TRADE POLICY

Lecture 6
Factor mobility and foreign direct investment

Fulbright School of Public Policy and Management
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Ari Kokko
Copenhagen Business School

Last time

”New” theme: Heterogeneous firms in international trade

- What determines exports at the firm level?
  - International business perspective
  - International economics perspective
- Trade intermediaries
- Free trade agreements and tariff preferences

Today’s lecture: Factor mobility and FDI

Key factors of production: labor, capital, technology

- Labor mobility
  - What happens when people move?
- Capital mobility
  - Effects of international capital markets
- Mobility of technology
  - Limitations of knowledge markets
- Foreign direct investment (FDI)
  - Labor, capital, and technology bundled together

Labor mobility: motives and consequences

- Why do people move?
  - Escaping war, persecution, disasters
  - Poverty
  - Better opportunities
- Effects of labor mobility
  - Factor price equalization
  - Economic growth and development (both in source and destination?)
    - Remittances, return migration, networks
  - Social and political effects

Capital mobility: motives

- Driven by differences in capital returns and wish to reduce risk
  - Profit motives
  - Risk diversification: not all eggs in one basket
  - Macroeconomic adjustment / management of current account imbalances: lending (surplus countries) and borrowing (deficit countries)
- Weak economic development
  - Limited domestic savings capability in developing economies

Capital mobility: consequences

- Growth and development
  - Developing economies can invest more than their domestic savings
  - Economies with large savings can generate higher returns

and

- Macroeconomic stability
  - Temporary imbalances in current account are easier to manage

or

- Macroeconomic instability
  - Short-term capital flows can be speculative
  - Even long capital flows can dry up
  - Role of expectations and policy credibility

When does capital mobility lead to more stability?

- Assume that a country is hit by a short-term disturbance that results in weaker competitiveness and a weaker currency

- How will short-term capital flows (speculation) affect the chances to recover (return to a ”normal” exchange rate)?

- Is government policy credible or not credible?

Mobility of technology

- Technological specialization and technology flows between countries
  - No economy is self-sufficient in all technology areas
- Much technology is embodied in goods and commercial services
  - As well as mobility of skilled labor, academic collaborations, scientific publications, R&D collaborations between firms
- But the market for commercial technology / knowledge does not work very well

Shortcomings of knowledge markets

- The transaction costs in international knowledge markets are high. It is difficult to sell a commercial technology (or any knowledge that can be used to earn money) for a fair price because of
  - Asymmetric information
  - Risk of opportunistic behavior
- Problems with asymmetric information and opportunism can sometimes be handled with very detailed contracts
  - But it is costly to draft and monitor such contracts, particularly if the sellers and buyers are not in the same location
- The international market for commercial technology is very narrow.

Solution to shortcomings in knowledge markets

- Instead of selling the technology, owners often decide to ***internalize*** the exploitation of the technology
  - The company can make higher profits by expanding its own activities to foreign markets than by selling the technology to outsiders
  - This international expansion can be in the form of exports or various kinds of ***Foreign Direct Investment*** (FDI)
  - Buckley, P. J., & Casson, M. C. 1976. *The future of the multinational enterprise.* London: Macmillan

Foreign direct investment: concepts

Direct investment - Portfolio investment

FDI stocks – FDI flows

Vertical – Horizontal

Greenfields – M&As

Resource seekers - Market seekers –

Efficiency seekers - Strategic Asset seekers

Motives for FDI

- Market-seeking FDI
  - It is easier to reach foreign customers if you are present in the foreign market
- Resource-seeking FDI
  - To secure access to raw materials / reduce dependency on outsiders
- Efficiency-seeking FDI
  - To take advantage of favorable production conditions abroad by locating each link in the value chain where costs are lowest
- Strategic asset-seeking FDI
  - To access resources that may strengthen competitiveness, e.g. acquiring competitors and technological assets or locating R&D in dynamic clusters and agglomerations abroad

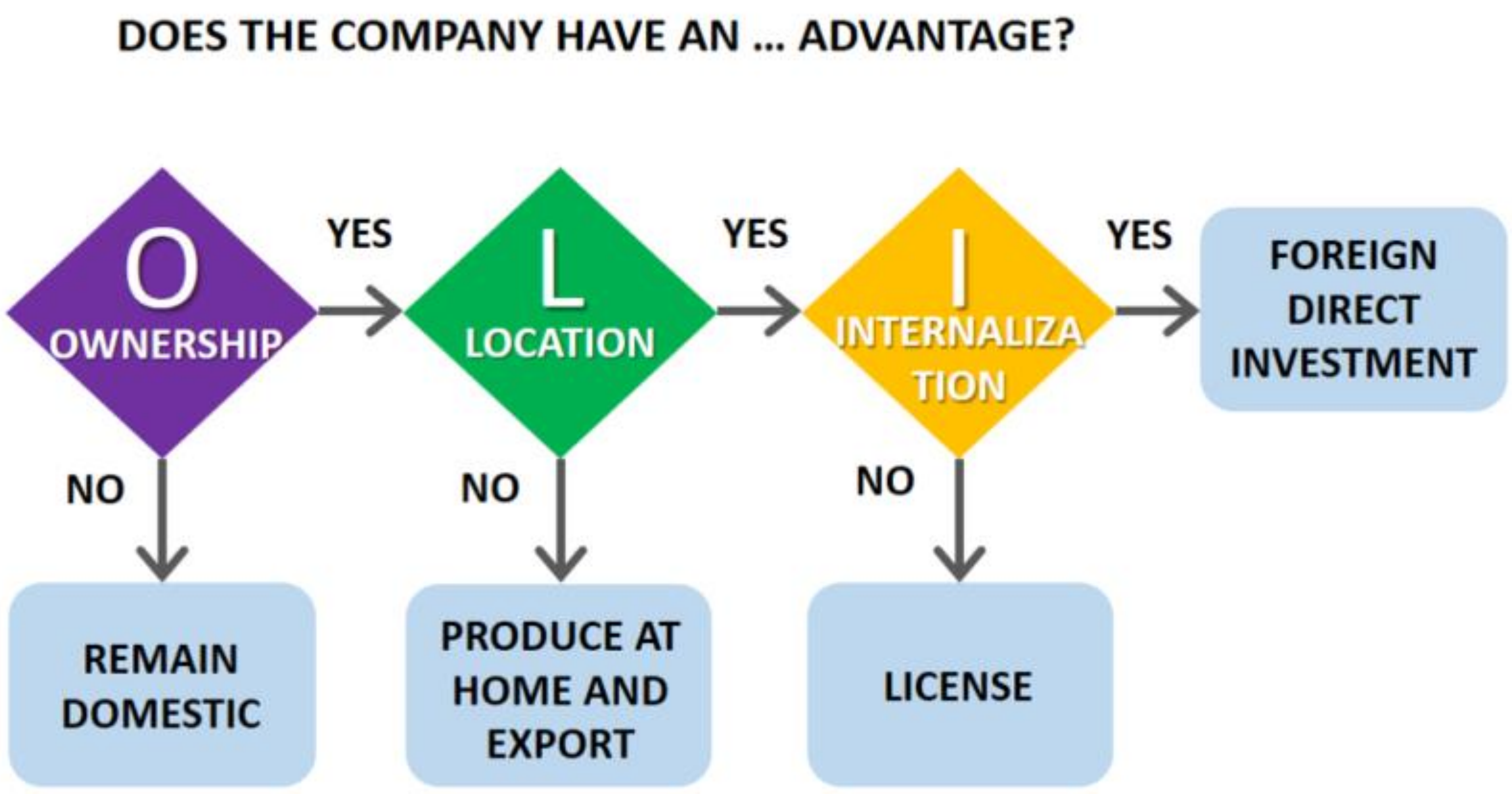
Eclectic theory: FDI requires OLI

- **Ownership advantages:** The firm must own or control some (intangible) assets that allow it to overcome the ”liability of foreignness” and be competitive abroad.
- **Location advantages:** There must be a reason to establish presence in the foreign location. This could be to get closer to customers, avoid import tariffs, get access to raw materials, reduce transportation costs, be close to dynamic and innovative firms, or something similar.
- **Internalization advantages:** The more profitable it is to internalize the exploitation of the ownership assets, the more likely it is that internationalization will be in the form of FDI.

Dunning, J. H. (1977). Trade, location of economic activity and the MNE: A search for an eclectic approach. In *The international allocation of economic activity: proceedings of a Nobel Symposium held at Stockholm* (pp. 395-418). London: Palgrave Macmillan UK.

Dunning, John (1979). Toward an Eclectic Theory of International Production: Some Empirical Tests. *Journal of International Business Studies*. 11 (1): 9–31

Checklist for FDI



What are the impacts of FDI on host economies?

Many determinants, differences between cases depending on:

- Level of analysis (individual firms or whole economy)
- Type of industry (extractive/manufacturing/services/infrastructure)
- Motive (resource/market/efficiency/strategic asset seeking)
- Mode of entry / operation (e.g. greenfield vs acquisition)
- Import substituting vs export oriented
- Host country characteristics (level of development, economic and industry structure, absorptive capacity, policies, …)
- Home country characteristics (level of development, technology transfer practices, corporate strategies, business system, …)

Main host country effects

In addition to employment (incomes, tax revenue), the debate has focused on:

- Resource transfers
  - *Spillovers*
- Competitive and anti-competitive effects
  - *Crowding out*
- Trade and balance-of-payments
- Sovereignty and autonomy

Resource transfers

- FDI as a source of capital
  - Some inflows of capital in connection with initial investment
    - But most investments are financed locally, and profits are repatriated
    - And FDI is an expensive source of funds
- FDI as a source of technology
  - Technology production dominated by MNCs
  - FDI = diffusion of technology to host country
  - Spillovers even when technology transfer is not intended
    - But is MNC technology appropriate?

Spillovers

- When the efficiency or productivity of local firms improves as a result of foreign entry, and the foreigner does not internalize the benefits
- Channels
  - Demonstration
  - Competition
  - Linkages
  - Labor mobility

Spillovers

- Differences across countries, industries, and firms in ability to benefit from spillovers
  - Not all local firms will be able to take advantage of opportunities: need for absorptive capability (and motives)
  - MNC behavior varies: What kind of technology do they bring? Are they integrated into the local economy, or do they operate in enclaves? Do they use local suppliers?
  - Methodology: cross-section or panel data?
    - Time is important. Initial negative effect changes over time as inefficient locals die

Competitive and anti-competitive effects

- The industries where MCNs are likely to enter are often characterized by concentration and collusion
  - Unlikely that new local firms will be able to enter and change industry structure
  - MNC entry may stimulate competition, efficiency, and development
- But MNCs are stronger and there is a risk that they will build their own oligopolies and monopolies
  - Local policy important. (Foreign) monopolies are less risky with an open trade environment

FDI and the survival of local firms

- The entry of foreign firms affects demand, supply, and prices – domestic firms face heavier competition
- Weaker domestic firms that are not able to capture any spillover benefits are likely to be crowded out
- Possible effects both from horizontal and vertical FDI
  - Upstream FDI changes price/quality of intermediate goods; downstream FDI changes demand

- Kokko and Tran (2014), Foreign Direct Investment and the Survival of Domestic Private Firms in Vietnam", *Asian Development Review*, 31:1, 53-91

Balance-of-payments effects

- Great hopes in many economies that FDI will ease BoP restrictions
  - Both export-oriented and import-substituting FDI could help earn (or save) foreign exchange and improve the BoP.
- But foreign MNCs are often highly import-dependent
  - Even the import-substituting FDIs are likely to import both machinery and raw materials
  - Local policy environment defines incentives and possibilities for local sourcing of inputs and reinvestment

Sovereignty and autonomy effects

- Heavy reliance on foreign investors could be costly
  - Foreign MNCs may have a bias in favor of the home country
  - Examples of political interference by MNCs
    - In particular, foreign SOEs could behave in a strange way…
  - Recent concerns about ”national security” have resulted in increased investment screening across the world
- But how important is ownership if FDI creates jobs and tax revenue?

Other effects

- FDI may be particularly valuable when domestic resources are unemployed
- Dutch disease?
- Negative externalities from FDI, e.g. on the environment?
- Cultural imperialism and ”inappropriate” consumption patterns - Camel, Heineken, and Yves St. Laurent in poor countries?
- FDI may create dependence on foreign capital
  - Is Vietnam dependent on foreign capital?

Direct vs indirect effects of FDI

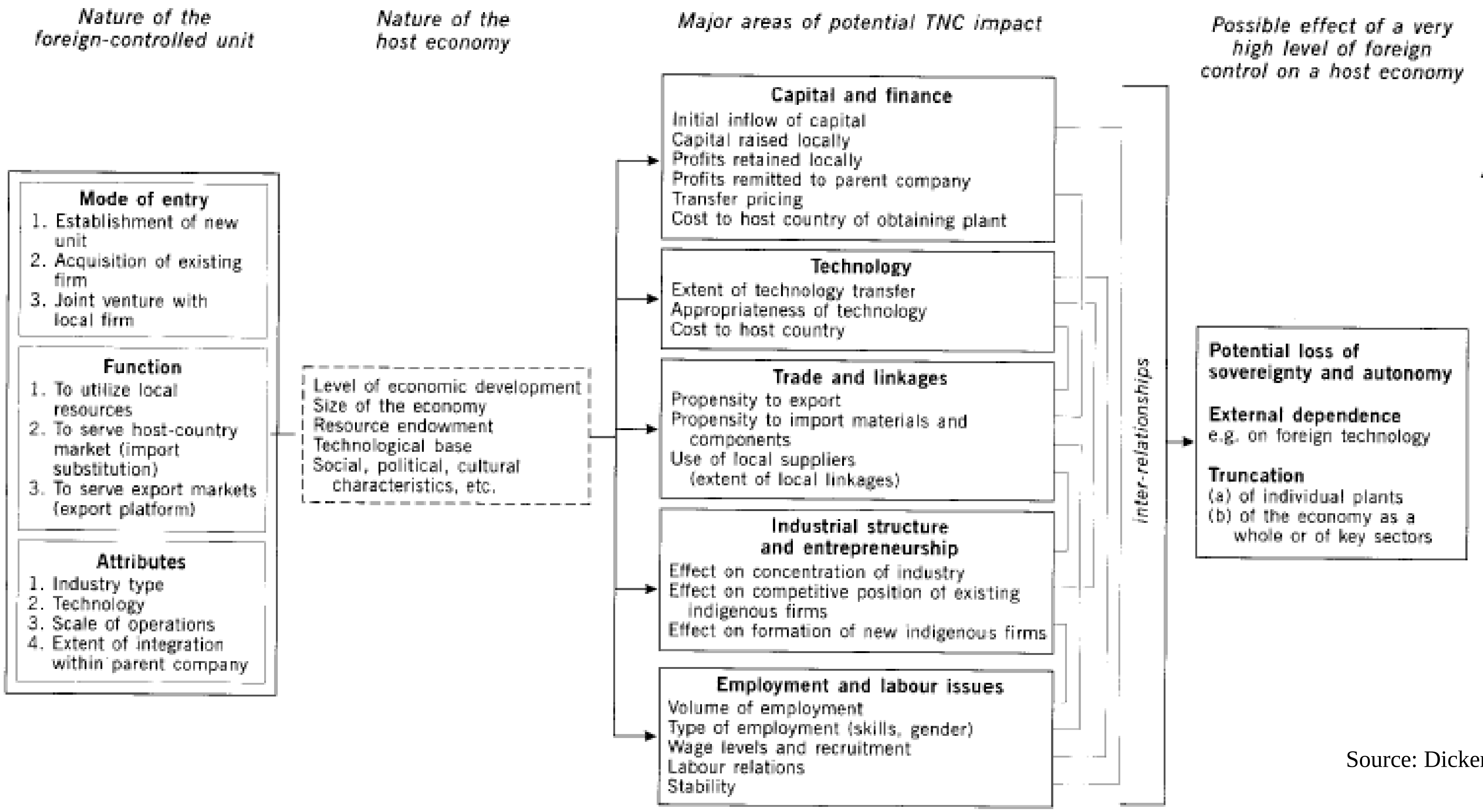
Direct effects

- Capital, technology, managerial/organizational skills
- Jobs (often higher paid)
- Productivity and skills increase
- Tax income
- Foreign exchange earnings (if exports) or savings (if import substitution)

Indirect effects (spillovers)

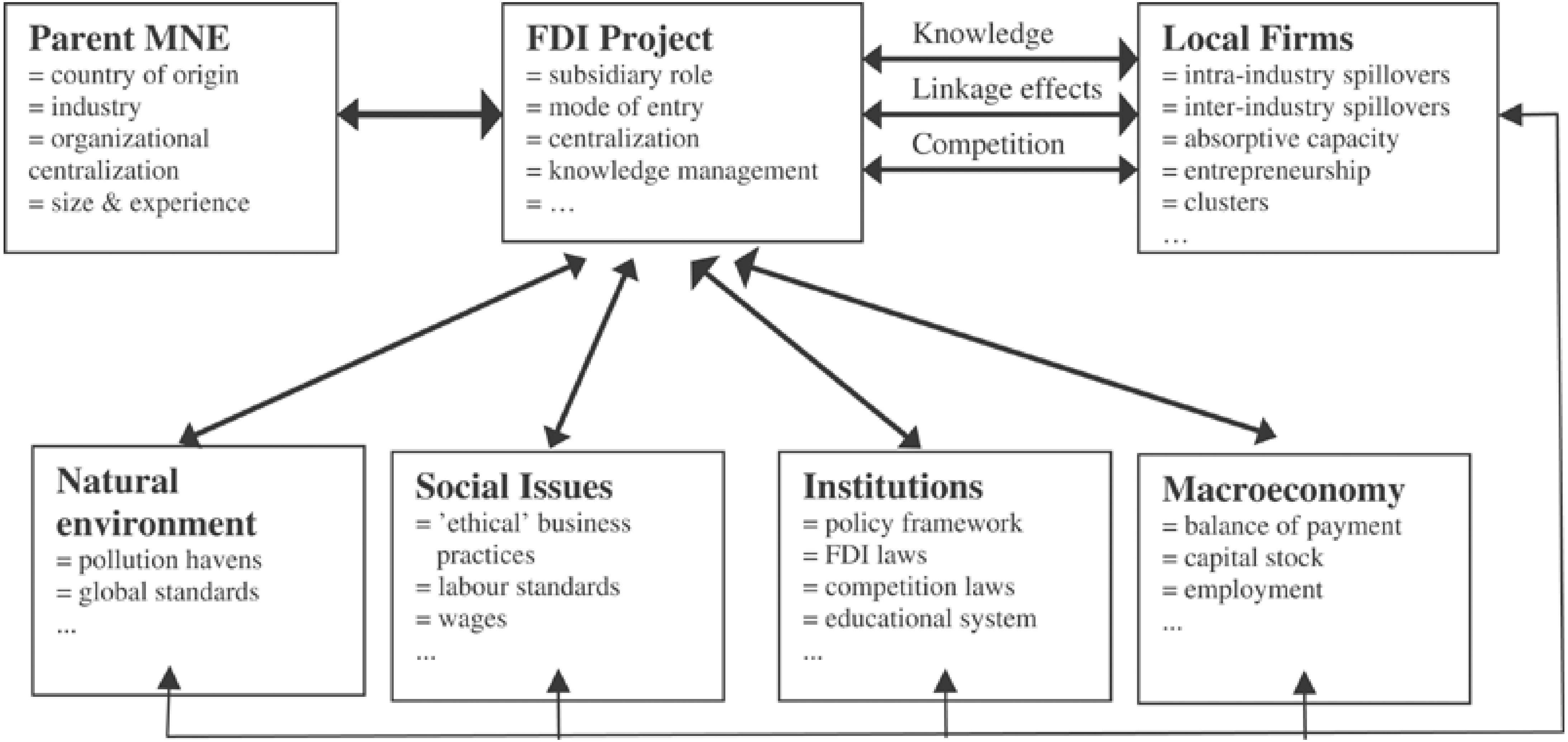
- Technology and knowledge spillovers (horizontal vs vertical)
- Upgrading of suppliers
- Personnel turnover
- Demonstration effects
- Competition effects

Potential impact of TNCs on host economies



Source: Dicken, 'Global Shift'

Framework for FDI impact in emerging economies



Source: Meyer, K. E. (2004). Perspectives on multinational enterprises in emerging economies. *Journal of international business studies*, *35*(4), 259-276.

How to attract FDI

- What are the main determinants of FDI inflows?
  - Country size, growth rate, openness, macroeconomic stability, real exchange rate, infrastructure, institutions, factor endowments, and factor costs
- How should countries try to attract FDI?
  - By trying to strengthen the fundamental determinants of FDI
- What about incentives for FDI?
  - *By enhancing the local supply of human capital and modern infrastructure and by improving other fundamentals for economic growth, a country does not only become a more attractive site for multinational firms, but there is increased likelihood that its private sector benefits from the foreign participation through spillovers*.

Blomström, M. and Kokko, A. (2003). "The economics of foreign direct investment incentives." In *Foreign direct investment in the real and financial sector of industrial countries*. Berlin: Springer.

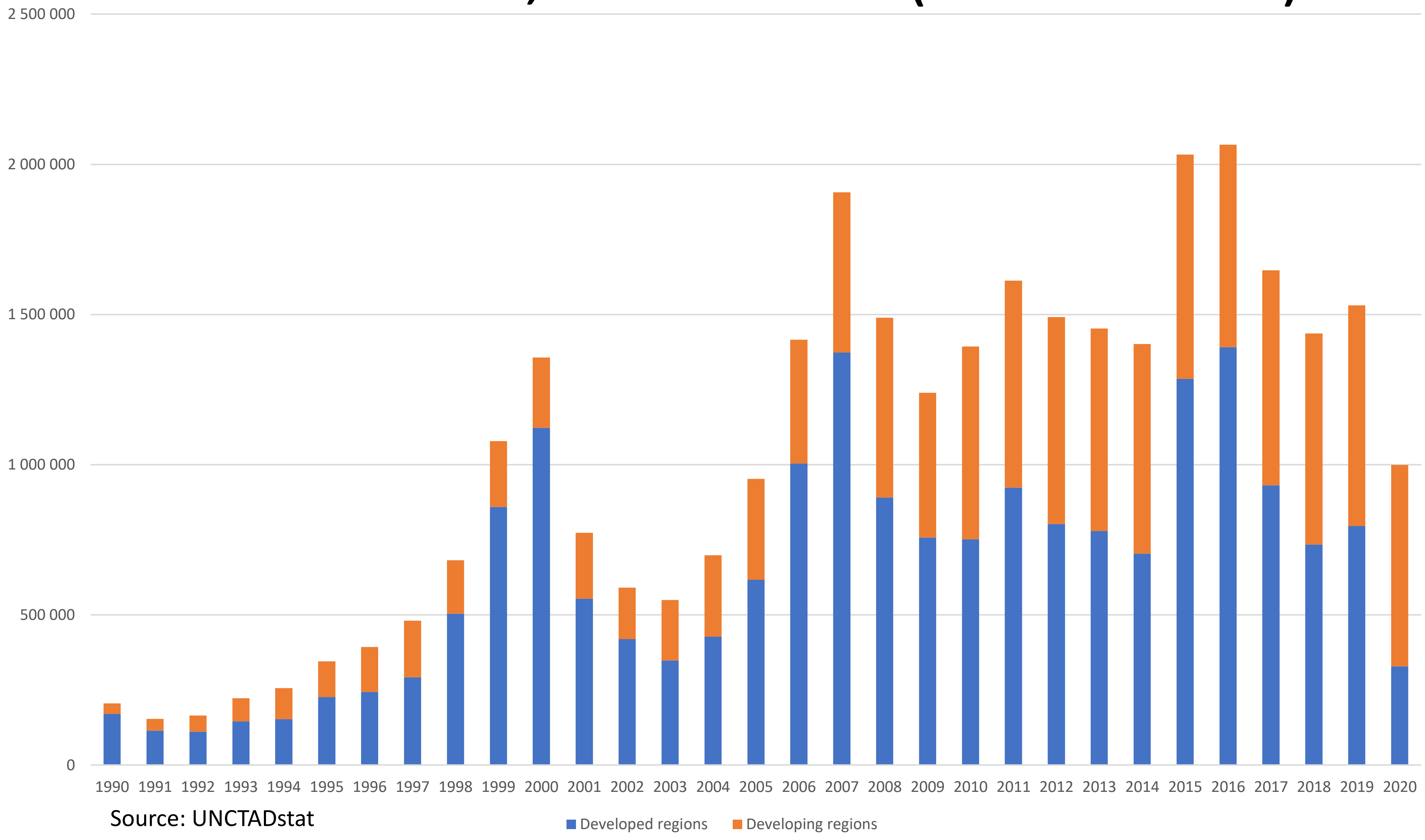
Preliminary conclusions: effects of FDI

- Diverse effects on host countries
  - Employment and taxes
  - Technology and productivity: direct impact (new technology) as well as spillovers
  - Crowding out: for those local firms that are not able to adjust
- Additional effects on least developed countries
  - Investment capital
- Political and ethical dimensions could be a challenge
  - How worried are we about the Chinese investments in our economy?

Empirical snapshots: FDI in the world economy

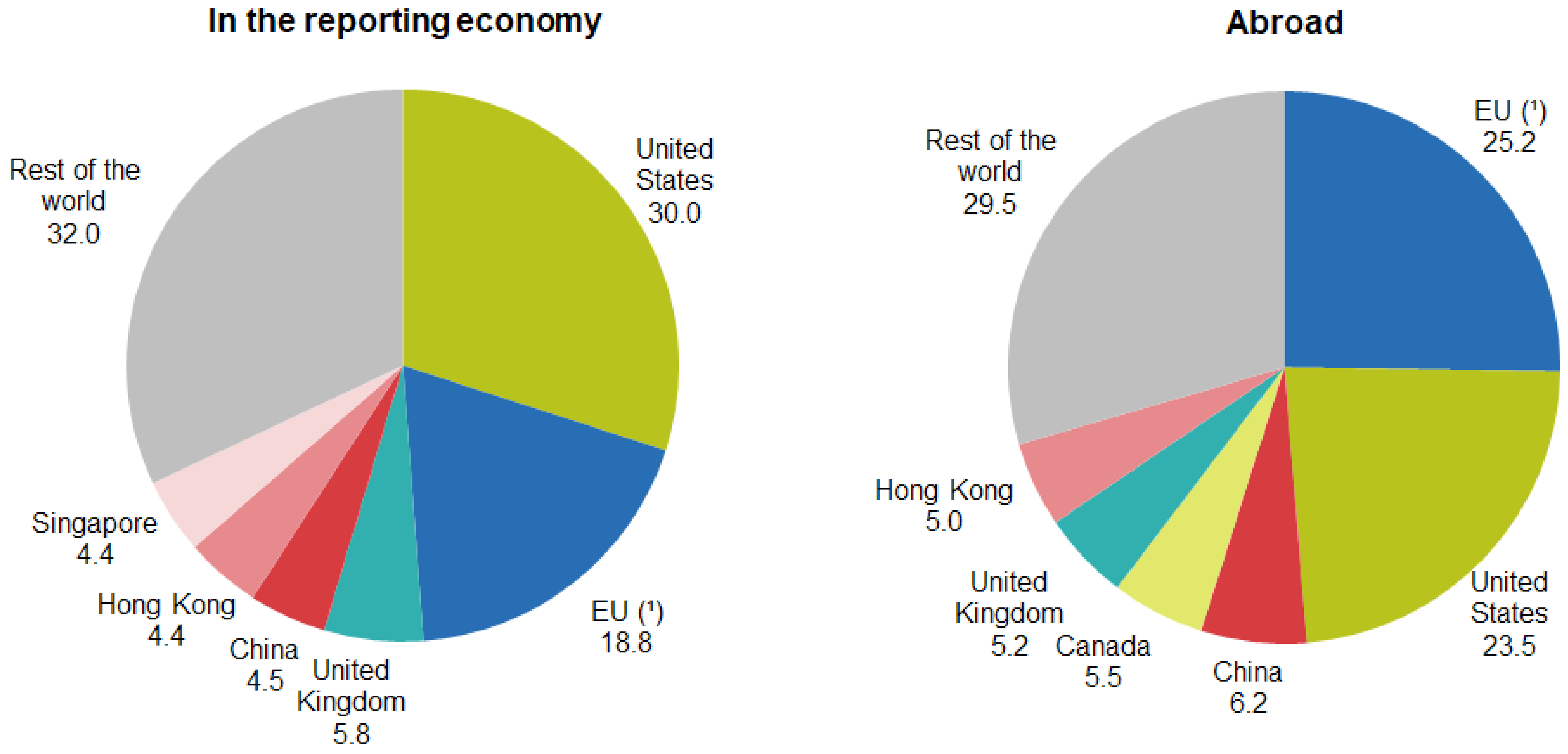
- Development over time
- Main investors and main destinations
- How important is FDI?
  - In relation to GDP in home and host economies
  - As a source of capital for developing economies
  - In comparison with international trade in goods and services

FDI inflows, 1990-2020 (USD million)



Source: UNCTADstat

World stocks of foreign direct investment, 2021
(% of total)



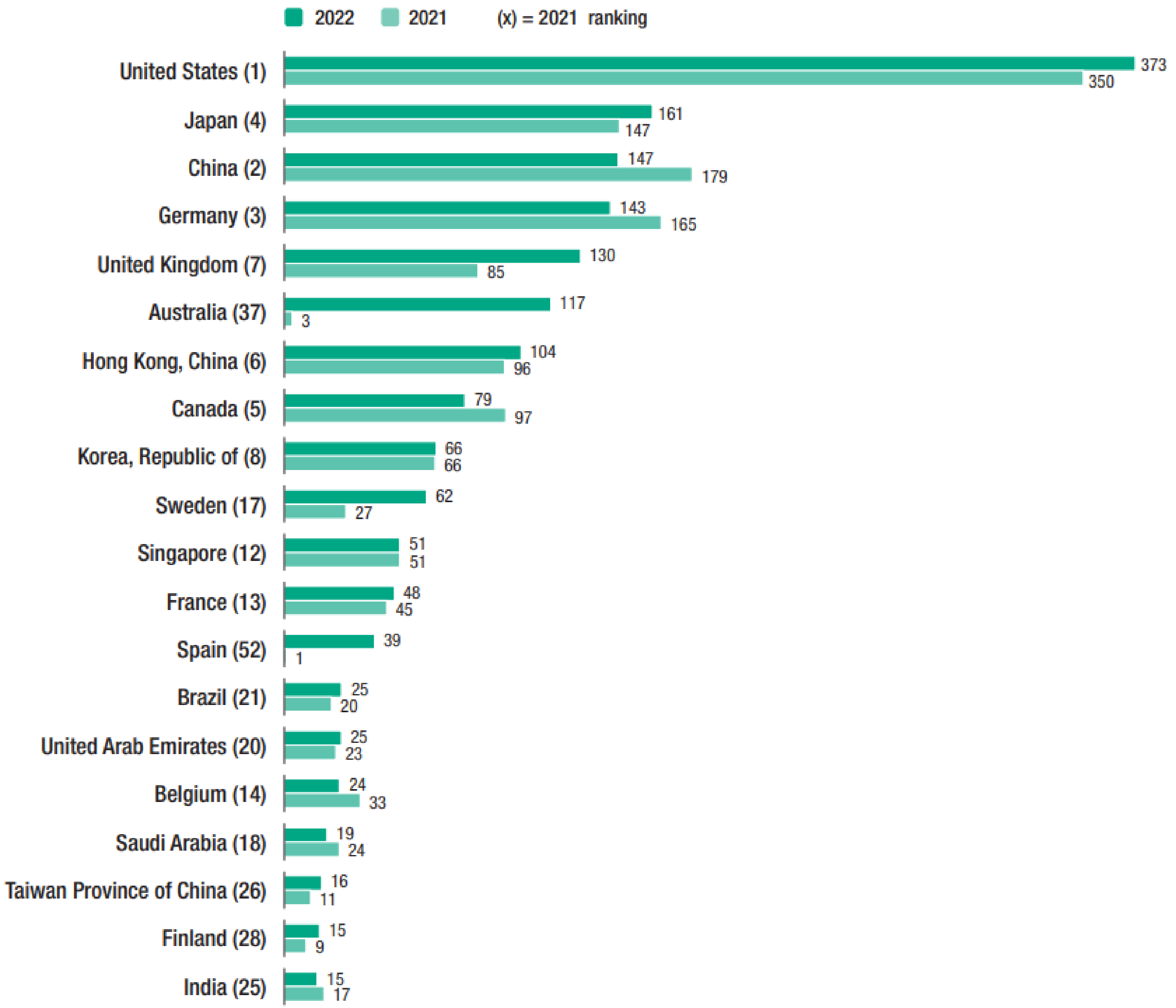
Note: the figure shows the six countries/geographic aggregates (among those in Table 2) with the highest values of inward and outward investment. Excludes offshore financial centres in the Caribbean.

(¹) Shown in relation to extra-EU partners. Includes special purpose entities (SPEs).

Source: Eurostat (online data code: bop_fdi6_pos) and UNCTAD (FDI/MNE database)

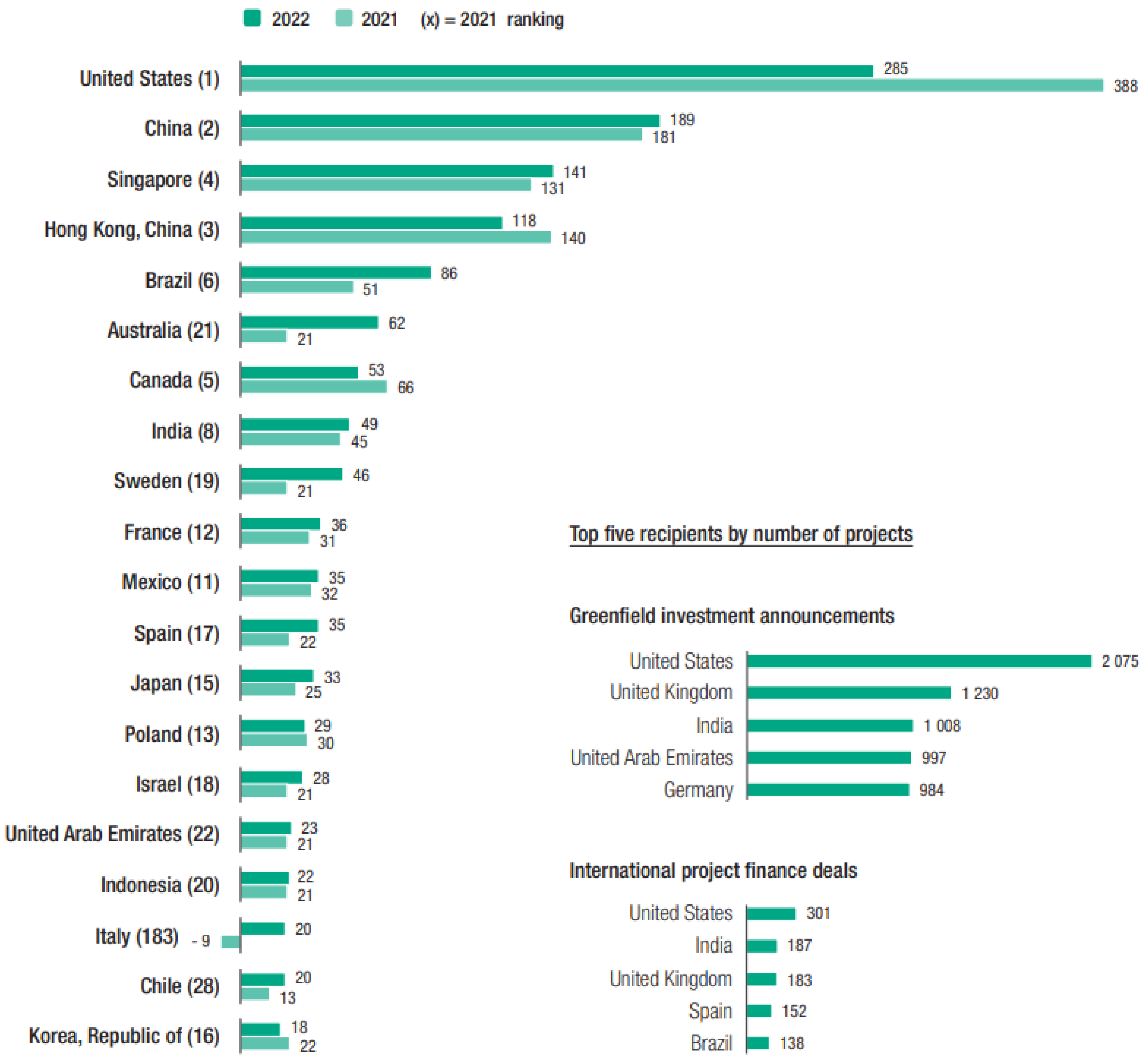
eurostat

FDI outflows, top 20 investors, 2021 and 2022 (Billions of dollars)



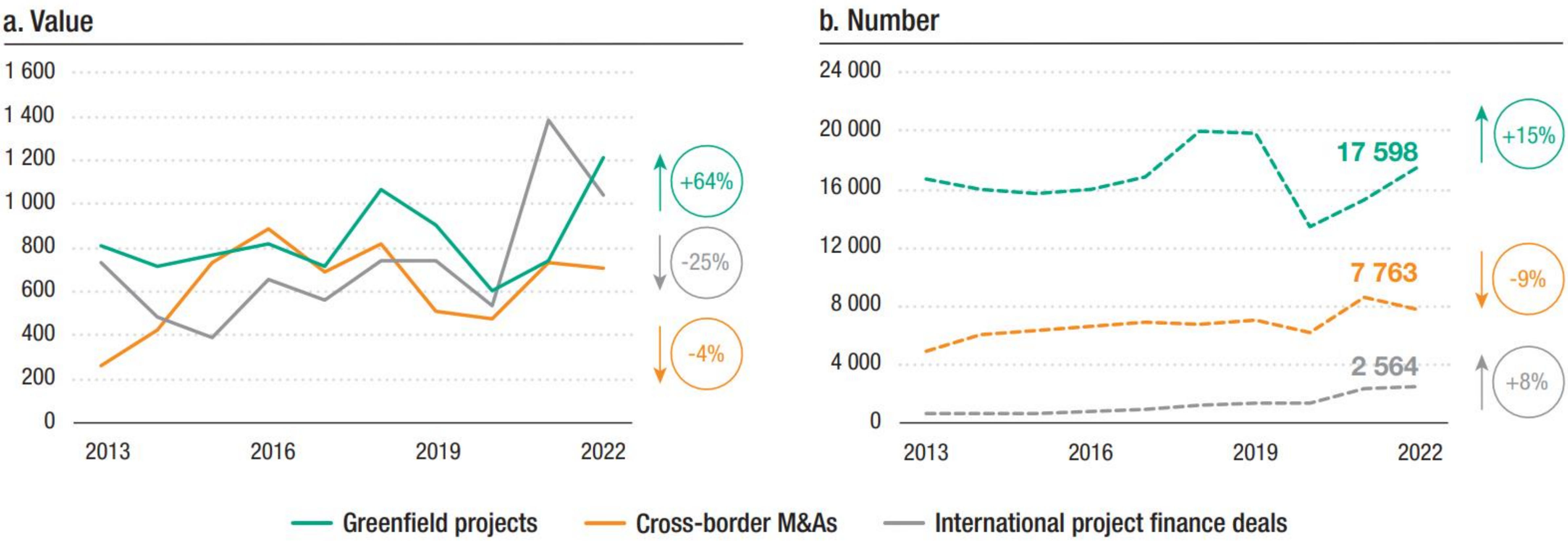
Source: UNCTAD, FDI/MNE database (https://unctad.org/fdistatistics).

FDI inflows, top 20 FDI recipients, 2021 and 2022 (Billions of dollars)



Source: UNCTAD, FDI/MNE database (https://unctad.org/fdistatistics).

Announced greenfield projects, international project finance deals and cross-border M&As, (2013–2022, Billions of dollars, number, and per cent)

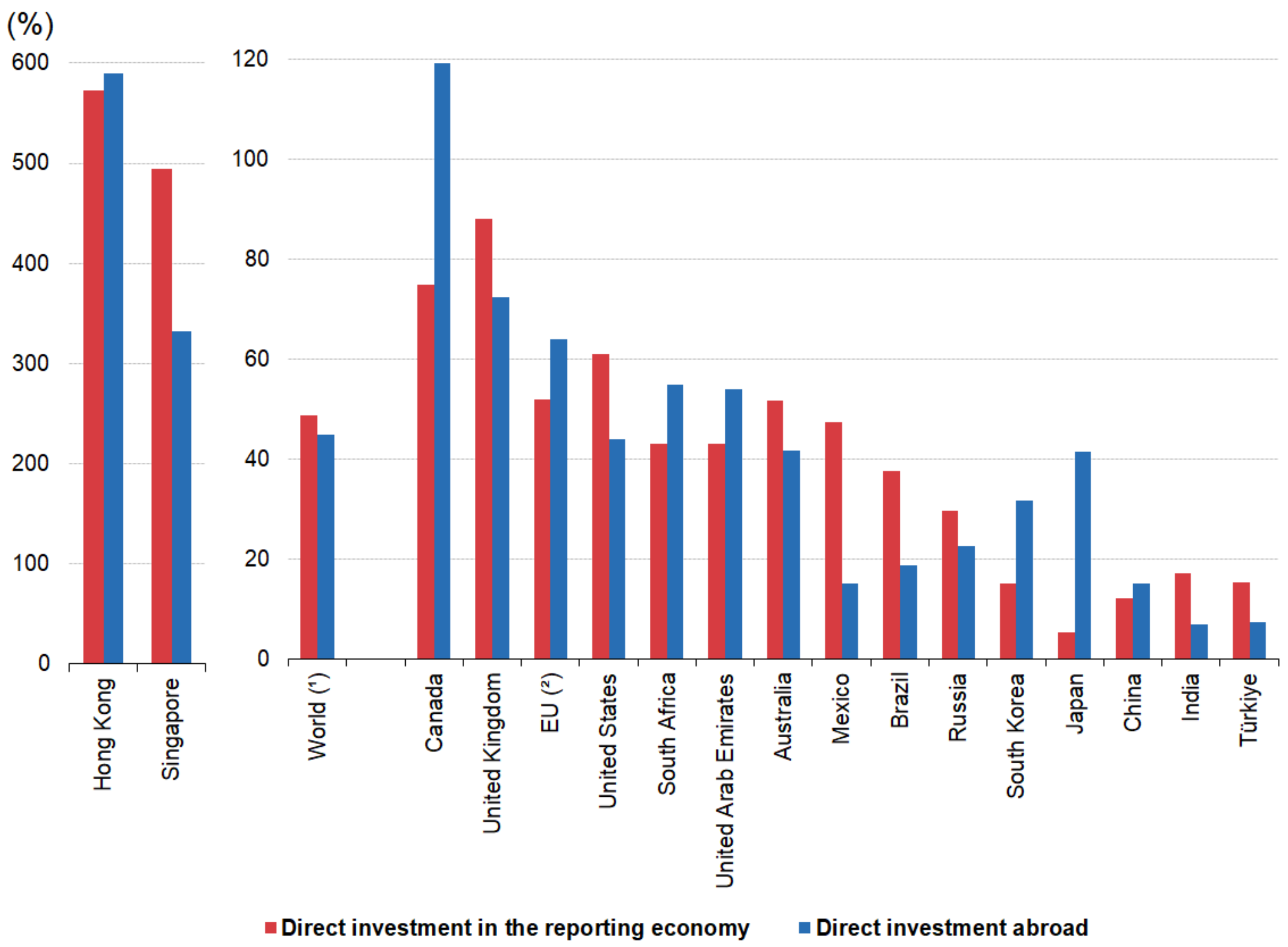


Source: UNCTAD, based on information from the Financial Times Ltd, fDi Markets (fDimarkets.com) and Refinitiv SA.

FDI most important in small open economies

Why is there so little FDI in Japan?

Stocks of foreign direct investment, relative to GDP, 2021



Note: the figure is split into two parts with different scales on the y-axis. Ranked on the average ratio for inward and outward stocks.

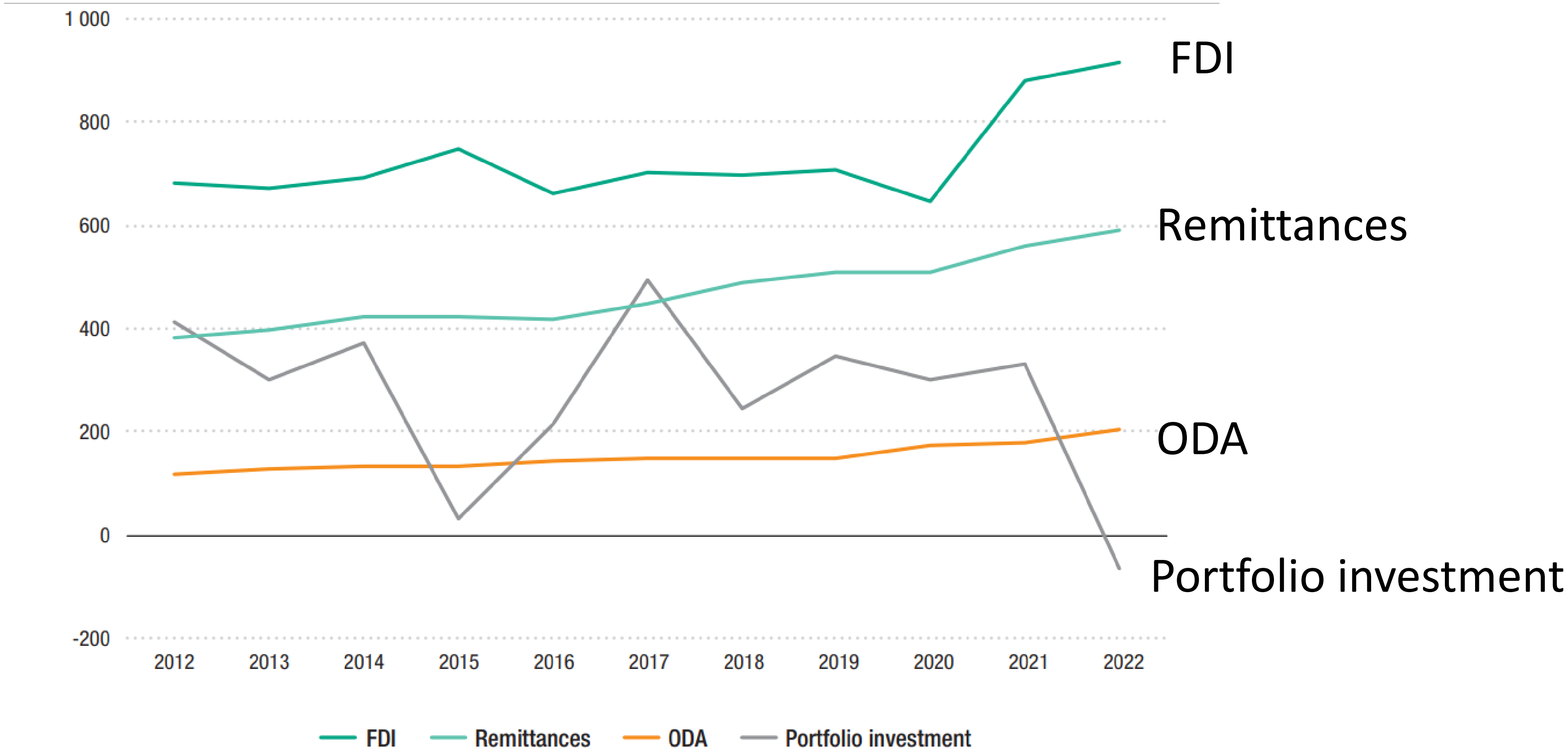
(¹) Direct investment excludes offshore financial centres in the Caribbean.

(²) Shown in relation to extra-EU partners. Includes special purpose entities (SPEs).

Source: Eurostat (online data codes: bop_fdi6_pos and nama_10_gdp) and UNCTAD (FDI/MNE database)

eurostat

Developing economies: sources of external finance, 2012–2022, billions of dollars



Source: UNCTAD, based on FDI/MNE database (https://unctad.org/fdistatistics) (for FDI), World Bank (for remittances), IMF International Financial Statistics (for portfolio investment) and OECD (for ODA).

Broad indicators of FDI and international business (BUSD)

Item	Value at current prices (Billions of dollars) 1990	2005–2007 (pre-crisis average)	2014	2015	2016
FDI inflows	205	1 426	1 324	1 774	1 746
FDI outflows	244	1 459	1 253	1 594	1 452
FDI inward stock	2 197	14 496	25 108	25 191	26 728
FDI outward stock	2 254	15 184	24 686	24 925	26 160
Income on inward FDI[a]	82	1 025	1 632	1 480	1 511
Rate of return on inward FDI[b]	*4.4*	*7.3*	*6.9*	*6.2*	*6.0*
Income on outward FDI[a]	128	1 101	1 533	1 382	1 376
Rate of return on outward FDI[b]	*5.9*	*7.5*	*6.4*	*5.7*	*5.5*
Cross-border M&As	98	729	428	735	869
Sales of foreign affiliates	5 097	19 973	33 476	36 069[c]	37 570[c]
Value added (product) of foreign affiliates	1 073	4 636	7 355	8 068[c]	8 355[c]
Total assets of foreign affiliates	4 595	41 140	104 931	108 621[c]	112 833[c]
Exports of foreign affiliates	1 444	4 976	7 854[d]	6 974[d]	6 812[d]
Employment by foreign affiliates (thousands)	21 438	49 478	75 565	79 817[c]	82 140[c]
Memorandum					
GDP[e]	23 464	52 331	78 501	74 178	75 259
Gross fixed capital formation[e]	5 797	12 431	19 410	18 533	18 451
Royalties and licence fee receipts	29	172	330	326	328
Exports of goods and services[e]	4 424	14 952	23 563	20 921	20 437

Source: ©UNCTAD.