FDI and multinationals

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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.

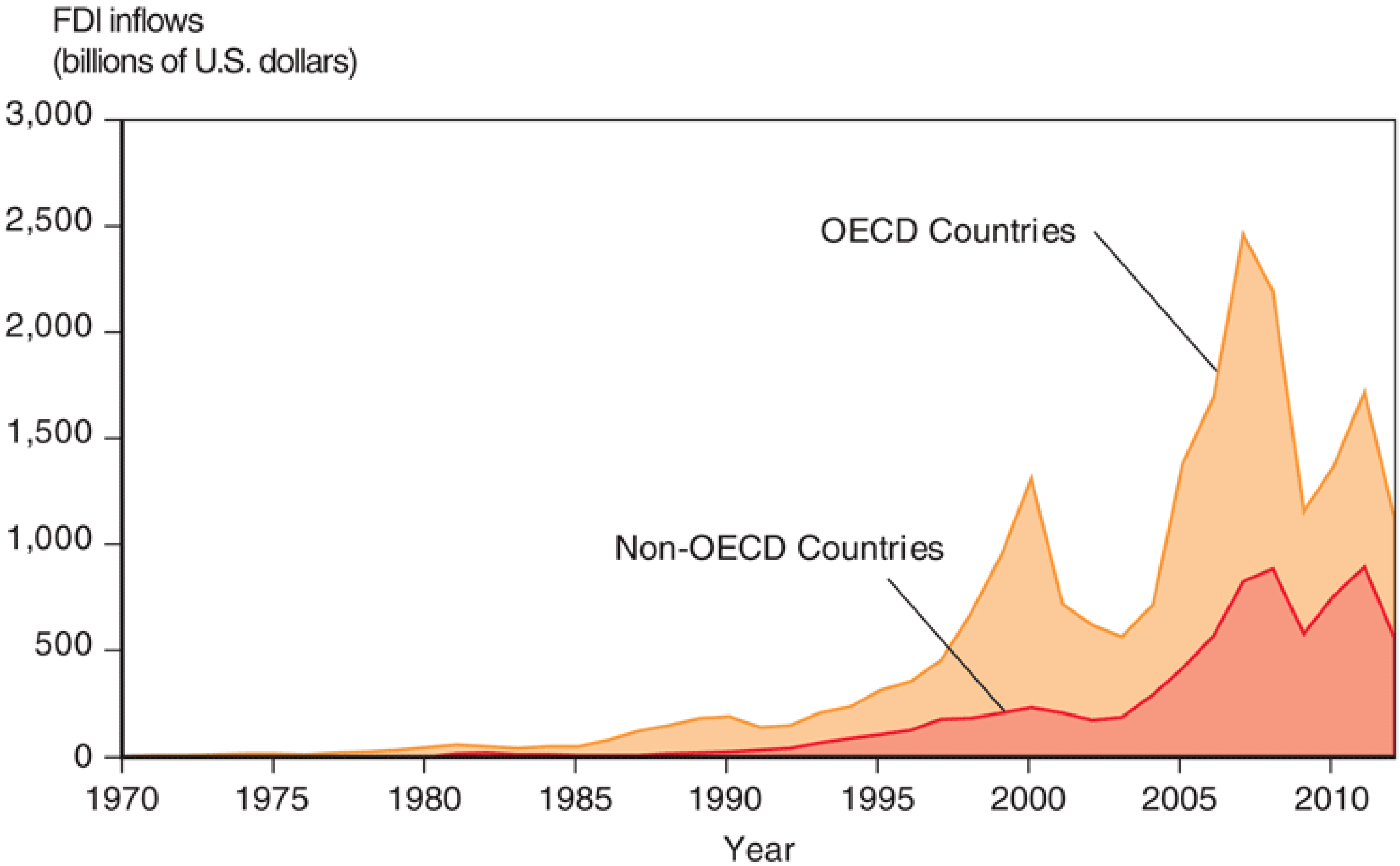
Multinationals and Outsourcing (cont.)

- *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.

Multinationals and Outsourcing (cont.)

- Developed countries have been the biggest recipients of inward FDI up to 2010.
  - 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 since 2009.
- Sales of FDI affiliates are often used as a measure of multinational activity.

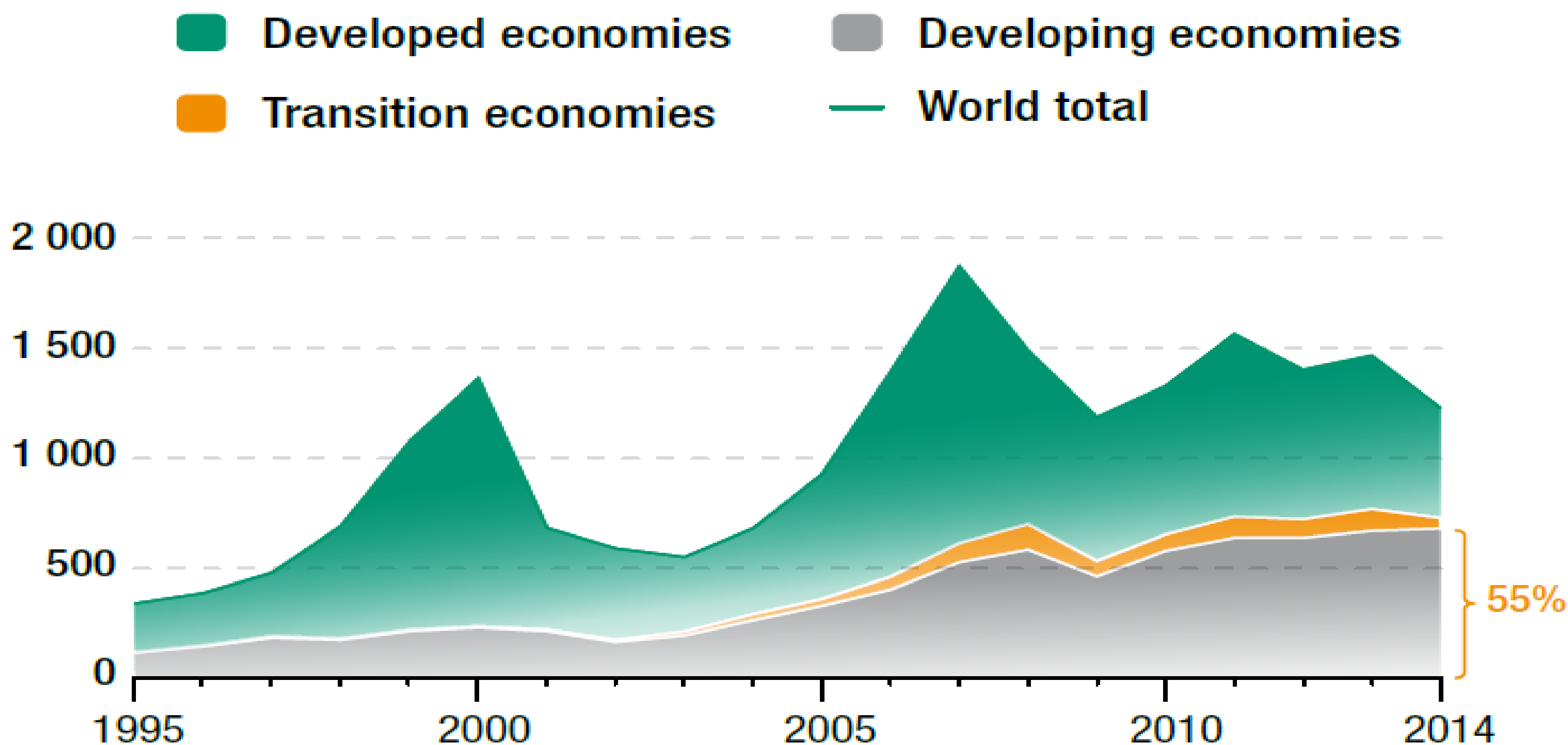
Fig. 8-9: Inflows of Foreign Direct Investment, 1970-2012



Source: World Bank, *World Development Indicators.*

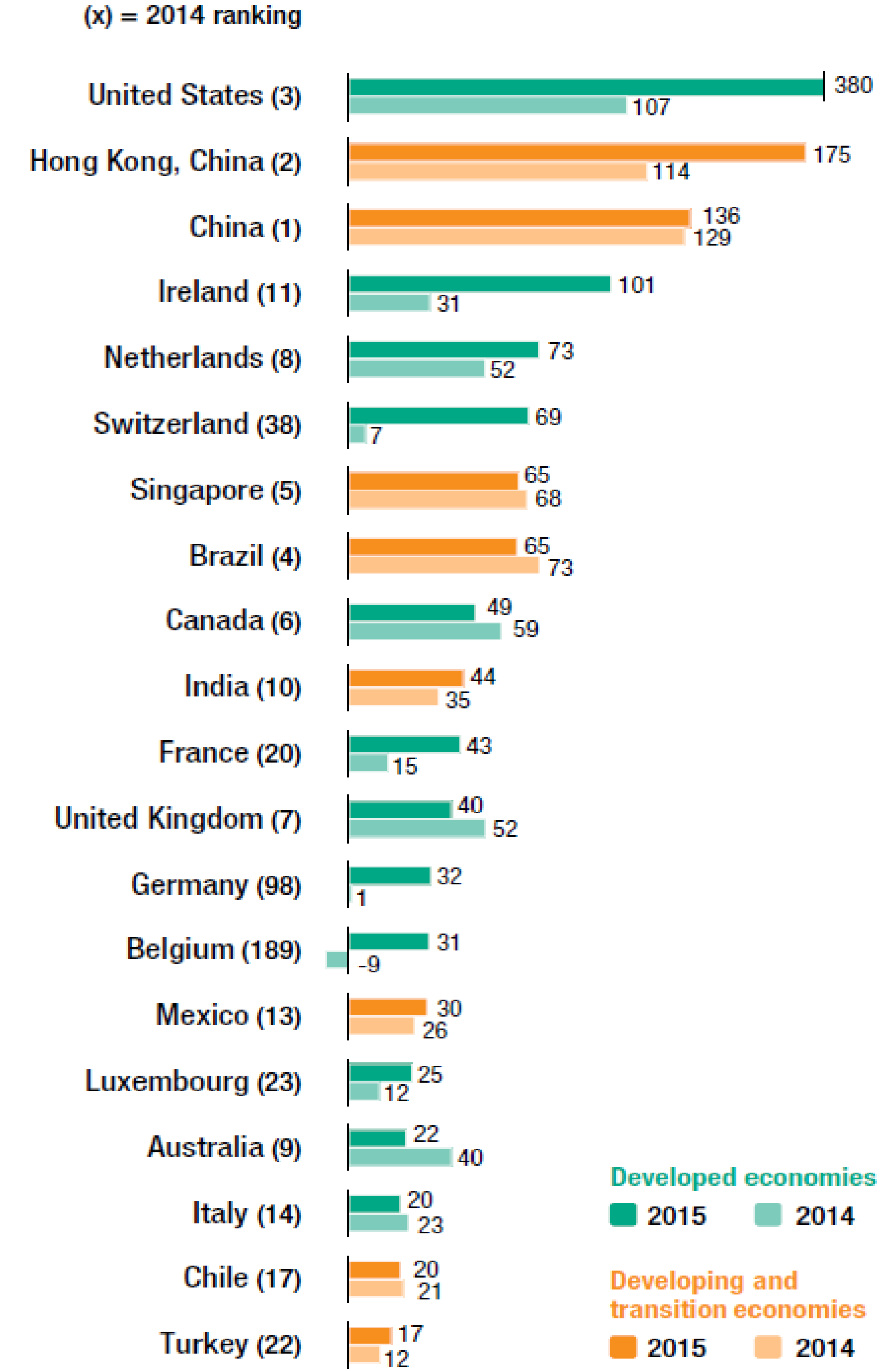
Foreign Direct Investment: inflows

source: UNCTAD, WIR 2015



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

the globalization of production

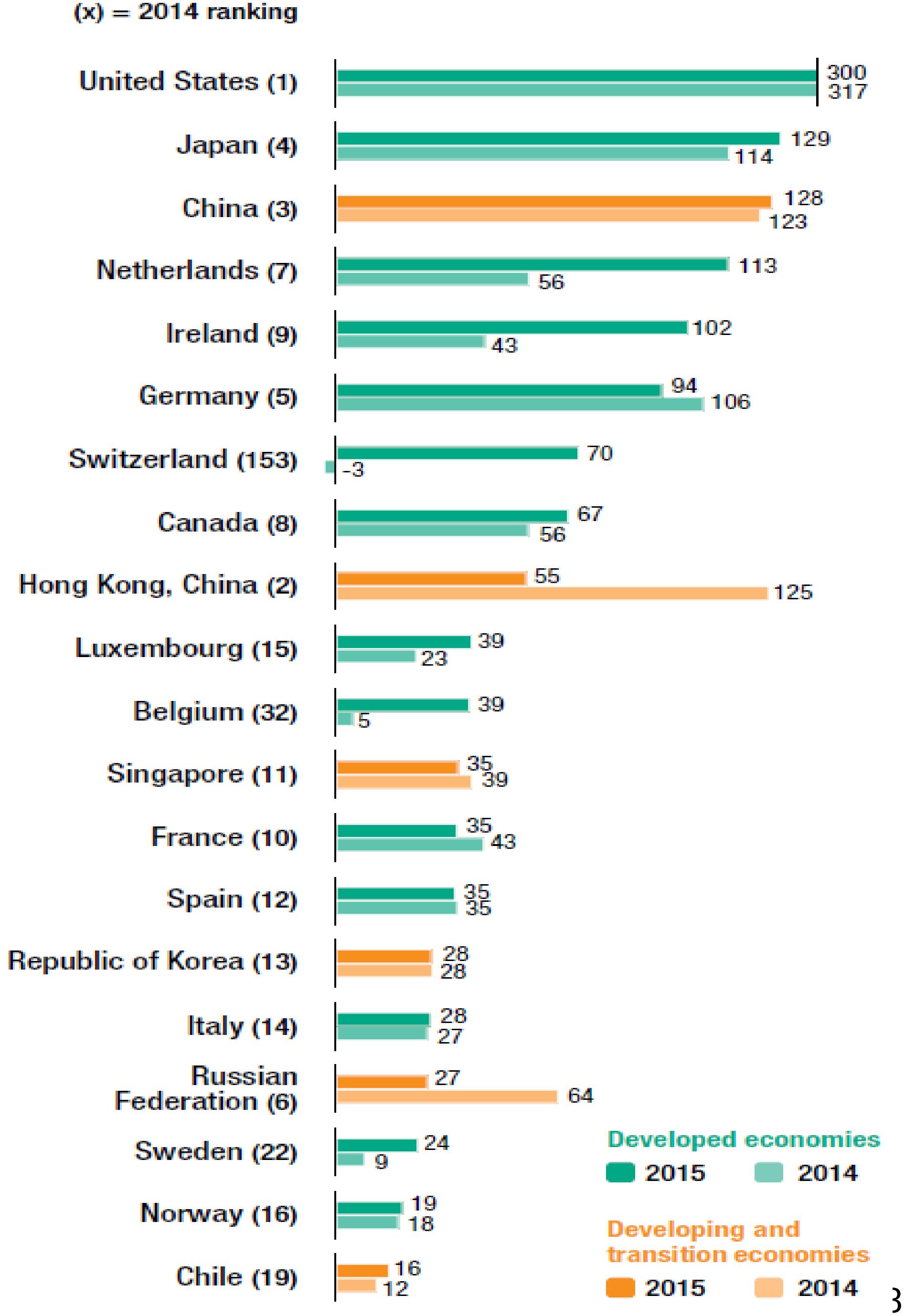


Source: ©UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

FDI inflows: top 20 host destinations

Fonte: UNCTAD, WIR 2016

the globalization of production



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

FDI outflows: top 20 home economies

Fonte: UNCTAD, WIR 2016

Multinationals and Outsourcing (cont.)

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

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).
- Mainly cost-saving motivations
  - Vertical FDI is growing fast and is behind the large increase in FDI inflows to developing countries.

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. Mainly, market-seeking motivations
  - Hence, trade and transport costs play a much more important role than production cost differences for these FDI decisions.

The Firm’ s Decision Regarding Foreign Direct Investment

*A) **LOCATION MOTIVE***

Proximity-concentration trade-off:

- High trade costs associated with exporting create an incentive to locate production near customers (higher FDI).
- Increasing returns to scale in production create an incentive to concentrate production in fewer locations (lower FDI).

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

- Empirical evidence:

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

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, then do FDI.
- Or, when foreign sales large $Q > F/t$, exporting is more expensive and FDI is the profit-maximizing choice.

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.

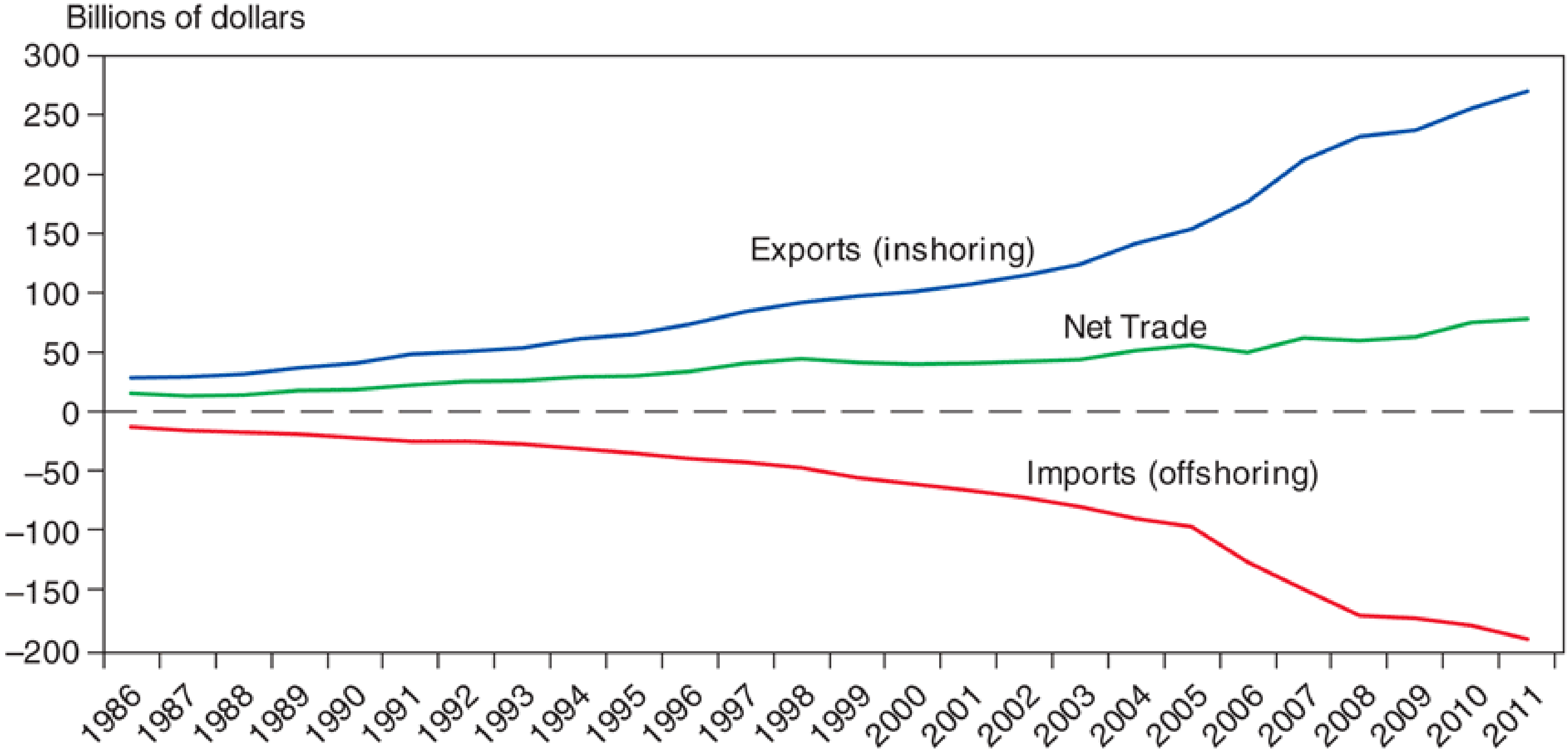
The Firm's Decision Regarding Foreign Direct Investment (cont.)

B) INTERNALIZATION MOTIVE

Why parent firm chooses to own the foreign affiliate?

- Instead of an HFDI a firm might **license** a foreign independent firm to produce and sell the product in the foreign location
- Instead of a VFDI a firm might **outsource** parts of the production chain abroad and then these parts are produced by independent foreign companies. The term **offshoring** refers to both VFDI and outsourcing

Fig. 8-11: U.S. International Trade in Business Services, 1986–2011



Source: U.S. Bureau of Economic Analysis.

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.

a) The **trade-off between HFDI and license** is related to the control over a firm proprietary technology: transfer of knowledge 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.

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

b) **Trade-off between VFDI and outsourcing** is more complicated:

- On one side, consolidating an input within the firm using it can avoid holdup problems and hassles in writing complete contracts.
- On the other side, an independent supplier could benefit from economies of scale if it performs the process for many parent firms.

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.

Summary

1. 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.
2. 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.