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IS EXPORT-ORIENTED FDI BETTER?

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(DRAFT: NOT FOR QUOTATION)

1. Introduction

The potential benefits of FDI, especially for developing countries, have been well documented in the literature.[2] Multinational enterprises (MNEs) are a source of capital, employment, technology, management skills and international distribution networks, among many other things. However, it has also been argued that these benefits vary according to the characteristics of different types of FDI and that some types of FDI are better than others. This has led, perhaps naturally enough, to arguments advocating the promotion of FDI that is, in one way or another, 'better'. This development is important to the extent that it implies that some types of FDI are more deserving of incentives than others.[3] Furthermore, there is growing recognition of the potentially negative implications associated with the growing use of financial and fiscal incentives in policy competition for FDI (OECD, 2001), such that any argument in favour of concentrating incentives on certain types of FDI deserves careful consideration.

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2 See, for example, UNCTAD (1999), Part 2.

3 We are not here concerned with the issue of the merits of providing incentives to attract FDI. Rather, we recognise that the use of incentives to attract FDI has become pervasive and that, to the extent that policy makers accept the argument that export oriented FDI is better than non-export oriented FDI, they are likely to act accordingly in terms of the conferral of incentives to investors.

With respect to trade, export-oriented FDI is, *ceteris paribus*, generally considered better than non-export-oriented FDI. Indeed, the positive role of export-oriented FDI, especially in the context of development, has been well documented (Lall, 2000). UNCTAD (2001) has therefore suggested that developing countries should actively seek to attract “the right FDI” in order to “tap into the new international production systems of TNCs, the perhaps most dynamic elements of international trade” (p. 5).

The objective of this paper is to take a step back and address the question, is export-oriented FDI really better? More specifically, we consider the possible implications of policies aimed at attracting export-oriented FDI in the context of current thinking on the dynamics of MNE behaviour. The rationale for this approach is that policies geared towards MNEs need to take into account the nature of these in order to be effective.

Section 2 selectively reviews some of the theoretical literature on MNEs in terms of the role played by information gained from foreign operations in shaping their subsequent FDI and trade patterns. This review suggests that many initial FDI projects will not be export-oriented at first but that such an orientation can emerge over time as MNEs learn more about the performance of their initial investments and possibilities for expanding production in particular markets. In effect, MNE theory raises questions concerning the feasibility of accurately identifying export-oriented FDI. Section 3 presents firm-level time series data on the international operations of a sub-sample of Fortune Global 500 companies. These data highlight one of the major motivations behind FDI, namely the performance of existing FDI. Data are also presented on the foreign intra-firm sales of a sample of Fortune Global 500 companies. These show that the share of foreign intra-firm sales in total foreign sales by foreign affiliates is quite low and that the share shows no apparent upward trend, in contrast with the share of third-party sales by foreign affiliates. This would seem to suggest that the growth of FDI during the 1990s has been motivated more by market access considerations than by opportunities for more deeply integrated international production, one of the arguments that has been put forward for the promotion of export-oriented FDI. Section 4 concludes with some policy implications.

2. The role of information in the FDI decisions of MNEs

Policies that aim to shape or influence the behaviour of MNEs need to take into account the behavioural characteristics of these. With respect to the export-orientation of the foreign subsidiaries of MNEs, the theoretical literature is rather sparse. However, the theoretical international business literature nonetheless highlights certain features of MNE behaviour that are relevant to a consideration of whether or not there is merit in identifying and subsequently promoting FDI that is export-oriented. One of the key themes that recurs in the literature is the role of information (or the lack thereof) in shaping the investment patterns of MNEs.

Information plays a central role in the FDI decision-making process. Before making FDI decisions, either with respect to new FDI projects or existing foreign facilities, managers will collect and evaluate information on a wide range of issues, such as the economic characteristics of foreign markets, the resources available to the firm (including those related to information itself) and possible responses of competitors.

Vernon (1966) is one of the first contributions to the international business literature to include information gained from initial FDI in a model of MNE behaviour. He points out that once MNEs have made their initial investment, “more ambitious possibilities for their use may be suggested… Accordingly, it may prove wise for the international firm to begin servicing third-country markets from the new location” (Vernon, 1966, p.18). This constitutes in effect the first instance of a dynamic model of international production by MNEs, in which the act of investing in foreign markets provides new information that feeds back into the international strategy process and the patterns of trade associated with FDI. What this suggests is that it is difficult to make a clear distinction between FDI that is export-oriented and FDI that isn’t since this orientation can change over time.

Learning from prior involvement in foreign markets as a force in shaping subsequent patterns of international business activity is dealt with even more explicitly by the 'Scandinavian school'. Originating in the study of four Swedish firms by Johanson and Wiedersheim-Paul (1975), the central premise of this literature is that the internationalisation process is characterised by a series of incremental steps. Johanson and Wiedersheim-Paul identify four stages of the "establishment chain", each representing an increase in the degree of involvement in foreign markets (p.28). These are: 1) no regular export activities, 2) export via independent representatives, 3) sales subsidiary and 4) production/manufacturing. Information plays a central role in this explanation of the international activities of MNEs, with each stage increasing the amount of information that the firm has available to it regarding foreign markets; "the first [stage] means that the firm has made no commitment of resources to the market and that it lacks any regular information channel to and from the market. The second means that the firm has a channel to the market through which it gets fairly regular information about sales influencing factors. It also means a certain commitment to the market. The third means a controlled information channel to the market, giving the firm ability to direct the type and amount of information flowing from the market to the firm. During this stage the firm also gets direct experience of resource influencing factors. The fourth stage means a still larger resource commitment" (Johanson and Wiedersheim-Paul, 1975, p.28). Recalling Vernon's (1966) point that subsequent opportunities to serve third markets from a subsidiary might become apparent, we might add a fifth stage to the incremental stages model, in which the firm increases its commitment to the foreign market even further by increasing capacity with a view to serving export markets.

In the context of the current discussion of the merits of export-oriented FDI over non-export-oriented FDI the Scandinavian School implies, along the lines of Vernon (1966), that the dynamics of MNE behaviour and their tendency to take an incremental approach to internationalisation, make the identification of FDI that is export-oriented from the outset a difficult exercise. If MNEs themselves do not know what their eventual commitment to a particular market will be at the time that an initial investment is made, depending upon the subsequent performance of the initial investment, it seems unlikely that policy-makers will know the answer either.

The first explicit recognition of the potential role of information on the performance of existing FDI in shaping the subsequent FDI decisions of MNEs is provided by Boddewyn (1979a, 1979b, 1983a,1983b), who considers whether the core explanations for FDI (Dunning's eclectic paradigm in particular; see, e.g. Dunning 1993) also serve to explain instances of foreign direct disinvestment (FDD) (see also Chopra et al, 1978). The motivation for asking this question was that FDD "has received hardly any attention from economists even though [the] phenomenon is already significant" (Boddewyn, 1983b, p.346).

One of Boddewyn's key insights is that "information levels are more apparent in FD [foreign direct divestment] than in FI [foreign direct investment] decisions. Before investment, there may be little familiarity with the possible foreign production site while divestment decisions apply to *known* locations" (Boddewyn, 1983b, p.349). This information plays an important role in the FDD decision but not in the initial FDI decision because the information is simply lacking before the investment is made. However, the significance of this point extends well beyond issues relating to FDD. Where an MNE already has a presence in the form of FDI, the logic outlined by Boddewyn would suggest that any subsequent decisions relating to resources committed to the foreign markets in question should be based to a significant extent on information gained on these markets because this information reflects, in real terms, the actual strength of the firm's ownership advantages, the benefits of internalisation and the strength of the location advantages. Likewise, the degree to which FDI is export-oriented will be conditioned by information gained through the initial investment, especially concerning regional markets.

Buckley (1989) provides another example from international business theory in which the role of information from existing FDI shapes subsequent FDI decisions of firms. He does so in the context of the specific challenges faced by small and medium-sized enterprises (SMEs) engaging in early internationalisation. Among the theoretical constructs he posits as useful in the interpretation of the FDI decisions of SMEs is the 'gambler's earnings' hypothesis, which suggests that, like seasoned gamblers, firms will begin the game with a small stake but then continually plough "back their 'winnings' (profits) into the game until a real 'killing' [is] made" (p. 103). The smallness of the initial stake owes, along the lines of Aharoni (1966) and Vernon (1966), to uncertainty about the likelihood of success in foreign markets.

However, once the initial foreign investment proves profitable, "uncertainty is lower and the costs of search for further profit approximate to zero" (p. 103). The result is that firms will "reinvest in [the] safe bet – the existing subsidiary…In other words, foreign investors are hypothesized to exhibit a bias in the allocation of investment funds towards existing, profitable subsidiaries" (p. 103-4).

That the performance of an MNE's international operations should influence subsequent FDI decisions is highly intuitive. After the initial FDI decision, managers obtain data on the costs of production in foreign markets, the profitability of FDI projects, the quality of the output from these facilities and opportunities for increasing exports to the home and third markets. This information in effect constitutes the acid test for the ex ante expectations of managers concerning the strength of the ownership, location and internalisation advantages for initial FDI projects. Furthermore, as globalisation progresses this dynamic should come to play an increasingly important role in the FDI decisions of MNEs to the extent that very few markets or regions constitute 'virgin' territory for MNEs. As Rugman (2000) has argued, most of the world's leading MNEs have established operations across the Triad (Japan, North America and the European Union) and, as such, these enjoy the benefits of ex-post information on the performance of their foreign operations in these regions. They do not have to 'reinvent the wheel' with respect to sequential FDI, as implied by most empirical studies on the determinants of FDI.

Information on the performance of FDI represents the cumulative representation of all variables that actually influence performance and hence shape subsequent FDI decisions of MNEs. Traditional models of MNE behaviour, on the other hand, with their static equilibrium orientation, effectively ignore the role of information on the performance of FDI in subsequent FDI decisions and imply that, each time an MNE considers FDI it does so as if such were an initial investment in an unknown market. This static equilibrium approach can also be found in much of the policy literature to the extent that MNEs and FDI continue to be viewed in terms of a 'package' of various benefits for the host economy, as opposed to a fluid evolutionary process linked to corporate behaviour and strategy in which the 'package' is constantly changing.

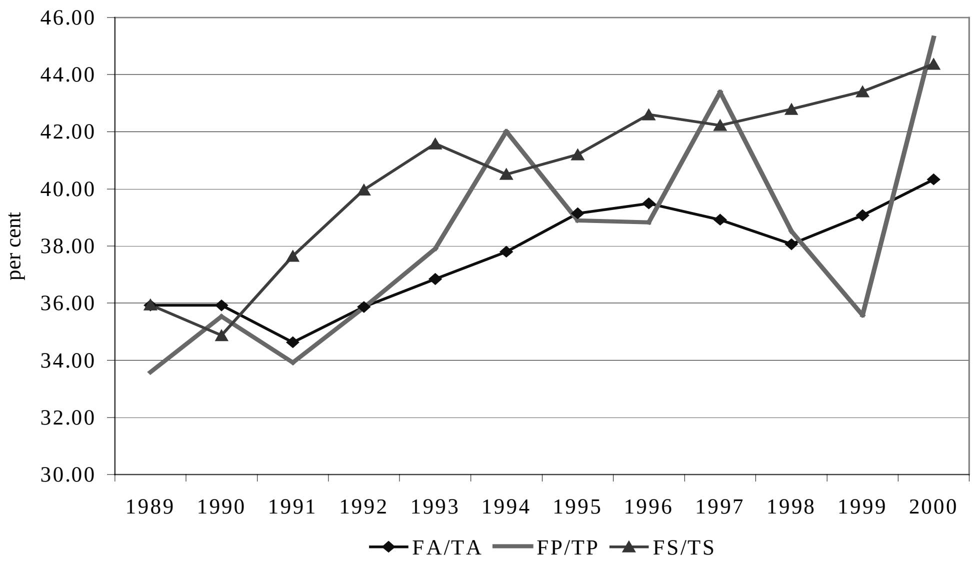
With respect to the view that export-oriented FDI is generally better than FDI that is not export-oriented, this review of the literature suggests that making such a distinction is fraught with difficulties given the dynamic nature of MNE behaviour in foreign markets. Indeed, while FDI has clearly contributed to the export performance of some countries (see, e.g. Lall, 2000), what has not been documented is whether this contribution was preceded by a period of more inward oriented FDI along the lines suggested by the various theories outlined above. What this implies for policy is that the targeting of certain types of FDI with a view to promoting long-run export competitiveness might need to involve efforts to attract FDI that, at least initially, is not export oriented at all. This is more so the case to the extent that a significant amount of FDI is conducted by SMEs, whose initial forays into international markets are unlikely to be export-oriented (UNCTAD, 2001).

3. Data on the performance of FDI

The previous section considered the role of information on the performance of FDI in shaping the subsequent FDI decisions of MNEs. This literature highlights the dynamic nature of the commitments that MNEs make to foreign markets and the role of information on the performance of existing foreign operations in shaping future commitments. One of the implications of this literature is that export orientation will, to a significant extent, be a function of the information received over time concerning opportunities in the market(s) in question.

In this section we will present descriptive data indicating that positive performance in foreign markets has been one of the driving forces behind the internationalisation of production during the 1990s. Figure 1 shows the shares of foreign in total assets (FA/TA), revenues (FR/TR) and profits (FP/TP) of 100 MNEs from the Fortune Global 500 between 1989 and 2000. The first clear trend in the chart is the steady process of internationalisation by these firms. In 1989, the average share of foreign in total assets for the sample was 36 per cent. By 2000, this share had increased to just over 40 per cent.

Figure 1. The foreign investment profitability gap



Source: Gestrin et al. (2001)

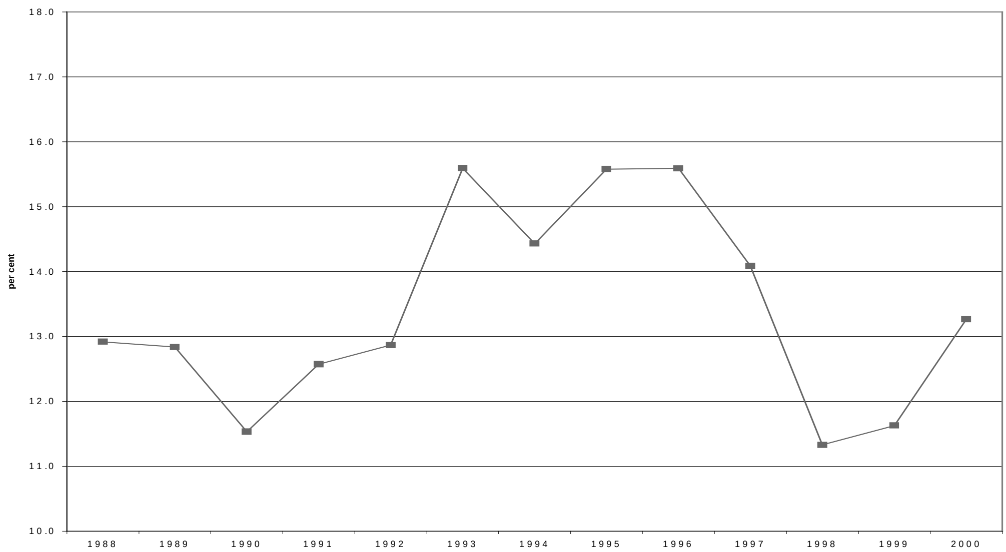
The second point to note is the tendency for the share of foreign revenues and profits to exceed the share of foreign assets. What this indicates is that throughout the 1990s, with only a few exceptions, the foreign assets of this sample of MNEs were generating a disproportionate share of total revenues and profits. This is an intuitive finding, and one that is consistent with the view that the 1990s witnessed the progressive globalisation of MNE activity. As long as MNEs generally managed to earn higher profits in foreign markets than at home, they logically continued to increase their investments in these. In the context of the previous discussion of the dynamic nature of MNE behaviour and the tendency of these to take an incremental approach to their foreign operations, this suggests itself to a fairly basic policy conclusion. Policies that allow MNEs generate profits and revenues through their foreign operations are likely to encourage further foreign investment in existing projects and in new capacity.

But to what extent is the sales intensity of foreign assets observed in figure 1 export oriented? This is difficult to know with certainty but we can make certain inferences based upon intra-firm sales data. A distinction is usually made between horizontal and vertical FDI. Horizontal FDI tends to be market seeking and involves the establishment of foreign facilities engaged in functions similar to those in other markets. Vertical FDI involves the distribution of various parts of an MNE’s value chain in countries where the various activities are best served by location advantages. A commonly held view is that an increasing share of global FDI is of this type and that MNEs are increasingly engaging in integrated international production.

Vertical FDI is export-oriented (and import-oriented) almost by definition. Integrated international production aims to concentrate certain value-chain activities in particular countries and to then export the intermediate products to the next stage of processing in other countries. Horizontal FDI might or might not be export-oriented but is certainly more likely to be characterised by the incremental approach described in section 2 above.

To the extent that MNEs are increasingly engaging in FDI for integrated international production, we would expect that a rising share of foreign affiliate sales be intra-firm. However, recent research has suggested that this is not the case. Rangan (2000), for example, observes that "over the thirty years spanning 1966-1997…the share of U.S. multinationals' intrafirm exports in total U.S. manufacturing exports has remained remarkably stable" (p. 3). This observation is supported by data on the foreign intra-firm revenues of a sample of 30 MNEs from the Fortune Global 500 for which these data were available from 1989 through 2000 (figure 2).

Figure 2. The share of foreign intra-firm revenue in foreign arm's length revenue



Source: author's calculations

Figure 2 seems to indicate is that there is no obvious upward trend in the propensity of MNEs to make FDI with a view to integrated international production networks. Furthermore, to the extent that these companies are representative (indeed, given that these are among the largest companies in the world we would expect them to be most likely to engage in IIP), the share of total revenue generated through intra-firm sales is modest at around 13 per cent.

Within the context of the present discussion concerning the desirability of promoting export-oriented FDI, we might draw several tentative conclusions from these descriptive data. First, it would seem that most FDI remains horizontal in nature and that, at least in this sample of companies, there is no clear trend towards integrated international production. One policy implication of this is that policy makers should probably not over-estimate the potential benefits of integrated international production for export competitiveness in their FDI promotion schemes. Second, most FDI continues to be horizontal in nature and, as such, is likely to have the incremental characteristics outlined in section 2. To the extent that MNEs engage in incremental horizontal FDI, policy makers need to take into account the fact that domestic markets might well be the main initial focus of MNE strategy but that this does not preclude increased export orientation over time.

4. Policy conclusions

The main message of this paper is that, although the potential benefits of export-oriented FDI are widely acknowledged, this does not necessarily lend support for policies aimed at targeting and promoting export-oriented FDI. One reason for this, outlined in our short review of international business literature, is that MNEs tend to take an incremental approach to foreign markets, especially new ones, and that their commitment to these over time will be conditioned to a significant extent by observed performance. Policies that aim to attract export-oriented FDI risk either neglecting or even discouraging FDI that might initially be oriented towards the domestic market but become more export-oriented over time. Indeed, policies that focus on attracting export-oriented FDI, to the extent that these either neglect or even discourage non-export oriented FDI, might actually detract from export competitiveness in the medium and long term.

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