Direct investment in the real and financial sector – the Bundesbank Spring Conference 2002

In May the Bundesbank held its traditional Spring Conference. This year, it was devoted to the subject of direct investment. One of the main issues discussed was why enterprises from the real sector invest in other countries and what implications this has for the economies concerned. The other main topic of discussion concerned matters relating to international mergers in the banking sector.

Greater international economic integration is an important feature of our times. It is accompanied by new development opportunities as well as challenges arising from the intensification of international competition. Both are aspects which affect a country's economic policy and therefore the central banks, too. In particular, central banks need to appreciate the relevance for them of banks from different countries merging to form larger, new types of institutions.

Strong worldwide growth of cross-border investment

The increase in global economic integration can be seen particularly clearly from cross-border investment. For example, the foreign direct investment stocks of German enterprises have more or less quadrupled in the past ten years. Globally, direct investment flows expanded in the 1990s at an annual rate of some 20%, which was far more than the increase in cross-border trading in goods and services. It is also worth noting that these investment flows are mainly between the industrial countries. The Bundesbank conference accordingly focused on direct invest-

ment in industrial countries (see the conference programme on page 77).

In the past, the Bundesbank has repeatedly looked at the extent to which German enterprises invest abroad, the level of investment by non-residents in projects in Germany and the conclusions which can be drawn from these two developments. The aim is, first, to achieve a better understanding of what determines this behaviour – why, for example, enterprises prefer to invest in one country rather than in another. The second aim is to gain a better basis from which to estimate the implications of direct investment for the target country and for the "exporting" country. The Spring Conference 2002 attempted to shed light on some of these aspects.

Various motives behind direct investment

Professional research often cites two key motives for enterprises to invest abroad. They want either to gain a foothold on the market in the country concerned or to exploit cost advantages. Whichever the predominant motive, different factors are decisive and different consequences can be expected for the home country and the host country.

On the basis of an analysis of US investment in Europe, it was conjectured during the conference that both underlying motives come into play (rather than market-oriented direct investment being predominant, as is sometimes assumed). This also implies that this direct investment is particularly responsive to government-set parameters. Several studies were presented which suggest that governments have various means of influencing an enterprise's choice of location.

High responsiveness of direct investment to tax incentives

One parameter is fiscal policy. Earlier analyses often showed that US investors respond to tax incentives in the target country. On account of the US tax system, this effect is less pronounced in the United States than in a good many other countries. Profits earned abroad by US investors are subject to domestic taxation but only if the foreign tax payable is less than that which would have been payable in the United States. By comparison with investors from countries such as Germany whose external profits are in principle only subject to foreign taxation, this should reduce the tax sensitivity of US firms when selecting their location. In actual fact, empirical results presented at the conference which were based on data from individual enterprises suggested that the tax sensitivity of enterprises outside the USA is significantly higher than that of enterprises domiciled in the USA. In addition, tax considerations appear to be a major factor for investors needing to decide between locations in Europe; given the comparatively great similarity of these countries, this also seems logical.

Subsidies need to be reviewed carefully

Similarly to the structure of tax systems, subsidies can also provide an incentive to select one location rather than another. This relates directly to the debate about the justification for and rationale behind subsidy competition between countries. From an economic standpoint, this kind of assistance can be considered justified if the investment has advantages for the economy concerned – advantages for which the enterprise in question is not rewarded by the market; in other words, the situation gives rise to positive externalities. This includes, for example, the transfer

FDI in the real and financial sector of industrial countries

Conference programme, 3-4 May 2002

Welcome address by Reiner König (Deutsche Bundesbank)

The economics of foreign direct investment incentives

Magnus Blomstrom/Ari Kokko (Stockholm School of Economics)
Discussant: Jean-Louis Mucchielli (University of Paris I)

Chains of ownership, tax competition and foreign direct investment

Mihir Desai (Harvard University), C Fritz Foley (Harvard University and University of Michigan), James R Hines Jr (University of Michigan)
Discussant: E Monty Graham (Institute for International Economics, Washington)

Host country determinants of US foreign direct investment into Europe

Matthew Slaughter (Dartmouth College)
Discussant: Karolina Ekholm (Stockholm School of Economics)

Foreign direct investment: Who cares about ownership?

Colin Mayer (University of Oxford)
Discussant: Stijn Claessens (University of Amsterdam)

Ownership, capital or outsourcing: What drives German investment in eastern Europe?

Dalia Marin (University of Munich), Andzelika Lorentowicz (University of Munich), Alexander Raubold (University of Munich)
Discussant: Anna Falzoni (Bocconi University, Milan)

Is there a potential for increases in FDI for Central and Eastern European countries following EU accession?

David Greenaway/Holger Görg (University of Nottingham)
Discussant: Christian Wey (Social Science Research Center Berlin)

EU accession and FDI flows to CEE countries: Lessons from the Irish experience

Frank Barry (University College Dublin)
Discussant: Robert Lipsey (City University New York and NBER)

Evening meeting
Recent developments in competition policy

Mario Monti (European Commission)

Fiscal policies, European integration and the location of German foreign direct investment

Nigel Pain (National Institute of Economic and Social Research, London)
Discussant: Ulrich Grosch (Deutsche Bundesbank)

A "new" micro data base for German FDI

Alexander Lipponer (Deutsche Bundesbank)

Determinants of cross-border mergers in European banking

Phil Molyneux (University of Wales, Bangor)
Discussant: Ben Craig (Federal Reserve Bank, Cleveland)

Determinants of cross-border bank mergers: Is Europe different?

Claudia Buch (Institute of World Economics, Kiel),
Gayle Delong (Baruch College, New York)
Discussant: Adrian Tschoegl (University of Pennsylvania)

Cross-border mergers in European banking and bank efficiency

Rudi Vander Vennet (University of Ghent)
Discussant: Reint Gropp (European Central Bank)

Panel discussion: Cross-border mergers in the financial industry: How we did it

Participants: Markus Fell (HypoVereinsbank, Munich)
Axel Wieandt (Deutsche Bank, Frankfurt)
Stefan M Goetz (Credit Swiss Group, Zurich)

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of knowledge and promoting competition in a given country. The extent to which externalities such as these are actually linked to investment is the subject of heated debate. It would seem at any rate to depend very much on the individual case. This in turn suggests that governments should exercise caution and review investment projects very carefully before granting subsidies.

A presentation on German investors in other European countries involved an empirical study of how their choice of location is influenced by fiscal factors in the broader sense. This includes the relatively high tax rates and the importance of spending on the infrastructure in the country concerned. By nature, such global variables are of only limited suitability for empirical analyses. On balance, however, it is evident in this case, too, that these government parameters have an impact on an enterprise's choice of location and that taxation plays a greater role than investment in infrastructure. By contrast, EU transfer payments to individual countries were found to have no significant effect on the standing of those countries as investment locations. Nor could confirmation be found for the assumption that the sensitivity of investors to tax and subsidy incentives has increased.

Empirical analyses which have no alternative but to draw on aggregate data are not always able to provide evidence of significant connections normally expected by an economist. In some cases, more strongly disaggregated sets of data can help. At the conference, data of this kind on German direct investment were presented as material which researchers will be able to use in the future, although confidentiality requirements need to be observed.

Although most direct investment takes place between highly developed industrial countries, the conference examined the effect that this has on the countries of central and eastern Europe that are in the process of catching up. How can they attract the interest of foreign investors? What types of direct investment exist in these countries? The responses, of course, also concern the current EU member states. They can compete as the best location for enterprises or they can benefit from such investment if, for example, it is a matter of gaining access to new markets.

Accession countries benefit from direct investment by German enterprises

A survey of the activity of German enterprises in the accession countries revealed that they have a variety of different reasons for investing in these countries. The distance from Germany was also a decisive factor. In neighbouring countries, vertical direct investment is more important than in economies which are further away. All in all, the study in question came to a positive conclusion for the countries of eastern Europe: they benefit from direct investment by knowledge transfer and also record a capital inflow because the investors frequently finance their projects in Germany.

What effect will the impending EU accession have on direct investment in the eastern European countries? A presentation which attempted to apply the lessons learned in Ireland to the accession countries presented a

clearly optimistic outlook and saw a promising future for the development of direct investment in eastern Europe. Not least, the Irish example suggests that in the future funds will flow to technologically more demanding economic sectors. However, some important preconditions such as low taxes and wages and efficient management were cited. By contrast, greater scepticism was expressed in a presentation which endeavoured to estimate the extent to which British enterprises will be prompted to invest more in these countries solely as a result of their acceding to the EU. It suggested that EU enlargement alone would have little effect; an impact is most likely to be felt in the services sector. However, this does not rule out the fact that the associated growth effect could give a positive impetus to foreign investment.

Direct investment from the perspective of company monitoring

When analysing the motives behind direct investment, it is frequently assumed that purchasing and monitoring a foreign enterprise are synonymous. In actual fact, however, the connections between ownership and monitoring are complex. At the conference the thesis was put forward that "remote" company monitoring is guided by other principles than when the monitoring of how the business is run is very direct. Which of the two methods seems the more appropriate depends not least on the sector in which the given enterprise operates. For instance, when a bank grants loans to enterprises, detailed information is vital. In this instance, a clear case can therefore be made for a "local" manager and owner. With regard to bank business with a strong international bias, however, "remote" monitoring can have advantages. This kind of approach can help to understand whether or not direct investment improves management efficiency and thereby boosts the economy. Accordingly, such considerations can also be applied to the development of rules which should be observed in respect of takeovers by non-residents.

Direct investment in the banking sector

In the example cited above, reference has already been made to direct investment in the banking sector, which has some significance in terms of total German foreign direct investment. Central banks have, in addition, a particular interest in such developments in the financial sector since they may have a bearing on the monetary transmission process and may be important for the stability of the financial sector. Against this backdrop, direct investment in the banking sector – by means of takeovers of non-resident banks, for instance – deserves particular attention.

Various motives for international bank mergers

Economic theory has listed various motives for activities of this nature. It may be appropriate for banks to undertake international mergers or acquisitions because they are looking for new customers outside their own country or are following their customers abroad. The reason for these mergers and acquisitions may also be that banks are seeking to increase their efficiency or to diversify risk. The empirical findings presented at the conference gave certain indications that international bank mergers bring about an increase in profits. However, experience shows that such effects take hold only after a fairly long period of time. Empirical studies are therefore not always able to provide sufficient evidence of these effects. There are also indi-

cations that it is more frequently large European banks from comparatively wealthy countries which buy up smaller institutions in poorer countries. This can be taken as a sign that experienced banks with extensive expertise purchase foreign banks and thus enhance their efficiency. Overall, research does not appear to have come up with a cogent theory to explain the international bank mergers. In addition, there are as yet few indications that the start of monetary union has given a boost to the tendency for banks to merge across member states.

The closing discussion with representatives of commercial banks also conveyed the impression that there is a whole range of motives which lead banks to acquire other institutions abroad or to merge with them. The ultimate success of such mergers mainly depends, in our experience, on whether a clear overall strategy is in place and whether the partners are "well matched". What this means in practical terms can vary considerably from one bank to another.

The conference showed the phenomenon of direct investment to be multifaceted. All in all, however, a very positive picture was painted. In particular, direct investment can help to stimulate the catching-up process of less developed economies.