TRADE POLICY

Lecture 6
Factor mobility and foreign direct investment

Fulbright School of Public Policy and Management
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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

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
  - 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
  - Profit motives
  - Macroeconomic adjustment / management of current account imbalances
- Economic development
  - Limited domestic savings capability in developing economies
- Diversification
  - To reduce risk (e.g. pension funds)

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

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 seller and buyer are not in the same location
- The international market for commercial technology is very narrow.

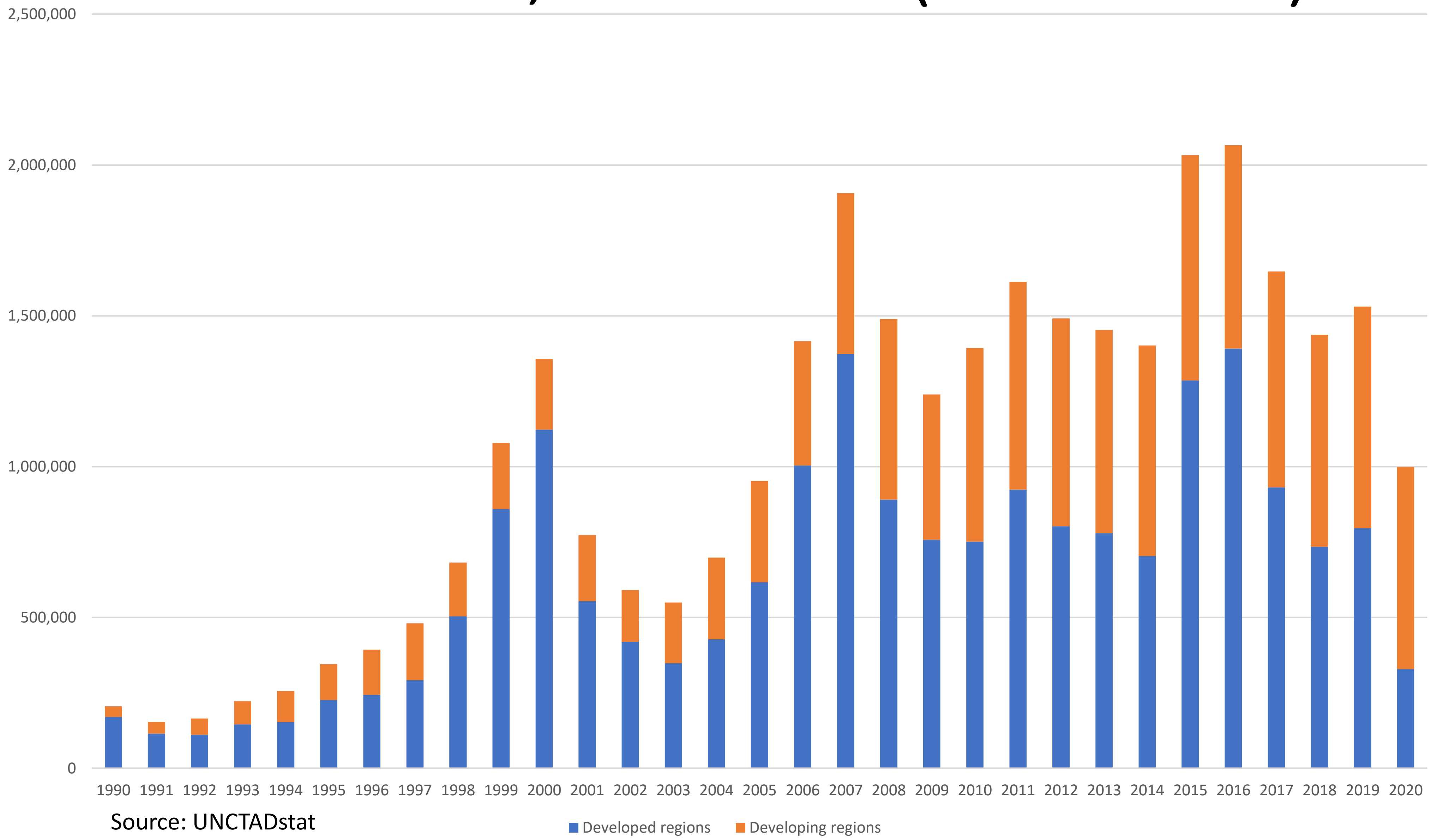
Solution to shortcomings in knowledge markets

- Instead of selling the technology, owners often decide to ***internalize*** the exploitation of the technology
  – The company can make higher profits by expanding its activities to foreign markets than by selling the technology
  – This international expansion can be in the form of exports or various kinds of ***Foreign Direct Investment*** (FDI)
- Several specific reasons for engaging in FDI rather than just exports

Several motives for FDI

- Market-seeking FDI
- Resource-seeking FDI
- Efficiency-seeking FDI
- Strategic asset-seeking FDI

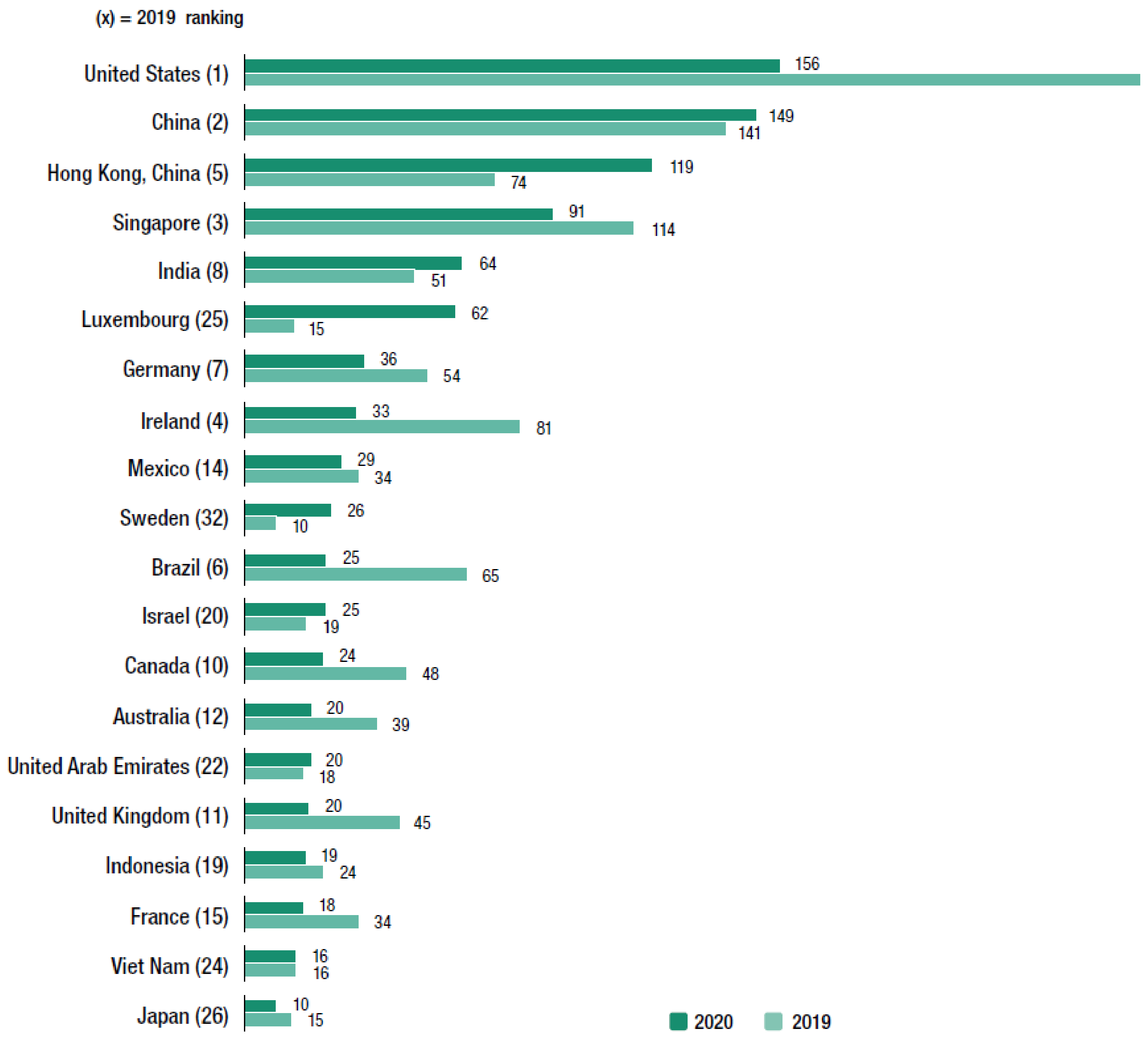
FDI inflows, 1990-2020 (USD million)



Source: UNCTADstat

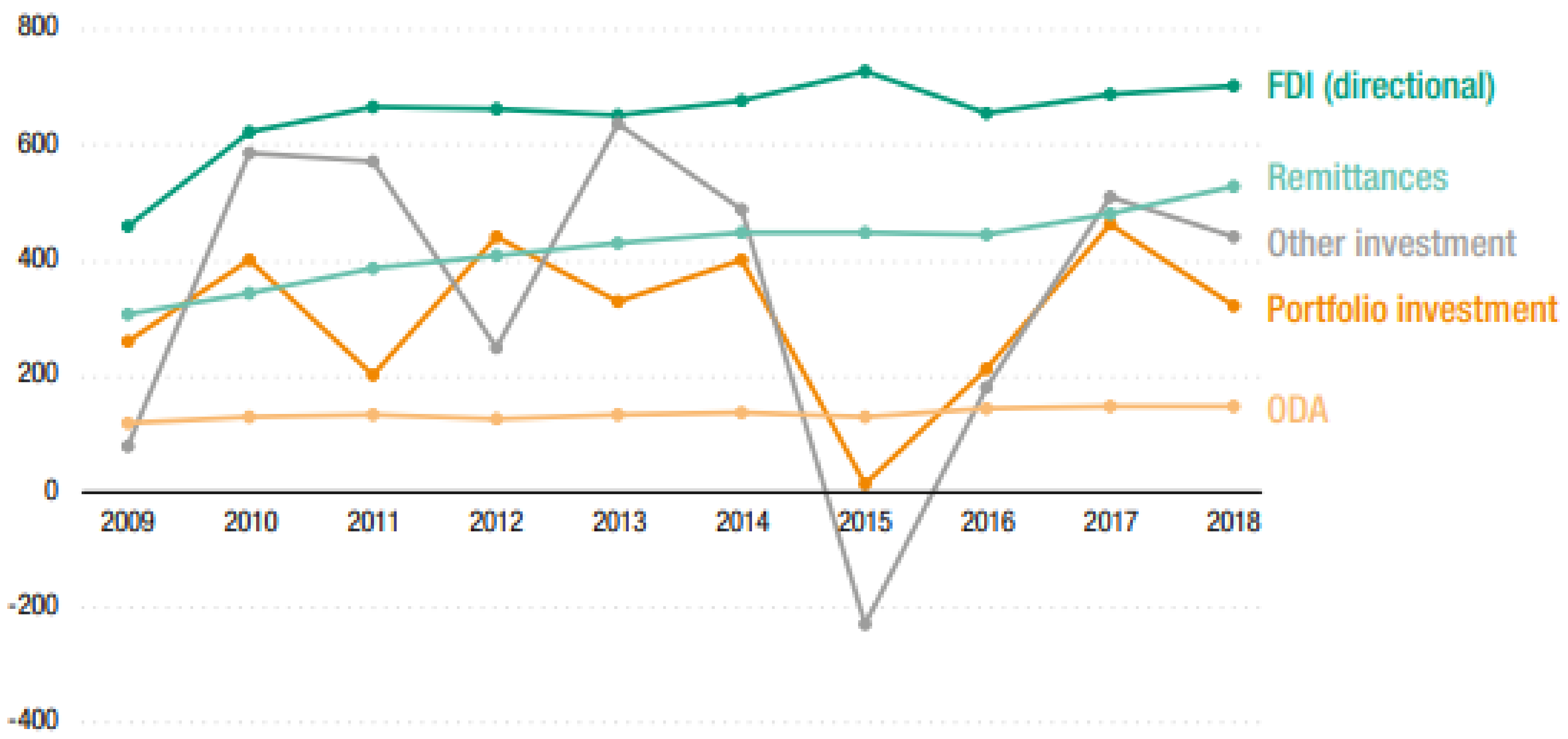
Top 20 host economies

Figure I.5. FDI inflows, top 20 host economies, 2019 and 2020 (Billions of dollars)



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

Figure I.10. **Developing economies: sources of external finance, 2009–2018**
(Billions of dollars)



Source: UNCTAD, based on KNOMAD (for remittances), UNCTAD (for FDI), IMF World Economic Dataset (for portfolio investment and other investment) and OECD (for ODA).

Note: Remittances and ODA are approximated by flows to low- and middle-income countries, as grouped by the World Bank.

Source: World Investment Report 2019

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]	$\boxed{37\ 570^{c}}$
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	$\boxed{20\ 437}$

Source: ©UNCTAD.

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

- 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 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 and industries in importance of spillovers
  - Local firms are not always able to take advantage of opportunities: need for absorptive capability (and motives)
  - MNCs behavior varies: are they integrated or do they operate in enclaves?
  - Methodology: cross-section or panel data?
    - Time is important. Initial negative effect disappears 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 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. Less risk with 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 that FDI will ease BoP restrictions
  - Both export-oriented and import-substituting FDI could help earn (or save) foreign exchange and improve BoP.
- But foreign MNCs are often highly import dependent
  - 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…
- 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

Direct vs indirect effects of FDI

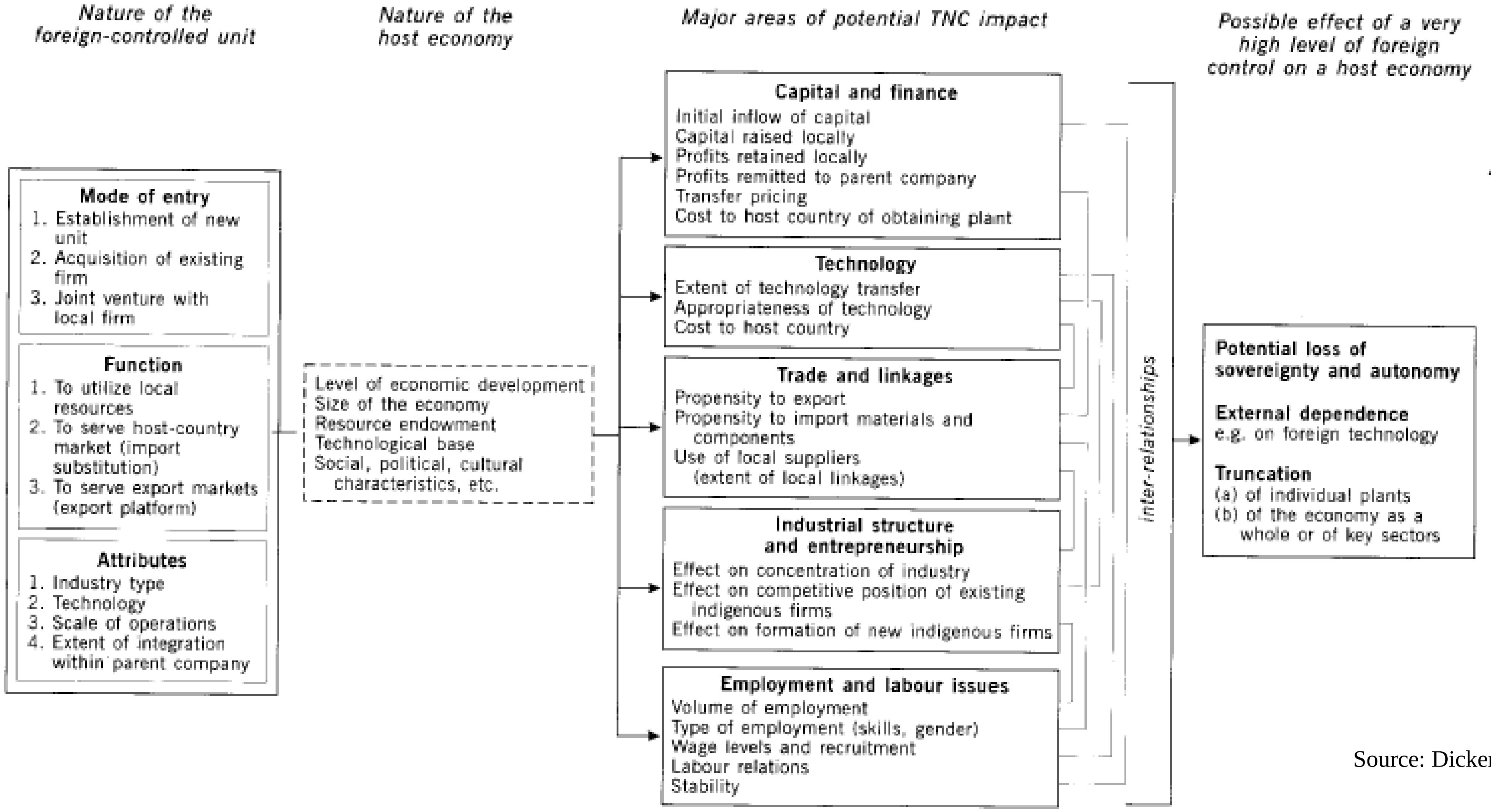
Direct effects

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

Indirect effects (spillovers)

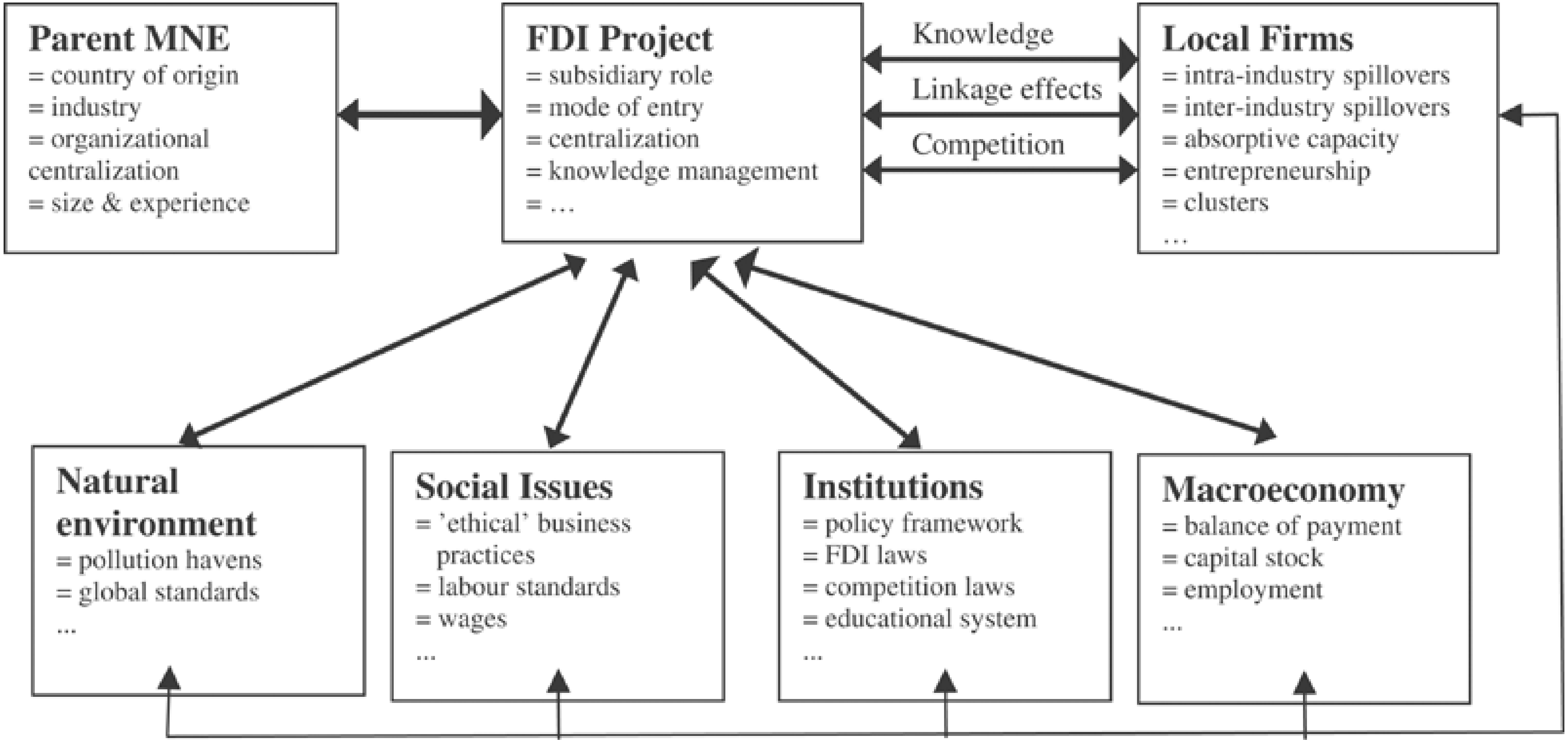
- Technology and knowledge spillovers (horizontal vs vertical)
- Upgrading of suppliers
- Personnel turnover
- Demonstration effects
- Competition effects

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.

Preliminary conclusion: 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