Econ 340

Lecture 11
Multinationals and International Capital Movements

Outline: Multinationals and International Capital Movements

• Terminology
  – FDI, DFI, MNEs, MNCs
  – Real Versus Financial Capital
• History
• Purposes Served by FDI
  – Local Market versus Export
  – Reasons for FDI
• Who Gains and Who Loses?
  – Effects that are Similar to Trade
  – Effects that are Similar to Migration
  – Other Effects

Terminology

• International Capital Movement
  (or “Capital Flow”)
  = Acquisition of assets in another country
  = Takes two forms
  • Real
    – Physical assets, land
    – Ownership of companies (stocks: 10% or more)
  • Financial
    – Bonds, loans, bank deposits, currency
    – Stocks if less than 10% ownership
Terminology

• FDI = Foreign Direct Investment
  = DFI = Direct Foreign Investment
  = Acquisition of real assets abroad
  Results in a firm owning assets in more than one country:

• MNC = Multinational Corporation
  = MNE = Multinational Enterprise
  = TNC = Transnational Corporation
  = Firm that operates (and usually owns assets) in more than one country

Terminology

• FDI does not necessarily involve a net capital flow
  – Reason: acquisition of assets abroad can also be financed locally

• Thus
  – Net capital flows…
    • Are due to unequal savings and investment
  – FDI and MNCs…
    • Are due to business opportunities
  – Both may sometimes also be due to incentives of taxation (see Economist on “Company Headquarters”)

Terminology

• When FDI happens from Country A into Country B,
  (That is, when a firm based in Country A acquires assets, perhaps a subsidiary, in Country B)
  – “Source Country” = Country A
  – “Host Country” = Country B
Terminology

SOURCE Country

$  

HOST Country

Ownership

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History

- FDI was very important in US industrialization
  - E.g., British firms built the railroads in the 19th century
    - Not just in U.S. Also in South America
- In 20th century, until the 1980s, FDI was small, and resisted by both source and host countries
  - Governments restricted capital movements and exchange of currencies
  - Developing countries equated FDI with colonialism and imperialism
  - Countries blamed MNCs for interfering in domestic political and military matters
History

• Starting in 1980s, attitudes began to change
  – Developing countries saw FDI as helping them grow
  – Host countries saw FDI as providing employment
    • Started using policies to attract FDI
  – IMF and World Bank encouraged reforms that would be friendly to FDI
  – US and other countries negotiated Bilateral Investment Treaties (BITs)
    • Wikipedia says there are now more than 2500 BITs in force

Who Does FDI?

- Source: Lipsey 2000 (Data for 1996)

Who Gets FDI?

- Source: Lipsey 2000 (Data for 1996)
History

Sources and Destinations of FDI, 1996, $ billions

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>Japan</th>
<th>Europe</th>
<th>Other Asia</th>
<th>Latin Amer</th>
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<tr>
<td>Source</td>
<td>87.8</td>
<td>23.4</td>
<td>172.1</td>
<td>48.0</td>
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<tr>
<td>Host</td>
<td>77.0</td>
<td>0.2</td>
<td>120.1</td>
<td>78.0</td>
<td>40.1</td>
</tr>
</tbody>
</table>

*Source: Lipsey 2000 (Data for 1996)*

Who Were Sources of FDI in 2012?

- Europe
- Japan
- China
- Other Asia
- Latin America
- Other

*Source: UNCTAD World Investment Report 2013*

Who Were Hosts of FDI in 2012?

- United States
- Europe
- Japan
- China
- Other Asia
- Latin America
- Other

*Source: UNCTAD World Investment Report 2013*
China’s Shares of World FDI

Source: UNCTAD World Investment Report 2013

Chinese Investment by State, 2000 - 2016

Source: Biwood Group

Foreign direct investment

Source: Economist, Jan 28, 2012

Econ 340, Deardorff, Lecture 11: FDI
History

- Conclusions about who sends and receives FDI
  - US and Europe are both huge sources and huge hosts
    (But lots of Europe’s FDI is from one to another)
  - Japan is a major source of FDI and hardly hosts any at all
  - Developing Asia, and especially Latin America, are mainly hosts of FDI
  - China has been a large host of FDI, especially in the 90s, and is now growing rapidly also as a source.
  - Africa does not appear significantly as either source or host
History

• US has received almost as much FDI as it has sent out
  – That means lots of US assets are foreign-owned
  – What are they?

History

• Some perhaps obvious foreign-owned companies and products in the US
  
  ![](burgerking.png)
  ![](bp.png)
  ![](dannon.png)
  ![](sonypictures.png)
  ![](shell.png)
  ![](nissan.png)
History

- Some not-so-obvious foreign-owned companies and products in the US
  - TRADER JOE'S from Germany
  - CHICAGO SUN-TIMES from Mexico
  - Stop & Shop from Switzerland
  - Sara Lee from Italy
  - Bonduelle from Belgium

- More not-so-obvious foreign-owned companies and products in the US
  - Burger King from Brazil
  - Universal Studios from China
  - Holiday Inn from Germany
  - Holiday Inn Express from China
  - AMC Theatres from Luxembourg

- Nationalities can change:
  - Jeep, actually made by Chrysler, owned by Fiat, an Italian company that in 2014 changed its...
    - legal domicile to the Netherlands
    - tax residence to Britain
    - main stockmarket listing to New York
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Why Do Firms Invest Abroad?

- Purposes of FDI
  1. To sell to the Host Country
  2. To export from the Host country
     - Back to the Source Country
     - To third countries (Host = “Export Platform”)
  3. To obtain inputs for production elsewhere
     (Really a special case of #2)

Why Do Firms Invest Abroad?

- Alternatives to FDI
  - Trade
    - To sell to Host: Export instead of producing there
    - Instead of exporting from Host: Import from independent firms there
  - Licensing, Subcontracting
    - Have an independent firm in Host do production for you
Why Do Firms Invest Abroad?

- Prerequisites for FDI
  - Reason for an activity in a foreign country
    - Something to sell (to host-country market)
    - Or something to buy (raw material or factor services)
  - Both require price or cost differences, similar to trade
    - Likely to require that host have comparative advantage (true if trade is nearly free)
  - Reason to produce abroad & own the facility, rather than export, license, or subcontract

Why Do Firms Invest Abroad?

- Reasons for FDI to Sell to Host
  - Tariff Jumping
    - Common reason for FDI instead of exporting:
      Trade Barriers (tariffs, quotas, VERs, etc.)
    - An import tariff can induce inward FDI, as exporters produce inside the host country to avoid paying the tariff
    - Worth doing if extra production cost is less than the tariff

Why Do Firms Invest Abroad?

- Reasons for FDI to Sell to Host
  - Tariff Jumping
    - Examples:
      - Much FDI in Developing countries;
      - US “Transplant” auto plants
        - Really “VER jumping”
        - Not the motive today
Why Do Firms Invest Abroad?

- Reasons for FDI to Sell to Host
  - Transport Costs
    - Makes FDI more likely for selling to Host market: raises cost of exporting to it

Why Do Firms Invest Abroad?

- Reasons for FDI to Sell to Host
  - Providing Services
    - Many services cannot be provided from a distance:
      Service firms must have local providers
      - Example: McDonalds

Why Do Firms Invest Abroad?

- Reasons for FDI to Sell to Host
  - Firm-specific assets
    - Examples: Proprietary technology, unique business model, expertise of CEO
    - These give firm advantage over competitors, including local host-country firms
    - Control of these assets may require ownership rather than licensing or subcontracting
Why Do Firms Invest Abroad?

- Reasons for FDI to Export
  - Lower cost, especially labor
  - Access to resources
  - Avoid regulations (e.g., environmental)
    - This is actually not a common reason for FDI
  - Minimize transport costs (in export platforms)

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Who Gains and Who Loses

- Effects that are similar to trade
  - If production shifts to foreign location
    - Some workers at home lose jobs (“exporting jobs”)
      - Same as if production was replaced by imports
    - Other workers have jobs “saved,” if employers use FDI to avoid shutting down completely
  - If FDI is motivated by lower cost
    - Firms and consumers gain from greater efficiency
    - Effects on wages are similar to trade
    - Other firms face increased competition
Who Gains and Who Loses

• Effects that are similar to migration
  – To the extent that FDI does move capital from country to country
    • Host country gains capital
      – Often an important source of capital growth for LDCs
    • Source country loses capital
  – Changes in capital alter demands for labor
    • Wages rise in host country
    • Wages fall in source country
  – All very similar to what we said of migration

Who Gains and Who Loses

• Other Effects of FDI and MNCs
  – MNCs typically differ from local firms in same industry
    • Pay higher wages
    • Provide better (though not always “good”) working conditions
    • Use more capital-intensive methods

Who Gains and Who Loses

• Other Effects of FDI and MNCs
  – Unlike trade, FDI requires the presence of foreign people and establishments in the host country
    • This may cause changes in the host-country society and culture
    • Friction possible between groups
José Bové

French farmer and anti-globalization activist who came to fame by dismantling a McDonald’s franchise in 1999

Now a politician and (since 2009) member of the European Parliament

Who Gains and Who Loses

- Other Effects of FDI and MNCs
  - MNCs pay taxes in both Source and Host countries
    - Provides revenue for Host country government
    - May be offset by inducements to invest
      - E.g., ‘tax holidays’
    - Efforts of MNCs to reduce tax burden
      - Shift income to low-tax jurisdiction

What Determines Company Nationality?

- See Economist, “Company Headquarters”
  - National pride
    - When Italian Fiat acquired US Chrysler, taking on the Netherlands as legal domicile was neutral
    - When Burger King merged with Canada’s Tim Horton’s, it became Canadian to please Tim Horton customers
      - (But later was bought by Brazil’s 3G Capital)
  - Legal structure: Netherlands has undemanding laws (like Delaware)
  - Tax laws and tax rates
    - Low corporate tax rate favors Ireland
    - Moving to get a lower tax rate is called “Tax Inversion”
Next Lecture: The Trade Balance

- The Balance of Trade and International Transactions
  - What the trade balance is
  - What it means and doesn't mean