Econ 340, Deardorff, Lecture 11: FDI

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

- 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,
    - “Source Country” = Country A
    - “Host Country” = Country B
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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
- 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)
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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<td>23.4</td>
<td>172.1</td>
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<td>Host</td>
<td>77.0</td>
<td>0.2</td>
<td>120.1</td>
<td>78.0</td>
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</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

[Graph showing China's inflows and outflows from 1990 to 2012]

• Source: UNCTAD World Investment Report 2013

Foreign direct investment

[Map of Chinese investment by state from 2000 to 2016]

• Source: Economist, Jan 28, 2012
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.
  - But that may be changing: China’s investment there

Sectors of FDI

- Some perhaps obvious foreign-owned companies and products in the US
History

- Some not-so-obvious foreign-owned companies and products in the US
  - TRADER JOE’S
  - STOP & SHO
  - CHICAGO SUN-TIMES
- History
  - More not-so-obvious foreign-owned companies and products in the US
  - Panera Bread
  - Sprint
  - China
  - AMC Theatres
  - Tommy Hilfiger

History

- Nationalities can change:
  - Jeep
  - Actually (see Economist), Jeep is 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
- History

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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)
- 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
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 (After Exam):
The Trade Balance

• The Balance of Trade and International Transactions
  – What the trade balance is
  – What it means and doesn’t mean