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

- 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

- **FDI**: Foreign Direct Investment
- **SOURCE Country**: Country that is providing investment
- **HOST Country**: Country that is receiving investment
- **Ownership**: Concept of ownership in the HOST Country

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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)
### History

#### Sources and Destinations of FDI, 1996, $ billions

<table>
<thead>
<tr>
<th>Source</th>
<th>US</th>
<th>Japan</th>
<th>Europe</th>
<th>Other Asia</th>
<th>Latin Amer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source</td>
<td>87.8</td>
<td>23.4</td>
<td>172.1</td>
<td>48.0</td>
<td>3.8</td>
</tr>
<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: 12%
- Japan: 8%
- China: 36%
- Other Asia: 21%
- Latin America: 13%
- Other: 10%

*Source: UNCTAD World Investment Report 2013*

### Who Were Hosts of FDI in 2012?

- United States: 20%
- Europe: 0%
- Japan: 0%
- China: 13%
- Other Asia: 9%
- Latin America: 18%
- Other: 19%

*Source: UNCTAD World Investment Report 2013*

### China’s Shares of World FDI

- 1990: 0.00
- 1992: 0.02
- 1994: 0.04
- 1996: 0.06
- 1998: 0.08
- 2000: 0.10
- 2002: 0.12
- 2004: 0.14
- 2006: 0.16
- 2008: 0.18
- 2010: 0.20
- 2012: 0.22

*Source: UNCTAD World Investment Report 2013*

### Foreign direct investment

- Global inflows, flows
- Economies: developed, developing, transition, North and South, others

*Source: Commonwealth of Independent States, 2011*

*Less than $200 million, $200 million - $750 million, $750 million - $2 billion, More than $2 billion*

*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

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?
Econ 340, Deardorff, Lecture 11: FDI

**History**

- Some not-so-obvious foreign-owned companies and products in the US
  - TRADER JOE'S
  - CHICAGO SUN-TIMES
  - Neiman Marcus
  - Chicago Tribune
- History

- More not-so-obvious foreign-owned companies and products in the US
  - Panera Bread
  - Tostitos
  - Stop & Shop

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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?**

- 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
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
  – 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 Hortons, it became Canadian to please Tim Hortons 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