

Lingnan University
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by Professor Avinash Dixit

The Rise of “Southern” Multinationals:
Bad Domestic Governance as
Good Training for FDI

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**Ben C M Wong Lecture Theatre (MBG22),
8 Castle Peak Road, Lingnan University**

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The Rise of “Southern” Multinationals:

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Avinash Dixit

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Lingnan University – October 12, 2010

Economic governance

- Provide security of property and contracts
- Essential for functioning of economic activity:
investment, production specialization, exchange

Institutions of governance

- The state's legislative and judicial system
- Social networks, norms, sanctions

Governance across countries

- All countries have mix of varying proportions and quality
- Always less than perfect, quite bad in many LDCs and transition economies

My research program (work in progress)

to explore some implications of this for FDI

Standard theory of FDI

Choice between exporting, licensing/outourcing, and FDI

Factors favoring FDI

- Firm-specific economies of scale
- Trade barriers or other transport costs
- Insecurity of contracts

Favoring exporting Plant-specific scale economies

Favoring licensing Local knowledge

Usual assumptions about FDI

- MNC is Northern firm
- Has advantage in R&D, high-tech, management
- Information makes these non-contractible
- Southern host country has cost advantage in low-tech production, this may also be non-contractible
- MNC chooses its mode of operation to be optimal constrained by information and contractibility

Contrast with recent FDI in the news

- Lenovo buys IBM's PC division
- Mittal invests in Indonesia, E. Europe; buys Arcelor
- Tata buys Jaguar, Land Rover; Geely buys Volvo
- Chinese, Indian, Malaysian oil companies in Africa
- Petrobras and Vale operate in many countries

Questions

- How important are these examples?
- What theories or models explain them?

Facts concerning “Southern” MNCs

From World Investment Review 2006, UNCTAD and other sources
(“Southern” is catch-all for “third world” and “transitional” economies)

Magnitudes

In 2005 Southern MNCs FDI outflows \$133 bn,
17% of world total \$779 bn

Stock \$1.4 trillion, 13% of world total

Asian Arc (S, SE and E Asia) outflows \$68 bn

E.Europe \$15 bn (87% Russia)

South-South FDI \$2 bn in 1985, \$60 bn in 2004

20,000 Southern MNCs, 26% of total, so smaller than average

Conclusion

Substantial and growing phenomenon, worth attention

Concentration

% of stock in 2004 (rows don't add to 100 because "unspecified" components)

		From (Source, Home)	
		DCs	LDCs
In (Host)	DCs	92.8	6.1
	Asian Arc	32.9	64.8

Regional concentration – in Asia, Latin America, E.Europe/Russia

Aside – many problems with data

- M&A and greenfield investments lumped together
- Fraction of ownership needed for control inconsistent
- FDI from offshore financial centers conceals true origin
- “Round-tripping” and “trans-shipping” create artificial FDI
- Change in listing of a firm creates FDI but no real change
- Single deal has big effect on one year’s flows ...

Early literature

Theodore Wells, Third World Multinationals, 1983

Sanjaya Lall et al., The New Multinationals, 1983

Some key findings

- Southern MNEs smaller
- Technologies, management adapted to local conditions
- Developed skills to manage low-skilled workers
- More likely to engage in joint ventures
- More likely to engage in bribery of local officials

Usual explanations (not mutually exclusive)

- Poor home-country governance makes FDI more attractive
- Responding to approach by host country firm or government
- Southern firms use FDI to acquire modern technology
- Acquire natural resources or land rights (esp. host state firms)
- Their home governments encourage or subsidize this

New possibility, related to governance

- Poor host-country governance creates non-contractibility
- Southern MNEs better at coping with bad governance

Southern MNCs governance advantage

- Technology better adapted for poor governance
- Know importance of contacts and relationships to navigate regulatory obstacles; have experience in doing so
- More used to bribery; less constrained by home country laws
- Pre-existing ethnic and linguistic networks

Some evidence in support of hypothesis

Case Studies, Anecdotal

- Inward – Chinese ethnic networks for inward FDI to China and for FDI around E, SE Asia (Fan J Contemporary China 1998, Rauch J Econ Lit 2001)
- Inward – Western investors use Hong Kong as intermediary when investing in China (Li and Lian City U. WP 1999)
- Huawei, TCL looked for political (Russia, Vietnam) and cultural (SE Asia) affinity with destination countries (Chen & Lin 2008)
- Turkish v. US investment in Kazakhstan (from G. Aldashev)

Statistical

- Fung and Garcia-Herrero (Working Paper 2010)
Chinese FDI attracted to more corrupt countries
- Cuervo-Cazurra and Genc (J Int Bus Studies 2008);
Darby, Desbordes, Wooten (CEPR DP 7533, Nov 2009):
Negative effect of bad governance on FDI is smaller when
investing firm's home country also has bad governance
- Hsiang-Chih Hwang (Working Paper 2010):
Within-region investors to E and SE Asia less sensitive to
country-risk, more to economic fundamentals

Preliminary exploratory modeling

Reinterpret or adapt existing models

- Interpret cost or technology parameters as transaction and governance costs; these lower for Southern MNCs
- Contractibility can be a property of MNC – host country *pair*
- Southern MNCs may choose different organizational mode

Will present such adaptation of a recent model

Then a skeleton for a new model

Model 1 – Extension of Javorcik and Wei, JIMF 2009

Choices stay away (Z), joint venture (J), FDI/vertical integration (V)

Level of technology used by MNC at home $= t$

Level of rottenness of host country governance $= r$

Revenue from project depending on mode: $R_V \geq R_J$

Cost of production including technology adaptation

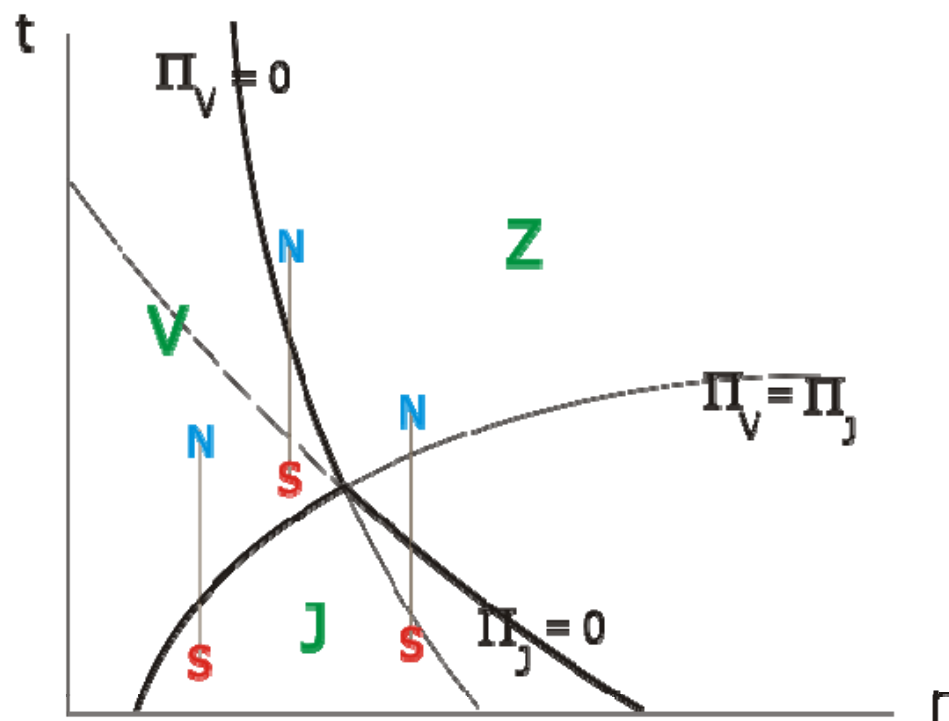
$$C_J = cr + at, \quad C_V = (c + \theta)r + (a + \mu)t$$

Cost arising from technology leakage $L_J = \gamma t + \phi tr$

Profits: $\Pi_W = R_V - (c + \theta)r + (a + \mu)t$

$$\Pi_J = R_J - (a + \gamma)t - cr - \phi tr$$

Regions **V**, **J**, and **Z** labeled in **green**, **thick** separating curves



Different choices by **Northern** and **Southern** firms – cases L to R

- [1] N is V, S is J [2] N is Z, S is V [3] N is Z, S is J

Model 2 – Skeleton multi-country, imperfect governance model

Quality of governance Q , in range $[0,1]$

If a firm from source country Q' invests in host country Q

$$\mathbf{Pr}(\text{Contracts honored}) = P(Q, Q') = \begin{cases} Q & \text{if } Q' \leq Q \\ Q f(Q' - Q) & \text{if } Q' > Q \end{cases}$$

Examples

$$f(x) = e^{-ax} \quad \text{or} \quad \frac{1}{1 + bx}$$

Consider country with governance quality Q

Value of successful project V ; Costs C_N , C_S

Compare investments by Northern, Southern MNCs

Difference in expected profits

as function of Q , host country's governance

Case A $Q_N > Q_S > Q$

$$\Delta\Pi(Q) = \Pi_S - \Pi_N = [f(Q_S - Q) - f(Q_N - Q)]QV - (C_S - C_N)$$

This is maximized at $\hat{Q} = Q_S$

so South-South FDI among similar countries

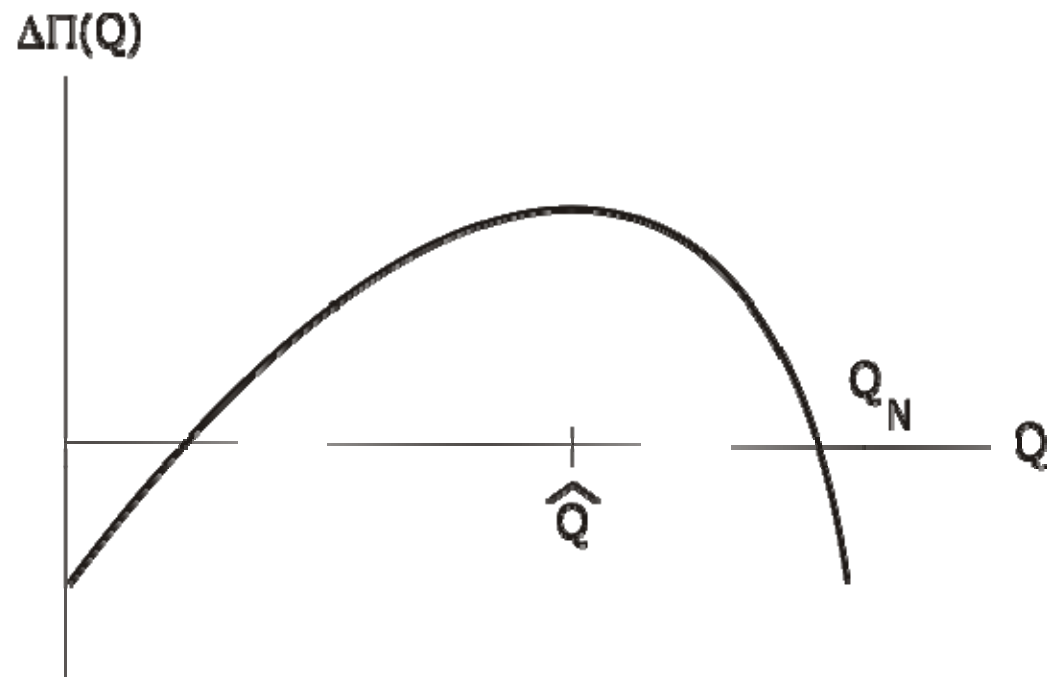
Case B $Q_N > Q > Q_S$

$$\Delta\Pi(Q) = \Pi_S - \Pi_N = [1 - f(Q_N - Q)]QV - (C_S - C_N)$$

Max at $\hat{Q} < Q_N$

$\hat{Q}$ depends on Q_N
but not on Q_S
(so long as $Q_S < \hat{Q}$)

Mid-range Q
host countries get
most Southern FDI



Testable hypotheses given sufficiently good data

But need to distinguish from

- Usual explanations that also apply to Northern MNCs
- Other network advantages of Southern MNCs
 - Regional
 - Linguistic
 - Ethnic
 - Colonial ...

Potentially rich program for future research

Summing up, research suggestions

One reason for success of Southern MNCs

Experience, skill in coping with low-quality governance
when investing in other South or “lower North”

Implications for theory and empirical work on FDI

- Both countries' governance quality matters interactively
- Effect highly nonlinear in the two governance qualities
- Need more, better data for further empirical testing

Policy implications

If an LDC wants FDI but cannot improve governance,
it should cultivate sources in other similar LDCs
Western investors should pay more attention to
governance defects, seek local partners/guides

The future

Hopefully, governance in most countries will improve
Then the special advantage of LDCs will diminish
Usual determinants of FDI will remain / become important