Foreign Direct Investment and MNCs

- FDI is investment that directly leads to productive activity within the host country

- Clearly growing importance of MNCs and FDI though some debate how important

- It would seem that to prosper many firms need to produce and sell in a number of countries

- Indeed, MNCs now outweigh exports as dominant means of servicing foreign markets.

- Top 100 MNCs control about 20% world production (UNCTAD, Held). MNCs on some estimates control around 70% world trade

- Many firms are multinational and some have a high proportion of their assets overseas:

- Changes over time marked –both in terms of firms and industries

- While FDI is one useful indicator of the growth of international production, but is an underestimate Held et al
    - Accounts for only 25% total invest in international production. MNCs raise money from a variety of sources
    - Global production not just ownership and control but cross border production networks between firms –systematic data on this not available

- When considering the option of moving abroad companies have a number of channels available:
    - Exports of goods and services
    - Direct investment in wholly owned subsidiaries
    - Licensed production
    - Joint ventures
    - Strategic Alliances between number of firms
    - Portfolio investment/cross equity holdings

- Pitelis and Sugden group theories of international production as:
    - Market power theory of the firm
    - Internalisation theory of the firm
    - Eclectic theory of the firm
    - Analysis of competitive international industries
    - Macroeconomic developmental theories

- Consider these:

Market power theory of the firm

- Traditional classical:
    - Smith: FDI provides outlet for surplus capital as rate of profit driven down by competition
    - Marx: falling rate of profit, tendency to underconsumption leads to export capital to countries at earlier stage

- Post 1945: trade and FDI between developed economies overtook that between developed and developing –theories didn't explain

- Hymer in 70s pointed out that NC theory did not explain foreign operations of MNCs, in particular two way flows of FDI. Expected export capital to developing countries that are less capital scarce –didn't happen

    - Argued that internationalisation was a means by which firms could increase extent of their market power (dominant mkts; be more secure; be less efficient; monopsonists and sellers)
    - Early stages growth firms merge and increase capacity and as concentration increases so do profits
    - Get to point difficult to increase concentration so invest in monopoly foreign operations
    - Also increase barriers to entry
    - May lead to reduction of efficiency

- Cowling and Sugden developed Hymer analysis: moving abroad increase market power and increases profits, also improve bargaining over wages and increase profit share; network of dependent subcontractors allow cost reductions; integrated into stagnationist argument –share of profit rising and increasing market power educes incentive to invest and decrease demand leading to stagnation a al Baran and Sweezy.

- Kindleberger reinterpreted to SCP approach considering monopolistic competition

Internalisation

- Consider trade between individual and groups but have transaction costs that vary with the type of exchange

- Administered exchange costs are lower than market ones so incentive to internalise

- Reasons are: reduced costs economies of scope –intangible assets particularly expensive to exchange in market

- Not more efficient to manage at arms length -subcontract

- So invest abroad to internalise exchange

- Context of gaining competitive advantage over rivals so increase competition rather than reduce it through barriers to entry

    - Really only valid for horizontal integration

    - Static model

    - Can apply to services as well as manufacturing

Eclectic paradigm: Dunning

- Synthesises the two

- MNCs have competitive advantage:
    - Ownership of particular unique intangible assets (proprietary assets) or their services, such as firm specific technology
    - Joint ownership of complementary assets such as ability to create new technologies

- MNCs retain control over such productive and financial assets because internalisation advantages of doing so

- Integrated form can more easily exploit such assets
    - Transactional market failure: means internalisation advantages from coordinating complementary assets.
    - Reasons:
        1. Risk and uncertainty substantial
        2. Externalities attached to transactions
        3. Economies of scope

- So overlaps with internalisation, but this is wider as there are differences between types of assets:
    - Some ownership advantages from particular asset can be sold – licenced production
    - Others have no market: ability to produce innovations
    - Both can develop alongside

- Locational factors specific to the host country are also still considered important. Proprietary assets distributed among several markets.

- Concept of ownership advantages open to different theoretical interpretations
    - Market power theory: anti compet to gain barriers
    - Competitive international industry: weapon that sustains competition between rivals
    - Dunning emphasises internalisation but Cantwell argues no need to

Horizontally versus Vertically Integrated MNCs

- Above demand side analysis (eclectic/internalisation) best suited to horizontal. Supply side ones will apply to both

  - Can understand using transactions costs: parties prefer internalising inputs than arms length relations because of monitoring costs, efforts of setting up contracts

  - For MNCs processing natural resources –evade problems of impacted information:
    - Moral hazard/asymmetric information on available resources

  - Can have forms of backward intergration subdividing production processes and placing labour intensive abroad

  - Considerable vertical integration can be involved in horizontal
  - Entwined; ancillary services; internal transfers; screwdriver operations.

Theories of MNCs: Some conclusions

- **Debate continues:**

  - Reasons why multinationals start
  - How they behave when they exist

- Seems no reason to focus on unidimensional theories

- Need to understand dynamics and historical specificity

- There are important demand and supply aspects

- Policy conclusion MNCs have both efficiency and inefficiency implications –
  - Remove inefficiencies –internalisation, technology transfer, create new markets
  - Danger that can close markets limit growth

Competitive International Industry Approach

- Focus on industry rather than theory of firm –mesoeconomic

- Focus on rivalry and technological competition: interaction of firms and pocess of industrial development

- Early theory: Oligopolostic version of Vernon's product cycle theory
  - Firms retain position thru scale econ rather than market leadership
  - Locate abroad profit maximising and risk reducing as avoid price wars in mature markets –don't need compete at home.

- Search for security also in market power theory, but there is thru collusion and monopolisation rather than competition

- Can integrate oligopolistic interaction with other ideas:
    - Penroses theory of growth; smaller share grow quickly so move to where smaller
    - Internalisation theory
    - Technological competition/accumulation/diversification
    - Growing connections between technologies

Macroeconomic developmental theories

- Early theories Marxist and neoclassical did not deal well with growth of international production between international economies
    - Marxist theories of imperialism: Marx – Lenin –Kautsky: search for raw materials, search for new markets with lower OCC, response to stagnation etc… Brewer (1990)
    - Hecksher-Ohlin theory applied to FDI implied capital movements greater between countries whose proportional factor endowments are most dissimilar
    - Theory that trade automatically balances based on comparative advantages

- New approach developed based on Product Cycle theory
    - High incomes and demand in US foster innovation especially in consumer durables produced by labour saving techniques.
    - Gives US firm competitive lead which export initially through exports then through import substit investment in the region catching up –Europe
    - As product matures trade returns to cost det comparative advantage. MNCs lose cost advantage and have to use barriers to entry in marketing and distribution instead. See Cantwell

- Then technological leadership gave way to more balanced technol competition in 60s with Eur and Japan

- Rather than import substit invest, since 1970s have seen growing importance of global integration of affiliates within MNCs

- Another approach: Dunnings investment development cycle
    - Level of inward and outward direct investment of countries and balance depends on their stage of development.
        - Poorest have very little –net invest close to zero
        - Higher level: mainly inward
        - Higher level development: increased outward but still negative net
        - Higher level increased outward zero then positive net

- Does seem countries embark on external much earlier in development process

- Dunning also adds character and composition of outward vary with level of development
  - Early foreign ventures often resource based as firms mature move beyond single activity or product and adopt a more internat perspective .
  - Characteristics of their activity and ownership advs become removed form conditions of home country

- Cantwell and Tolentino expand to argument about nature of countries themselves, Eur and US it has been going on for hundreds of years and resource related investment in LDCs overtaken by research related investment in idustruialised economies
  - Growth in developing country LDCs embarking on multinat expansion earlier than advanced economies did.

- Macro approaches to growth of internat production can be combined with competitive international industry:
  - Types of inds involved in internat expansion vary with characts of country and the stage of devel it has reached and indust composition in turn influence macroeconomy

- Macro approach and market power: stagnationist tendency because of collusion

- Macro approach plus add in finance
  - Growth leads to BoT surplus
  - Strong domestic currency leads to internationalisation
  - Can lead to conflict between domestic ind (want lower) and MNCs (want high)

- Dunning argues currency markets can effect timing of FDI but not long run trend. Probably better for portfolio invest flows rather than FDI.

- Case studies of industries show clear difference in the nature and extent of FDI. Held

- More recent developments:
  - Improved transport and communications
  - growth of networks of production
  - internationalisation supply chains: outsourcing without ownership
  - SME networks: Benneton: franchising ; co-op agreements
  - Business services internationalisation: India
  - Portfolio investment and cross ownership
  - Joint ventures: share technology/specialise
  - Strategic alliances
  - Clusters
- Emerging global manufacturing sytem?

Economic Effects of FDI

- Considerable amounts of empirical work:
    - Cross country
    - Case study
    - Empirical or qualitative
    - Focusing on a range of factors

- Recently new growth theory has provided focus for empirical research and a powerful argument for benefits of FDI.
    - emphasises role of human capitals R&D and externalities.
    - Endogenous growth as although diminishing returns to factors are constant or increasing returns to scale.
    - Social greater than private return as indiv invest adds to stock of knowledge and so productivity of the capital stock.
    - There are also spillover and externality effects.
    - Investment in knowledge subject to diminishing returns but use of such knowledge in productive activity leads to increasing returns

- Many of these growth promoting factors can be initiated and nurtured to promote growth through FDI

    - FDI major source of technology and know how
    - FDI leads to transfer of management skills
    - FDI creates important externalities and spillovers

- FDI can help developing countries overcome constraints of low value of human capital and so low R&D
    - Could spill over through training and managers moving
    - Could spill over via links between firms: subcontractors/suppliers
    - Local firms learn by watching
    - Local firm need to invest more to keep up with the competition from MNCs

- So new growth theory suggests FDI a potent force in promoting growth
    - Exploiting it needs conducive economic and political environment: governance
    - Otherwise could be counterproductive
    - Many argue needs liberalisation to promote allocative and technological efficiency
    - Others less convinced
        - need to develop skills in developing countries
        - limited regional movements

- Balasubramanyam et al (1996): consider Bhagwati's hypothesis that the volume and efficiency of FDI will vary depending on whether the country follows export promotion or import substitution policies.
    - They find evidence to support this.

    - Argue EP is neutral and supportive of MNCs

- Wider considerations include governance structure
    - Globerman and Shapiro (2002) World Development

- Impact of FDI on host countries is an empirical question: –positive and negative effects possible
    - Labour
    - Capital
    - Infrastructure
    - Spillovers:Harris and Robinson for UK,NIER, 2004
    - R&D/TP: Hubert and Pain for UK, SJPE 2001
    - Social relations

    - Developed and developing differ

- Impact of FDI on provider countries is also an empirical question: –positive and negative effects possible. Internat can benefit the companies but not necessarily the country as a whole –impact of empires in past: Spain and Portugal.
    - Labour
    - Capital
    - Infrastructure
    - Spillovers:
    - R&D/TP:
    - Social relations

- Tend to show positive effects, but are they asking the right question
    - Important distributional issues
    - Developing countries: Africa
    - Unpleasant activities

- Role of FDI only positive and important in countries that have achieved prior levels of development, infrastructure and skills to sustain growth

Overall

- So considerable debate and no clear conclusions.

- FDI and MNCs certainly important in the modern world

- FDI and MNCs likely to continue to grow –but consider what happened pre war.

- Link to globalisation debates
    - Trade reform/liberalisation agenda
    - Sceptical perspective has a point but globalisation still important
    - Need to engage with globalisation to make increased international integration work in terms of desired development paths of countries.

- Interesting issues raised by the recent recessionary period and will need to see how international capital responds.