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# ROLE AND SIGNIFICANCE OF FOREIGN DIRECT INVESTMENTS AND THEIR CONNECTION WITH TRANSNATIONAL COMPANIES

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**Abstract:** In great part of the world, the investment of transnational corporations whose headquarters is abroad is closely monitored and it is subject to strict regulations. It follows that movement of factors is probably less important in practice than trade in goods, and that is the main reason for which the analysis of trade in the absence of factor movement has served as the starting point. Movement of factors includes migrations of labour, capital transfer through international borrowing and lending and complex international relationships that are a constituent part of transnational companies' development.

**Key words:** investment, transnational companies, capital.

## 1. INTRODUCTION

Today, there are a lot of restrictions of labour movements – practically every country limits the immigration of new inhabitants. For that reason, the labour mobility in practice is less frequent than capital mobility. However, it is significant; in a way it is even easier for analysis than capital movement. International capital movement is significant feature of international economic system. When we talk about international labour mobility, it is obvious that the workers are physically moving from one country to another. It is important that international transactions do not exist only on paper. They have real consequences. Particularly, international borrowing and lending can be seen as a type of international trade. The exchange of goods for other goods is not performed in a given moment, but the goods of today are exchanged for the goods of future. Significant part of international capital movement appears in long-term form as foreign direct investment.

### Foreign direct investments – their role and significance

Significant part of international capital movement appears in a different form, i.e. it is about **foreign direct investments.** Under foreign direct investments, we imply such capital flows in which the company from one country opens or increases the number of its subsidiaries in another country. Foreign direct investments not only include the transfer of resources, but the acquisition of control as well. More precisely, the subsidiary does not only have a financial obligation towards home company, but it is a part of the same organizational structure.

The greatest number of foreign investors in Serbia comes from the countries of European Union and USA. In today's world economy, foreign direct investments represent the fastest way of the development of one country and region and, as such, they are welcome even in the most developed countries of the world. Today, they are the basic mechanism of the globalization of world economy, by assuming the role of the key developmental factor of each country. For the country in which it is invested, foreign direct investments imply opening new workplaces, export increase and, generally, initiation of the economic growth and development.

On the other hand, direct investments, as a form of foreign capital investments, enable the investor to acquire the right of ownership, control and management on the basis of the capital invested. Large, and small companies as well, are trying to appear in as many different world markets, which is the easiest to achieve by approaching the production capacities to the locations desired. In addition to winning new markets, investing in other countries can also imply faster and more favourable supply of raw materials, electricity, easier transport, or approach to the free economic zones.

Transnational companies are the generators of international borrowing and lending. Mother companies often supply their subsidiaries abroad with capital, expecting that those funds will be repaid to them in the future. Since transnational companies finance their affiliations abroad, foreign direct investments are an alternative way to achieve the same goals as through international lending. However, the question why are direct investments and not some other type of funds transfer chosen as alternatives still remains open. In any case, the existence of transnational companies does not necessarily illustrate the net capital movement from one country to another. Transnational companies sometimes collect the money in order to increase the number of its subsidiaries in the country in which the subsidiary operates instead of the mother country. Moreover, there are a lot of two-way foreign direct investments between industrially developed countries, where, for example, the companies from USA increase the number of their subsidiaries in Europe while European companies simultaneously increase the number of their subsidiaries in the USA.

The point is that although transnational companies sometimes encourage international capital flows, it is probably wrong to view foreign direct investments primarily as an alternative way in which the countries can borrow and lend. As opposed to that, basic purpose of foreign direct investments is to provide the creation of transnational organizations. More precisely, the point is in assuming the control.

The classification criteria – classification of foreign direct investments can be done according to the several criteria. One of them can be the classification into basic and special forms. According to this criterion, the basic forms of foreign direct investments include:

- founding the company – (implies the construction of production capacities from the part of investor; the most frequent term for this type of investment is greenfield);
- acquisition of the major stake in the equity of already existing company (buying the company through the privatization, buying the shares or a direct purchase of equity stake – acquisition).

Special forms of foreign direct investments include:

- concession (purchase of the right to use natural resources or goods in general use for a certain period in order to perform activities of the general interest);
- B.O.T. (Build-Operate-Transfer) jobs (a permit given to the foreign investor to construct and use particular object, facility or installation, as well as the facilities of infrastructure and communications, with the obligation of ownership transfer onto the country after the expiry of the contract).

One of the classifications of foreign direct investments, which comes from the World Bank, is the division according to the motives for investing. This division can be very useful, because target groups of investors can simply be determined in this way. According to this division, there are:

- investments that require resources:
- investments that require natural resources, such as ores, raw materials and agriculture products;
- investments that require cheaper or specialized labour;
- investments that require the market:
- investments that come to the markets from which the import of particular products is high;
- investments that follow the movement of its buyers – large companies;
- investments that follow certain trends in the market and engage local suppliers;

- investments that require increase of production's productivity, which implies the rationalization of production or linking production operations to the other companies for the reduction of costs and/or specialization of production;
- investments that require already existing capacities in order to retain and promote long-term goals of their company (they are focused, primarily, on privatization and acquisition, because by purchasing the existing companies they retain the production programme and the existing market).

Classification of foreign direct investments can be done in other ways as well. Still, it is important to understand that each company has different reasons for making a decision about where and how it will invest. Whether a foreign company will decide to invest capital in one country depends on a lot of factors and, primarily, on the assessment of profits that can be gained, duration of business, but also the readiness of the host country to accept, accelerate and facilitate the business. Therefore, it is up to each state to create a good investment climate, i.e. a clear and stable framework for business in order to attract the best world's companies.

There is no doubt that our companies need to improve the competitiveness of their products and services, which is, due to the lack of investments in the past twenty years, significantly retarded in the greatest number of companies in comparison to the competitors from other countries. We need new investments, both in production technology and in marketing, so that we could successfully cope with competition in the world market. Cooperation with foreign partners would successfully solve the greatest part of these problems, and the majority of our companies had such cooperation before the period of sanctions.

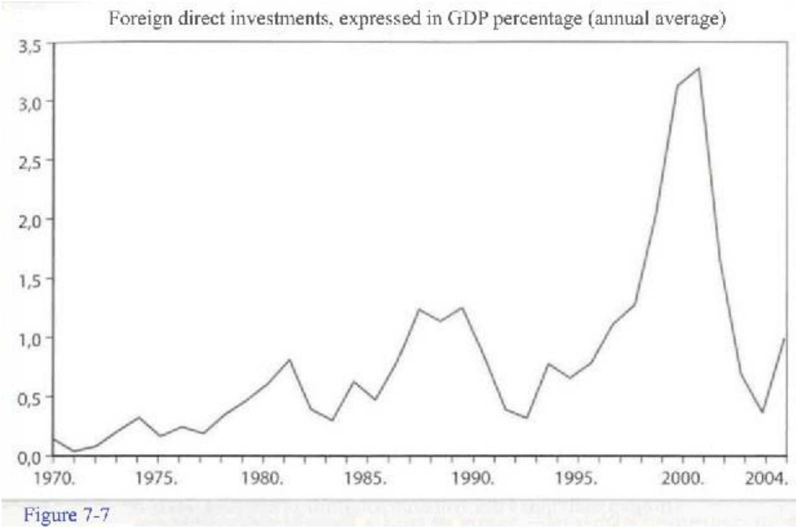
In terms of global business, brands become increasingly important, but the creation and maintenance of brands have become increasingly expensive processes. What we must also have in mind is that brands of products and manufacturers are relied on the brand or image of the country from which it comes. The examples of that are Japanese precision, Italian elegance or German technology. Serbian brand is something that is yet to be formed, and a good basis for something like that exists, for example, in high-quality food that is produced in our country, including juices and wines, but also in the international successes of our athletes in team sports. Generally speaking, regional markets, which we know better than the others are very significant for us. The market of EU countries is also very significant for us, since we will be a part of it in a few years. Of course, the markets of developing countries are also significant; in those markets we were present and successful for many years and now we could get back on them with a little effort.

Foreign direct investment in USA

Until the 80's of the XX century, the USA was almost always treated as a country of „origin" of the transnational companies rather than as a „host" for transnational companies with headquarters abroad. Moreover, the French author Jean-Jacques Servan- Schreiber has written a bestseller warning about the increasing power of transnational companies, his book – published in 1968. – was titled *American challenge*.

In the mid 80's, this standpoint was changed. Figure 1 shows the inflow of foreign direct investments in the USA – i.e., the capital that is used for acquiring the control over the American company or it is invested in the company that was already controlled by foreigners – expressed in GDP percentages. In the second half of the 80's, those capital movements, which previously were less than 0,5% of GDP, have suddenly increased. Japanese companies have begun to construct car factories in the USA, and European companies to buy American banks and insurance companies. Then, in the beginning of the 90's, foreign direct investments have suddenly dropped and then, in the end of the

90's, they began to grow incredibly fast.
What was the cause of these fluctuations? Quite paradoxically, soaring of foreign direct investments in the end of the 80's of the XX century and even greater soaring in the end of the 90's have occurred for practically opposite reasons.




Foreign direct investments in the USA

The inflow of foreign direct investments in the USA rose sharply in the period from 1986. to 1989, and then again after 1992, which has increased the share of USA production that is controlled by foreign companies.
**Source:** U.S. Department of Commerce.

A great part of foreign direct investments during the 80's was encouraged by the perception of the USA weakness. At that time, Japanese production companies, especially in the field of automotive industry, were leading in relation to their American competitors in the aspect of productivity and technology. Lower prices and high quality of Japanese products have enabled them to rapidly increase their share in the American market; in order to serve that market in the best way; the Japanese have started to open factories throughout the USA.
In addition, in the end of the 80's, American dollar was rather weak both in relation to Japanese yen and former European currencies, such as German mark. Due to that, the financial assets in the USA seemed cheap and foreign companies were encouraged to enter the market.
However, from the Figure 1, it can be seen that foreign direct investments in the USA have recorded a sudden drop and the concern of the public was reduced simultaneously with the drop in the volume of investments themselves.
When foreign direct investments rose sharply in the end of the 90's, the situation was a lot different: at that time, main impetus for the wave of investments was the perception of strength, rather than weaknesses of the American economy. USA experienced unprecedented economic boom; in the meantime, European growth was moderate, while Japan during those ten years was in the period of economic stagnation and it was increasingly lagging behind them. Since the USA re-established the economic domination, almost every company on the planet considered that it needs to have a share in the USA economy. Thus, the companies gathered in the USA, mostly by assuming control over the existing American companies. The second question is whether that was a good idea: problematic acquisition of the company Chrysler by German company Daimler- Benz has

become a famous example of the way in which investing in USA can go wrong.
Reception of foreign investors, during the 90's of the XX century was completely different than the one that was encountered during the previous wave. It is not clear to what extent the Americans were aware of the money wave that was coming. The extent to which the inflow of foreign direct investments was noticed, it was observed as a factor that contributes to the strength of American economy, and not as the threat.
Big boom of foreign direct investments from the end of the 90's of the XX century was suddenly ended by the beginning of the following decade when there was a crisis in the American stock exchange, and the USA economy fell into recession.

## 2. CONNECTION BETWEEN TRANSNATIONAL COMPANIES AND FOREIGN DIRECT INVESTMENTS

Transnational companies are the generators of international borrowing and lending. Mother companies often supply their subsidiaries abroad with capital, expecting that those funds will be repaid to them in the future. Since transnational companies finance their affiliations abroad, foreign direct investments are an alternative way to achieve the same goals as through international lending. However, the question why are direct investments and not some other type of funds transfer chosen as alternatives still remains open. In any case, the existence of transnational companies does not necessarily illustrate the net capital movement from one country to another. Transnational companies sometimes collect the money in order to increase the number of its subsidiaries in the country in which the subsidiary operates instead of the mother country. Moreover, there are a lot of two-way foreign direct investments between industrially developed countries, where, for example, the companies from USA increase the number of their subsidiaries in Europe while European companies simultaneously increase the number of their subsidiaries in the USA.
The point is that although transnational companies sometimes encourage international capital flows, it is probably wrong to view foreign direct investments primarily as an alternative way in which the countries can borrow and lend. As opposed to that, basic purpose of foreign direct investments is to provide the creation of transnational organizations. More precisely, the point is in assuming the control.
Foreign direct investments (FDI) are defined as investments that include long-term relationships and reflect the ongoing interests and control of the company – resident of one country (investor of foreign direct investment or home company) in the company that is resident of another country. Market expansion and export growth were leading in transferring the after-sale activities, such as servicing and training from a mother country to the market of buyer's country. For more efficient distribution of products, in export market, manufacturer opens his commercial representation abroad, organizes service and sales service, so that he could transfer the entire facility, i.e. production, in the following phase. A product made in foreign subsidiary carries the label of the host country. Traditional export of goods, services and intellectual property gets replaced by transferring entire production abroad, to the target market. Foreign market is won by foreign direct investments, whose carriers are the transnational companies. In that way, foreign direct investments substitute the export from home country and, at the first glance, we get the impression that it comes to a decline in exports and change in the structure of foreign trade of home countries. Indeed, the classic form of export – direct export is decreased in value and quantity but the export through foreign direct investments is increased, which is the most complex form of foreign trade job.
Limitations of the national market are the major obstacles for further development of big companies, thus their constant tendency is to transfer their activities or to expand them onto a several legal areas, they contribute to the height of many countries' gross national

and gross domestic product by their activities. Strong competition in the global market requires a constant price competition.
The companies compete in cheapening the products in different ways (cutting of prices, increasing the content amount with unchanged price etc.). In order to reduce the price of their products as much as possible, without jeopardizing their profits, production companies want to reduce the price of their products. They often do that by using modern techniques and technologies, increasing productivity in production, but since the situation in the market changes rapidly, it wouldn't be economic to change production facilities for short period, instead they are modernized. When the situation is changed so rapidly that this option reduces the company's profitability, the companies want to provide the reduction of the price through the reduction of workers' wages.
In such circumstances, the company wants to relocate its production facilities to some other country, and the countries in transition are usually the most suitable areas for such moves for the following reasons: the governments often prescribe tax rates that are lower than in developed countries, in order to support economic development or to attract foreign capital, then, countries in transition are characterized by great unemployment, low cost of labour and non-existence of certain laws that refer to the environmental protection. The easiest way to accomplish these requirements is to participate in privatization in countries in transition. We are witnesses of the sale of domestic companies to numerous foreign companies, which want to achieve certain results through the investments in our economy (approaching to some developed market, then the reduction of the cost, etc.). Lately, there is a fierce battle going on the global steel market between EU and USA. The second reason for which the transfer of capital to other countries is done is that some countries have particular agreements with large markets, they are close to the large markets, so that products can easily be found in them.
In accordance with the nature of their business, international companies need maximum freedom of the movement of capital, technology, materials, professional staff. They also need full freedom of decision-making. They accept nation state only to the extent in which it supports their expansion. National governments have an obligation to lead national policy, to direct and control their economy, balance of payments, main financial flows, employment, investments etc., so the possibility that it might limit the desired autonomy of transnational companies seems quite realistic. Their policy does not always coincide with the national interest of the home country. For now, there is no reliable knowledge about the possible definite outcome in further development of these relationships between the state and international corporations. All of that necessarily leads up to the particular changes in previous economic role of the state and strengthening of the role of particular international institutions (IMF, World Bank etc.), but it also expresses the concern about the possibility that such a development can jeopardize the required economic sovereignty of nation states. According to the others, such a development is positive, because it is an objectively conditioned need to liberate the economic development from unnecessary state limitations.
Transnational corporations have emerged as a result of concentration and centralization of capital. They firstly appear in home countries, and later on, through the investments abroad or through the purchase of existing companies, with the application of technological achievements, they create gigantic corporations throughout the world, forming the world market for their needs. Transnational companies have become a first class world power thanks to their economic power, centralizations and concentration of capital, presence almost all over the world and occupying positions in almost all key branches of economy. In accomplishing their goals, they can change not only international economic relations, but they can also influence and solve the problems in social and

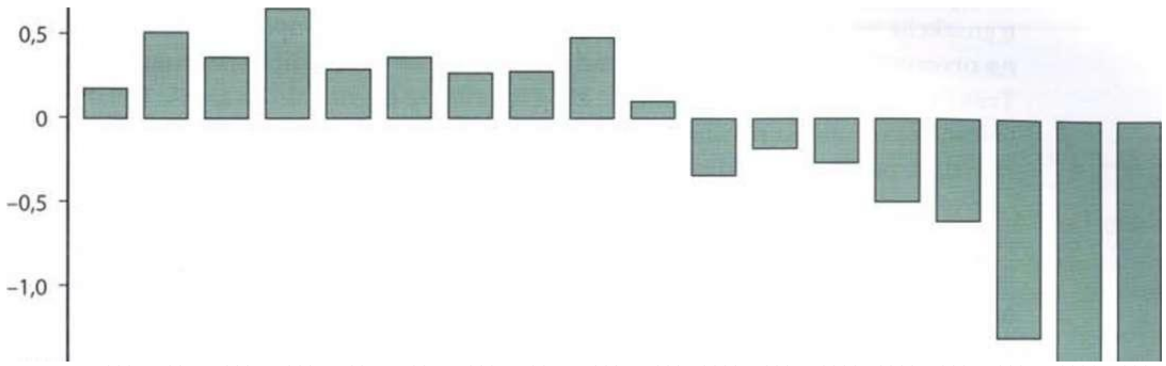
political life. Transnational companies incorporate in scientific and technical achievements, application of automation, computer technology, cybernetics, scientific and research work to the highest possible level, so that they have become the generator of development of the entire world. However, they also cause negative connotations in global economy, because they are primarily led by their own objective, the maximization of profit in global proportions. They have a developed mechanism of extracting the accumulation from the countries in which it was realized and directing it to the areas where the profit is higher, so that the gap between developed and underdeveloped countries is constantly widened. The success of these corporations is based on: long-term planning, mobilization of financial resources and application of technical progress in global relations. In that way, they succeed in providing enormous capital for production, for marketing of global proportions, high degree of specialization, cooperation and standardization, by which they become the embodiment of modern world economy. We conclude that national economy is an outdated concept of development.

Development of technology, modern communications and means of transport, has contributed that subsidiaries of transnational companies throughout the world can be mutually connected, and they can also be connected with their central, home company in every moment. Development of modern means of transport has bridged enormous spatial distances, as well the development of information and telecommunication technology, and contributed to the creation of the global company, which organizes the production in one country, draws resources from various parts of the world, so that its end product would be distributed to the third markets. Development of international market resulted in standardization of consumers' taste in various parts of the world (facilitated by modern media, TV, radio, advertising, computer technology). If there was not standardization of tastes and fashion in needs, a man from Africa would hardly have the need to drink Coca-Cola, as the American consumer does.

The tendency of liberalization of international economic relations, and especially the liberalization of international trade, has contributed to the expansion of transnational companies. Liberalization in trade was followed by liberalization of national legislation about foreign investments, which accelerated and encouraged foreign direct investments. Convertibility of the currencies is the factor that has contributed to the precise and realistic observation of the costs of establishing subsidiaries abroad and profitability of investments.

The basic required elements of the theory on transnational companies can be observed through an example. Consider the operation of American car manufacturers in Europe. Ford and General Motors, for example, sell a lot of cars in Europe, given that almost all those cars are made in factories located in Germany, Great Britain and Spain. Such a mode of operation is known, but we should observe that there are two obvious alternatives. On one hand, instead of making cars in Europe, the American companies could make them in the USA and then export them to the European market. On the other hand, the entire market could be covered by European manufacturers, such as Volkswagen and Renault. Then, why do we encounter such a specific situation in which the *same* companies produce in *various* countries?

Modern theory on transnational company starts from dividing this question into two sub-questions. Firstly, why are the goods produced in two (or more) different countries instead in one? That question is known as the matter of **location**. And the second one, why aren't there various companies that would deal with production on various locations instead on one company? That question is, for the reasons that will soon become clear, known as matter of **internalization**.




1990. 1991. 1992. 1993. 1994. 1995. 1996. 1997. 1998. 1999. 2000. 2001. 2002. 2003. 2004. 2005. 2006. 2007.

Figure 2

Capital movement to developing countries, expressed as the percentage of GDP of the developed countries

Capital movement to the countries with low wages could never be compared with the economies of the rich countries and in recent years, the capital actually moves in opposite direction, from the countries with low wages to the countries with high wages (written beneath the figure).

Capital movements were the decisions of Asian governments, particularly the Chinese government, which has bought huge amounts of dollars attempting to prevent the growth of the Chinese currency's value. Motivation will be considered later on. For now, it is important to highlight that the capital does not flow from the countries with high wages, but it actually flows from the countries with low wages, and largely arrives to the USA.

Location theory is necessary so that we could explain why the Europe does not import its cars from the USA; internalization theory is necessary to explain why the European automotive industry isn't exclusively under independent control of European companies.

Location theory is generally not very difficult to understand. It is actually nothing else but trade theory. Resources are the ones that determine the location of production. Aluminium mining has to be placed where bauxite is located, and aluminium smelting where cheap electricity is.

American companies produce goods for European market partially to reduce transportation costs; since the models that are well-sold in Europe are significantly different than the models that are well-sold in the USA, it is logical to have separate production capacities and locate them on different continents. From the given examples, it can be seen that factors that influence the decisions of transnational companies on location for production are probably not much different than the factors that determine trade model in general.

There are always significant transactions between business units of transnational companies in different countries. The product of one subsidiary can often be an input for the production of another subsidiary. In the same way, the technology that is developed in one country can also be used in the other countries. In addition, company's management can successfully coordinate the activities of the factories in several countries. Precisely those transactions are the ones that connect transnational company in a whole, and the company itself, as it seems, exists in that form precisely to facilitate those transactions. However, international transactions do not have to be conducted within the company. Components can be sold in the open market, and there are licences that can be approved to other companies for the technology. Transnational companies exist because it appeared that it is better to conduct those transactions within the company than between them.

Because of that, motive for the creation of transnational companies is called „internalization".
What leads up to the internalization? Why are some transactions better to perform within one company than between more companies? There are lot theories about it, but none of them has a good theoretical or practical basis as our location theory. However, we will mention two influential views for which it can be useful to integrate the activities in various countries within one company.
The first view highlights the advantages of internalization in the aspect of technological transfer. Technology, widely defined as any type of economic and useful knowledge, can sometimes be sold and licensed. However, there are significant difficulties in that process. Very often, it happens that a technology, which is, for example, used in running a factory, is never „written down"; it is contained in the knowledge of the group of individuals and it cannot be packed and sold. In addition, a potential buyer can hardly know the value of the knowledge, because if the buyer would know as much as the seller, then he wouldn't have the need for buying! In the end, property rights regarding the knowledge are often very difficult to determine. If the European company gives an American company a licence for using the technology, the other American companies will be able to imitate that technology legitimately. All those problems can be reduced if the company, instead of selling the technology, focuses on gaining the profit on the basis of technology application in other countries by opening the subsidiaries abroad.
The second view highlights the advantages of internalization in the aspect of vertical integration. If one company („the previous one in chain") makes goods that are used as input in another company „the next in chain"), numerous problems can appear. Firstly, if both companies are monopolists, there can be a conflict between then in case when „the next" company tries to maintain low price, while „the previous" tries to raise it. There can be problems in coordination if demand and supply are uncertain. In the end, a fluctuating price can produce an excessive risk for one or the other side. If „the previous" and „the next" companies are merged into a single „vertically integrated" company, those problems can be avoided or at least diminished.
A significant issue is the way in which the presence of transnational companies changes the state of affairs. It is difficult to provide the answer to it, because we only partially understand the reasons of transitional companies' existence. Regardless of that, the existing theory offers some preliminary answers.
We primarily need to observe that the greatest part of what transnational companies do could be done without them, although that is probably not easy. There are two examples for that: transferring labour-intensive production from industrially developed countries to the countries with abundant labour and moving the capital from the countries that are rich in capital to those who lack it. Transnational companies sometimes contribute to those changes and they are either praised or judged for their actions (depending on analysts' standpoint). However, those changes reflect the location aspect of our theory on transnational companies, which is actually the same as our usual trade theory. When transnational companies would not exist, the same would still be happening, though, perhaps, not to the same extent. Because of this observation, theoreticians of international economy attribute less significance to transnational companies than most ordinary observers.

## 3. CONCLUSION

International borrowing and lending can be observed as a type of international trade, but as the type that includes the exchange of current consumption for the future, and not the

type that includes the exchange of goods for the other goods. Relative price at which intertemporal trade is done is one plus real interest rate.
Transnational companies, although frequently encountered in the role of the generator of international borrowing and lending, primarily serve for assuming the control over the activities that take place in two or more countries. Theory of transnational companies is not as developed as some other fields of international economy. A basic framework can be presented, in which two key elements are highlighted that explain the existence of transnational company: motive of location that causes the activities of one company to be placed in various countries and motive of internalization that causes the activities to be integrated in one company.
Location motives of transnational companies are the same as all that are in the basis of international trade. Internalization motives are somewhat more difficult to understand; modern theory indicates to two main motives, and those are: the need to find a way for the transfer of technology and advantages in some cases of vertical integration.

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