Lecture 9: Multinational Corporations and FDI

- Contrast with portfolio investment
- Overview of recent developments
- Explaining FDI
Portfolio Investment and FDI

- Investments without managerial control
- Driven by differential rates of expected return among national economies
- FDI is not driven by international differences in the price of capital
MNCs and Intrafirm Trade

• A firm becomes a multinational corporation by engaging in foreign direct investment
  – An MNC has plants in at least two countries
• Trade takes place across borders within firms
• Intrafirm trade accounts for 30-40% of world trade
• Intrafirm trade is part of a global strategy
• Prices are set by the firms
Changing Government Attitudes

• Governments invest significant resources trying to attract FDI
  – China, Mexico, Russia, states of former Soviet Union try hard
  – India, Indonesia, Korea, Brazil show signs of changing their minds: liberalize traditionally restrictive policies

• Less liberal: the United States
  – 1986-1991: significant foreign control of economic activity
The Irregular Flow of FDI

• Boom in FDI in 1985-1992: increased by a factor of 2.6
  – Total worldwide stock of FDI in 1985: $745.8 billion
  – 1992: c. $2 trillion
  – 1999: $4.8 trillion
  – Involved firms from dozens of home nations (a lot flowed into the United States)
  – US, Western Europe, and Japan account for 82% of world total FDI in 1999
• Probably have had other booms (but lack accurate data for world as a whole)
  – Late 1950s until about 1967: a boom fueled by international expansion of US manufacturing and petroleum firms
• Major challenge: how do we explain the irregular flow of FDI?
Where FDI Flows

- FDI does not flow from areas that are well endowed with capital to ones that are not
  - 1985-92 boom: flows within Western Europe, Japan, and North America
  - Germany and the United States: both home and host to considerable FDI in the chemical and auto industries
- But by 1997 about 53% went to Europe and the United States, and 42% to developing countries (Asia and Latin America)
Explaining FDI I

- Gain secure access to natural resources
  - Petroleum and mining the third most important area for MNC activity
  - 11 of the 100 largest MNCs are in mining and petroleum
Explaining FDI II

• Jump protectionist barriers
  – US investments in automobile manufacturing in the 1960s in Europe
  – Japanese and German investments in the US in the 1980s

• Auto industry the second most heavily represented industry among the 100 largest MNCs
Explaining FDI III

- Designed to improve efficiency of operations
  - Allocate different elements of the production process to different parts of the world
  - Capital-intensive element located in capital-rich countries (advanced industrial countries)
  - Labor-intensive element located in labor-rich countries (developing countries)
The Firm’s Options

- Firms can choose their mode of participation in the world economy
  - Rely on market-based transactions: import inputs from foreign suppliers + export its products to foreign markets
  - Internalize these international transactions within the firm: own foreign firms that supply its inputs + locating production in foreign markets
  - MNCs exist because firms have chosen the second option. Why?
The Economists’ Puzzle

• Why exploit ownership advantages through FDI?
  – Why not license to indigenous producers?
  – Or, export through independent distributors?

• Lack of knowledge of foreign markets and startup costs mean that licensing (or exports) should dominate

• Internalization is more efficient than arm’s length relationships or selling assets to rival firms
Proprietary or Intangible Assets

• Various kinds of knowledge or skills that go into producing and marketing goods

• Market transactions of these skills subject to market failures
  – Knowledge is in joint supply (cf. public goods)
  – The fundamental paradox of information: value of information for
    the purchaser is not know until he has the information, but then he
    has acquired it without cost

• Create incentives for horizontal integration: create multiple production sites, each producing the same good(s)
Specific Assets

• Specific asset: an investment dedicated to a particular long-term economic relationship

• Difficult to write and enforce long-term contracts
  – Existence of a specific asset creates possibilities for opportunistic behavior once the investment has been made
  – Problem would disappear if it were costless to enforce the original contract: typically is not

• Create incentives for vertical integration: internalize transactions for intermediate goods
Why Internalization Is More Efficient

- Avoids creating a future competitor
  - Intangible assets
- Avoids transaction costs
  - Search and negotiation costs
  - Costs of broken contracts (including litigation)
Why MNCs?

- Explaining horizontal and vertical integration not the same as explaining FDI or expansion across borders
- To explain MNCs we need to add locational advantages
Locational Advantages

• Host country locational advantages
  – Large consumer markets and their expected rate of growth
  – Factor endowments (cheap labor; highly-skilled labor)
  – Natural resources (oil, minerals)
  – Tariff and nontariff barriers to imports: sheltered from international competition
  – Degree of industry competition: little competition is good
  – Well-developed infrastructure
  – Tax incentives

• Explain flows of FDI
## Market Imperfections, Locational Advantages, and MNCs

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<th>Locational Advantages</th>
<th>Intangible assets</th>
<th>Specific assets</th>
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<tr>
<td>Yes</td>
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<td>No</td>
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