Foreign Direct Investment (FDI)

Import substitution (IS) or Export orientation (EO)?: Exchange rate matters

- Importance of exchange rate : Incentives for domestic producers
- If one good (1\$) is traded and the exchange rate is fixed at 1\$=140 ¥, and for the domestic producer's cost and profit is 145¥ → No export, No import for survival
- How about 10% import tariff?
- How about 5% of export subsidies?

Trade policies and Protection Indicators (1)

- **Prices are affected by TRADE POLICIES (t_M) and EXCHANGE RATE(e)**
- $p^{\$}$= world market price in foreign currency 1US$, p^b=border price in local currency units (LCU), p^d=domestic price in LCU, e=nominal exchange rate in LCU/$
- Tradable goods(T) price: $p^d= p^b(1+t)$, $p^b=ep^{\$}$ ($t=t_M$: import tariff rate, $t=-t_E$: export tax rate)
- ***Nominal Protection Coefficients NPC***$=p^d/p^b=1+t$
- If NPC>1, producers are protected, consumers are dis-protected (taxed) , NPC<1 (vice versa)

Trade policies and Protection Indicators (2)

- ***Effective Protection Coefficient (EPC)***
- Better than NPC by reflecting the intermediate input
- Production + Intermediate inputs
- p=unit value of output, c=cost of intermediate goods in production, VA=Value added, cost of labor, financial capital per unit of production, then $p=c$+VA ($VA=p-c$)
- EPC= $VA^d/VA^b=p^d-c^d/p^b-c^b$
- If EPC>1, producers are protected and consumers are taxed, EPC<1 (vice versa)

Trade policies and Protection Indicators (3)

- ***Real Protection Coefficient (RPC)***

☞ ***Exchange rate polity and/or Trade policy can protect tradable goods, changing the incentives for domestic producers***

- Import substitutes price: $p^{d} = ep^{\$}(1+t_M)$
- Export price: $ep^{\$}(1-t_E)$
- If e^*= equilibrium exchange rate, and $p^{b*} = e^* p^{\$}$ then, RPC= $p^{d}/p^{b*} = ep^{\$}(1+t)/\ e^* p^{\$} = e/e^*(1+t)$: Exchange rate distortion*NPC

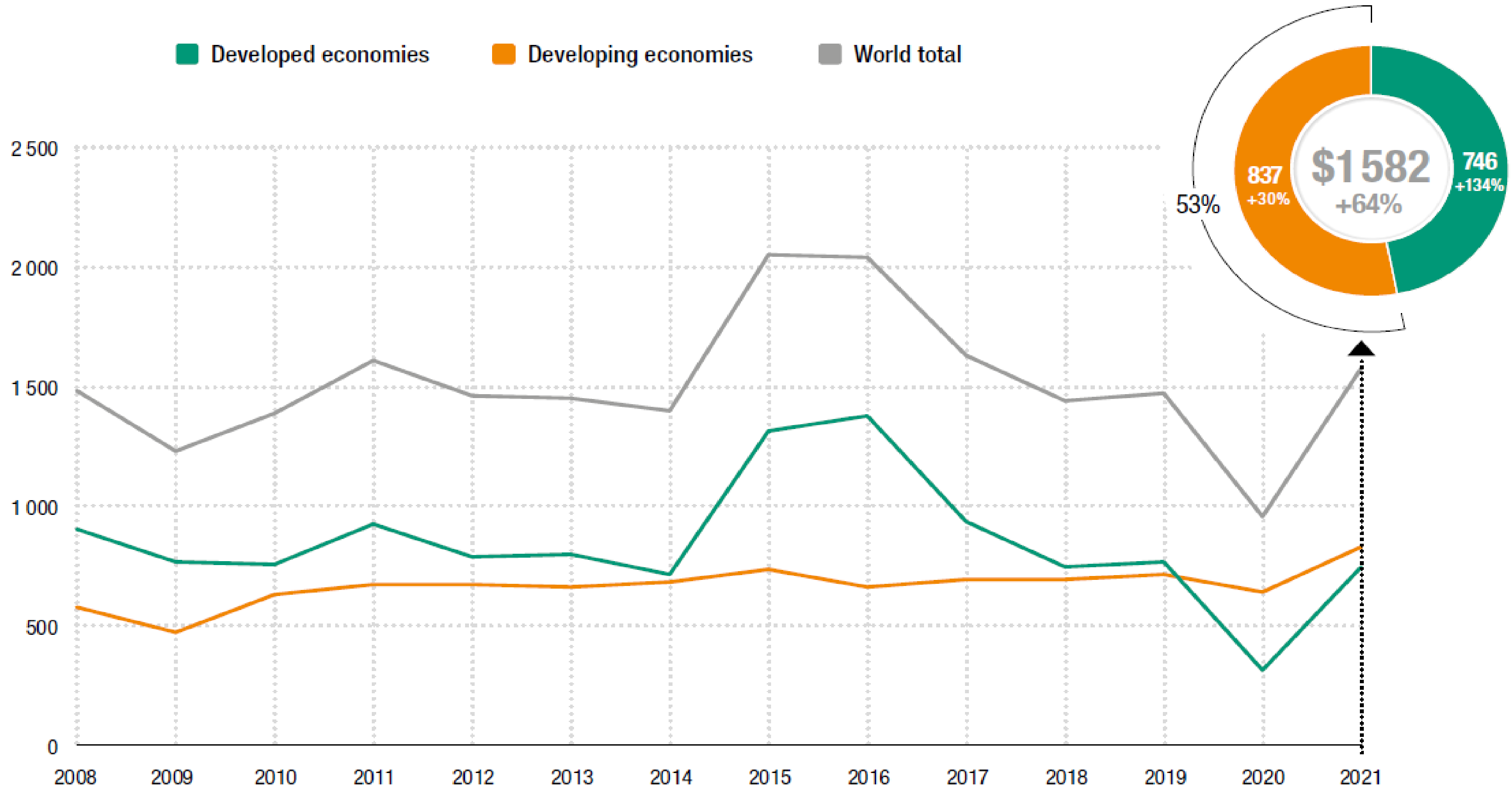
Foreign Direct Investment (FDI)

- Direct investment ≠Portfolio Investment
- Cross-border Investment for managerial participation by Multi-National Enterprise :MNE
- Dunning (1977)：OLI theory (Ownership-specific advantage, Location-specific variables, and Internalization incentives)
- FDI includes transfer of managerial resources: Firm specific knowledge/ technologies, managerial skills, Brands, Marketing/ Sales capabilities…("Knowledge capital")

  → Intra-firm transactions, Internalizing profits
- Acquisition of location advantage
- Types: Green Field investment, M&A

FDI peak-out? (Source: UNCTAD : World Investment Report 2022)

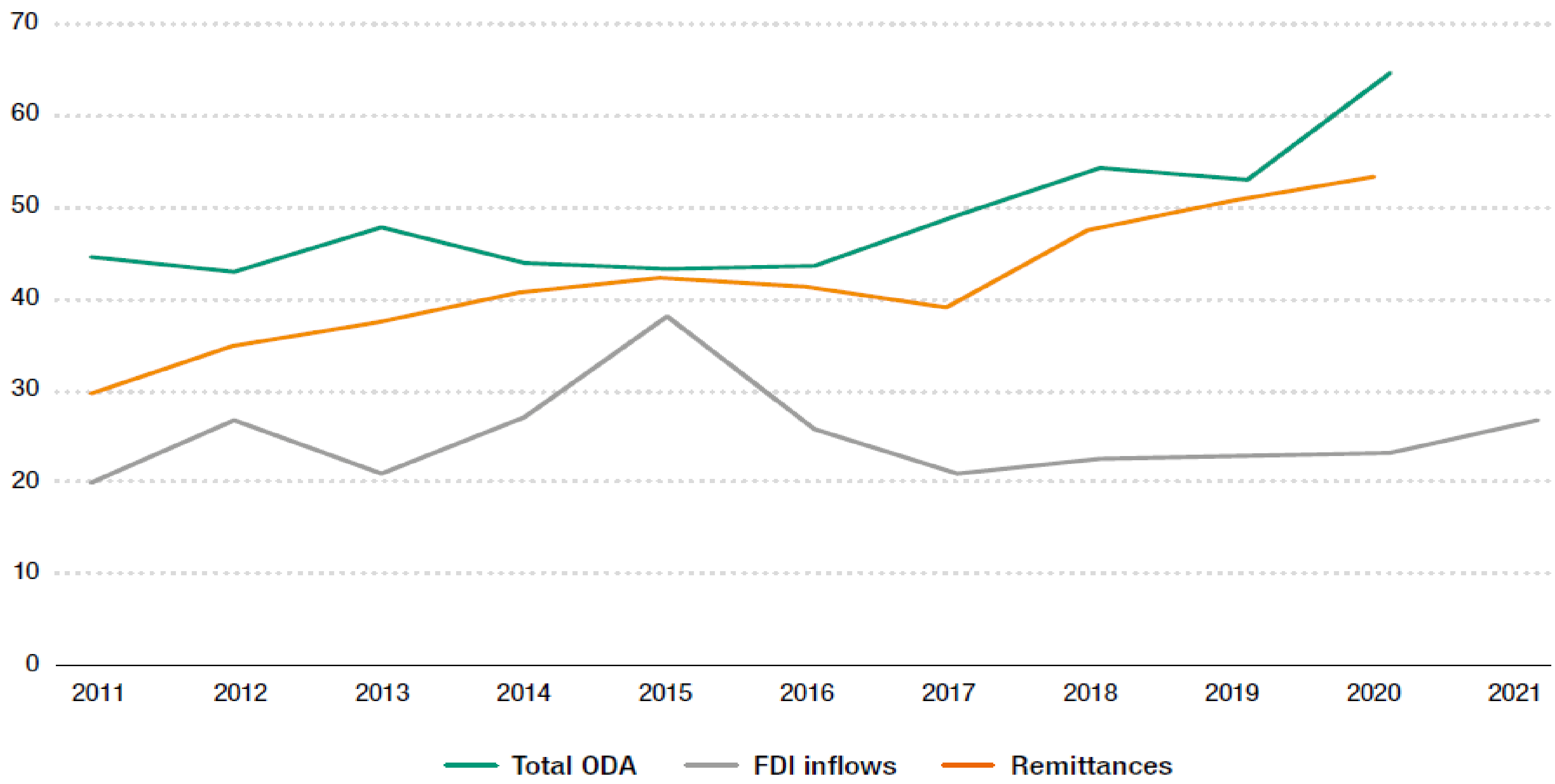
Figure I.1. | **FDI inflows, global and by economic grouping, 2008–2021** (Billions of dollars and per cent)



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

FDI as the largest capital inflow to developing economies (Source: the same as P.3)

Figure I.13. | **LDCs: FDI inflows, ODA and remittances, 2011–2021** (Billions of dollars)



Source: UNCTAD, FDI/MNE database (https://unctad.org/fdistatistics) (for FDI inflows), OECD (for ODA flows) and World Bank (for remittances).

Development and FDI

- FDI: Long-term, stable capital without re-imbursement
  ⇨ May increase saving rate
- Transaction of managerial resources and the Spill-over effects : Positive externalities and production gains (←ex. Spill-over of technologies and skills by business transactions and/or movement of workers/ employees *without fees*
- Intra-firm managerial transfer (≠Market transaction)
- Good access to latest technologies
- Employee education may contribute to human capital → Implications from endogenous growth theory
- Trade promotion (Export processing Zones) : Textile, Apparel, Semi-conductors, Electronics (≠ Capital intensive industries: Steel, Petrochemical)

Gov.'s supports for FDI

- Business environment reform ⇨ MNEs (Smaller Value Chains for production and distribution networks), Location fragmentation in global competition
- Infrastructure investment (Electricity, Water, Telecommunication, Legal framework to protect investors, Service (One-stop window), Transparency (Public comments)
- Maximizing agglomeration effects
- Positive externalities for local firms ($\neq$ Export enclave), Supporting industries
- MNE's contributions for national economy (Adjusting profit maximization, monitoring)

Horizontal / Vertical FDI

- Access to foreign markets：Export? Or Local production (FDI)? (Trade cost or Production cost?)
- Horizontal FDI: Supplying the same goods to the foreign markets (Local production), typically in responding to trade frictions

(Responding to high tariffs / Import restriction under IS strategy)

- Vertical FDI: Producing the different goods at the foreign market, Division of labor processes for efficiency or cost reduction

→ Typically observed in "flying gees" patterns of production change in export-led growth in Asia

Horizontal FDI (Markusen, Brainard)

- Investment to enter into the host country market
- Substitutional relations between trade and FDI

1) If trade cost is higher (High tariffs, High transportation costs), then FDI

2) Deregulations of FDI control, Investment climate change (Pro-business)

3) Business with smaller economy of scale (No concentration benefits in original market)

4) Size of host country market : FDI with decreasing average costs

5) Institutional reasons by trade friction, environment standards, regulations….

⇨Usually positive impact on host country's employment, but not sure about the investor economies

Vertical FDI (Helpman, Krugman)

- Cost reduction purposes by local production
- Complementary relations with trade: Exporting intermediate goods for assembling, Importing the finished goods, or Exporting to the 3rd destination

⇨ Typically labor industries in developing countries (Positive impacts) but unknown impacts on investor countries (Negative impacts if "hollowing out")

1) Domestic production cost > Foreign production cost

⇨ Division of labor in process

2) Cheaper managerial costs (Wage/Productivity, Business establishments, generous incentives….)

3) Cheap trading costs for the final goods for export (Soft/ Hard infrastructure

Gov.'s concerns for FDI(2)

- Transfer pricing：Manipulating prices in intra-company trade for tax evasive purposes, Profit transferring
- Market monopoly：Avoiding technology transfer, Controlling product development, Export control, Competition control…(Host gov. vs. MNEs: Investor-States Dispute Settlement (ISDs)
- Crowding-out local firms (Brand power, Job market…)
- Balance of payment: Income transfer, Overseas remittance
- Migrating MNEs for cheaper labor

Host governments and FDI

- Host gov. vs. Investors (Sovereignty vs. MNEs)

⇨ FDI control and industrial policy tool

ex. Linking foreign share and export ratio

Local content requirement, Foreign exchange control

Latest technology transfer

⇨1995：TRIMs（Trade Related Investment Measures) in WTO

⇨Bi-lateral investment treaty (Investor protection from expropriation (socialist countries), IPR and others

⇨OECD: Multilateral Agreement on Investment (MAI) for MFN and National treatment

⇨FTA + Bilateral Investment Treaty(BIT)

⇨FTA + ISDs

FDI and Industrial Policies (Source: UNCTAD(2018))

Investment Policy Framework for Sustainable Development

Industrial policy design criteria

- Openness
- Sustainability
- NIR readiness
- Inclusiveness
- Coherence
- Flexibility
- Effectiveness

Core FDI policies

- FDI entry rules and ownership restrictions
- Investment promotion and facilitation
- Incentives
- SEZs
- Performance requirements
- Promotion of linkages and spillovers
- Treatment and protection of investments

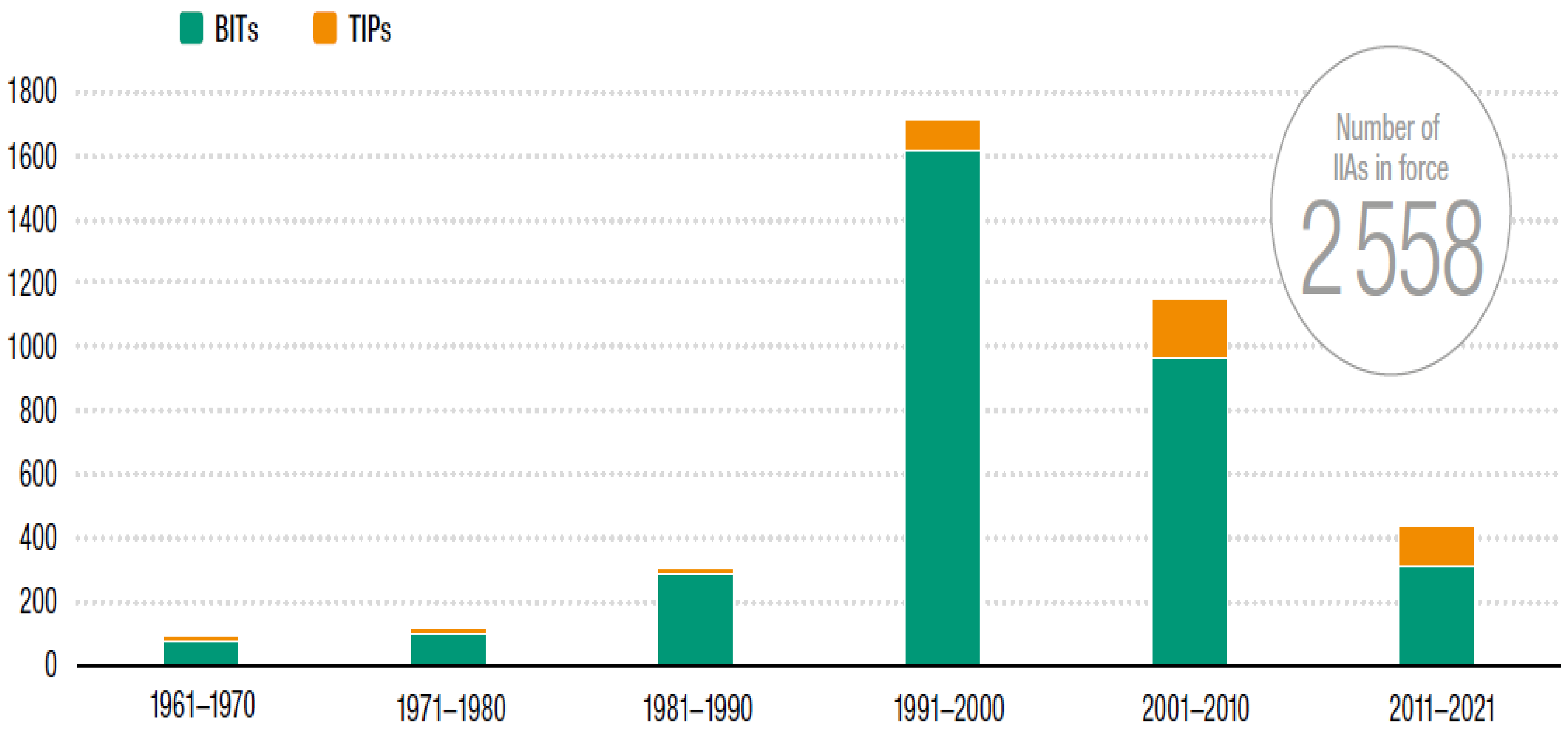
Investment-related policies

- Trade policy
- Tax policy
- Intellectual property policies
- Competition policies
- Labour market regulation
- Infrastructure and PPP framework
- Environmental policy
- Corporate responsibility
- Macro- and socioeconomic policy framework

Source: UNCTAD.

BIT to attract FDI

Figure II.4. | **Number of IIAs signed, by decade, 1961–2021**



Source: UNCTAD, IIA Navigator.

Suggested Readings

- Dunning, John H. (1977) "Trade, Location of Economic Activity and the MNE: A Search for an Eclectic Approach", in B. Ohlin, Bertil, Hesselborn, Wijkman (Eds.), *The International Allocation of Economic Activity,* Palgrave Macmillan
- Geoffrey Jones (2004) *Multinationals And Global Capitalism: From the Nineteenth to the Twenty-first*, Oxford University Press
- Markusen, James R.(2002) *Multinational Firms and the Theory of International Trade*, MIT Press
- Elhanan Helpman, 2006. "Trade, FDI, and the Organization of Firms," Journal of Economic Literature, American Economic Association, vol. 44(3), pages 589-630, September.
- United Nations Conference on Trade and Development(UNCTAD) World Investment Report (Various years)