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Major Trends in the Explanation of Direct International Investment

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MAJOR TRENDS IN THE EXPLANATION OF

DIRECT INTERNATIONAL INVESTMENT

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MARK GRIER

THESIS

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INTRODUCTION

This paper deals with the reasons for the existence of what have come to be popularly called multinational corporations, and provides a review of contributions to the literature that is concerned with explaining their existence. More specifically, I will discuss firms that have physical facilities in more than one country. They have invested across national boundaries, and own or control affiliates in countries other than the country in which they originated. This ownership may be complete, or it may be shared with others, either within the country of the affiliates domicile, or internationally held. The specific ownership characteristics are important, but will not be considered here. Rather, the characteristic that is important for this discussion is that the foreign affiliate be part of a coherent, integrated production or marketing entity, with products, personnel, and policies in common with the parent firm.

The parent firm is that firm which initiates direct foreign investment. It is a firm that is established in one country, and then expands to other countries by establishing facilities in those countries. The country in which the parent firm is initially established is called the home country for that firm. The home country is generally associated with the firm as a whole, and specific affiliates may have different home countries within the same firm, if it is advantageous for the affiliate investment to initiate from some country other than the country of origin for the corporation as a whole. Generally though, the home country will be that country in which the original parent company began, and the country from which the corporation is managed.

The term affiliate will refer to any firm associated with another, and other than the original, or parent, firm. All facilities that are within one country and controlled by a central management will be considered to be part of the same affiliate; e.g., a Volvo factory in Chicago would not be considered as a separate affiliate if Volvo had other facilities in the United States. Rather, it would be part of the American affiliate of Volvo.

The host country will be the country that is the recipient of direct foreign investment. It is a country other than the home country in which a corporation has affiliate operations, and is associated with a specific affiliate.

The source country or source firm is the firm or country from which an investment or innovation is initiated. Source countries are those from which investment originates, and when that country is other than the home country for the corporation the terms refer to different countries, and otherwise they refer to the same country. A source firm is a firm that is responsible for the developement of a patent, and the originator of methods using that patent.

A patent is any advantage that one firm has over others in the induatry. It may be in the form of a legal patent on some product or process, or it may be an advantage that is not legally protected. The nature of patents depends on the country with which a firm is involved.

A management technique, for example, that is not an advantage over firms in the United States because it is widely used would not be a patent in the United States. However, the same technique might be a patent in Nigeria if it is not generally in use, and a firm using it would have an advantage over domestic firms.

There are three main approaches to the problem of explaining why multinational corporations exist. The first is the survey approach, and involves the application of survey techniques to the problem. There have been several attempts to determine the motives behind the direct foreign investment by asking the firms that have foreign affiliates why they established those affiliates. The results have been less than ideal. The surveys show many reasons, and different surveys emphasize different motives. They are, for the most part, not consistent with each other, and it would seem that the results depend to a great extent on the particular corporations that are questioned. I have chosen to discuss in detail one particular survey, by Brooke and Remmers, because it is somewhat unique in that it has a great deal of emphasis on the defensive motives of the foreign investors. Defensive motives are mentioned in other surveys, but they are investigated most thoroughly by Brooke and Remmers. Other surveys tend to mention specific advantages and aggressive motives more frequently, and they are mentioned in connection with the second approach.

The second approach involves the application of general business theory to the multinational form of business organization, and focuses on the functional advantages enjoyed by multinational firms relative to uninational firms. Given the dispersion of raw materials, and the cost and market differences in the world, the multinational organization is presented as the best structure for expansion and security. Many of the advantages were mentioned as reasons for expansion in the surveys, and this approach seems to provide the best information about the nature of the affiliate operations, and the reasons for their existence.

The third approach involves the application of economic theories to the direct international investment. Capital theory, international trade theory, location theory and oligopoly theory, as well as portfolio theory, are the most popular applications. The first three are generally able to explain the existence of affiliates in certain areas, but are not able to explain the ownership characteristics of multinational firms. Portfolio theory, which is related to capital theory, uses the risk minimizing argument to explain why investment is dispersed among countries. This argument falls into line somewhat with some of the defensive motives mentioned in surveys, and helps explain some of the ownership characteristics. For the most part, though, their ~~there~~ theories do little to help with the understanding of direct foreign investment by established firms.

The most promising theory contributions are from the theory of industrial organization. This theory attributes monopoly and oligopoly motives to the firms that invest across notional borders. This theory is consistent with many of the advantages discussed by the advocates of the functional approach. The multinational firms invest in foreign markets because they have some competitive advantage over other firms in the same industry in the foreign country. This is related to the advantage approach discussed earlier, and also to the theories involving the more profitable use of capital. There is still a need for expansion of this type of theory, but many economists think that it provides the right approach.

Another theory, related to the ideas in capital theory and oligopoly theory, is that presented by Aliber involving the currency differences involved with international investment. He makes some contributions to the theory of the value of foreign investments, but does not shed much light on the theory of ownership; I discuss his theory at length because little has been written about it.

CHAPTER I

THE SURVEY RESULTS

The results of a survey taken by Brooke and Remmers[1] provide some especially interesting information about the motives of the multinational corporation. The survey was taken between 1964 and 1969, and involved the questioning of senior executives from a number of multinational firms. In all, the survey included representatives from about eighty manufacturing firms and thirty banks. Most of the firms were very large, with 80 per cent having assets over 150 million dollars, 30 per cent over 1.5 billion. They represented nine different nationalities, and affiliates were located in seven European countries and the United States. Manufacturing industries represented included chemicals, electrical equipment and electronics, machinery, office equipment and computers, paper, textiles, automotive products, food, mining and oil.

According to the authors there are two especially interesting points that are indicated by the survey results. The first point is that very often the actual decision to begin multinational operations was made often almost by chance, or because of some factor other than specific planning for such a move. Approaches from foreign businessmen, anti-trust suits, and taking over a company that already had operations in other

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[1]The survey method is dicussed in the Appendix of the book, and on page 227. Brooke and Remmers, The Strategy of the Multinational Enterprise (New York: American Elsevier Publishing Compnay, Inc.).

countries were often cited as factors leading to the firm's international operations. The influence of strong personalities within the firm also played a role in the firm becoming multinational.

Defensive Motives

The second interesting point is that most firms cited defensive motives for beginning multinational operations. Many of the executives said that they began multinational operations to protect existing markets or to provide greater security for their stockholders. Although they are often thought of as aggressive businessmen searching for new markets to conquer, the senior executives in many large firms appear to see themselves as very cautious risk averters trying mainly to protect their existing markets and provide additional security for their stockholders.

General reasons for market protection and security seem to stem from the actions of governments, or the fear of the possibility of actions by governments. The reason most often mentioned by those interviewed for operating abroad to defend an existing market involved the problem of tariff barriers. Another reason cited under the same category was the need to manufacture overseas because of nationalistic pressures. Other frequently cited reasons for operating abroad to protect existing markets include: transport costs and delays, difficulties with agents, the need to ensure adequate supplies of raw materials and components, and the need to operate internationally because either customers or competitors were doing so. Less frequently mentioned reasons included legislation (in the home country or abroad) against monopolies or trade agreements, problems with service and other technical difficulties abroad, and the need to protect patents.

The primary motive mentioned in this survey with respect to the protection of shareholders involves both geographical and product diversification. This was compared by one executive to "parlaying one's bets" at the race track,[2] and simply means that the risk is spread out both in terms of geographical distribution and product diversification.

The Protection of Existing Markets

By far the most common reason given in this survey for beginning international operations is the need to protect existing markets. Executives interviewed by Brooke and Remmers see actions by governments as the greatest threat to their existing operations. Presumably this fear is based on the possibility that a government may attempt to protect local industry through the establishment of some type of barrier to trade. This assumption is supported by the fact that tariffs and import controls were seen as the greatest threats to the existing markets. In the absence of the fear of the imposition of higher tariffs or more strict import controls the establishment of local manufacturers would still be favored if any tariffs were in existence. It appears then that it may be barriers to trade rather than free trade that leads to the establishment of multinational corporations.

If there were no barriers to trade, firms in manufacturing might be reluctant to establish a number of different manufacturing locations simply because of the advantages in many industries of large-scale production. Trade barriers that favor local manufacturing may force firms

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[2]Quoted from the survey results by Brooke and Remmers, Ibid., p. 225.

to build several plants, each in a different country, and each of less than optimal size, to remain competitive.

Besides the specific legislation designed to promote local industry, nationalistic pressures were also listed as a reason for the need to produce abroad to protect existing markets. The government of a country may be reluctant to award contracts for manufacture outside of the country, so often the lucrative government contracts go only to firms manufacturing within the country.[3] The private sector may also have the same bias, and local manufacture would be beneficial. The possibility of the adoption of local standards may also be listed under nationalistic pressures. Firms far removed from the market may not be able to exert influence as the standards are adopted, and it may be difficult for them to adjust to changes in the standards and to other changes in the market.

The general public may also have opinions about products that are manufactured abroad that they may not have about products that are identical but manufactured locally. During the 1950's and 60's the words "Made in Japan" appeared on many inexpensive products selling in the U.S., and came to be associated with cheap, shoddy products, an image that was detrimental to Japanese producers, especially when they began to manufacture quality electronic products. A reverse type of nationalism may also exist. This "reverse nationalism" would involve a situation where products are favored that are manufactured in a foreign country. The Germans enjoy a reputation for making well-engineered products of superior quality, and as a result are able to sell a large number of automobiles in the United

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[3]This is a point made by several authors, and mentioned frequently in the literature. It is mentioned specifically as a motive for expansion by some firms interviewed by Brooke and Remmers. Ibid., p. 231.

States for very high prices. The establishment of local manufacture is not favored under those conditions, but it is favored when the public prefers local manufacture.

Problems of transportation were also mentioned by many as leading to the establishment of foreign operations. One small engineering company began its overseas operations with marketing subsidiaries in several foreign countries, with laboratories and manufacturing still in the United States.[4] The marketing subsidiary grew into a manufacturing plant first in Australia, where a great deal of expense for transportation was eliminated. The great distance involved made the transportation costs significant for the marketing of their products in Australia. The same firm also was in the process of building an overseas manufacturing plant to serve the European Common Market, again the result of transportation costs and delays.

The establishment of manufacturing facilities close to the market becomes more lucrative as the costs of transportation rise. Large, heavy equipment that is expensive and difficult to transport may lead to the establishment of overseas manufacturing concerns. Production overseas by such corporations as Caterpillar, Ford, and General Motors provides a good example of production moving closer to the market to avoid transportation costs and problems. As the foreign automobile manufacturers gain a larger share of the U.S. market, they are beginning to plan for manufacturing concerns within the United States, Canada or South America in order to avoid

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[4] The case history of this particular firm was related to Brooke and Remmers in their survey. Ibid., p. 232.

some of the costs involved in the importation of automobiles. Volkswagen has a plant in operation in Brazil, and Volvo is planning to manufacture automobiles within the United States.

Transportation costs may also be very high for firms manufacturing highly specialized products. Rapid transportation needs may necessitate transport by air, which is a very expensive method. Electronic components are often of this type, and may also be fragile and not easily shipped. Manufacture close to the market provides an obvious advantage for makers of that type of product.

Another problem related to the problem of transport involves agents. A company that wishes to enter the foreign market without establishing operations outside of the home country may try to market its product through a foreign agency. A number of firms in the survey mentioned problems with these foreign agents as providing them with the initiative, or the need, to begin overseas operations of their own. There are a number of problems that can be foreseen as possibly arising as a result of the use of overseas agents to market domestically-manufactured goods. The first involves the additional cost of retaining an overseas agent. Transportation costs must be added to the agent's fee in order to establish the foreign price, and this may make the product unable to compete with locally-manufactured goods. Besides the obvious problem of the additional cost of foreign agents, other difficulties may arise. The output of the foreign agent may not be high enough to justify the expense and inconvenience involved for the company to begin the foreign sales. Effort put forth by the agent may be minimal, while the manufacturing company may have to do a great deal in order to begin sales abroad. Agents may also provide unsatisfactory contacts with customers. A lack of thorough knowledge about the product line, related products, and service facilities may lead to a poor record of sales and a bad reputation for the product.

The problem of the contact with the customers, especially if it relates to follow-up and other technical service was also mentioned by many firms as helping to lead to overseas operations. As was mentioned above, the overseas agent can provide little in the way of service and information that must be a necessary part of the sales of specific products. The establishment abroad of manufacturing facilities provides an immediate service of technical advisement and a facility from which service can be performed. This may be especially important for firms in such manufacturing areas as business machines (office equipment), computers, and engineering.

Another motive listed involves the protection of patents. Again, this is especially important to technically-oriented firms. Patents registered and used in a foreign country are generally enforced,[5] and it may be in the best interest of a firm to register and use a patent in as many countries as possible in order to avoid the possibility of a firm manufacturing a product in a country that does not offer patent protection to the originator of the product. This may be done indirectly by licensing a firm to use the patent in a country where the original firm does not have production facilities.

Another motive listed under defensive motives is that of the need to ensure the supply of raw materials. "Whenever materials or components

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[5] Ibid., p. 232.

are scarce, there is a tendency for companies to buy up their suppliers."[6] This, then, is mainly a pressure to operate abroad only when certain raw materials or components are involved--that is, those that are supplied exclusively or primarily by foreign firms. The need to maintain a reliable source of inputs may lead a firm to become vertically integrated, with raw materials as the inputs, and finished products as the outputs. This may become an increasingly important motive as various materials become scarce, or as the sources of inputs are controlled by very unpredictable individuals, nations, or companies. As world commodity markets become more and more volatile, firms will begin to integrate vertically in order to gain some security with respect to quantities and prices of inputs.

Vertical integration on an international scale is not without its problems. The immediate problem is that it may reduce to some extent the flexibility of the firm, as far as seeking other input markets and limiting the possibilities of a complete global strategy.[7] Firms become committed to certain suppliers and certain inputs. The expansion of a firm into other aspects of production such as are involved in vertical integration may also lead to other commitements or relationships with firms and governments abroad. These further commitments may not be in the best interest of the company, but may have to be undertaken if the input situation is such that vertical integration is the only way to stabilize the input conditions for a firm and provide some quantity and price security.

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[6] Ibid., p. 232.

[7] Clearly a firm would be committed to purchase inputs from its own subsidiaries, to the exclusion of other possible suppliers.

The final motive mentioned under the category of defensive strategies taken to protect existing markets involves the actions of related firms. It was stated by some surveyed that the fact that a customer, competitor or supplier was going multinational was the reason that they decided to do so. Action taken for this reason means that the executives felt a need to keep up with the actions of related firms. The need to maintain facilities that were suited to those of the customers was cited as the strongest influence. Clearly full service is essential, and the expansion of several very important customers into the international market would make expansion essential in some industries and desirable in many others. Service-oriented industries might see a special need to expand to provide facilities for customers in all markets in which the customer participates, as it may be best for the customer to award service contracts to only one multinational firm rather than to many firms, each operating within just one country.

Security Motives

The last two defensive pressures mentioned involve the desire to provide as much security as possible for shareholders. The primary strategy here involves geographical diversity. The basic concept behind this diversification is that if a corporation operates in enough different countries any market fluctuations will be offset by other fluctuations. For example, a recession in one country would be offset by an expansion in another country, or by several small expansions in a number of other countries. The result is supposed to be a stable, and rising profit situation.

Product diversity also is supposed to provide greater security for stockholders, but product diversity is not necessarily related to the need for international operations.

The Australian Case

A good example that supports the emphasis given by Brooke and Remmers on the defensive nature of the many motives for international expansion involves the case of foreign investment in Australia, as discussed by Donald T. Brash.[8] There is a great deal of foreign-based activity in the Australian economy. In 1965 it was estimated by the Federal Minister of Works that foreign companies enjoyed a share of 95 per cent in the automobile market, 55 per cent of motor parts and accessories, 83 per cent of tele-communications, of pharmeceuticals and toiletries, 97 per cent, of soap and detergents, 80 per cent, and of petroleum refining and distribution, 95 per cent.[9] It is estimated by Brash that by the mid-sixties 26-27 per cent of the total company income after taxes was payable abroad. This is compared to 18-20 per cent in the early fifties.[10]

Australia had during the time of the greatest inflow of foreign capital (1950's and 60's) many very favorable characteristics according to the article. First of all, Australia has a very stable political environment. She has a federal structure of government, like the United Kingdom.

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[8]Quoted by Donald T. Brash in "Australia as Host to the International Corporation," Kindleberger, C. P., Editor, The International Corporation (Cambridge, Mass: M.I.T. Press, 1970), from data of the Australian government, p. 296

[9]Ibid., p. 296.

[10]Ibid., p. 296.

The most popular political party in those years had been a conservative party, favoring economic development through the encouragement of the private sector. English is the only language spoken by most of the people, and the legal system, like that of the United States, is based on the British system. Brash also cited intangibles as making for a friendly climate for investment, especially from the United States and the United Kingdom. He says that Australia shares a common history and membership in the Commonwealth with Britain, and some of the same history and mutual interest in the stability of the Pacific region with the United States.

According to Brash, economic performance of the country made it very attractive to investors. He cites the following statistics put out by the Australian government to support his statement. Australia grew by about 5 per cent during the fifties and by more than 5 per cent during the sixties. By the mid-sixties the per capita GNP had risen to $1,840, one of the highest in the world. The ratio of gross investment to GNP has also been high, and by the late sixties had reached 26 per cent. The population has also grown at a rapid rate for an advanced country, almost 2 per cent per year. Australia has also enjoyed virtual full-employment, with unemployment below 3 per cent during the sixties. The rate of inflation was a modest 2 1/4 per cent annually between 1960 and 1968. The country also lost work days due to strikes at a rate of only 331 days per 1000 workers, about one-third of the U.S. rate for the same period (1957-1967).

All of these good characteristics were enhanced by the great mineral discoveries of the sixties. At the beginning of the sixties Australia imported virtually all of its oil, nickel and phosphates, and there was a ban on the export of iron ore for fear of depleting the thought to be limited reserves. By the end of 1970 Australia was supplying 67 per cent of her oil needs from domestic wells, and was exporting iron ore, nickel and phosphates. Proven bauxite reserves were the largest in the world.

That gives Australia three very favorable characteristics with respect to investment, including foreign investment. According to Brash, "neither growth prospects nor mineral discoveries was a sufficient condition for much of the foreign investment that has taken place in the manufacturing sector."[11] He says that "the additional element needed in most cases was some form of trade barrier, because in the absence of that, or some Australian cost advantage, there would be nothing to prevent most international corporations /from/ taking advantage of the growing Australian market through exports from their home base."[12] Survey results tend to support this conclusion. A survey taken by Hagan of British firms that had invested in Australia came up with results similar to the survey by Brooke and Remmers. Over half of the firms questioned (53 per cent) mentioned import controls or tariffs as a "very important" motive for establishment of facilities in Australia. Long-term market growth was listed by most of the other firms as the main motive.[13] Brash surveyed American firms that had operations in Australia, and again, over half of the firms

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[11] Ibid., p. 297.

[12] Ibid., p. 297.

[13] Quoted by B. L. Johns, "Private Overseas Investment in Australia: Profitability and Motivation," Economic Record, Vol. 43 (June 1967), p. 259.

listed trade barriers as an important consideration in their decision to invest in Australia.[14] This would also tend to support the argument that a great deal of direct foreign investment is a result of governmental actions designed to establish trade barriers, with the foreign investment then a defensive countermeasure against the established or expected trade barriers.

Aggressive Motives

Certain motives are also discussed by Brooke and Remmers that are described as aggressive. In their particular survey no motive categorized as aggressive was mentioned as often as the most frequently mentioned defensive motives discussed above, but there are several that should be mentioned. The most frequently mentioned aggressive strategy involves the more profitable use of underemployed capital and equipment. A firm faced with limited investment prospects at home may be expected to search for the most profitable use for its capital; this may involve the purchase of a foreign company, or a joint venture whereby the firm with the excess capital (financial capital) will aid in the expansion of a foreign firm that is unable to finance the expansion without some outside help. To a limited extent this may also be applied to personnel. A firm with talented individuals not being used to full capacity may seek outlets for this talent, and expansion into the international market may be the solution. Firms also mentioned the possibility of more profitable use of knowhow as a motive for expansion. This may include several different kinds of

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[14]D. T. Brash, American Investment in Australian Industry (Cambridge, Mass.: Harvard University Press, 1966), pp. 34-40.

knowhow. First of all, more efficient or advanced managerial techniques may lead a firm to believe that there exists a possibility that it may be able to operate more efficiently in a country than those firms that are already there in the same industry, leading it to establish operations in that country in order to take advantage of its superior management skills. Knowhow that it wishes to put to more efficient use may also be of a technical nature. In addition to the use and protection of patents a firm may also have knowledge of more efficient methods of production than those currently employed in a foreign market, making it possible for it to begin foreign operations in a favorable competitive position. A firm that must purchase new equipment in order to maintain its position in the domestic market may be able to use the equipment that is replaced, which may be obsolete in the domestic market, to begin production in a foreign country if that equipment can produce competitive goods relative to those being produced in the country.

The second major aggressive strategy mentioned involves the search for a coherent world-wide policy and general strategy regarding both input and output markets. This motive relates to the defensive motive of ensuring adequate supplies of raw materials, especially as the corporations consider the opportunities and advantages that are gained from having access to global input markets. This provides much more complete knowledge about where a product can be manufactured most cheaply. A firm can take into account all political (trade barriers) and economic (cost) conditions to determine the cost of the product from many different locations. Foreign subsidiaries also provide access to information about world conditions that may not be gained unless such a close affiliation with other countries is maintained. Another benefit of having affiliates in foreign countries is that a corporation may gain access to government contracts that would not have been awarded to a firm without local manufacturing facilities, as was mentioned above.

Other Motives

Certain other pressures are mentioned by Brooke and Remmers as providing motives for expansion into foreign countries. Again, these motives were not mentioned as often as the defensive motives previously discussed. One general motive mentioned was that the executives felt a need to expand; in order to grow when domestic and export markets are not easily enlarged a firm must seek foreign operations. According to this survey this expansion usually involves the purchase of foreign companies (as opposed to the establishment of a new affiliate abroad) or corporations manufacturing products that are used primarily in a developed economy will expand as development takes place in foreign countries.

Governmental concessions are not considered to be a significant factor in the formation of multinational corporations according to this survey. Incentives provided by governments, such as tax breaks, loans, and grants were mentioned only once or twice by the executives interviewed as motives for expansion. This would lead one to conclude that the negative actions of governments (the establishment of trade barriers) play a greater role in the establishment of multinational corporations than do the positive actions (inducements).

CHAPTER II

THE MARKETING ADVANTAGES AND OTHER FUNCTIONAL ASPECTS OF MULTINATIONAL ORGANIZATIONS

According to a number of other authors, and the results of other surveys, the last conclusion may be in error. Many authors, especially Kolde, emphasize the market differences as a major motive for international expansion.

Market Access

Kolde cites the results of a survey taken by him in 1959 which tried to determine the reasons for expansion into the international market.[15] Fifty-three per cent of the respondents cited the need to gain access rights and marketing capabilities in foreign countries as the major motive for the establishment of foreign affiliates. Ninety-three per cent of those firms in what Kolde describes as market-oriented industries listed the need to acquire unimpaired marketing access as the reason for establishing facilities within foreign markets. Only 31 per cent of the firms said that they had established affiliates in order to overcome legal trade barriers and trade restrictions. Sixty-two per cent of the foreign affiliates had been established in order to provide better contact with the local market; to overcome the market "discontinuities" that occur from one country to the next.

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15 See Kolde, Endel, J., International Business Enterprise (Englewood Cliffs, N.J.: Prentice-Hall, 1973), pp. 161-168.

Kolde is discussing primarily firms that are market-oriented, as opposed to firms mainly involved in resource extraction and processing, or firms concerned with intermediate rather than final products. According to Kolde, access to new markets provides the source of growth for market-oriented firms. It is assumed that those firms which are concerned with the extraction of raw materials from the earth will expand as is necessary to maintain access to those raw materials.

The concept of market discountinuity plays a major role in Kolde's discussion of the advantages of multinational over uninational corporations. National boundaries present two major problems for market-oriented firms, according to Kolde. The first problem involves the official border controls and legal restrictions, as well as any other regulations that may apply to the shipment of goods. It is this barrier that was discussed, and considered most important, by Brooke and Remmers. According to the advocates of the marketing motives the international border also represents a breakoff point for various other factors, especially the technological, economic and cultural factors that make the market different in ways that are not geographical, providing another barrier that must be overcome.

Simple access to a country, that is, the ability to import goods, is only the ability to meet all legal requirements for importation. It does not necessarily mean that a firm can market goods in that specific country. Differences in technology may make a product that is useful in one country less useful, or of no use, in another country. Economic differences may make products that are necessities in one country luxuries in another country because of differences in income. Cultural differences may make for very wide differences of opinion about the value of the same product in two different countries. Differences of this kind may significantly affect the price that consumers are willing to pay for a product and the marketing methods that must be used. A firm must have the ability to successfully meet the legal requirements and must be able to deal with the discontinuities that exist from one market to another effectively. It is argued by those who say that the market expansion problems provide the main incentive for the establishment of foreign subsidiaries that the multinational corporation enjoys a very great advantage over the uninational firm with respect to the market discontinuities. This advantage is called access capability by Kolde, and the ability simply to meet the legal requirements is called access right.

It is argued by Kolde that uninational firms can never overcome the barriers needed to gain access capability to a foreign market, but that they can only try to minimize the problems that arise. On the other hand, a multinational firm can market effectively in a foreign country because its affiliate there will have the necessary contact with the country to deal with the market discontinuities. Local manufacture will allow a firm to adjust to local conditions, and to gain a much closer relationship with the market. Local changes can also be better dealt with by a firm with a local subsidiary. Multinational firms, then, develop because they are better able to expand than a uninational firm that is trying to expand by increasing exports, according to Kolde, and others.

Other surveys tend to support the proposition that market expansion is one of the most significant factors leading to the establishment of foreign subsidiaries. In a survey by Robinson in 1961[16] the market growth potential was mentioned as a motive twice as many times as the trade barriers were mentioned and all marketing factors were mentioned almost four times as often. The availability of labor and other cost factors were also mentioned much more often than the trade barriers, and a favorable investment climate was more often cited also. A survey by Behrman in 1962 had similar results, except that the investment climate was not listed as often.[17]

A survey by Basi in 1966 came up with some interesting results. The investment climate was mentioned as a factor nearly one and one-half times as often as any other factor.[18] The marketing factors and cost advantages were listed virtually the same number of times, and the barriers to trade were not mentioned at all by the 214 firms that were involved in the survey. The availability of raw materials was listed as the most important cost advantage in this survey, as opposed to the availability of labor that was the most significant cost factor mentioned in the survey by Robinson five years earlier.

In a 1972 survey Forsyth found that the marketing factors were by far the most important determinants of the foreign investment.[19] The

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[16] Robinson, H. J., The Motivation and Flow of Private Foreign Investment (Calif: Stanford Research Institute, 1961).

[17] Behrman, Jack, "Foreign Associates and Their Financing," in MiKesell, R., Editor, U.S. Private and Government Investment Abroad, (Portland: Oregon University Press, 1962).

[18] Basi, R. S., Determinants of U.S. Direct Investment in Foreign Countries (Kent University Press, various pages).

[19] Quoted by Dunning, J. H. in "The Determinants of International Production," Oxford Economic Papers, Vol. 25 (Nov. 1973), pp. 296-297.

barriers to trade were mentioned by about 25 per cent of the firms questioned, and only about 4 per cent mentioned any cost advantages.

The results of these four surveys tend to indicate that firms expand into multinational forms for many, and varied reasons. It would appear that the advantages mentioned by all of the surveys must be considered as reasons for the existence of multinational corporations. They must be considered as factors that make a multinational corporation somehow better than a uninational corporation, for if there were no advantages there probably would be no multinational corporations.

Generally the avaoidance of tariffs and other trade barriers must be considered as an important factor, and especially as an advantage that a multinational firm has over a uninational firm that is trying to export goods.

The possibility of an expanded market must also be considered important. Here is where Kolde's "access capability" concept becomes important. A firm gains several direct marketing advantages when it has an affiliate in a foreign country. They especially include the ability to adopt better to local conditions in the market; better market information; more efficient warehousing (lower inventory and shipment costs); more efficient advertising; better customer contact, especially for service and technical assistance; and less sales resistance because of nationalistic pressures.

Strategic Flexibility

A 1970 study by Kolde also listed strategic flexibility as an important reason for the establishment of foreign subsidiaries. With affiliates in each country that a firm markets products, there is a much greater ability to adjust marketing strategies to changing conditions. This, again, is presented as an advantage over the uninational firm, which must take into account any trade controls and domestic sourcing limitations. It should not be assumed that the multinational firm is not subject to such limitations, but it is emphasized that a multinational firm enjoys a great deal more flexibility with regard to its operations than does a uninational firm. The multinational firm may operate almost as a uninational firm, with a great deal of marketing activity from one country to another, or it may operate as so many separate firms, with a high degree of separation between markets. Between these two extremes the multinational firm has a wide range of choices while a uninational firm is able to produce in just one country and export to others.

Marketing Advantages

In addition to the international advantages of the multinational firm this discussion has also mentioned the marketing advantages that a multinational firm enjoys over a uninational firm in a specific country. In addition to the flexibility enjoyed with respect to the marketing of existing products this also includes more flexibility with regard to the introduction of new products. Facilities in foreign countries provide two major advantages for the multinational firm in this respect. First of all, the multinational firm has access to a number of different test markets through its facilities in different countries. A uninational firm has access only to its domestic market unless it is willing to become involved with a foreign firm in order to test foreign markets. The lack of its own marketing capacity abroad makes this market testing a difficult procedure, and it is limited to those countries in which there exists some mechanism for testing new products. A multinational firm, on the other hand, is limited only by the number of foreign affiliates that it has. If it has facilities in many countries, it may be able to choose as a test market a large, medium or small country; one that is developed, developing or underdeveloped; or one of different racial or religious background or any other charactersitic that the firm wishes to test. These facilities, then, provide additional advantages with respect to the introduction of a new product. World-wide facilities also give a firm a great advantage when a new product is to be introduced into many markets at once. This is known as the "big-bang" approach in marketing, and a uninational firm would be severely limited in its ability to use this strategy on a world-wide basis, while a firm with many foreign subsidiaries is well-suited for a sudden global introduction of a new product. According to Kolde, the only marketing strategy that a uninational firm can use as effectively as the multinational firm is the method whereby a product is introduced gradually into different markets, usually going into just one market at a time. Again the multinational firm enjoys the ultimate advantage here because it has the superior ability to test markets and may have considerably more knowledge about each market into which the new product will be introduced. It is advantageous when introducing a new product into markets one by one to introduce it in an order such that each successive market is the most similar to the previous market of those remaining.[20]

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[20] Kolde, E. J., The Multinational Company (Lexington, Mass: D. C. Heath and Company, 1974), p. 53.

The second major specific marketing advantage that a multinational firm enjoys involves the production flexibility gained from having production facilities in many different countries. Product changes can be made much more easily to conform with local demand, and local specifications. Simple changes, such as label translations and different voltage requirements for electronics products may not present a great problem for a uninational firm, but when major product changes must be made, for whatever reason, to conform with the local market, the firm with local manufacturing facilities gains an advantage. The multinational firm has the option of producing the same product for all markets, or differentiating the product for regional, national or any other market. Again, the uninational firm may be able to somehow accomplish the same product differentiation, but the emphasis is on the advantage that the multinational firm enjoys over the uninational firm.

These advantages combine to give the multinational firm both marketing and production advantages in foreign countries over the uninational firms. The multinational corporation also has a great deal more access to stimulating input that comes about as a result of its market, marketing and technological diversities. This may give the multinational firm more of a range of new product possibilities than a uninational firm, and as we have already mentioned, a wider range of markets into which new products may be introduced. The market characteristics often dictate the type of products introduced. Kolde cites the introduction of the motorcycle and the small car into markets less advanced than the United States, and the introduction of labor-saving devices into the United States, where labor is expensive. A firm that is extensively involved in marketing in other countries and that carries on marketing research in these countries may be expected to introduce new products that are suited for different economic conditions, while a uninational firm with intimate knowledge of, and access to, only one (the domestic) market will probably not be as innovative as the multinational firm. In the words of Kolde this provides a "head-start" advantage for the more innovative companies.

The head-start advantage is the advantage gained by a firm that is the first to introduce a new product, and gains both production finesse and cost advantages over other firms. A firm that is able to gain such advantages then gains further advantages by establishing production facilities in foreign countries before any domestic firms are able to, and thus gaining an immediately superior position in the market. This position is maintained by innovations in both product and production if the firm can stay ahead of local competition in product quality and cost. Kolde says that the firm will be able to maintain its advantage at least for a while because of its experience in production that no other firm has. Clearly this type of situation leads to the establishment of more and more multinational firms, and is considered an aggressive strategy because a firm is trying to exploit some product or production advantage that it may have over all other firms in a country.

Production Advantages

The need to ensure the supplies of raw materials was discussed earlier as a defensive motive presented by Brooke and Remmers; it must now be considered again as it relates to the positive marketing motives and world-wide strategic multinational advantages that are considered to be so important by the other authors. This again is considered mainly as it is an advantage over the uninational corporation. The major advantage here, as explained by Kolde, is that the multinational corporation has the ability to shift production from one country to another. Certain standardized parts can be produced in those countries best suited for their production, enabling the multinational firm to take advantage of the economies of scale from mass production, but enabling them to still make adjustments in regional or national facilities for local market conditions. According to Kolde, many parts or components can be standardized, enabling a multinational corporation to manipulate its production to make optimal use of the distribution of resources. This optimal combination of production facilities is an option that is not available to a uninational firm, which must rely on the domestic availability of inputs, and will become more of an advantage as raw materials become increasingly scarce.

CHAPTER III

THE FINANCIAL ASPECTS OF MULTINATIONAL ORGANIZATIONS

A motive frequently mentioned in several surveys studied involves the financial aspect of international business. The multinational firm, and its subsidiaries enjoy several advantages with regard to finance. The purpose of this section is to explore the financial avenues open to the multinational firm, and to disucss some of the advantages that a multinational firm has over a uninational firm.

Finance Flexibility

Basically a firm that is established in one country and wishes to establish an affiliate in another country has three general alternatives with respect to the financing of that subsidiary. The first choice is that the subsidiary may be financed entirely from outside of the prospective host country; this apparently seldom happens.[21] The second choice is that a firm may internationally transfer only a part of the intended investment, with the rest of the needed financing being somehow generated from within the host country. This is the most popular method. Third, the entire investment may be financed from within the host country. This third method is becoming more popular, as firms are able to maintain a better relationship with other countries if they can minimize international capital movements.

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[21] *Ibid.*, p. 56.

Finance Within a Host Country

If a firm is to finance and affiliate from within a potential host country, it has three alternatives. It may sell equity shares (stock) within that country; it may borrow; or it may use profits from a firm licensed to operate in that country. Kolde says that this last method is gaining in popularity, and that firms now often set up licensing arrangements specifically for the purpose of generating revenue with which to begin an affiliate operation. Of course, once the affiliate has been established, the reinvestment of earnings becomes another method of financing investment from within the host country.

The results of several surveys, as has already been mentioned, show that the investment climate within a country is considered to be important by a firm when establishing a foreign affiliate. The Conference Board study provides some additional information about the financing plans and attitudes of the firms studied.[22] The study shows that generally U.S. firms think of funds in terms of U.S. capital and foreign (or locally generated) capital when planning foreign investment, rather than in the traditional terms; i.e., internal and external capital. The need to borrow abroad was not listed as a deterrent to investment, however the conditions for borrowing abroad may discourage investment. More specifically, most companies desired some local financing and, in the event local capital was unavailable, would cancel plans for investment rather than finance the project from other sources entirely. Another deterrent to investment listed

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[22] Polk, Judd, Meister, Irene, and Veit, Lawrence A., U.S. Production Abroad and the Balance of Payments: A Survey of the Corporate Investment Experience, The Conference Board; Special Study, 1966, various pages.

was the unavailability of short-term loans. Most companies expressed a desire to avoid borrowing long-term, possibly because long-term borrowing abroad has historically required guarantees from the parent company, and would refrain from investment rather than borrow long-term in the local market, or finance the investment from the home country.

The position of the company in the U.S. market also influenced its method of financing a foreign investment, according to the Conference Board study. Small firms usually were limited in their ability to raise capital in the money markets, and had to rely more on the profits generated by licensing operations than did the large firms studied. New international companies were found to prefer parent company loans to equity sales for financing foreign investment, apparently for two major reasons, mentioned by firms interviewed. It was generally believed by the firms that the interest and principal payments on the loan would be more easily repatriated than would dividend payments to stockholders. They also thought that the fixed repayment schedule associated with the loans, but not with equity sales (dividends are not mandatory), would provide greater incentive for the affiliates to produce.

The method of finance may also be influenced by governmental actions. Restrictions and pressures may be imposed either in the home country, necessitating financing from other sources, or in the host country, possibly causing abandonment of the investment plans altogether. An example of governmental action that casues a change in foreign investment patterns is the imposition in the United States of the Voluntary Foreign Direct Investment Program.[23] The program was initiated in 1965,

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[23]Kolde, E. J., The Multinational Company, p. 56.

and was designed to limit the export of U.S. capital to finance foreign investments. It was voluntary during its first three years, and U.S. firms became very active in the Eurobond market in 1965 in order to comply with the provisions of the program. The controls became mandatory in 1968, and in that year U.S. corporations raised about 21 billion dollars in the Eurobond market, compared with 1.2 billion from the previous three years combined. The government had forced the corporations to seek financing outside of the domestic market by imposing controls on the export of capital. U.S. corporate activity in the Eurobond market diminished somewhat in 1969, as the controls were eased.[24]

The survey also indicates that there are some differences in the financing of foreign investment in developed and less developed economies. Some companies surveyed indicated that they required more local capital for investments in politically or economically unstable economies. Financing in less developed countries does not differ substantially from that in developed countries with regard to the amount of capital transferred into the country compared to the amount of financing done by reinvesting profits.[25]

Generally, then, foreign affiliates are financed at least to some degree with local capital. The amount of local capital used depends on a number of factors. Among them: the cost, availability, and nature (long-term or short-term) of financial capital available in the prospective host country; the size and financial market position of the investing corpora-

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[24] _Ibid._, p. 56.

[25] _Ibid._, p. 56.

tion; governmental influences, either specific regulations or pressures; and the attitude of the investing corporation toward the prospective host country. Most corporations seek to structure their investment financing in such a way as to meet two main objectives. First, they seek to accomplish the desired investment with a minimum of risk to the parent company, and second, they wish to minimize governmental frictions, either home or host. They also have other financial goals, including the minimization of tax liabilities and possible desired distribution of funds among subsidiaries. The financial methods, motives and possibilities of multinational corporations are extremely complex, and I will try to present, in a general way, some of the advantages that a multinational firm has, and some of the manipulations available to a firm with subsidiaries in several countries.

Financial Options

The power of the parent company, the generally high earnings of affiliates, and the ability to transfer funds provide the multinational firm with its main financial advantages. Multinational firms are in a very strong position in the international money market, especially the Eurobond market, for several reasons. The multinational firm has ready access to several currencies, banks, and nations, permitting it to spread the risk around in a manner that is not possible for a uninational firm. This also gives the multinational corporation more flexibility in its issues, allowing it to adjust to meet the current demands of investors.[26]

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[26] *Ibid.*, p. 57.

Flexibility with respect to the currency denomination is especially important. The breadth of the market available to the multinational firm also enables it to avoid a great deal of inconvenience caused by restrictions or shortages in local capital markets.

Another method of raising capital that is open to the multinational firm is the sale in foreign markets of equity shares, or stocks. This is not used to a great extent as yet, but is gaining in popularity. A number of large corporations have their shares listed on several exchanges in different countries, among which are Exxon, ITT, Ford, General Motors, DuPont, Eastman Kodak, IBM, GE, and many others.[27] Issuing stock in foreign countries has two advantages. It allows local finance of investment, and it provides for some degree of local ownership, often a desirable characteristic when dealing with host governments.

Banking has also expanded considerably in the international market in order to keep pace with world-wide corporate expansion. Many U.S. banks opened branches in Europe in order to serve U.S. corporate interests there. These U.S. affiliates are the primary repositories of Eurodollar holdings (estimated at over 70 billion dollars), and since they are there primarily to serve the overseas interests of U.S. corporations, the affiliates of those corporations have access to a very large money market.[28] Large multinational firms also have an advantage in the money market because credit extension often depends on the credit rating of the parent company.

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[27] Ibid., p. 58.

[28] Ibid., p. 58.

The following table shows the diversification in the financing of foreign affiliates of United States-based corporations.

Sources of Funds for U.S. Direct Investment Abroad
Manufacturing Affiliates

Per Cent of Total	1950	1957	1966
Retained Earnings	20.5	14.9	19.8
Depreciation and Depletion	28.7	28.6	38.9
Funds from U.S.	11.8	22.2	4.4
Funds from Abroad			
from foreign affiliates	1.6	3.1	1.4
from financial institutions	9.4	15.3	6.5
other foreign sources	21.1	10.3	23.5
Issue of Equity Shares	5.2	.0	2.8
Other Sources	1.7	5.6	2.7
Total	100.0	100.0	100.0

Source: U.S. Direct Investment Abroad 1966, U.S. Department of Commerce Census, 1966, and Survey of Current Business, November 1971. Computed from various pages.

As the table indicates, the manufacturing affiliates were not financed to any great degree with funds from the United States, with only 4.4 per cent from the U.S. in 1966. Retained earnings and depreciation/ depletion are methods of financing that are internal to the affiliate, and were major sources of funds during each of the three years studied. The internal financing methods were used to a greater extent in 1966, apparently instead of some funds from the U.S. Foreign sources provided about 30 per cent of the funds in each year studied, although the sources of these foreign funds varied. The increase in the percentage listed under "other foreign sources" from 1957 to 1966 is due to the increase in U.S. corporate activity in the Eurobond market in the 1960's, as discussed on page 29.

The Stobaugh Study

In a study of the financing of multinational affiliates Stobaugh found that several variables affect the financing methods of the corporations.[29] Size is apparently one of the most important factors. He found that small multinational firms (those with about $50 million in foreign sales, representing about 18 per cent of total sales and manufacturing affiliates in eight foreign countries) were generally decentralized with respect to their foreign operations. They tended to view each subsidiary as an autonomous unit, and finance plans were made at the local level, in the absence of an overall corporate finance plan. Affiliates of these firms tended to rely mostly on retained earnings and local borrowing to finance investment. Although some firms used non-bank sources, most of the borrowing was done from local banks, indicating the use of relatively few sources.

The medium size multinationals (ones with foreign sales of $200 million, representing 29 per cent of total sales and with manufacturing affiliates in 14 foreign countries) used a very different approach to their foreign investments. They tended to be centralized, with all investment decisions some part of a unified corporate policy. The "system optimization" program made these firms the most willing to use parent company funds to finance affiliate investment, especially when local credit conditions were not good. The goal of these firms was to maintain central and tight control over the system.

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[29]Stobaugh, Robert B., "The Multinational Corporation: Measuring the Consequences," Columbia Journal of World Business, January-February, 1971, various pages.

The large firms (sales of \$1 billion in foreign markets, representing 30 per cent of total sales, with affiliates in 21 countries) were generally decentralized, with much of the decision making done at the local level. This is probably because of the complexity of the operation, making centralized control too difficult to operate. Guidelines were used to direct the local decision makers somewhat; so the strategy was really somewhere in between the decentralized small firms and the highly centralized medium size firms. The large firms were observed to use a wide variety of financial sources, and were much more likely than the other firms to obtain funds from non-bank sources, especially by issuing bonds in both local and European markets. A guideline used by most firms was to provide the affiliate with a strong borrowing position of its own by maintaining equity equal to fixed assets.

The degree of parent company ownership of affiliates was also found to affect the source of funds used to finance foreign investment. Firms that wholly owned their foreign sunsidiaries were much more willing to use parent company funds than those firms involved in joint ventures. Also, firms involved in very technologically-advanced industries were more dependent on local funds than low-technology firms of similar size. High-technology firms also tended to use non-bank sources to a greater extent than did the low-technology firms.

The Transfer of Funds

The ability to transfer funds presents the greatest possibility of advantage for a multinational firm over a uninational firm. Just as having productive capacity in several countries gives the multinational firm the opportunity to increase or decrease production in one area to the strategic advantage of the whole company, the ability to transfer funds from one affiliate to another gives the firm the opportunity to make optimal use of capital. Any type of funds, short-term or long-term, or different currencies, can be mobilized to be directed into their best use. This becomes and even greater advantage given the access of the multinational firms to the different capital markets. The firm has the ability to borrow from the least expensive source and transfer the funds to the affiliate in need of them.

This transfer of funds may be accomplished in any one of four basic methods. First, one affiliate may charge another affiliate payments against income such as interest, royalties, management fees, or other technical service fees. Second, the affiliate may transfer funds by direct after tax payments, which are usually in the form of dividends. Third, capital may be transferred directly in several ways, including the purchase by one affiliate of equity shares in another, direct loans within the company, or the extension of trade credit. The fourth method involves the transfer of goods from one affiliate to another. This transfer may be made at prices higher or lower than the actual value of the goods transferred, making the transaction an effective transfer of credit. The first and last methods of transfer have a special advantage in that they provide a method for transferring before tax profits from one firm to another. This possibility can lead to the creation of a company that exists in a low tax or low risk country for the purpose of dealing with financial matters, especially the profits of other affiliates. A company that is established for the purpose of transferring funds is called a base company.

Borrowing Ability

The ability to transfer funds gives the multinational firm access to as many capital markets as it has affiliates, and each affiliate has the same access if there are no impediments to the transfer of funds. Additionally, the multinational firm not only can obtain funds from many different sources, it can also raise more capital than could be raised by the affiliates, if each was a uninational company. This is because of the strong bargaining position of each multinational corporate affiliate. The local credit rating of each affiliate depends not only on the assets held in the host country, but depends also on the total assets held by the corporation in all countries. This gives the multinational firm a greater ability to influence the potential lender and makes it possible for the firm to use assets held elsewhere as collateral, in addition to assets held within the lender's country. This gives the affiliate of the multinational firm the capacity to qualify for a larger loan than could a uninational firm of a size similar to the affiliate alone.

Certain conditions might limit the borrowing capacity of the multinationals. For example, if specific collateral agreements are drawn up for each loan, the firm would be limited to the same amount of borrowing as a number of uninational firms with the same total asset value, since each asset could only appear as collateral one time. This is generally not the case. Lenders to large corporations are generally more concerned with the total assets held by the firm, the cash flows, and the competitive position of the firm than they are with listing specific assets as collateral.[30]

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[30] Kolde, The Multinational Company, p. 61.

Regulations also vary from country to country, enabling the financial planners to take advantage of residence and corporate size to gain leverage in financial markets, making it possible for the multinational firm to outborrow uninational firms in most cases.

Governmental Financial Policies

Other factors may influence the financial situation of the multinational corporation, most of them governmenally controlled. Governmental investment policies may influence the distribution of investment in a way that is contrary to the economic comparative advantage. Policies such as guaranteed loans, grants, contributions or allowances for research and development, preferential tax treatment, or any of a number of other incentives may affect investment by their effect on the cost and/or use of capital. Although not mentioned as a great influential factor by most of those involved in the surveys studied, such factors must be considered because they remain as possible influences on international investment.

Any such governmental policies, whether specifically implemented because of their influence on investment or for some other reason, affect the profitability of foreign investment projects. They have, first of all, a geographical effect in that they present additional factors that tend to change the distribution of the "normal" economic comparative advantage. Government policies may enhance the existing comparative advantage of a country, or they may virtually eliminate a comparative advantage. Either would have an affect on the distribution of foreign investment.

Secondly, government policies may also have an effect on investment by industry, as well as by geographic location. Certain favored industries may be made more profitable by selective government policies, and thus would attract more investment. Even if policies are not instituted to discourage investment in certain industries, policies favoring other industries may have that effect by their influence on the relative profitability of investment.

Investment incentive policies simply magnify the existing differences between national financial environments. Each country has its own monetary system, and thus inconsistencies are natural from one country to another. These may all have an effect on the costs and availability of financing, the profitability of investments, and the general financial management of the firm. Each country has its own interest-rate structure, which may or may not be affected by the performance of interest rates anywhere else. Social and political factors that influence the interest rate may be more important in some cases than the pure economics of supply and demand. Again, each country has its own rate making system, and they differ. This presents an environment of constantly changing costs of capital and rates of return, and provides both problems and possibilities for the multinational firm that are not faced by the uninational firm. These national differences that affect both the cost of obtaining and using capital may be used by multinational corporations to their advantage; that is, obtaining funds where the cost of capital is lowest and using them where the rate of return is greatest. The multinational firm is unique in its ability to take advantage of such differences in cost and rate of return on capital.

Multinational firms have an advantage over uninational firms with respect to national restrictions on international transfers of capital. These restrictions may take many forms, including exchange quotas, transfer taxes, and multiple exchange rates. Whatever the form of the restrictions they generally reduce the uninational company's ability to conduct foreign business, without similarly limiting the multinational firm. The uninational company is always subject to the restrictions imposed by its domestic government. The multinational firm, however, may use different bases for foreign operations, depending on which is best suited, and is limited only by the number of affiliates that it has. If the capital transfer restrictions of the home country do not permit a corporation to take advantage of a particular foreign investment opportunity, because of explicit limiations or because the restrictions imposed would make it too costly, the corporation may use an affiliate in another country as the "parent" firm for that particular project. The corporation has as many potential parent companies as it has affiliates, and can effectively avoid capital transfer restrictions set up by various countries. This advantage gives it a competitive benefit with respect to uninational firms.

CHAPTER IV

THEORIES RELATING TO DIRECT INTERNATIONAL INVESTMENT

In addition to information gained from surveys and the discussion of the general business advantages, there are certain economic theories about the reasons for the existence of multinational corporations. In this chapter I will attempt to briefly discuss some of the theories, before presenting conclusions on the reasons for the existence of multinational corporations.

The Product Life Cycle Theory

The first theory that I will discuss is known as the "product life cycle" theory.[31] This theory explains the existence of multinational corporations in this way. New products are developed in high technology, high income, advanced economies. The initial operation is totally within the country of origin for several reasons; the product was developed for the domestic economy--it is suited for that market in terms of use, and income. As the product "matures" the costs of producing it decrease, and at the same time it becomes more attractive to foreign consumers, who may be developing new tastes or new needs for products of this type. This then leads to export of the product. As the product becomes more and more popular in the foreign market the possibility of foreign production becomes

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[31]Discussed by several authors, see Kolde, The Multinational Company, p. 40, and Dunning, "The Determinants of International Production," p. 305.

more realistic. Any initial constraints on foreign production, specifically the need for a large plant in order to take advantage of economies of scale, are minimized as foreign sales increase to the point at which foreign production could be supported. Trade restrictions may also keep the exporter at a disadvantage. Local production becomes necessary in order to keep other firms, producing locally, from taking over the market. Thus the life cycle of the product necessitates the construction of foreign facilities by a firm, because in the absence of foreign production by the originating country when foreign production becomes profitable, another firm will produce in the foreign market, to its advantage, and eliminate the exporter from the market.

This theory appears to agree somewhat with the survey results published by Brooke and Remmers. That is, the emphasis is on the need to expand in order to protect an existing market. The product life cycle theory seems to ignore the marketing, financing, and production advantages already discussed and thought to be most important by some of the writers, and it also assumes that innovations that result in products to be eventually marketed in several countries come only in advanced economies. This assumption is arbitrary, and not supported by the empirical evidence.[32]

The "Gamble" Approach

Another theory presents aforeign investment as a type of gamble. The fact that multinational firms tend to use a great deal of an affiliate's profits for investment in that affiliate is interpreted to mean that small foreign investments are made with the hope of becoming large, pro-

[32]Kolde, The Multinational Company, p. 41.

fitable venture. The reinvestment of profits is compared by some to the gambler who leaves his winnings on the table with the hope of hitting it big.[33] It would seem that any firm that attempts expansion through the use of reinvested profits, whether foreign or not, would qualify as a "gambler" using this definition, and I think that the survey results discussed and the business advantages enjoyed by multinational corporations would tend to discredit this theory.

Portfolio Theory

A third theory involves portfolio diversification and assumes that differences exist between rates of return in different countries and that those differnces are greater than within any one country. Grubel,[34] in one paper, and Levy and Sarat[35] in another, present models that indicate that international diversification of portfolios reduces risk as measured as the variance of the entire diversified portfolio. This application is to the individual saver, and provides increased welfare for the saver because of several factors. There are more investors (those wishing to make real investments) competing for his funds when he extends beyond just the domestic capital market. His welfare gain may be the result of either higher return on investments made, or lower perceived risks than on domestic investments.

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[33] Ibid., p. 46.

[34] Grubel, H., "Internationally Diversified Portfolios: Welfare Gains and Capital Flows," American Economic Review, Vol. 58 (June 1968).

[35] Levy, H., and Sarat, M., "International Diversification of Investment Portfolios," American Economic Review, Vol. 60 (1970).

The portfolio theory can be applied to multinational corporations. To the extent that a firm is able to reduce its risk by making investments in foreign countries it may be able to offset the possibility of lower rates of return on some projects. In this sense the multinational firm is able to benefit from some investments that would not be feasible for a uninational firm because of the low rate of return. The low risk and low rate of return on one project may offset the higher risk and potentially higher return on another project in the "portfolio" of the multinational corporation. This might also make the bonds issued by a multinational firm more attractive to investors (savers) than those issued by a uninational firm, because of the reduced risk.

This theory tends to coincide with some of the financial advantages that have already been discussed, and also some of the marketing advantages that were mentioned. Specifically, geographic as well as product diversification has already been mentioned as a motive that increases the security of investments in multinational corporations.

Capital Theory

Somewhat related to this portfolio approach is the theory that is derived from capital theory. The traditional theory of international capital movements asserts that such movements take place because of international differences in interest rates. Under conditions of different interest rates in different countries, then, money capital would move from one country to another if the difference between the expected yield and the cost of (real) capital is greater than the difference at home; that is, if a greater return could be expected on the same capital investment. Until the mid-sixties this was thought to explain movements in portfolio investment.[36] A new view has emerged fairly recently, especially in the writings of Floyd[37] (1969) and Branson[38] (1970). They contend that while the stock of assets held domestically and abroad depends on the level of interest rates in all markets, changes in this allocation of capital depend on changes in the interest rates. For example, an increase in the foreign interest rate would cause a subsequent shift in the stock of portfolios toward foreign assets, called the "stock-shift" effect, and would cause the allocation of new portfolios in the direction of foreign assets, called the "continuing flow" effect. As applied to portfolio holdings, this theory is supported by the empirical study presented by Branson and Hill.[39]

This portfolio theory, however, can only partially explain the movement of real capital from one country to another according to Dunning.[40] This is mainly because movements of portfolio capital involve essentially financial transactions between a lender on the one hand and a borrower on the other, while direct (real) investment involves no change in ownership. It does, however, involve the movements of inputs other than just money capital; things like technology, management ability, and other inputs must

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[36] Dunning, J. H., "The Determinants of International Production," p. 229.

[37] Floyd, J. E., "International Capital Movements and Monetary Equilibrium," <u>American Economic Review</u>, Vol. 59.

[38] Branson, W. H., "Monetary Policy and the New View of International Capital Movements," The Brookings Papers on Economic Activity, no. 2, 1970.

[39] Branson, W. H., and Hill, R. D., <u>Capital Movements in the OECD Area: An Economic Analysis</u>, OECD, 1971, various pages.

[40] Dunning, J. H., "The Determinants of International Production," p. 303.

be transferred as well as the money capital. This means that, while the portfolio allocation decision can be made only on the basis of the return on one input (money capital), the international allocation of business depends on the rate of return not only on money invested, but on management skills and techniques employed, technology used, and general entrepreneurship. In other words, these models assume that the businesses involved in international investment have the same behavioral characteristics with regard to the use of all inputs necessary to establish operations abroad.[41]

Profit vs. Interest Rate Differentials

Some authors, however, distinguish between capital movements that take place because of differences in interest rates, and those that occur because of expected higher profits.[42] The theory that some capital movements take place because of expected higher profits is somewhat related to the product life cycle theory in that they both involve expansion of the market. Borts and Kopecky argue that factors that influence economic growth also influence this type of international investment.[43] Among those factors would be such things as population increases, technological

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[41]Leamer, E. E., and Stern, R. M., "Problems in the Theory and Empirical Estimation of International Capital Movements," in Machlup, F., Salant, W., and Tarshis, L., Editors, International Mobility and Movement of Capital, National Bureau of Economic Research, 1972, p. 171.

[42]Dunning, J. H., "The Determinants of International Production," p. 300.

[43]Borts, G. H., and Kopecky, K. J., "Capital Movements and Economic Growth in Developed Countries," in Machlup, F., Salant W., and Tarshis, L., Editors, International Mobility and Movement of Capital, National Bureau of Economic Research, 1972, pp. 563-593.

progress, higher rate of saving, improved capital to output ratio, and improved terms of trade with respect to capital imports. These are some of the same factors mentioned in the discussion on the product life theory, and this theory of the movement of capital must be thought of from the same point of view; that of increasing profits by establishing production facilities in overseas markets.

The Most Popular Theories

The mainstream of theory on the subject of international investment takes a more microeconomic approach, and is generally an extension of the theory of domestic investment to international investment.

The first approach taken here involves, again, some of the concepts of portfolio theory already discussed. The basic assumption is that investment is allocated according to some utility function that is related positively to the rate of return and negatively to the amount of risk.[44] This has already been discussed in connection with the portfolio theory.

The Theory of Capital Formation

The second approach involves the theory of capital formation, and attempts to explain foreign investment through the use of theories on domestic capital formation.[45] Some authors here apply the neo-classical theory of real investment, assuming that the goal is the maximization of the market value of all assets. Numerous equations are presented by Jorgenson in an attempt to describe the adjustment of the capital stock

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[44] Dunning, J. H., "The Determinants of International Investment," p. 300.

[45] *Ibid.*, p. 301.

to its desired level, with that adjustment shown as a function of the price of the product, the expected output, the rental price of capital, and a constant from the Cobb-Douglas production function that shows the elasticity of output with respect to capital.[46] This is, then, an application of one of the general theories of investment to the foreign investment question, with little adjustment in the theory.

Other authors center their theories around many of the concepts already discussed, explaining foreign investment by the high correlation between investment profits and output with sales as a significant factor in investment. The emphasis on relative profit rates is not particularly surprising, given the firm's affinity for profits, and actually explains nothing. These theories simply restate what every entrepreneur hopes for when he invests, and provide little information about <u>why</u> the foreign affiliates are profitable. The main issue is that of why foreign investment takes place, and to say that it takes place simply because it is profitable does not explain very much. Other factors must be taken into account; specifically, the competitive position of the affiliate relative to other firms that produce locally and those that import, and the functional advantages of multinational firms. Theories that try to explain international investment in terms of geographical area distribution have the same problem; they may explain the existence of foreign investment, but they do little to explain why it exists.

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[46]Jorgenson, D. U., "Capital Theory and Investment Behavior," <u>American Economic Review</u>, Vol. 53, 1963.

International Trade Theory

International trade theory has had to undergo some modifications in order to explain the international croporations because traditional comparative advantage theory does not allow for trade in factor inputs. One line of theory suggests that capital movement is similar to commodity movement in that the objective is to equalize the price ratios between countries. This is based on the assumption that, given free trade, price ratios would be the same in all countries, and treats capital as just another good, the price of which will also be adjusted by trade.

Another approach involves what is known as the "dynamic comparative advantage." This theory asserts that changes in one country, in technology or other factors, may affect the comparative advantage of another country or other countries. This would tend to change trade and investment patterns, and might result in new investment in some countries. If that new investment is done by a firm that already has facilities in another country, the result is a multinational enterprise.

The product life cycle theory is also discussed here, as an attempt to explain how foreign markets are best exploited. These theories are important because they try to explain much of the international investment in terms of the behavioral characteristics of the firm. This allows the concepts of global strategy, etc., to enter into the discussion, and presents the discussion in terms other than just pure return on investment. In general, though, trade theory does not explain why some production is done by affiliates of multinational firms rather than indigenous uninational firms.

Location Theory

Certain elements of location theory may also be applied to attempt to explain the multinational corporations. Location theory is concerned with both the supply and demand oriented variables that influence the distribution of the production facilities, research and development, and management of firms while trade theory is concerned with the division of labor between countries.[47] On a purely theoretical basis, then, a firm considering the construction of a plant will not be influenced by the fact that one location is in one country and another choice in a different country, if the goals of the new enterprise will not be affected by the national location of the plant. In a situation of competition, where the firm is a price taker, and given sufficient market size, production will take place where costs are lowest if the firm is interested only in profit maximization. Of course, there are factors that affect production in a particular country such as exchange rates, taxes, political pressures or instability, and a host of other national characteristics that make it impossible for a firm to consider plant location purely on the basis of cost. Political variables and uncertanties make this theory especially hard to use, because they cannot be easily integrated into a cost function.

The theory of spatial monopoly (an element of location theory) has been applied to the concept of multinational corporations by Losch.[48] This type of theory is demand oriented, assuming that the location of both markets and competitors will govern the distribution of production. Each

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[47] Dunning, J. H., "The Determinants of International Investment," p. 310.

[48] Losch, A., The Economics of Location (Yale University Press, 1954), various pages.

location guarantees an element of spatial monopoly, the extent of which will depend on the competition within that market (efficiency of competitors and transportation costs) and the character of the market. The type of production involved also has an effect, for if there is one large firm that is able to benefit from the economies of scale that coincide with that particular industry, there will not be as many firms within a given geographical area as there would be if there were no economies of scale in an industry or if existing firms were too small to take advantage of any. The consideration of these market factors means that a firm must consider factors other than just cost because, given the possibility of the firm enjoying monopoly or oligopoly market conditions, the maximum profit location may be different from the least cost location. Although the international market factors may make the problem more complex, they do not significantly alter the basic question; that of supplying a given demand. In order to develop the theory along the lines of multinational corporations we must divide the basic question of the location of production into two parts. The first task is to explain the geographic distribution of production--one of the basics of location theory--and the other is to explain the ownership of the means of production. A simple problem of this type would have two countries, A and B, with a given market for a product in country A. The first question to answer would be: to what extent is the market supplied with goods produced in country A and to what extent with goods produced in B? The second question then is: given the distribution of the production facilities, what is their nationality? In this light the major question to be answered becomes: Why is a market of a particular country served by the affiliates of a foreign firm rather than by indigenous local firms?[49]

From the standpoint of one individual affiliate the multinational firm is faced with the same type of cost decisions as a uninational firm, except that the multinational firm may have more options in purchasing, financing, and marketing, as has been pointed out. From the demand side, however, the decisions may be different. The product life cycle theory argues that innovations take place in certain countries, and are then transferred to other countries through affiliates of the innovating firm. This means that the affiliates are creating markets, or supplying a market that was created by the parent firm exporting from its home country. The innovating firm may thus induce a certain response from other firms that would influence future locational decisions. Location theory must then distinguish between those firms that establish affiliates in order to satisfy an existing demand, and those firms that establish affiliates with the intention of creating new demand or expanding an existing market that was created by the parent firm.

Depending on the relationships between production costs and output, and transportation costs and distances from markets, a firm that is in a purely competitive market may have to produce in more than one location in order to keep its marginal cost equal to the price of the output (the profit maximizing condition). Firms in pure competition do not influence the market; they are unable to create new demand and then expand in order to satisfy that demand. This is not the case under imperfect

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[49]Dunning, J. H., "The Determinants of International Production," p. 309.

market conditions; the firm is able to influence the character of its market. Thus the firm in pure competition will make location decisions based on the need to keep marginal cost equal to the price of the output, subject to the conditions discussed above. The firm in an imperfect market, however, must consider not only the cost data relating to a location decision, but must also consider the possibility that by producing overseas a firm may gain an advantage over existing producers, or may prevent the entry into the market of new competitors, or may simply protect its current market share. These and other similar factors, may lead a multinational firm to make a new overseas investment even if the return on that new investment is small. Basically, this means that the choice between domestic production with exporting and foreign production will not be made solely on the basis of cost information; but will depend also on the possible effects of local production on the market structure and the ability of the firm to sell in an imperfectly competitive market.[50] If these market conditions can be effectively considered, location theory can provide some insight into the existence of multinational corporations, but one problem that comes to mind is that a great deal of the ability of a multinational firm to enter a market, and the superior position in a market, may be the result of the fact that the firm is multinational, making the theory one that may explain why an affiliate is specifically located but not why the firm is multinational to begin with. It is likely the marketing and financial advantages already discussed must be applied here as well. Explaining the implications of these business advantages

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[50] _Ibid._, p. 310.

falls outside of location theory.[51] It is difficult to try to sort out, and use, those factors most influential in the location decision.

Most of the survey results indicate that certain factors are considered more important than others, but unfortunately those factors thought to be most important vary from one survey to the next, making general conclusions difficult. It seems, though, that market size and growth potential make up one significant motive that corresponds well with the location theorists.

Studies into the influence on the location decisions have taken not only the general marketing motive approach, but have also tried to determine motives for investment in particular countries, or international investment by industry. Those studies that try to determine the influential factors in particular countries present no more information than the surveys that study only general motives. However, studies of motives affecting plant location by industry give some indication of the way in which plant location depends on ownership. This is because studies of this type are able to consider the competitive position within the industry of various firms, and can better examine that aspect of location theory that deals with the market structure that a firm operates within, and the effect of location decisions on that market structure.

In a 1973 article Vernon argues that the determinants of locational strategy will vary according to the stage of the product cycle that the firm is in.[52] He says that the behavior depends to a great extent on

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[51] Ibid., p. 312.

[52] Vernon, R., "International Investment and International Trade in the Product Cycle," Quarterly Journal of Economics, Vol. 80, 1966.

the market conditions when the product is young ("innovative oligopoly), and when the product is in its final stage ("mature oligopoly"), and that decisions tend to be based more on cost considerations in the intermediate phase of development, when oligopoly exists but there is also some degree of price competition. Presumably there will be little price competition in the innovative and mature stages of the oligopoly. Vernon wants location theorists to place more emphasis on the model that stresses the relationship between the firm and the market, rather than just cost factors, because multinational enterprises tend to be concentrated in oligopolistic industries.

A different approach is taken by Hymer who argues that there is a trend toward "spatial hierarchy" as firms become more concentrated within an industry.[53] They maintain that there are two types of geographical decision making occurring as firms expand. First of all, production and cost criteria. Second, certain other activities, especially top-level administration, policy formation, decision making, and other specialized tasks are being increasingly centralized. According to him, the spacial interdependence arising from these trends, and particularly the concentration of the higher order functions has important implications both for the distribution of income earned by multinational firms and their affiliates and the economic power between nations.

Although location theory is able to consider many of the issues that are important in the theory of multinational enterprises, and thus

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[53] Hymer, S., with Rowthorn, R., "Multinational Corporations and International Oligopoly: The Non-American Challenge," in Kindleberger, C. P., Editor, The International Corporation (Cambridge, Mass: The M.I.T. Press, 1970), pp. 57-94.

aid in the understanding of why there are multinational corporations, there are certain limitations to its use. Many of the functional business advantages are not considered, and surveys indicate that these play a significant role in the determination of foreign direct investment. Location theory also does not allow for the degree of resource mobility that exists within a multinational firm, taking resource distribution as given. Some of the nationalistic characteristics, with respect to product image based on the location of production, are not considered, as the acceptability of the product is assumed to be independent of the location of production. For these, and other, reasons, location theory does not provide a complete answer to the question "why interntional production?"[54]

The Aliber Theory

Before moving on to a discussion of industrial organization theory and multinational corporations I would like to consider a special theory presented by Robert Aliber of the University of Chicago. His theory was first put forth at a symposium on international business held at the Massachusetts Institute of Technology, and appears in a book written about that symposium by Charles Kindleberger, entitled "The International Corporation."[55] His theory does not fit into any of the categories previously discussed, or into the area of industrial organization theory.

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[54]Dunning, J. H., "The Determinants of International Production," p. 312.

[55]Aliber, Robert Z., "A Theory of Direct Foreign Investment," in Kindleberger, C. P., Editor, The International Corporation (Cambridge, Mass.: The M.I.T. Press, 1970), pp. 17-34.

The theory is, however, related in some ways to capital theory, portfolio theory, and industrial organization theory; the similarities will be apparent.

Aliber argues that there are three main influences on the pattern of foreign investment. These factors are the capital market relationships (between different countries); the exchange risk involved in holding and trading in different currencies; and the advantage gained by firms holding assets denominated in certain currencies, or what he calls the market's preferences for certain currencies.

These factors are based on what Aliber calls different "currency areas." These currency areas are areas where different currencies are used. These are distinguished mainly from "customs areas" by Aliber, although he also mentions "tax areas" and "political areas" as other possible boundaries that could be considered. For the purpose of his discussion direct foreign investment is defined as the acquisition of plant and equipment for production in a customs area or currency area other than the area in which a firm is domiciled.[56] That characteristic which makes investment foreign is that it involves movement across the boundaries between customs areas and between currency areas. Aliber maintains that in the absence of different customs areas and currency acreas there would be no distinction between foreign and domestic investment, unless one considers political areas and tax areas to be "foreign" for this purpose.

The importance of customs area boundaries is that the prices of the same commodity in different customs areas may be affected by those

[56] Ibid., p. 21.

factors that distinguish one customs area from another; i.e., tariffs, quotas or other restrictions. As survey results indicate, these barriers may influence the decision as to whether a market should be served by imports or by local producers.

The importance of multiple currency areas is that the interest rates on similar securities (same risk) issued by borrowers in different currency areas might be different because of what Aliber calls exchange risk; that is, the risk that foreign exchange values might change. Aliber directs his analysis to the question of whether or not direct foreign investment is best explained in terms of customs areas or in terms of currency areas.

The main effect of customs area barriers is that they add to the cost of transportation from one area to another, or in some way alter the free movement of goods. These barriers can be integrated into the cost function of the firm, and the problem becomes for the most part one of location theory, according to Aliber.

It is investment in a different currency area that he thinks is the important distinction between foreign investment and domestic investment. According to his definition investment must be across a currency area border in order for it to be considered foreign. Aliber distinguishes between investment made in a different currency area and investment in the same currency area as the parent firm; this distinction sets him apart from other writers, and he attempts to explain foreign investment in terms of the relationship between different currencies and between different currency areas.

The central point of his theory is that foreign firms (he calls them source-country firms) capitalize the same stream of income (or expected income) at a higher rate than host-country firms. There is a difference in capitalization rates because of the differences in currencies; that is, the market places different values (different capitalization rates) on income streams that are denominated in different currencies. According to Aliber, then, foreign investment takes place when the capitalized value of an income stream, generated by some commercial advantage (called patent), is greater if the source-country firm uses that advantage itself than is the capitalized value of that same income stream to a host-country firm that could use the advantage through a licensing agreement. It is also necessary that the market price of that patent be below the capitalized value assigned to the patent by the firm, but this is a requirement for any investment to take place. What must be examined is the relationship between the capitalization rate of an income stream to a source-country firm and the capitalization rate of that same income stream to a host-country firm.

The process of capitalization determines the present market value of an income stream. The formula used to find this capitalized value is $C = {}^{I}/_{R}$, where C is the value of an asset, I is the stream of income that it produces, and R is the rate of return on the investment. The capitalization rate, K, is defined in these same terms as ${}^{I}/_{C}$ by Phillippatos.[57]

The initial investment overseas follows much the same pattern as that described by the product life cycle theory. A firm has access to

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[57]Phillippatos, George C., Financial Management Theory and Techniques (San Francisco: Holden-Day, Inc., 1973), p. 270.

some commercial advantage, called a patent. The firm with initial ownership of the patent is the source firm, with respect to its use in a foreign country, meaning that C, the cost of using the patent, is high relative to I, the income received from the use of the patent. A firm within that foreign country, however, may have a strong deisre to use the patent and may capitalize it at a higher rate. If the source firm is willing to license the patent to the host country firm for an amount less than the capitalized value of that patent, according to the host country firm, then licensing will take place. As the product "matures" in the foreign market, that is to say that as the host country market expands, the costs per unit of operating in that country decline for the source firm. As these costs decline the capitalized value of the patent increases for the source firm, and it demands more rent from the host country firm. This continues up to the point where the rent demanded by the source firm exceeds the capitalized value of the patent to the host country firm. Presumably the rent demanded has kept pace with the increasing capitalized value of the asset to the source firm, so that now the capitalized value of the patent to the source firm is greater than the capitalized value of the patent to the host country firm. The source firm may then choose to use the patent itself in the foreign market, and direct foreign investment results. Since the same income stream results, at least initially, from the source firm's use of the patent that results from the host country firm's use of the patent the higher capitalized value implies that the source firm somehow accepts a lower R, because given $C = {}^{I}/_{R}$ the only way that C can increase if I stays constant is if R decreases. An explanation of this may be that the source firm is able to make better use of the patent than could the host country firm for any of a number of reasons. Experience, and generally more efficient management practices, with regard to the use of the patent, may make it more valuable. The source firm may enjoy any of a number of advantages that have already been discussed as common to multinational firms; i.e., access to lower input costs or cheaper financial capital. Any number of things may enable the source firm to "get more" out of the same income stream than the host country firm, thus giving the patent a higher capitalized value when it is used by the source firm. Clearly, though, the higher capitalized value determined by the source country firm is attributable to some imperfection in the market for inputs (or an input) or the source firm enjoys an advantage over the host country because of some economies of scale.

The market also places a capitalized value on that same stream of income, and Aliber argues that the capitalization rate used by the market depends on to which firm the income stream is going. The income stream of source country firms may be capitalized at a higher rate than the same income stream to a host country firm for a variety of reasons. Income streams in the source country may be growing more rapidly, either because of a higher rate of growth in the economy as a whole, or because the share of profits in national income is increasing.[58] These factors will affect the expected performance of earnings, and may also be applied to individual industries within the economy. Aliber says that the capitalization rate

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[58]Aliber, Robert Z., "A Theory of Direct Foreign Investment," p. 29.

used can also be influenced by the denomination of the currency in which assets are held, and there may also be different capitalization rates in the different countries in which assets are held. Aliber says that the higher the capitalization rate on certain income streams the higher the capitalization rate on uncertain income streams in the same currency. Differences in the capitalization rate on assets held in the same currency exist for the reasons mentioned above, and others; what Aliber next tries to explain is the existence of different capitalization rates for assets held in separate currency areas.

As has been mentioned, his main point is that direct foreign investment occurs because source country firms capitalize the same income stream at a higher rate than do host country firms. He says that this difference in capitalization rates is because the market places different values on income streams in different currencies. According to him, then, source firms are likely to come from countries with high capitalization rates, while host countries will be countries with low capitalization rates. Investment will flow from the high capitalization rate areas to the low capitalization rate areas.

He cites the traditional risk premium as accounting for some of the difference in yields on assets (debts issued by firms), and he also stresses the importance of what he calls the currency premium in the determination of the yield on an asset. Two factors may explain why the market capitalizes assets held in different currencies at different rates. First of all, there is a premium that must be paid because of the uncertainty about the future exchange rate, or, in other words, the premium that one is paid for taking on this element of exchange risk. Second, there is the expected change in the value of the asset held in terms of another currency. So the currency premium reflects the expected change in the value of one currency relative to another, and also an additional premium that must be paid because that change is not certain. That is the risk premium.

The difference between the yield paid on two assets of the same risk class that are issued in different currencies represents this currency premium. Given two currencies a high currency premium means that borrowers issuing securities in one currency must pay high interest rates relative to those issuing securities in the other currency--they must pay the currency premium to lenders because of the currency denomination of their assets. A reverse of this currency premium exists when a firm in a host country (low capitalization rate) borrows funds in the currency of a source country (high capitalization rate) and pays a lower interest rate because that debt is in the source country's currency. The difference between the interest rate that the host country firm would have to pay on debt issued in its own currency and the rate that it does pay (lower) on the debt in the other currency is the compensation to the firm for taking on the exchange risk involved with the two currencies.

The currency premium provides only part of the explanation as to why income streams are capitalized at a higher rate for some firms than others. The other part of the explanation is that the market is biased in favor of the source country firms. Host country equities are subject to the currency premium, while source country equities are not. Aliber says that if the market applies the same capitalization rate to the income stream when received by a source country firm as it does when that income stream is received by a host country firm there would be no incentive for foreign investment. This means that in the absence of the market bias (a higher capitalization rate on income streams to source country firms than to host country firms) there would be no foreign investment.

The fact that the market does not attach a currency premium to the income earned in the host country by a source country firm means that that income is worth more when it goes to the source country firm; it is capitalized at a different rate (higher) because of the lack of currency premium. Aliber says that because of this bias, financial intermeidaries in the source country may issue liabilities and use the proceeds to purchase securities in the host country. The firm gains because the debt issued in the source country is not subject to the currency premium, and therefore pays less interest than the security purchased in the host country, which is subject to the currency premium. The larger the currency premium, then, the greater the advantage for source country firms. If firms in the host country were able to issue securities in those currencies that are not associated with the currency premium, they could gain the same cost advantages as firms that are always dealing in low premium currencies.

The significance of this disadvantage to host country firms depends on two factors. The first is the size of the currency premium, and the second is the degree of capital intensiveness in the industry. A small currency premium in a very capital intensive industry may put the host firm at a significant disadvantage relative to the source country firm because of the financial advantage gained by the firm that does not have to pay the currency premium in order to obtain capital. One consequence of this is that foreign investment will be more extensive in capital intensive industries, since the advantage is greater for source country firms.

Aliber says that the distribution of foreign investment tends to support his hypothesis. The United States, for example, is the largest source of foreign investment because the dollar has a high value in the market; there is a preference for assets denominated in dollars. Thus the dollar has a high currency premium relative to other currencies, and there is a higher capitalization rate on United States equities.

The differences in the pattern of direct foreign investment that cannot be explained by differences in the capitalization rate can be explained by other factors, according to Aliber. He mentions specifically the size of the host country markets, the value of patents, tariff levels, and different cost leveles in different countries and in different industries. There are also different capitalization rates for different industries, especially between industries that are very capital intensive and industries that are not very capital intensive, because it is in those industries that the currency premium becomes most important. Generally a large host market would provide greater incentive for direct foreign investment than less-developed markets; coincident, according to Aliber, with higher capitalization rates in large, developed economies. This would apply especially to the more market-oriented industries. High tariffs, and any other factors that make it more expensive to produce in the source country and export to the host country, make production in the host country economically feasible sooner than it might be in the absence of such cost-increasing factors.

Aliber also has an explanation for direct foreign investment into high currency premium countries from low premium countries, for example, direct investment into the United States. Two factors cause such investment. First of all, the firms within the host country (United States) may not be willing to pay as much for the patent as the foreign firm desires, and thus the firm will choose to use the patent itself in the United States through direct investment, even if the profit rate on that patent will be lower than domestic competitors.[59] Secondly, the firm may find it advantageous to have an income stream in dollars, because the presence of this dollar income stream may increase the market value of the firm's equities more than would equivalent investment in other countries that would yield income in some currency other than dollars, or, more generally, any investment that would yield income in any currency that carries a low currency premium.

This explanation is in apparent conflict with the rest of his theory. As I understand it, Aliber maintains that an investment by a firm from a high currency premium currency area into a low currency premium currency area is considered by the market to be an asset in the currency of the source country, and is capitalized at a higher rate for that reason. For example, if a United States-based firm invested in manufacturing facilities in Nigeria that would be considered a dollar asset, and would be capitalized at a high rate relative to similar investments by Nigerian firms because of the high currency premium on the dollar. The income, although in the form of Nigerian currency, is more valuable,

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[59]*Ibid.*, p. 33.

according to the bias in the market, than income to domestic (Nigerian) firms.

In his theory of investment in the United States, he assumes that assets held by foreign firms in the United States are dollar assets, contrary to the previous statements that foreign assets are denominated in the currency of the source country. He also attaches the high capitalization rate to the dollar income of the foreign firm, although a United States firm earning income in the currency of a foreign country is also able to take advantage of the high capitalization rate associated with dollars.

This is inconsistent, and is not explained adequately by Aliber. He says that even if the dollar earnings of a foreign firm are capitalized at a lower rate than similar earnings by United States firms, that rate may still be higher than the capitalization rate on alternative investments that would generate income in currencies other than dollars. This would suggest a market bias in favor of dollar <u>income</u>, regardless of the currency that the <u>assets</u> are held in; his earlier statments suggest a market bias in favor of dollar <u>assets</u>, regardless of the currency denomination of the <u>income</u>. The higher capitalization rate on income to foreign firms that invest in the United States is consistent with the concept of the currency premium if the market recognizes that the income is in a currency to which a high currency premium is attached. The market then apparently does not consider the fact that foreign income of United States-based firms may be in a currency that has a low premium, and is capitalized at a low rate. The problem is that Aliber is trying to generalize about the capitalization rate that is applied by both the firm and the market to a specific income stream.

The capitalization rate is defined by Phillippatos as the effective yield on the firm's equity.[60] "It is the rate at which the market capitalizes the expected residual stream of income to the firm's owners."[61] As such, it is a reflection of the quality of the stream of income as the income is affected by the business and financial risks undertaken. Aliber considers mainly the financial risks, and more specifically, the risk involved with dealing in different currency areas because of the uncertainty about the exchange rates between currencies.

Going back to the original statement about the effective yield, it must be remembered that this effective yield will be influenced most by exchange rate uncertainties if there is to be an exchange from one currency to another; that is, if the income is to be transferred from one currency area to another. If there is to be no transfer, exchange risk is minimized. Taking one extreme case, this means that if assets are held in the host country currency, then the income will be generated in a currency that is consistent with the denomination of any dividend or interest payments that must be made, and the required income will depend primarily on the internal conditions in the host country rather than the exchange rate (Americans that invest in the United States wish to earn money on their investment relative to the price level in the United States not relative to the value of the dollar in francs, pounds or any

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[60]Phillippatos, G., Financial Management Theory and Techniques, p. 271.

[61]Aliber, Robert Z., "A Theory of Direct Foreign Investment," p. 27.

other currency, unless they speculate in such matters, which makes them a different case) unless the investors are extremely sensitive to the foreign exchange rate. In this case there is no reason why the income stream of the affiliate should be capitalized at a rate that is different from the capitalization rate that is applied to host country domestic firms earning the same income. Kindleberger argues that this is the case, and that there is no currency premium applied here. He says that foreign investment takes place because a multinational firm is able to generate more income from an investment than is a uninational firm, for the reasons that were discussed as functional advantages of multinational firms. Given the capitalized value $C = {}^{I}/_{R}$ already defined, Kindleberger argues that I is higher for multinational firms because of the advantages that they have over uninational firms.[62]

The other extreme would be the case of an affiliate in a foreign country that is financed entirely from a source country that is in a different currency area. Exchange risk then becomes very important because interest and dividends must be paid in a currency other than the currency in which the income of the affiliate is denominated, or if the interest and dividend payments are to be made in the same currency as the income, the investors will consider the exchange value of that currency relative to the currency in which they must pay their bills. Clearly in this case an investment that returns eight per cent annually in a host country currency that depreciates five per cent annually relative to the currency of the source country has an effective yield of only three per cent for investors in the source country.

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[62]Kindleberger, C. P., American Business Abroad (New Haven: Yale University Press, 1969), pp. 24-25.

I think that it is basically situations of the second type with which Aliber is concerned. Of course, in either case, there are other considerations that must be made. For example: the currency of account used by the firm; the beneficiary of profits (parent firm or affiliate) and the currency denomination of these profits; how, when, why and in what currency funds are to be transferred, etc. These are all things that will be considered by the firm when capitalizing the value of a foreign income stream, but much of this type of information may not be available to investors. They must consider only the performance of the firm in the currency that is relevant to them.

It should be pointed out that under conditions of fixed exchange rates there would be no exchange uncertainty involved in different currency valuations. However, there would still be uncertainty about the price levels in various countries, and investors would be concerned with the real value of different currencies. The currency premium would then be associated with currencies that maintain their real values, while currencies from countries with high inflation rates would not be popular.

This viewpoint reduces Aliber's theory to an extension of capital theory, or the related portfolio theory. Investment takes place because of differences in interest rates, with those differences modified somewhat by the relationships between different currency areas. The return is tied, in cases where exchange will take place, to the exchange risk involved with either (or both) the currency in which the assets are denominated or the currency in which the income is denominated, depending on the financial structure of the affiliate.

Based on the information about the diversity of the financial arrangements made by multinational corporations, especially the extent to which affiliates are financed outside of the source country and within host country capital markets it would seem that the market bias would not be a significant factor in direct foreign investment. The existence of a currency premium does reflect the uncertainty about exchange rates, but foreign investment takes place because the business advantages enjoyed by a multinational firm, relative to other firms, enables the multinational firm to generate more income than a domestic firm given the same investment, thus enabling the multinational firm to pay the currency premium to those investors that demand it; namely, investors outside of the host country who may find it necessary to convert interest and dividend payments (in the currency of the host country) to other currencies. This would appear to be consistent with the viewpoint of Kindleberger.

Aliber's theory is significant because he recognizes that one of the characteristics of international direct investment that sets it apart from domestic investment is the movement across currency borders. His attempts to generalize are inadequate, however it is important to realize that in some cases the profitability of foreign investment may be affected by the performance of one currency in terms of others. Exactly how this currency relationship affects investment depends on the specific financial arrangements that are to be made for a given investment; the expected relative currency values will be taken into consideration as they are relevant.

According to Dunning, Aliber's theory is an extension of the theory of monopolistic competition, or oligopoly theory, because Aliber is concerned with the position of the firm relative to others that are in competition with it. The multinational firm enjoys certain advantages over uninational firms, especially, as Aliber sees it, the ability to take advantage of the characteristics of different currency areas.

Industrial Organization Theory

The theory of monopolistic competition as applied to direct foreign investment is one of the most widely accepted. Endorsed by, among others, Dunning, Johnson, and Caves, the theory considers the position of the individual firm in the market, and concentrates on the advantages that a multinational firm has over others. Many of the characteristics are the same as those discussed previously as associated with the business oriented approach to international investment, but they are taken in a somewhat different light by economic theorists because of their effect on the monopoly or oligopoly position of the firm.

Oligopoly theory is concerned directly with the ownership characteristics of manufacturing facilities, and can help explain why production takes place in a country at a plant that is owned by a firm based in another country. As advanced by Stephen Hymer the theory holds that direct foreign investment takes place in order to establish, or further advance, a monopoly or oligopoly. The distinctive advantages enjoyed by multinational enterprises are used to exploit patents that the firm has to the point where the firm can make monopolistic profits from the use of those patents. The functional advantages previously discussed are used to the benefit of the firm to increase profits either because of some product or knowledge patent that the firm has (patent again refers to any idea, technique or product, whether legally patented or not, that the firm has access to ahead of other firms).

According to this theory there are two major determinants of direct foreign investment. The first is the nature of the foreign market, and the second is the competitive position of the domestic firms (firms in the host country) relative to the foreign firms. The first one will deal with the general problems of the ease or difficulty involved with supplying a particular foreign market from any location, and is for the most part a problem in location theory. The second case involves the ease or difficulty with which a product can be supplied to a given market from the same location (within the host country) by firms with different ownership characteristics, and considerations of this type determine whether a patent will be exploited by sale or licensing to a foreign firm or by direct foreign investment by the source firm. The answer to this second problem is thought by some to be best explained by the theory of monopolistic competition.

Industrial organization theory associates certain advantages with multinational firms.[63]

(1) Better access to knowledge and information.
(2) Better access to factor inputs.
(3) Better access to markets and superior marketing techniques.
(4) Economies of scale and vertical integration.

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[63] Dunning, J. H., "The Determinants of International Production," p. 314.

Some of the advantages may be characteristic of any firm of sufficient size, regardless of the nationalities involved, and have to do with specific internal or external economies of scale in certain industries. Other advantages may be associated with a firm specifically because it is an affiliate of another foreign firm (specifically the access to input and capital markets already discussed); and finally, other advantages arise because a firm (an affiliate) is part of an integrated global corporation (more specifically the vertical integration advantages and world-wide input and output marketing strategies). It is these particular advantages that give multinational corporations a competitive edge over other firms in similar locations. These advantages are specifically related to the character and ownership of each individual firm, and vary from one firm to another. The Gray report on foreign investment in Canada indicates that some specific firms and some countries are more likely to produce distinctive advantages than others.[64] According to Dunning, these include firms in research-intensive industries and those industries that produce differentiated products; national characteristics that lead to distinct advantages include large markets, a competitive environment, and a rapid rate of technological innovation. Small countries may also have specific distinctive advantages in particular industries or give rise to firms that have advantages relative to other firms in the same industry, which explains why foreign investment may be in both directions between two countries.

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[64]Quoted by Dunning, J. H., in "The Determinants of International Production."

The economies of scale that coincide with a high degree of integration in some industries and with global input-output strategies are usually characteristic of very large firms that are able to take advantage of these economies of scale because of their prominent position in their respective markets. The motive mentioned as defensive in the Brooke-Remmers survey that deals with expansion in order to keep up with competitors or customers coincides with the monopolistic competition theory because the primary reason for expansion is that the firm feels need to maintain its competitive position relative to other firms. As others expand they gain certain advantages that are characteristic of multinational corporations in their respective industries, and consequently if an existing firm is to remain competitive it must also be able to take advantage of the same benefits; if direct international investment is required that is what must be done.

Hymer and Rowthorn see this head to head competition as resulting in more and more foreign investment as each firm tries to keep its share of the world market. The defensive motives for international investment discussed earlier as being so important to the firms interviewed lend support to the monopolistic competition theory that foreign investment takes place because of the desire of a firm to maintain its position in the market. The functional advantages that the multinational firm has over the uninational firm enable the multinational corporations to better meet their marketing objectives, especially as these goals relate to the market structure of a particular industry.

Johnson emphasizes the unique ability of a multinational firm to use its knowledge, enterprise-specific, to gain monopoly profits in the international markets.[65] Superior knowledge gained through research and development in one country can be rewarded with monopoly profits in other countries, if domestic firms are unable to compete. Since production of new knowledge is rewarded by monopoly profits, there would be wasted resources if domestic firms tried to duplicate the knowledge of the multinational firm, because, in the event that they did gain access to whatever patent was being exploited by the firm they would, depending on the number of firms involved, increase competition in that industry and fail to earn monopoly profits as reimbursement for the cost of acquiring the knowledge, so that research in areas where firms already have knowledge may not yield the profit rate needed to support such research, leaving the original firm to its monopoly profit rate.

Caves mentions product differentiation in his theory as one of the unique advantages chcaracteristic of multinational firms. The ability to differentiate products for different markets has already been discussed. This gives the firm more flexibility in its marketing, thus enabling easier expansion, or better adaption to growing markets than uninational firms. This keeps the multinational firm in a position where it is able to maintain its share of the market when markets and other firms grow and change.

The theory that expansion (direct foreign investment) is motivated by a desire to gain or maintain a monopolistic or oligopolistic share of the market for a particular industry concentrates mainly on the functional

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[65]See Johnson, Harry G., "The Efficiency and Welfare Implications of the International Corporation," in Kindleberger, C. P., Editor, The International Corporation (Cambridge, Mass.: The M.I.T. Press, 1970) pp. 35-56.

advantages of the multinational organization, as described by many of the more business-oriented economists. However, Kolde, a strong proponent of the theory of functional advantage, is opposed to the theory that firms expand for motives that may or may not coincide with profit maximization. His criticism is based on his feelings that monopoly profits are repulsive, and that a firm that earns monopoly profits is an "antisocial abnormality." This, of course, is not necessarily true, since monopoly profits generally provide the payment to a firm for research and development (and implementation) of new techniques and products (at least in theory). He defends the multinational form of organization in terms of its cost and efficiency advantages. Proponents of the monopoly theory also cite these cost and efficiency advantages, and Kolde's criticism is based on a misunderstanding of the cost relationships explained by Hymer in his original theory. Hymer seems to agree with Kolde that cost considerations are important in the decision to expand.

While industrial organization theory emphasizes the distinct advantage that multinational firms have, it does not adequately explain why some advantages are exploited by the firm itself while others are licensed or sold. If production remains under the control of the source firm the problem is primarily one of location, and can be examined as such. In cases where the return on "distinctiveness" is best maximized by licensing or sub-contracting the theory is not well-defined. Cases can be cited (Kolde) where licensing is preferred to direct investment, but these have not as yet been integrated into the theories of international investment or marketing.

CONCLUSION

It is difficult to generalize, because, as the survey results indicate, there are many different reasons for direct foreign investment. Different surveys yield different results, depending on the firms questioned. Results tend to emphasize several important motives, however. The defensive motive is mentioned by many firms, and is the dominant motive mentioned by some. It centers around what the firms see as either existing or potential artificial barriers to trade; that is, barriers established by governments. They feel that in order to protect their interests they must be able to minimize the possible effects of any governmental restrictions. If they are active in international markets, this means that they must establish facilities in various different counties in order to gain flexibility in production and shipment.

Defensive strategies may also be applied to the problems involved with exporting, or selling in a foreign market through an agent in that country. Once a firm has established a market abroad it may feel that the service provided by its contacts in that country is not adequate to preserve that market, and that uncertainties and problems involved with transportation put the firm in a postition that is not competitive with others that might provide the product in the event that the original firm was unable to deliver. This means that the firm will establish overseas facilities in order to secure its established position in the market.

This also places the firm in a position from which to expand its foreign markets and borders on being an aggressive motive.

Firms also mentioned that they expand in order to maintain their competitive positions relative to both customers and competitors. This defensive motive coincides somewhat with the monopolistic competition theory, which holds that firms expand in order to gain or maintain a monopolistic or oligopolistic share in the market. Even if other firms do not expand it is conceivable that a firm in a dominant position in a domestic market may expand in order to gain control of foreign markets also, because in the absence of the original firm's presence in foreign markets another firm may grow large enough in those foreign markets to challenge the original firm in its home market. This also leads to the expansion, or possible expansion of a firm's market and is somewhat aggressive.

Firms also gain security by establishing production facilities close to input, or raw material, sources. They may also purchase these sources, and in doing so, vertically integrate themselves from inputs to finished products. This expansion in order to gain or maintain access to inputs represents a move toward a global production plan, and expansion of facilities that enables a firm to take advantage of, or adjust to, changes in various input markets, a flexibility that may not be open to uninational firms.

The expanded market that is available to the multinational firm is another important motive for foreign investment. Gaining marketing capability through the establishment of foreign production facilities was mentioned in several of the surveys studied. Firms see the potential for expanding sales in a foreign market, and expand in an attempt to realize that potential with the feeling that direct foreign investment is the best way to maximize the benefit from a foreign market. The advantages that a multinational firm has over uninational firms are exploited through the expansion into foreign markets.

Foreign investment also serves as an outlet for capital, manpower or some production or product innovation that may provide a more profitable rate of return on investment. Access to different financial markets can be gained through the establishment of foreign operations, enhancing the profitability of some investments because the firm can borrow at the lowest interest rate available and invest where the return is the highest. This ties in with the approach taken in capital and location theory. The idea of investing or building production facilities where conditions are best suited in terms of financial, input and market conditions is explained by economic theory, especially capital theory and location theory, however these theories do not adequately explain the ownership characteristics of plant location, most likely because they fail to consider some of the unique aspects of direct international investment when compared with domestic investment, specifically the marketing, production, and financing characteristics that give multinational firms advantages over uninational firms in the same country.

The underlying theme is the advantageous situation that the multinational firm is in relative to uninational firms. If the main objective is market expansion, and it often is, or if a firm simply desires to become more secure in its current market position by gaining better access to inputs and minimizing the possible effects of political uncertainties, the multinational organization is the best organization for reaching those goals.

The major marketing advantages arise out of closer contact with the various markets. The firm has a physical presence in the market and is in better touch with marketing conditions. The multinational firm is able to respond to market changes better than a uninational firm serving a market with exports because the multinational affiliate is closer to the changes and can react more quickly, and because the affiliate has (usually) more thorough knowledge of the market it can respond in a more effective way.

Multinationals are also generally better suited for international marketing research and product introduction. Their superior knowledge of several markets gives them the ability to formulate more effective marketing strategies and to make the best use of each market. They gain inputs from a number of markets, and may be able to introduce a wide variety of new products, based on the mixture of cultural and business inputs that they receive.

In order to expand into a market or to expand one's share of that market certain services must be made available to potential product buyers. The presence of production facilities within a market gives the firm repair facilities and a training center both for repair personnel and for purchasers of the product who may be unfamiliar with its operation. This is of more importance in some industries than in others, but with certain products there will be no sales without readily available service and instruction facilities. A uninational firm would have to provide service and training through agents or licensees in foreign markets, and is subject to the consequent uncertainties and problems, while a multinational firm can provide facilities that are as complete in one market as in any other.

The financial options open to a multinational firm provide it with a great deal of flexibility that is not characteristic of uninational corporations. The ability to generate funds in the least expensive manner and transfer them to the investment that will provide the highest return, or to the affiliate that needs them, is one strong advantage. Another advantage is the superior credit rating sometimes enjoyed by a multinational firms, and the subsequent increased ability to raise financial capital. Multinational firms, through their affiliates, have access to various currencies, and can issue debt in those currencies that are most in demand by the market, thus taking advantage of the currency premium, and gaining the ability to raise capital much more quickly than a firm that must wait until investors are prone to invest in its currency, and the multinational firm can pay the lower interest rates associated with the currency premium.

A multinational firm can also manipulate its production from one facility to another, enabling it to make optimum use of its facilities, and to take advantage of any cost or input advantage that may arise in one production area. This production flexibility gives additional protection to the firm from governmental actions, and adds to the marketing flexibility of the firm.

All of these financial, marketing, and production factors combine to enable the multinational firm to function, and expand more effectively than uninational firms. They have easier and cheaper access to knowledge and market information; easier and cheaper access to raw materials and inputs; better marketing capability; the advantages and economies of size and vertical integration; and more outlets for profitable uses of patents. They exist primarily because they are better suited for expansion and operation in a multimarket world with resources geographically dispersed.

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