Week 8: Foreign Direct Investment and Multinational Corporations

As we discussed in Week 1, international trade in goods and services is only one of many channels through which national economies interact with each other. Not only can firms export goods from their home country, but they can also invest in a foreign country to establish a subsidiary and cater directly to local customers. Such investment is called foreign direct investment (FDI) while firms that are incorporated in more than one country are known as multinational corporations/companies (MNCs).

FDI and MNCs are important facilitators of economic globalization. Nevertheless, FDI in Japan by foreign MNCs remains very limited, so much so that many Japanese still seem to regard foreign-affiliated companies (gaisikei kigyo) as something special and even suspicious. Accordingly, this note will survey the state of FDI and MNCs around the world and consider why Japan receives so little FDI.

Direct Investment around the World

As noted in the Week 1 lecture note, foreign direct investment has been increasing at a faster pace than world GDP but is quite volatile in the short run. Figure 1 plots annual flows of FDI in the world, broken down by the income level of source (investor) countries and destination (host) countries. According to this figure, the majority of world FDI takes place between high-income countries. While the share of middle-income countries (most notably China) has been increasing, that of low-income countries remains negligible on both the sending and receiving sides.

Figure 1. World direct investment flows by source and host countries (US billion)

(Notes) The left-hand panel presents data disaggregated by the income level of source (investor) countries. The right-hand panel reports data broken down by the income level of destination (host) countries. Although the total values for each year in the left and right panels should in principle be the same, this is not necessarily the case because of statistical errors and gaps in the timing of reporting in source and host countries. (Source) UNCTAD, UNCTADSTAT (http://unctadstat.unctad.org/EN/).

At first sight, the near absence of low-income countries in Figure 1, particularly in the right-hand panel, is puzzling. As discussed in Week 3, high-income countries are relatively capital-/technology-abundant but labor-scarce; in contrast, low-income countries are capital-/labor-scarce but labor-abundant. To the extent that FDI is an important channel through which capital and technology are transferred from one country to another, we would expect a sizable amount of direct investment going from high-income to low-income countries.
One reason why this is not the case in reality is that FDI is conducted for a variety of reasons. In international economics, FDI is often classified into two types: vertical FDI and horizontal FDI.

The purpose of *vertical FDI* is to break up the investor firm’s business into multiple operations and to place each activity in a country where the cost of operation is lowest. This type of FDI is often conducted by manufacturing companies headquartered in advanced countries. For example, Japanese apparel firms typically design their clothes in Japan but conduct manufacturing operations in developing countries whose wage rates are low. This type of FDI should indeed go from high-income countries to low-income countries.

In contrast, the primary purpose of *horizontal FDI* is to gain access to foreign markets. In recent years, major Japanese operators of convenience store chains have been expanding their business to other Asian countries. These firms are clearly concerned about the saturation of Japan’s domestic demand and wish to tap into growing markets of its neighbors. According to Figure 2, more than 60 percent of world FDI stocks concern service (rather than manufacturing) operations, suggesting that horizontal FDI accounts for a large fraction of global direct investment.

### Figure 2. Global FDI stock by sector (US trillion)


**Methods of Foreign Market Entry**

Despite recent acceleration of globalization, firms that engage in international business still remain a minority. Even in highly developed countries, only a small fraction of companies export their goods to and/or possess affiliates in foreign countries. Such firms tend to be larger and more efficient than companies catering exclusively to the domestic market. This implies that how a particular firm engages in (or does not engage in) overseas business is not a matter of chance but the result of its conscious decision.

There are three main methods for firms to gain access to foreign markets: *exporting*, *contractual* and *FDI*. Exporting is least expensive in terms of initial costs but is not possible for producers of non-tradable services. Firms can also enter into a licensing or subcontracting contract with a foreign company and let the latter produce and/or sell their products on their behalf. The last method, FDI, can take a number of forms, including *greenfield investment* and *merger and acquisition* (M&A). A company choosing greenfield investment sets up a new foreign affiliate entirely by itself. With M&A, a firm purchases a part (merger) or all (acquisition) of the shares in a foreign company to place the latter under its control. In practice, M&A is much faster to execute than other modes of FDI and accounts for the bulk of world direct investment flows.

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1. Recall our discussion in Week 7.
Of the above three methods, the contractual type of arrangements is not very popular among MNCs because these arrangements often result in serious disputes with the local partner. Therefore, let us consider how a firm chooses between exporting and FDI. In Figure 3, Panel (a) illustrates the typical relationship between the scale (size) and the cost of a firm’s overseas business under alternative modes of entry. The two intercepts on the vertical line, $e$ and $f$, represent the fixed cost of entering and maintaining business in a foreign country. This cost is higher when the firm chooses FDI because of large initial investment. The two lines are both upward-sloping due to variable costs of operation, of which the most important are production and transportation costs. A steeper slope of the export line reflects higher transportation costs.

According to Panel (a), when the size of foreign business is smaller than $A$, firms export from their home country. Once the size of their business has reached $A$, however, these firms establish a foreign subsidiary, through greenfield investment or M&A, and start serving the local market directly. This analysis is consistent with the fact that turnovers of MNCs are often considerably larger than those of purely domestic companies.

Nevertheless, FDI is riskier than exporting in that MNCs’ affiliates are subject to a foreign country’s tax and regulatory regime over which they have little control. Moreover, if the host country is rampant with corruption and red tape, establishing and running a foreign affiliate may involve considerable time and expenditures. In Panel (b), this effect is illustrated as a counter-clockwise shift of the FDI line, which shifts the cut-off point $A$ to the right on the horizontal axis. Arguably, this is one reason why low-income countries receive so little inward investment despite their cheap and abundant labor.

**Why does Japan receive so little inward direct investment?**

In Japan, inward FDI remained anemic in spite of the country’s large and sophisticated market. According to Figure 4, Japan’s outward FDI stock stands at 28 percent of its GDP while its inward FDI stock remains at a mere 4 percent of its GDP. This asymmetry between outward and inward investment suggests that jobs created in foreign countries by Japanese MNCs are not compensated for by jobs created in Japan by foreign MNCs.

In 2013, the Japanese government set the target of doubling the stock of inward investment to ¥35 trillion by 2020. At the end of 2017, the stock stood at ¥30.0 trillion. In recent years, foreign firms entering the Japanese market has been outnumbered by those liquidating their previous investment and leaving Japan. According to an annual survey by the Japanese Ministry of Economy, Trade and Industry (METI), the main factors
preventing foreign firms from expanding their business in Japan include high business costs, the exclusivity of the Japanese market, and difficulties in hiring suitable local (meaning Japanese) personnel.

**Figure 4. FDI stocks in OECD counties (2016)**

(Source) UNCTAT, UNCTADSTAT (http://unctadstat.unctad.org/EN/).

**Figure 5. Why do foreign firms not expand their business in Japan?**


What is apparent from the METI survey is that Japan’s unpopularity among foreign MNCs is related closely to the country’s deep-seated business and employment practices. For example, the traditional Japanese practice of *lifetime employment* and *seniority wages* makes it difficult for competent Japanese businesspersons to move to foreign-affiliated firms in the middle of their careers. Similarly, Japanese firms’ emphasis on long-term business relations prevents affiliates of foreign MNCs from expanding their business in Japan swiftly and earning profits that satisfy their parent companies. To the extent that this is the case, it is unlikely that large net outflows of corporate investment and employment opportunities from Japan to foreign countries will be reversed in the near future.

**Suggested Readings:** Reinert, Chap.9, 10, 11; Sawyer & Sprinkle, Chap.6.