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Rethinking Multinational Enterprises' Capital Budgeting in the Globalized New Millennium

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A strict interpretation of the Ricardian assumptions on international trade leads to a conclusion in favour of the impossibility of a firm investing abroad. Even extending the Ricardian model by including capital among the factors of production, it has to be supposed that, from a purely economic and financial perspective, the choice between directly investing abroad and not doing so is totally indifferent. It is the existence of imperfections in the real and/or financial markets that give rise to the convenience for a firm to exploit its competitive advantages through foreign direct investment (FDI).

In a broad sense, a multinational enterprise (MNE) can be intended as a company that holds controlled firms, producing branches, divisions, establishments, subsidiaries, etc., in a foreign country. The reasons that can persuade a firm to become multinational are manifold.

First of all, it can be the sole action in order to conduct a specific business. Think about the activity of the extraction of raw materials: it cannot be conducted anywhere other than the mine's location.

Many firms are seeking greater production efficiency, and are thus investing in countries where one or more of the factors of production, capital included, are undervalued given their productivity. Others achieve significant economies of scale, scope or integration through expansion abroad that would not have been exploited otherwise.

Considering the Japanese automobile industry expansion in the U.S., FDI can also be a powerful driver to satisfy better the internal demand of a foreign country.

In some industries (like biotech or telecom), direct operation in a foreign country allows easier and more immediate access to the technologies, knowledge and professional skills developed in that country.

Furthermore, the more favourable social, political, economic and financial context can influence the decision to invest abroad directly: advanced infrastructures, an efficient legal framework, a slim bureaucracy, a fair tax system, the absence of corruption and nepotism, financial and tax incentives for investments and so on.

Finally, investing abroad can be a response to fears of nationalization of a firm's own private activity by the domestic government.

It should be clear that the motivations to engage in FDI are not alternatives but often concur in the investment decision.

From a strategic perspective, FDI cannot be only a proactive investment, that is, an investment that looks forward to the exploitation of new income opportunities; it can also have a defensive perspective, i.e. as a response to the presence in the home market of new and aggressive competitors who are believed seriously to be able to erode significant market shares.

Having identified its competitive advantages, a company should analyse the international markets, looking for imperfections to be exploited, and invest only in those countries where the net present value (NPV) of the FDI is expected to be positive (or, if the investments are alternatives each other, in the one where the NPV is maximized). However, it is not rare to observe in the practice that behavioural factors, like psychical proximity (in which psychical distance refers to the difference in countries' culture, legal system, religion, social conditions and so on) or imitation of other companies, significantly influence the choice to become multinational. It is also not unusual to verify in MNEs that have invested in more than one country that the investment process followed for the first FDI was significantly different (regarding dimension, location, selection process, entry method and so forth) from the following investments, as if a learning process based on the previous experience drives the subsequent investments.

The United Nations Conference on Trade and Development (UNCTAD) reported that 2007 saw world foreign direct investment inflows reaching the record of $1.9 trillion. However, the global financial and economic crisis led to a sharp decline in FDI flows in subsequent years. The UNCTAD figures reveal an amount of $1.35 trillion of FDI inflows in 2012. Its expectation is for a consistent recovery in 2013 and subsequent years with an estimate of $1.8 trillion FDI inflows in 2015.However, significant risks to this growth scenario remain. Factors such as structural weaknesses in the global financial system, the possible deterioration of the macroeconomic environment and significant policy uncertainty in areas crucial to investor confidence might lead to a further decline in FDI flows.

As the international financial and economic context evolves and becomes increasingly globalized, the capital budgeting for multinational companies faces new challenges and needs more refined models and tools of analysis. Indeed, capital budgeting for foreign direct investments carries complexities that do not affect the corporate decision-making process for domestic projects.

First of all, a business abroad is subject to its own political sources of risk, often totally different from and not correlated with those that affect the same activity carried out in the homeland.

FDI exposes an MNE to exchange rate risk and inflation risk. Moreover, unexpected variations in the

exchange rate and in the differential between homeland and foreign inflation can significantly affect the net cash flows generated by the FDI and negatively impact on the competitive position of the MNE or of its foreign subsidiary. The terminal value of the activity is often more difficult to estimate than in the domestic environment.

The differences in the tax system between the home country and the host country also complicate the capital budgeting for foreign direct investments and can give rise to fiscal arbitrage opportunities. At the same time, starting a new activity abroad can impact (positively or negatively) on the net cash flows and on the value of the other investments of the company. Hence, the capital budgeting for FDI must accurately take into account the collateral effects of the new FDI on the value of the other (domestic and international) investments of the firm.

The net cash flow to the parent company of an FDI is also dependent on the financial structure of the subsidiary. Taking the parent view of the valuation of an FDI, the financial structure of the foreign branch has to be defined bearing in mind the optimization of the consolidated financial structure of the MNE group and not the optimal financial structure of the foreign subsidiary alone. Moreover, it can be more difficult to separate the effects of the investment decisions from the outcomes of the financing decision in an international context than for a domestic project. In this context, the financial contributions of foreign agencies to the investment also complicate the estimate of the weighted cost of capital of the FDI.

The issues mentioned above are the ones that more often impact on the complexities of an FDI capital budget. However, the list is not intended to be exhaustive, nor do all the factors described necessarily impact on all FDI projects at the same time and to the same extent. It should also be clear that these factors call for assumptions and estimates, and thus models of analysis, that inevitably affect the capital budgeting process of any MNE involved in expanding its operations abroad.

The papers published in this special issue make a significant contribution to the complexities of multinational capital budgeting in the modern globalized financial and economic markets by addressing a number of difficult tasks related to foreign direct investments and by developing models aimed at handling the intricacy associated with non-domestic business.

In the introductory paper, Josè Vargas examines the procedures followed by multinational enterprises to distribute the income generated by their foreign subsidiaries. His analysis leads to the conclusion that MNEs use organizational strategies and intercompany trade to benefit from the comparative advantages of the different countries in which they operate.

The complexities of taxation of loans in the multinational capital budgeting for international investment are handled by Charles Higgins. He demonstrates that the net present value of any loan at its own discount rate is zero in both the pre-tax and the after-tax world. This, in a capital budgeting context, allows separation from any investment net present value analysis and reduces the assumptions to be made for the evaluation of the investment project. He also argues that, even in complex financing, one could still regard the marginal cost of the loan at its own discount rate, in both the pre-tax and the post-tax world.

The third paper, co-authored by me and Francesco Calò, analyses foreign direct investment location choices under uncertainty using a binomial approach. We develop an innovative model to deal with this crucial step for any multinational involved in expanding its operations abroad. An application explores the practical implementation of the model and outlines the extent to which different financial variables impact on the location choice of FDIs.

Then, Seyedashkan Madani and Mahya Nobakht focus on the political determinant of FDI inflows in upper middle income countries (UMIC), investigating how the quality of political institutions in host countries can impact on the level of political risks perceived by foreign investors and multinational enterprises. Their analysis is based on a dynamic panel model that makes use of "difference" generalized method of moments estimators to cope with the autocorrelation and endogeneity of the variables in the models. Their study covers a sample of 31 UMICs with different political regimes over the period 1990–2001, finding that democratic systems attract more foreign direct investments in UMICs.

In the fifth paper, Kanchan Datta explores from an econometric perspective the relationship between currency depreciation and trade balance in India. His analysis supports the conclusion that in the short run India's trade balance Granger caused depreciation of the rupee over the period 2009–2013. He also concludes that increases in India's trade balance reduced the growth of the real effective exchange rate of the rupee.

The concluding paper of this special issue is written by Oskar Kowalewski. He focuses on multinational banks and investigates whether foreign subsidiaries outperform their parent banks in terms of profitability. Using a sample of multinational banks in a large number of countries, the research shows that, on average, foreign subsidiaries are less profitable than their parent banks, but that foreign subsidiaries tend to perform better than their parent banks if they are well capitalized and have low overhead costs and low loss provision.

My gratitude is extended to all of these researchers, who have supported the success of this special issue with their work. I also greatly appreciate the anonymous but indispensable shadow effort of the colleagues who I involved in the review process of the papers submitted to this special issue. Their contribution was of enormous importance in selecting the articles to be included in the issue and their suggestions helped the authors to improve the quality of their research significantly.

As can be seen, the papers of this special issue provide a rich scientific analysis of a comprehensive set of topics related to multinational capital budgeting. I hope that their findings will provide significant insights and will be useful to academics and practitioners worldwide. New empirical and theoretical research on multinational capital budgeting issues is nonetheless necessary to continue to provide new perspectives on this fascinating area of financial studies.