Menzie Chinn, October 16, 2000

A New Role for Multinational Firms

Multinational corporations exist because firms find that there are advantages to locating production and other activities in foreign locations. Keeping foreign activities within the corporate structure provides two benefits: firms avoid the costs inherent in arms length dealings with separate entities, and are able to fully utilize their own firm-specific knowledge such as advanced production techniques. By internalizing the elements of cross-border transactions, multinationals can bridge information obstacles that might otherwise hinder international trade. For example, firms may be able to more carefully monitor product quality or worker conditions in wholly-owned factories than in those of contractors, or adapt the composition of output more quickly to changes in market conditions. Or it could be that multinationals are able to instill a common "corporate culture" in workers across different countries in a way that mitigates cross-country cultural differences that might otherwise hinder international transactions. Trust is a necessary ingredient for international trade, and this trust is likely to be more easily present in dealings within a corporation than across international boundaries.

Firms globalize their activities both to supply their parent market and to directly service foreign locations. In the "vertical" model of the multinational corporation, the stages of a firm's operations are divided by location; for example, research, design and financial analysis may be located in the parent company site in an advanced economy, while production takes place in developing countries with lower production costs. It turns out, however, that multinationals replicating substantial parts of their operations in different countries, so that the alternative

"horizontal" model appears to be more common than a strictly vertical separation.[1] Under this arrangement, multinationals use separate factories or sales offices to supply local or regional markets—an example would be that of a major U.S. computer firm with regional headquarters in four locations for different parts of the world, and manufacturing sites in six world-wide locations.

Improvements in communications and information technology provide a broader role for multinational corporations. These advances reduce the impediments to exerting corporate control across borders, expanding the optimal scope of the firm not just within a country but also across national boundaries. This has combined in recent years with an increasing openness on the part of governments to foreign investment, based on the recognition of the benefits of a foreign presence to the host country. These include the increased investment and the associated jobs and income that come with the multinational investment, and especially the technological transfer and improved productivity that has been found to go along with inward foreign direct investment.

Evidence of these effects can be seen in the heightened pace in foreign direct investment in recent years. In 1999, foreign direct investment among OECD countries reached record levels, with inflows reaching 2.5 percent of GDP and outflows about 3 percent of GDP.[2] As in past years, most of the FDI was from developed country to developed country; over the 1982-98 period, 75 percent of FDI outflows went to other OECD countries, with this proportion remaining in the 70-80% band. 1998 and 1999 figures indicate a substantial increase in intra-OECD FDI, relative to total OECD FDI outflows.

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[1] Markusen and Maskus, 1999, "Discriminating among alternative theories of the multinational enterprise," NBER WP 7164.

[2] Figure 1, OECD (2000), *Financial Market Trends* (June), chapter on Recent Trends in Foreign Direct Investment.

While firms can expand internationally by the establishment of subsidiaries, multinational corporations are increasingly opting to acquire existing enterprises rather than develop a foreign presence from scratch. In developed countries from 1991-1997, cross-border mergers and acquisitions accounted for 62 percent of total inflows of foreign direct investment in OECD countries. The value of cross-border mergers and acquisitions jumped from $85 billion in 1991 to $558 billion in 1998, an increase of more than six-fold. The average size of deals rose substantially, from $21 million in 1991 to $104 million in 1998. The importance of mergers and acquisitions was considerably less in developing countries, where they accounted for only 18 percent of total FDI inflows. A merger or acquisition offers a relatively fast route to entry into a foreign market, particularly compared to the possibly lengthy process of setting up a foreign subsidiary. Acquiring a foreign firm also provides intangibles such as country-specific knowledge, including familiarity with the host country business culture and regulatory structure.

Moreover, with the advent of new information technologies, the knowledge content of a typical firm's assets increases, and it becomes increasingly profitable to invest by acquiring domestic firms, rather than going through the lengthy process of establishing an entirely new subsidiary. Thus, in the OECD countries from 1991 to 1997, cross-border mergers and acquisitions accounted for 62 percent of total inflows of foreign direct investment. The value of cross-border mergers and acquisitions jumped from $85 billion in 1991 to $558 billion in 1998, a more than six-fold increase.

Certain sectors appear to be particularly fertile territory for multinationals and for cross-border mergers. This may be particularly the case in knowledge-based industries such as telecommunications, where there has been a concentration of merger and acquisition activity. The value of cross-border mergers in the telecommunications sector over 1995 to 1998 was

nearly ten times that of 1991 to 1994. This reflects two factors. First, the dramatic changes in technology such as the growth of mobile telephony, the Internet, and most recently, the rising importance of broadband capabilities required both increased capital and technological prowess, so that firms may seek to combine in order to possess the capital and technological capabilities to compete. This impetus has interacted with a move toward deregulation in the telecommunications industry. These moves include auctions of cellular licenses and the liberalization of fixed telephony networks, that have allowed new entrants into a sector that was until recently the province of a single large provider, and often one with explicit or implicit support from the state.

In other industries, such as air transportation, global alliances have largely taken the place of mergers and acquisitions. This reflects several factors, including restrictions in many countries (including the United States) on foreign ownership of domestic airlines. At least as important, however, is the business necessity for airlines to link their networks with a variety of partners serving complementary routes. Even here, technology has enabled this new role for alliances between multinationals, as improved communications embodied in reservations systems allow for cross listing of flights and seamless connections between flights across carriers and countries.

The motivation for FDI flows to transition and less developed countries is somewhat different. The objective of FDI is often to take advantage of attractive production costs, with gaining entrée to the local market or country-specific knowledge less prominent factors. This is reflected in the considerably smaller share of mergers and acquisitions in developing countries, where these activities accounted for about 18 percent of total FDI inflows in 1998 (although this proportion is rising as privatization programs expand.

The fact that FDI is becoming more motivated by acquisition of knowledge-based assets has substantial implications for the world economy. To the extent that multinationals bring skills and knowledge of production processes from the host economy to recipient economies,[3] FDI serves as an important channel for the diffusion of technology and organizational changes to developing countries.[4] First, multinationals typically introduce production techniques that are more advanced than the prevailing domestic standard. In addition, the local interaction with multinational corporations provides an impetus for further development of the host economy. Labor mobility of highly trained skilled personnel between multinationals and local firms can also be an important channel of technology and knowledge diffusion. Finally, spillovers can occur in which domestic suppliers to multinationals begin to service other domestic clients. Hence, the presence of multinationals encourages the expansion of service professions such as accounting, financial, legal and technical specialties that both serve the multinationals and local firms. In Vietnam, for example, computer programmers who were initially hired by foreign multinationals to develop customized applications for the financial service industry have widened their efforts to address the local market

[3] Lipsey, 2000, “Interpreting developed countries’ foreign direct investment,” NBER WP #7810.
[4] We need statistical verification of this point.