Chapter 8

Firms in the Global Economy: Export Decisions, Outsourcing, and Multinational Enterprises

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Preview

- Multinationals and outsourcing

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Multinationals and Outsourcing

- **Foreign direct investment** refers to investment in which a firm in one country *directly controls or owns* a subsidiary in another country.
- If a foreign company invests in at least 10% of the stock in a subsidiary, the two firms are typically classified as a **multinational corporation**.
  - 10% or more of ownership in stock is deemed to be sufficient for direct control of business operations.

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Multinationals and Outsourcing (cont.)

- *Greenfield* FDI is when a company builds a new production facility abroad.
- *Brownfield* FDI (or cross-border mergers and acquisitions) is when a domestic firm buys a controlling stake in a foreign firm.
- Greenfield FDI has tended to be more stable, while cross-border mergers and acquisitions tend to occur in surges.

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Multinationals and Outsourcing (cont.)

- Developed countries have been the biggest recipients of inward FDI.
  - much more volatile than FDI going to developing and transition economies.
- Steady expansion in the share of FDI flowing to developing and transition countries.
  - Accounted for half of worldwide FDI flows in 2009.
- Sales of FDI affiliates are often used as a measure of multinational activity.

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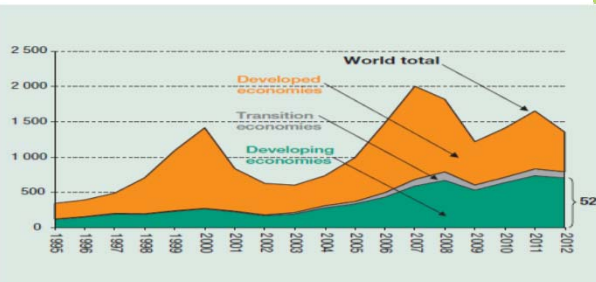
Fig. 8-9: Inflows of Foreign Direct Investment, 1995-2012

source: UNCTAD, WIR July 2013



Source: UNCTAD FDI-TNC-GVC Information System, FDI database (www.unctad.org/fdistatistics).

Multinationals and Outsourcing (cont.)

- Two main types of FDI:
  - **Horizontal FDI** when the affiliate replicates the production process (that the parent firm undertakes in its domestic facilities) elsewhere in the world.
  - **Vertical FDI** when the production chain is broken up, and parts of the production processes are transferred to the affiliate location.

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Multinationals and Outsourcing (cont.)

- Vertical FDI is mainly driven by production cost differences between countries (for those parts of the production process that can be performed in another location).
  - Vertical FDI is growing fast and is behind the large increase in FDI inflows to developing countries.

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Multinationals and Outsourcing (cont.)

- Horizontal FDI is dominated by flows between developed countries.
  - Both the multinational parent and the affiliates are usually located in developed countries.
- The main reason for this type of FDI is to locate production near a firm's large customer bases.
  - Hence, trade and transport costs play a much more important role than production cost differences for these FDI decisions.

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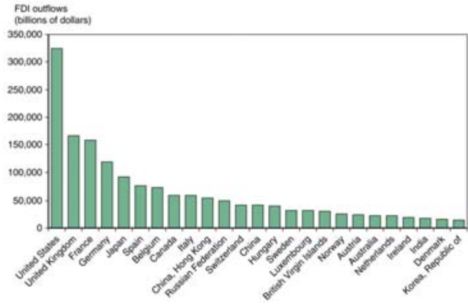
Fig. 8-10: Outward Foreign Direct Investment for Top Countries, 2007-2009



Source: UNCTAD, World Investment Report, 2010.

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The Firm's Decision Regarding Foreign Direct Investment

- *Proximity-concentration* trade-off:
  - High trade costs associated with exporting create an incentive to locate production near customers.
  - Increasing returns to scale in production create an incentive to concentrate production in fewer locations.

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The Firm's Decision Regarding Foreign Direct Investment (cont.)

- FDI activity concentrated in sectors with high trade costs.
  - When increasing returns to scale are important and average plant sizes are large, we observe higher export volumes relative to FDI.
- Multinationals tend to be much larger and more productive than other firms (even exporters) in the same country.

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The Firm's Decision Regarding Foreign Direct Investment (cont.)

- The horizontal FDI decision involves a trade-off between the per-unit export cost t and the fixed cost F of setting up an additional production facility.
- If $t(Q) > F$, costs more to pay trade costs t on Q units sold abroad than to pay fixed cost F to build a plant abroad.
  - When foreign sales large $Q > F/t$, exporting is more expensive and FDI is the profit-maximizing choice.
  - Low costs make more apt to choose FDI due to larger sales.

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The Firm's Decision Regarding Foreign Direct Investment (cont.)

- The vertical FDI decision also involves a trade-off between cost savings and the fixed cost F of setting up an additional production facility.
  - Cost savings related to comparative advantage make some stages of production cheaper in other countries.

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The Firm's Decision Regarding Foreign Direct Investment (cont.)

- Foreign **outsourcing** or **offshoring** occurs when a firm contracts with an independent firm to produce in the foreign location.
  - In addition to deciding the **location** of where to produce, firms also face an **internalization** decision: whether to keep production done by one firm or by separate firms.

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The Firm's Decision Regarding Foreign Direct Investment (cont.)

- Internalization occurs when it is more profitable to conduct transactions and production within a single organization. Reasons for this include:

1. **Technology transfers**: transfer of knowledge or another form of technology may be easier within a single organization than through a market transaction between separate organizations.
   - Patent or property rights may be weak or nonexistent.
   - Knowledge may not be easily packaged and sold.

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The Firm's Decision Regarding Foreign Direct Investment (cont.)

2. **Vertical integration** involves consolidation of different stages of a production process.
   - Consolidating an input within the firm using it can avoid holdup problems and hassles in writing complete contracts.
   - But an independent supplier could benefit from economies of scale if it performs the process for many parent firms.

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The Firm's Decision Regarding Foreign Direct Investment (cont.)

- Foreign direct investment should benefit the countries involved for reasons similar to why international trade generates gains.
  - Multinationals and firms that outsource take advantage of cost differentials that favor moving production (or parts thereof) to particular locations.
  - FDI is very similar to the relocation of production that occurred *across* sectors when opening to trade.
  - There are similar welfare consequences for the case of multinationals and outsourcing: Relocating production to take advantage of cost differences leads to overall gains from trade.

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Summary

1. Internal economies of scale imply that more production at the firm level causes average costs to fall.
2. With monopolistic competition, each firm can raise prices somewhat above those on competing products due to product differentiation but must compete with other firms whose prices are believed to be unaffected by each firm's actions.
3. Monopolistic competition allows for gains from trade through lower costs and prices, as well as through wider consumer choice.

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Summary (cont.)

4. Monopolistic competition predicts intra-industry trade, and does not predict changes in income distribution within a country.
5. Location of firms under monopolistic competition is unpredictable, but countries with similar relative factors are predicted to engage in intra-industry trade.

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Summary (cont.)

6. Dumping may be a profitable strategy when a firm faces little competition in its domestic market and faces heavy competition in foreign markets.
7. Multinationals are typically larger and more productive than exporters, which in turn are larger and more efficient than firms that sell only to the domestic market.

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Summary (cont.)

8. Multinational corporations undertake foreign direct investment when proximity is more important than concentrating production in one location.
   – Firms produce where it is most cost-effective — abroad if the scale is large enough. They replicate entire production process abroad or locate stages in different countries.
   – Firms also decide whether to keep transactions within the firm or contract with another firm.

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