risk (or Country Risk Analysis – CRA) identifies the likelihood of this risk, and specialized agencies duly rate its components.

A deep kowledge of the degree and complexity of the country risk is the premise for the implementation and development of foreign investments. Investors will decide whether it is cost-effective or not and whether they will allow it to enter the new markets.

The degree of involvement in a specific market increases in direct proportion to the level of risk of the latter. In these terms, the country risk analysis is important not only in deciding to move business abroad but also in elaborating strategies for the installation, the choice of operation type that is to be carried out on a given market, in the strategic planning process of the company or in establishing the conditions for creditation (granting grace periods and reducting interest). [7]

In conclusion, the decision to invest in a particular country is based on an analysis of the factors characterizing the local market of the host country, as well as the opportunities offered by this market in order to obtain profitability.

Among the factors to be considered we can mention: the economic and political stability, the seriousness of governmental institutions, the safety and fairness of the legal system, the accessibility to the information system and the development of the infrastructure of the host country, etc.

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**[10] *****http://www.iises.net/download/Soubory/soubory-puvodni/pp093116_ijoes_2012V1N2 .pdf
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**[14] *****http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf
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ANNEX NO.1

Country List - All CRTs

Algeria CRT- 5
Anguilla CRT- 3
Antigua And Barbuda CRT- 4
Argentina CRT- 5
Australia CRT- 1
Austria CRT- 1
Azerbaijan CRT- 4
Bahamas CRT- 3
Bahrain CRT- 4
Barbados CRT- 3
Belarus CRT- 5
Belgium CRT- 1
Bermuda CRT- 2
Bhutan CRT- 5
Bolivia CRT- 5
Bosnia And Herzegovina CRT- 5
Brazil CRT- 3
British Virgin Islands CRT- 2
Brunei Darussalam CRT- 4
Canada CRT- 1
Cayman Islands CRT- 2
Chile CRT- 2
China CRT- 3
Colombia CRT- 4
Costa Rica CRT- 4
Curaçao CRT- 3
Cyprus CRT- 3
Czech Republic CRT- 2
Denmark CRT- 1
Dominican Republic CRT- 4
Ecuador CRT- 5
Egypt CRT- 5
El Salvador CRT- 4
Finland CRT- 1
France CRT- 1
Gabon CRT- 5
Germany CRT- 1
Ghana CRT- 5
Gibraltar CRT- 1
Guatemala CRT- 5
Guernsey CRT- 1
Honduras CRT- 5
Hong Kong CRT- 2
Iceland CRT- 3
India CRT- 4
Indonesia CRT- 4
Ireland CRT- 2
Isle Of Man CRT- 1
Israel CRT- 3
Italy CRT- 2
Jamaica CRT- 5
Japan CRT- 2
Jersey CRT- 1
Jordan CRT- 4
Kazakhstan CRT- 4
Kenya CRT- 5
Kuwait CRT- 3
Lebanon CRT- 5
Libya CRT- 5
Liechtenstein CRT- 2
Luxembourg CRT- 1
Macau CRT- 2
Malaysia CRT- 3
Malta CRT- 3
Mauritius CRT- 4
Mexico CRT- 3
Micronesia CRT- 5
Mongolia CRT- 5
Morocco CRT- 4
Netherlands CRT- 1
New Zealand CRT- 2
Nicaragua CRT- 5
Nigeria CRT- 5
Norway CRT- 1
Oman CRT- 3
Pakistan CRT- 5
Panama CRT- 4
Papua New Guinea CRT- 5
Peru CRT- 4
Philippines CRT- 4
Poland CRT- 2
Portugal CRT- 3
Qatar CRT- 3
Romania CRT- 4
Russia CRT- 4
Saint Kitts And Nevis CRT- 3
Saudi Arabia CRT- 3
Singapore CRT- 1
Slovenia CRT- 2
South Africa CRT- 3
South Korea CRT- 2
Spain CRT- 2
Sri Lanka CRT- 4
St. Lucia CRT- 3
St. Maarten CRT- 3
Suriname CRT- 5
Sweden CRT- 1
Switzerland CRT- 1
Taiwan CRT- 2
Thailand CRT- 3
Togo CRT- 5
Trinidad And Tobago CRT- 3
Tunisia CRT- 4
Turkey CRT- 4
Ukraine CRT- 5
United Arab Emirates CRT- 3
United Kingdom CRT- 1
United States CRT- 1
Uzbekistan CRT- 5
Venezuela CRT- 5
Vietnam CRT- 4

Source: http://www3.ambest.com/ratings/cr/crisk.aspx