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Comment Anne O. Krueger

This paper is a well-done and interesting exercise in which the authors develop an asymmetric information model of foreign direct investment (FDI). The driving factor in the model is the assumption that foreigners have inside information about the prospects of the domestic firms into which they buy. They then retain equity shares in firms with good prospects, but sell shares in firms with less satisfactory prospects. Domestic investors do not have this information, and buy shares on the domestic capital market.

Because foreigners have selectively retained shares, the average return on the domestic share market is less than it would have been had there been less (or no) FDI. There is overinvestment by foreigners (who get above-average rates of return because of their superior knowledge) and undersavings by domestic residents (who are receiving below-average rates of return), with a consequent welfare loss (which could be offset by increased competition, technology transfer, and other benefits of FDI in their model). Razin, Sadka, and Yuen (RSY) then simulate their model, and conclude that welfare losses may well result from FDI based on plausible estimates for the parameters.

The model is ingenious and well developed. It has long been known that capital inflows in the presence of distortions could be immiserizing (see

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Brecher and Diaz-Alejandro 1977 for an early demonstration), and the RSY result is another instance of that outcome. In the RSY specification, all firms are alike except that, in the production function for each firm, there is a stochastic element which is not known ex ante. Once there is a specific shock, insiders know about it and outsiders do not, so there is a distortion. The result as modeled by RSY is a "lemons" problem for the domestic capital market, as "good firms" are ones in which foreigners retain their investments while "bad firms" are ones they remove from their portfolios. FDI is thus a firm-specific equity investment on the part of foreigners.

While the model generates that result, one can question how applicable it is to the real world. One might first ask, if there is asymmetric information, who is likely to be better informed: domestic residents or foreigners? For the RSY model, the timing of who knows what and when is crucial to the outcome: If domestic residents know, or sense, that there are problems before foreigners do, the outcome could easily be reversed.

A second question relates to the behavior of domestic entrepreneurs who know they have a good outcome. In the RSY model, they cannot finance with equity because domestic residents will underprice their prospects. From this specification, a question arises as to what domestic entrepreneurs do, and where domestic savings go. Does this imply that good investments are not made at all? Why cannot domestic entrepreneurs attract foreign capital?

While these questions are specific to the model, there are some more general issues that give rise to concern. All production functions are assumed to be alike, with the difference only in the stochastic element. In the real world, managers differ in their abilities: The same physical assets may yield significantly different returns when placed in the hands of a competent manager. If foreigners are competent managers, the benefits of FDI (as takeovers from incompetent managers) would be much greater than can be modeled within the RSY framework.

Related to that consideration, FDI might be regarded as a mechanism with which foreigners identify (and perhaps improve) domestic managers. If the quality of domestic management increases as a result of FDI, the welfare results would be quite different than those that emanate from the asymmetric information framework.

Finally, RSY find that FDI goes to countries where there is good growth, which they believe is consistent with their hypothesis. In fact, it is equally consistent with the view that FDI goes to countries whose overall economic policy framework is conducive to efficient resource allocation; and, countries with such policy frameworks achieve superior growth performance.

Overall, then, I find the paper interesting and useful in demonstrating one mechanism through which FDI might interact with domestic distortions. I question, however, whether the sort of asymmetric information assumed in the model is the type most frequently found in developing countries, and believe that other alternatives—with the opposite implications for the impact of FDI—are at least as plausible as the RSY mechanism.

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Comment Mario B. Lamberte

The issues raised in this paper are indeed timely, especially since most governments in Asia are now reviewing their policies on foreign capital flows in light of the Asian financial crisis. There is currently much talk about favoring foreign direct investment (FDI) more than portfolio inflows; however, the results of this paper suggest that an appropriate policy for FDI is needed for a country to benefit fully from it.

The paper attempts to formalize, in models, two nontraditional views on FDI. I will comment on each model in order.

First Model

There is a need to remind ourselves of the difference between FDI and portfolio inflows. Usually, FDI investors go to a developing country not to buy an existing firm but to establish a new one, bringing with them their capital and technology. Unlike portfolio investment inflows, FDI inflows stay much longer. Foreign direct investments typically go into areas where domestic investors do not go for lack of access to capital and technology. All this implies that

1. FDI investors know already the productivity levels of the firms before they establish them as subsidiaries in developing countries;
2. Unlike short-term portfolio investments, FDI subsidiaries are kept by parent firms because they confer strategic advantages to the parent firms; and
3. As the paper suggests, local investors are facing liquidity constraint and, given the huge amount of capital required to acquire the shares of FDI investor in a firm, they cannot possibly afford to buy and take over the subsidiaries of foreign corporations. Aside from financial constraint,

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