Direct Foreign Investment (DFI) and the Multinationals

Based on Chap 27 of Pugel and Lindert

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Objective

- In the previous chapter we have seen the effect of capital flows into and out of a country, and we have seen that it has positive effect for the host as well as the source country. The results are true for all types of capital flows provided there was no risk factors involved. However, different types of capital flows carries different types of risks. Apart from risk, multinational companies when they invest in another country, they bring other inputs of production apart from capital, such as management, technology and marketing network. Because multinational firms can directly manage the company, they can also reduce the risk of bad performance of the company and thus reduce the low returns to their investment.
- Broad issues of this lecture are:
- The nature of DFI around the world.
- Why DFI occur?
- Should a source country or host country encourage or discourage DFI?

Topics

1. Definition of DFI
2. Difference between DFI and portfolio, bond and official investment.
3. Nature of Capital flow
4. What explains DFI? DFI as imperfect competition (two views).
    1. The Hymer view
    2. The Appropriability Theory
5. Should home country Restrict DFI outflow?
6. Should the host country restrict DFI?

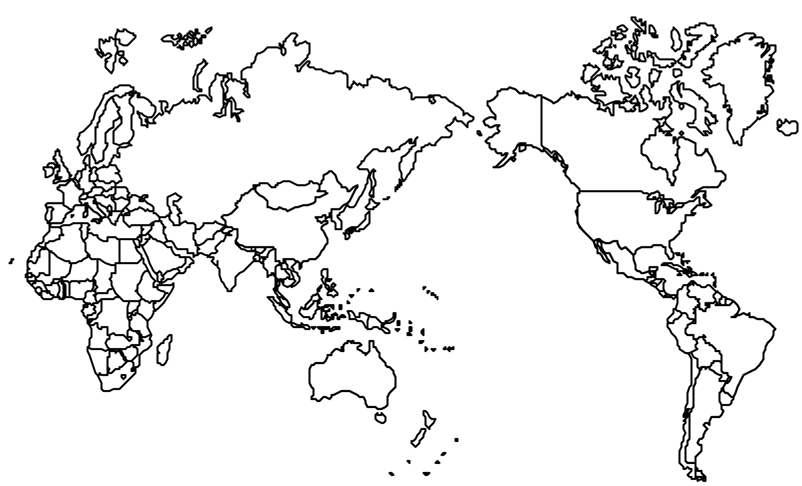
1. Definition of DFI

A. DFI is a flow of a mixture of financial capital and intangible assets like technology managerial capabilities, and marketing skills and other assets. Also it needs the ownership requirement: at least 10% by the investing firms, although this percentage ownership requirement varies from country to country.

B. Multinational firm: There is a parent company based in a home country say coco cola company with home based in the US and it also sets up affiliates or subsidiaries in other countries. (why?)

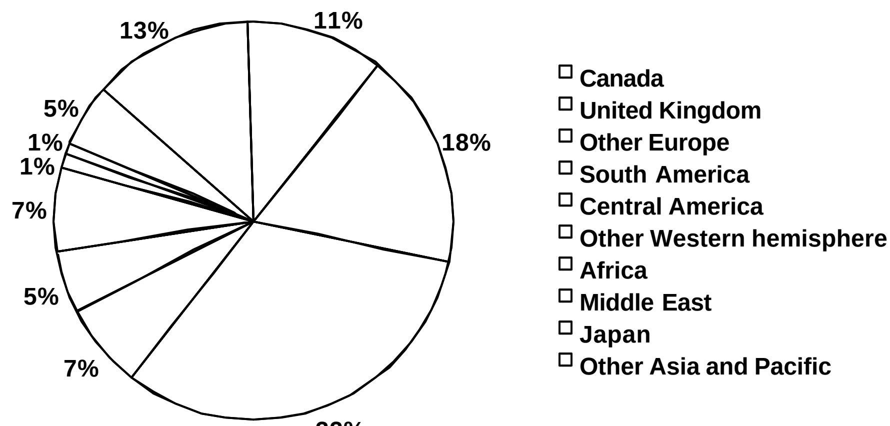
2. Difference between DFI and portfolio, bond and official investment.

Top Source and Host Countries for Foreign Direct Investment, 1985–1995



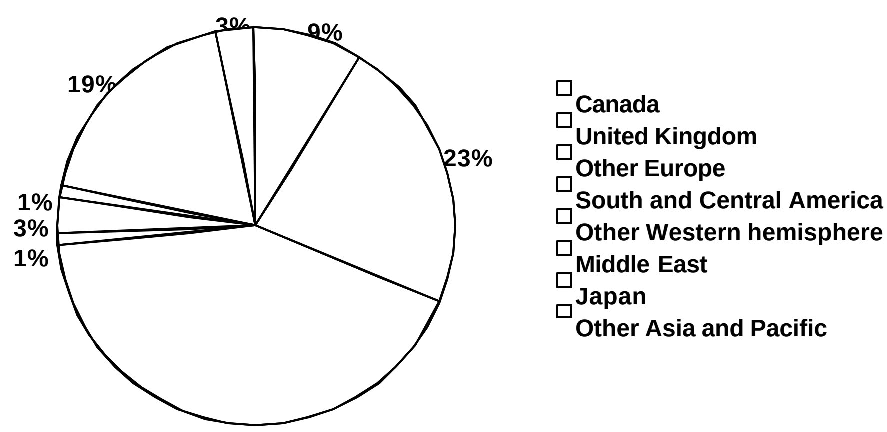
The shaded area represents leading host economies, the darker shaded Areas represent the top twenty source economies for FDI

Destination of US outward FDI



(a) Destinations

Sources of FDI into the US



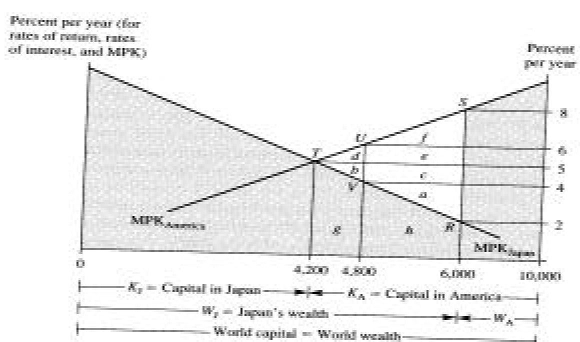
(b) Sources

What explains DFI?

- The Hymer View:
  - Combines the idea of firm specific advantages of multinational corporations and imperfect competition.
  - A monopolist by establishing a foreign subsidiary trying to cut out the host country firms of market share. The foreign firm's advantage is its firm specific technology, management practice etc.
- Appropriability Theory
  - To recoup the costly R&D investment in developing products and processes, and it makes sense to establish subsidiaries in other countries to produce the product and make profit instead of letting a foreign firm to immitate the product.

Should the home country and the host country restrict DFI?

FIGURE 26.1
Gains and Losses from Well-Behaved International Lending



From no international lending (*RS*) to free lending (*T*):

Japan	gains ($a + b + c$)	= 27
America	gains ($d + e + f$)	= 27
World	gains (a through f)	= 54

If Japan imposes a 2 percent per year tax on lending abroad (from *T* to *UV*):

Japan	gains ($e - b$)	= 9
America	loses ($d + e$)	= 15
World	loses ($b + d$)	= 6

If America imposes a 2 percent per year tax on borrowing abroad (from *T* to *UV*):

Japan	loses ($b + c$)	= 15
America	gains ($c - d$)	= 9
World	loses ($b + d$)	= 6

Good luck and good-bye.

Have a great summer and great career.