ANALYSIS OF CURRENCY IMPACT ON INTERNATIONAL INVESTMENT

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ABSTRACT

The developing countries are highly attractive towards foreign direct investment for their economic growth. After the emergence of globalization, the FDI concept kicked up in the international market. During 1950s the companies were limited to capital market and portfolio investment. However, in 1960s globalization served as the strength to the companies to invest freely in others' economy which turned as the optimistic market position for both the investing and host countries. The FDI started capturing the international market by offering economic growth to the developing counties. So, they started promoting MNCs and other FDI by offering flexible policies to invest in their economy. All that development encouraged many economists and researchers to investigate the international market potential, international capital movement and MNCs' problems like expansion, production and foreign investment types. Consequently, they came up with many FDI theories and solutions for MNCs. In this context, the article discusses the economic growth on adoption of FDI in developing countries, the factors that influence it and examines various theories that explain FDI.

KEYWORDS: Foreign direct investments, FDI, Exchange rate, FDI theories, International investment

INTRODUCTION

International investment basically aims for the financial investment among the participating countries. When a company or individual from one nation invests in assets or ownership stakes of a company based in another nation; it becomes foreign investment.

A country who has faith in another country's economic growth and consistency, will take an interest in a type of investment that involves purchasing securities, mutual funds, exchange-traded funds (ETFs) and depository receipts etc. The investments bring diversification and opportunities for superior growth and development for both the countries involved.

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After liberalization around the 1990s, many foreign companies came into existence to invest in Indian companies by which robust benefits were realized since then. In the form of FDIs and diversified portfolio of the Indian companies, this development promoted competitive edge to Indian Industries by enhancing diversified business in both domestic as well as in foreign nations and attracted foreign currency. Thus, at that recession time of Indian economy the concept of FDI or allowing foreign investment was an aid to preserve the value of our economy's portfolio. Another benefit of this type of investment was that it can provide large amounts of growth, with technology transfer, cost-effective, reduce monopoly, innovations etc. Many investors focused on emerging markets of the world where there was ample opportunity for growth.

Globalization picked up a rapid growth, as it became the most likely concept for the big companies to take entry in another country by setting up their own branches/subsidiaries units or by investing money in existing companies located in that Country. These companies are interested to open new manufacturing plants or work because of comparatively cheaper labor, production resources, and fewer taxes in other Country as well as to have more access to additional customers that the purchasing firm wants. Moreover, FDI in any country resulted in the overall growth and development of the respective economy in the form of job opportunities, the standard of living improvement, infrastructure, foreign currency circulation etc. It also helped to gain stable economy at the International level by which more international investment attracted.

Foreign investments divided into two types of investment i.e direct and indirect investments. Direct investments are those investment in which one companies makes direct and physical investments for the purchase of asset like infrastructures, factories, machines, and other equipment outside to its own home country which will called as host country. On the other hand, Indirect investments are those investments in which companies or financial institutions purchase share, debentures positions or stakes in the host country's companies foreign stock exchange. Direct investments considered as a longer-term investment in the economy of a foreign country because their investment is physical which cannot easily liquidities as compared to shares of stock.

All types of investments involve risk and international investing may present some special risks. Some of the risks involved with international investing include the following:

- Fluctuations in currency exchange rates
- Changes in market value
- Significant political, economic and social events
- Low liquidity
- Less access to important information
- Varying market operations and procedures

Our purpose under this study is to examine the currency fluctuation impact on International Investment, analysis of risk factors involved and solution to mitigate the risk. The analysis will be model based and will be done by opting sampling based on secondary data – monthly data on six stock index series and exchange rates from Financial Times Sources.

The past studies mostly focused to examine market correlations, the risk- return outcome of the international investment, and/or the impact of exchange rate movement on the risk- return outcome, have generally used dollar- based investment. Some papers use both dollars- and non- dollar- based investigation on investments to determine whether there were any major differences in the way exchange rate affects investment outcomes and market correlations.

We hereby reviewing some of the research papers to provide a base for our research study and trying to find the exact gap to be filled with the available knowledge in the selected research topic.

REVIEW OF LITERATURE

Foreign Direct Investment always proved its sovereignty for the effective economic growth by the adopted countries. Many economists and researchers have discussed different folds of international investments, its impact, limitations, and benefits.

In the era of 90's, FDI came as the rescue element for the Indian economy and with the end of almost three-decade India have secured the position of the seventh largest economy in the world and third largest by PPP. Further, India has been graced with the 139th position in per capita GDP (nominal) with \$2,134 and 122nd in per capita GDP (PPP) with \$7,783 as of 2018. All this achievement could be possible after the adaptation of economic liberalization policy in 1991. Now, Indian economy is world's fastest growing economy and ahead than China. In this section, we discuss the FDI effects, its impacts on other economic factors all over the world. (Steven and Karsten 1999) studied the different impact of FDI on emerging credit markets based on new bond issues and bank loans and found that the short-term interest rates had relatively little influence on emerging market bond spreads. (Rajkumar, K. P. and Pagavathi, K. 2016) premeditated the work on foreign direct equity investment in various sectors and opposed that the overall inflows of information & broadcasting, automobile, computer hardware & software, power, mining those sectors were contributed very high in GDP growth of Indian economy.

At the beginning of the 90s, the main concern for foreign investment was the risk factor involved in it and that was considered as the most challenging factor to evaluate. Many researchers presented analytical reports to highlight the undiscovered sides of international investment and to promote it. Different studies discussed (Thomas, J.P. and Worrall, T. 1994, AlHajhouj, H. R. 2002 and Wley, P. and Lee, J. 2003) that the FDI and the risk of expropriation in it. These researches have been focused on investor's behavior of self-willingness to invest. (Ahn Y.S., Adji S.S. and Willett T.D. 1998), evaluated the inflow of FDI in developing countries and measured, the inflation influence level was highly significant on the exchange rate and the policy introduced to control the negative consequence on capital inflows caused by inflation, which only reduced the risk. They also suggested for the extensive watch on overvaluation of currency for exchange rate stability. Moreover, (Sung, H. and Lapan, E. H. 2000) investigation study offered a great solution to overcome exchange-rate uncertainty factor by which FDI got affected, by the establishment of many MNF in foreign markets, that helped to control local competition and expanded profit by cost advantage.

The researches, (Froot, K.A. and Stein, J.C. 1991 and Phillips, S. and Ahmadi-Esfahani F.Z. 2008) reflected the relationship between two important variables of foreign investment, exchange rate, and FDI. Generally, researchers concluded that the exchange rate dominated the FDI inflows; when the currency of the host country at weak. Thus, strong players acquired more assets in those economies. Another similar study (Aizenman, J. 1992) evaluated the correlation between different variables with FDI. The study found the negative correlation between investment and exchange rate instability when the exchange rate regime considered as flexible, it derived to nominal shock. However, positive correlation achieved when dominant shock got real. The study concluded that a flexible exchange rate had adverse implications on investment behavior hence fixed exchange rate regime adopted to attract more FDI. On the other hand, (Goldberg, L.S. and Klein, M.W. 1997), presented the relationship between trade, FDI and exchange rate of the Southeast Asian and Latin American countries compared to - US and Japan. Resulted that the Southeast Asian FDI market was significantly affected by bilateral real exchange rates as well as of trade in both the compared set of countries.

Moreover, an empirical study (Harchaoui, T., Tarkhani, F. and Yuen, T. 2005), on 22 Canadian production-based companies assessed the relationship between exchange rate and investment. It proved the inconsequential impact of exchange rate on total investment and suggested three major aspects to control instability in investment status due to exchange rate fluctuation, i) proper environmental study ii) The total investment based on the mobility of machinery and equipment not just by IT and infrastructure. Lastly, iii) investment in low market share companies were more sensitive to exchange rate fluctuations. Further, (Klein, M.W. and Rosengren E. 1994) the relationship between exchange rate and inward FDI in US economy, found the two different interrelated reasons which influenced the inflow of FDI, i) the real exchange rate affected the relative cost of labour and 2) the real exchange rate altered the relative wealth across countries. In addition, a time series study on the US, Canada, UK, and Japan economies (Campa, J.M. and Goldberg, L.S. 1999) analyzed the exchange rate fluctuations, resulted in the positive on exports, however, had a negative impact on input imports for finished goods production. Also, found the low mark-up sectors have a direct impact on the exchange rate in the specific market sector.

A further addition to the literature, the US - FDI analyzed on 12 developed countries (Görg, H. and Wakelin, K. 2002), with respect to exchange rate fluctuations, found no significant variation in the inflow and outflow of the US FDI in the period of 1983 to 1995. Exchange rate showed a positive relationship between the US outward investment and appreciated the currency of host country whereas, a negative relationship found between US inward investment and appreciation in the home currency dollar. (Barrell R., Gottschalk S.D., and Hall S.G. 2004) analyzed the European market for US investment purpose. The variable considered was the exchange rate risk diversification impact on the market of seven manufacturing Companies. It demonstrated the instability of exchange rates and its impact. Further, the correlation tested on investment & exchange rate which indicated, the US firms were reluctant to face the high risk of exchange rate fluctuations in the European Market and thus, controlled their investment. Ended up with the fact, unbalanced FDI because of the instability of foreign exchange rate and the companies presented the Euro market had less control to determine the market price, for that reason the US investment got diverted from Euro market to the UK.

A study, on the flow of FDI in 46 developing countries (by Fry J. M., Claessens, S., Burridge, P. and Blanchet, M.C. 1995), and analyzed the independence or interdependence of FDI with respect to the flow of fund from the capital to current accounts vice versa in selected countries. Resulted, BOP flow when FDI - completely independent, free from restrictions and thus, directed considerably increased capital formation in the host country. A similar study (Taylor, A.M. 1996), on 12 different countries data have been picked up in 1850. That investigation was enhanced in the literature by test on long-run and short-run criteria of capital mobility. It analyzed the saving-investment correlation between the selected countries. Most importantly, it concluded that the capital market was at the evolution stage by the late nineteenth century. It found significant diversity between the cross-country tests and the interwar period was the most depressed period and caused low FDI mobility.

Different studies (Oladipo, O. S. 2010, Imoughele, E.L. and Ismaila, M. 2014) explained the fundamental relationship between the factors which affected the economic growth in Nigeria and studied the main elements of FDI. To add in the literature, (Zakari, M. 2017) studied the relationship among three variables FDI, Exchange Rate and GDP on Nigeria's economy and found the positive relationship among FDI and Exchange Rates whereas FDI and GDP have a weak positive relationship. That study assisted the Government to format a new strategic policy and provided clarity on the positive or negative effect on foreign investment encountered with the fluctuation in the exchange rate and so for GDP. Thus, it was concluded that the exchange rate, FDI, and GDP are positively correlated, and the Nigeria government adopted a fully liberalized exchange rate regime. Furthermore, (Buch, Claudia M., Kleinert, J. 2006) presented the impact of exchange rate fluctuation, due to FDI and found main reason for change in the economy and FDI affected in two ways i) in the presence of information frictions on capital markets and ii) when investment by firms depends on their net worth. It found positive support for goods market friction hypothesis. Similarly, (Lane, P. R. and Shambaugh, J.C. 2007), evaluated the impact of international currency movement of different countries from 1990-2004. Concluded, that many developing countries hold short foreign-currency positions, which gave an open negative valuation effect and the domestic currency were depreciated at that moment.

FACTORS INFLUENCING FDI IN A COUNTRY

FDIs show positive effects on the economies worldwide. However, the investment countries must consider the following factors before investing in host country for an accurate decision:

1. Political/Government stability:
For investment in any country it's very important that the host country's political situations are stable enough and government supports FDI. This situation reduces the risk factors of investing country. Moreover, ROI will increase, and both the countries can enjoy benefits with adequate expansion.

2. Generous Government Policy:
Liberal policies attract more FDI which generates employment opportunities, technical support, knowledge transfer, innovation, infrastructure development and so on. Rigid policy or restrictions limits the working capacity of the investing companies which also limits the smooth functioning. So, to attract FDI government must offer supportive policies to allow these companies to participate for the enhancement of our country's economy. Moreover, with WTO regulation intervention, host country's government must adopt flexible policies, permitting FDIs in all areas including those in which they were prevented previously. For example, in India, power generation was not permitted to private sector. Now, in Maharashtra, Dabhol Power Company was allowed to work.

3. Government Dynamic Promotional measures (infrastructure):
The Government should facilitate by developing high-quality transport, power and connectivity facilities like roads, railways, airport, sea-ports, captive power, development of highways, atomic power etc. These measures will attract more FDI, simplify working conditions and investor's trust to invest.

4. Exchange Rate Stability:
Exchange rate stability has the direct impact on the inflow of FDI. Thus, frequent fluctuation in the value of domestic currency disturbs the market situations as well as while repatriating the funds by the foreign investor will suffer heavy losses. This can generate weak market position of domestic country in the international competitive ground. Miner changes in exchange rate is acceptable but big and uncertain fluctuation can cause heavy losses to investors.

5. Tax policies and concessions:
Uniform tax policy must be followed by the government as per international norms to attract more FDI with ease. Restrictions like heavy excise duty or sales tax or customs duty will limit the flow of FDI in host country. Therefore, a moderate tax policy is required to generate optimum level of FDIs.

6. Market Potential:
Adequate and efficient utilization of resources must be focused through FDIs in both the domestic and international market. This will lead to proper exploitation of resources which ultimately increase production capacity at low cost and develop huge market potential with diversification.

7. Geographical favourable factors (including logistics and labour):
High production efficiency of any country attracts more foreign investments. Geographical favourable conditions are an additional advantage. Moreover, proper training, skills development and technical support for labour development will positively increase the investment inflows. On the other hand, supply chain management and other transport facility reduce the transit time and cost. Thus, it will lead to better business growth opportunities.

8. Return on Investment (ROI):
Every business-deal aimed to earn handsome return on their investment. In FDI, both the countries that are coming into the contract are focused for a win-win position under the agreement. Investing/Financing countries would attract for venture deal with the competitive advantage, consistent, safety, money back guaranty and periodically increasing ROI as compared to the other countries. These factors are most essential tool to be considered before undertaking investment.

Therefore, ROI is a major deciding factor for FDls while undertaking investment in foreign countries. They also would like to ensure that the payback period is also less so that the return is ensured within a short period. Weightage is given to each of these factors and decisions are finalized.

INTERNATIONAL INVESTMENT THEORIES

With the passage of time in almost every developed and developing countries, Foreign Direct Investment (FDI) strategy proved its robust leading power in international economy. Many theoretical studies on FDI came out to highlight the importance of it in different market conditions in both micro and macro level. Under the influence of the FDI supremacy many economists presented international investment and FDI theories with the specific focus. To understand the technical folds of it in better way, we need to understand the basic stimuli that cause a firm to invest abroad rather than export or outsource production to national firms. In this article we will briefing the main trends in FDI theory and highlighting the basic aim of these theories.

The Major Theories of FDI

The traditional theories of FDI emerged in respect of location-specific advantages by MacDougall (1958) and then elaborated by Kemp (1964). They demonstrated based on model under the assumptions of perfectly competitive market existence. Their studies highlighted under the assumption of two-country model and capital prices = marginal productivity. As per MacDougall and Kemp, if the movement of capital tends to be free from investing country to a host country, in that case the marginal productivity of capital will become equal between the two contracting countries. The theories were focused on long term investment return concept. Thus, they stated that after investment, the result output of that country dejected without any diminution in the national income of that country because of the presence of the long run benefits.

However, some of the economists and researchers of that era was against on the assumption of perfect market condition. Hymer was the first economist who pointed out this downside of traditional theory in 1960. Further, in 1976 he advanced his own Morden theory which was based on an imperfect market setup and followed by others too. Modern theories emphasised the fact that in both markets domestic as well as international, product and factor markets were imperfect and therefore to serve market solutions, significant transaction costs must require to be considered. Modern theories also highlighted that the managerial and organisational factors were the major element of FDI to undertake its proper functions. Third category was counted as Radical theories, which was focused on the Multinational National Corporation (MNCs) development concept.

Main Theories are discussed as follows:

1. Theory of Monopolistic Advantage
2. Oligopoly Theory of Advantage
3. Product Life Cycle Model
4. Internalisation Theory
5. Eclectic theory

1. Monopoly Theory of Advantage:

Monopolistic advantage theory was proposed by S. H. Hymer and it was further stretched by C. P. Kindleberger in 1969 based on imperfect market framework which explains the technical grounds on which international companies can compete with domestic firms of host country being the solitary supplier in that selected market. This microeconomic theory highlights the positive cause of shift of capital and goods to abroad market on the following basis: i) economies of scale, ii) advanced technology, iii) better knowledge in marketing, management, or finance. Theory also stated the reason of FDI movement due to imperfect market situation in respect of product and other market factors.

2. Oligopoly Theory of Advantage

An oligopoly theory of advantage was produced by Knickerbocker (1973) also based on imperfect market condition in which few firms dominate most of the market place of the selected country. The market is controlled by niche market players, so it resulted highly concentrated. The best example can be of oil and petrol companies in world market. In oligopoly market the companies on their pricing and strategic policies are very sensitive. If one market player reduces their product’s price, it can effectively capture the market shares. As a result, other few players will automatically reduce their prices to maintain the market place.

3. Product Life Cycle (PLC) Theory:

Product Life Cycle theory was exposed by Vernon in 1966, it explains both trade and FDI. The theory applies time feature in the life cycle of the product when it enters in the market for direct consumers. The theory was the extension of monopoly theory with time variable. Vernon described four different stages of product life cycle when it penetrates in the market: 1) innovation, 2) growth, 3) maturity and 4) decline.

When any company produce an innovative/unique product, it will enjoy its monopolistic advantage in export market of the same. However, with the passage of time the competitors find out a solution with substitute or similar product at competitive price. Thus, PLC theory stated that the manufacturing firm's therefore shift their focus from exporting to FDI to save their profit. When the new product reaches to its standardised growth phase, the domestic firms develop the oligopolistic market in the host country.

4. The Internalisation Theory

In the year 1976 another theory of Internalisation was expressed by Buckley and Casson. They took FDI at another level by studying the impact of international investment through industrial or firm level rather than focusing to a specific country. Their theory became so popular as it highlights the concepts of MNCs formation. Thus, it was called as internalization theory under imperfect market condition which give birth to transnational companies aiming to target FDI.

They both discussed in their theory that transnational companies are smartly managing their internal functioning to earn markable profit and specific advantage by optimum resource utilization. Further, this theory of Internalisation became the base theory for eclectic theory of Dunning, however, he argued that the internalisation theory explains only part of FDI flows.

5. Eclectic Theory:

Eclectic theory was promulgated by Dunning in the year 1988, it was the most dynamic approach to serve the solutions on the production issues dealing by the MNCs in host country and for FDI. Eclectic model theory presented under the third dimension of Location factor that the foreign companies open their subsidiary units in the host country. Therefore, to setup their subsidiary unit, location selection became the most important point to evaluate. Under these influencing factors, Dunning (1993) presented his Eclectic theory with technical analysis of FDI came out in three variables of it: FDI = O+L+I.

(i) Investing Firms should have ownership advantages; (O)

(ii) It proposed to setup international unit to gain the benefits of direct supply; (I)

(iii) By this setup the foreign companies have location advantages to exploits local resources being under ownership advantages in a host country; (L).

Ownership advantage are firm specific internal strength like its managerial effectiveness, organisation structure, efficient functioning system, technological dominance etc. These advantages of investing companies over host country’s companies are in both kind of assets i.e. tangible as well as intangible. The O advantage controls the unnecessary production cost, and which result as the strong element for foreign companies to compete in host country’s market players.

In addition to location advantage, Eclectic theory expressed internalisation variable of a company which goes abroad with its indispensable flexibility and robust knowledge of

marketing capabilities. This will ultimately assist to gain healthy profit as the transactions are carrying out with the organization which holds external market.
Furthermore, the companies stretch highest emphasis to evaluate the best possible location to invest and setup. This decision turns as most advantages for the investing companies. Thus, location advantage is the most valuable factor to examine before going international. The basis evaluation factors to be considered are EPRG and PEST factors before selecting the country to invest.

CONCLUSION

The article tries to explain the impact of FDI and currency movement under the light of economic growth of many developing countries for the duration of 1980 to 2018. The most noteworthy result to arise in the study that the membership countries like EUROZONE and other currency union countries are enjoying FDI flow and high growth rate. Further, it is observed that the developing countries are attempting to liberalize their policies to increase the inflow of FDI in their economy which ultimately provide the overall development in the economy with proper utilization of resources. Literature reviews also enlighten the fact to apply corrective actions to put controlled and reduction over inflation in the economy. Secondly, try to keep exchange rate more stable to generate more FDI and to earn the trust of host country in international market it will have the positive influence on GDP growth.

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