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Chapter Title: Comment on "Social Benefits and Losses from FDI: Two Nontraditional Views"

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tions. 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.

Reference

Brecher, Richard, and Carlos Diaz-Alejandro. 1977. Tariffs, foreign capital and immiserizing growth. *Journal of International Economics* 7 (4): 317–22.

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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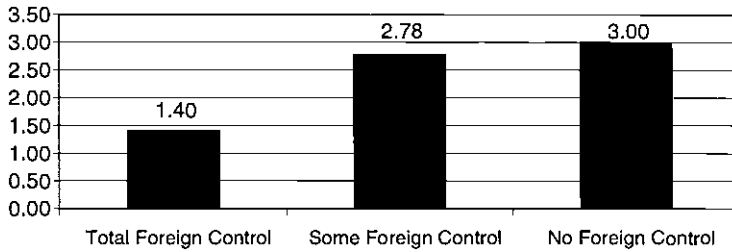


Fig. 9C.1 Average debt-equity ratio of firms according to the extent of foreign participation

local investors are unlikely to have access to the technology and the management system to manage it. It is to be noted that subsidiaries are dependent on their parent companies for so many things, one of which is research and product development. Given the cost of R&D, the local investors will not be on equal footing with FDI investors when they acquire subsidiaries of foreign companies.

The paper assumes that in the presence of a domestic credit market, “it is often observed that FDI is highly leveraged domestically” (315). I tried to check the situation in the Philippines and found that wholly foreign-owned firms are the least leveraged firms (see fig. 9C.1). The most highly leveraged firms are the wholly domestically-owned firms.

There are several reasons for this. First, banks in host countries are usually subject to several regulations, one of which is the single-borrower’s limit. Given that banks in developing countries are small, subsidiaries of foreign corporations that normally have huge capital requirement easily hit the single-borrower’s limit; thus they cannot borrow from domestic banks as much as they want to. Secondly, developing countries usually have laws limiting the amount that subsidiaries of foreign corporations can borrow from the domestic market so as not to crowd out local firms as well as to encourage them to bring in more capital. For example, in the Philippines, subsidiaries of foreign corporations are allowed to borrow from local banks up to only 50 percent of their capital.

If, indeed, FDI investors unload their shares in their subsidiaries in the local market because their productivity is later found to be lower than their “reservation” productivity level, then what will they do with the proceeds? Will they repatriate them? If so, then how will the process of FDI inflows suggested by the model be affected?

Second Model

The second model banks on the assumption that an increase in competition in the input market brought about by FDI inflows (given the perfectly

elastic supply of inputs from abroad) will drive w , the price of intermediate inputs, to its competitive level. This implies that inputs brought in by FDI and domestic inputs are perfect substitutes. This may not be an appropriate assumption because, typically, inputs brought in by FDI are different from those that are locally available. If so, then w will not be driven down to its competitive level.

Finally, near the end of the paper, the authors state that their “. . . simulation results show that substantial welfare losses can indeed be brought about by FDI in the presence of adverse selection in the domestic equity market. These losses can nonetheless be dominated by the gains induced by the technology transfer and competition promotion effects of FDI” (329). This assertion is not clear to me from the analyses presented in the paper. It seems to me that the two models have not yet been integrated.