8th Annual Conference in Political Economy
Berlin School of Economics and Law
September 13-15, 2017

Re-approaching Foreign Direct Investment through the eyes of Political Economy

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FOREIGN DIRECT INVESTMENT (FDI)

Between countries

Long-term control

Transfer of productive capital by MNCs

FDI is different from foreign portfolio (financial) investment

UNCTAD WORLD INVESTMENT REPORTS 2011, 2013

In 2010

- About 80% of international trade in goods and services related to MNCs

- Global FDI reached $1.24 trillion, i.e. 10% of the world gross fixed capital formation

PRESENTATION OUTLINE

- Historical overview of FDI movements
- Theoretical framework
- Empirical evidence from the European South
- Conclusions

Historical overview of FDI movements (1/4)

- FDI historically appears around the mid-19th century (Cohen 2007; Dunning and Lundan 2008)

- Two main distinct periods of FDI movements:
  1) The period prior to the Second World War (1870-1938)
  2) The period after the Second World War (1945-present)

Historical overview of FDI movements (2/4)

During the 1870-1938 period

- FDI flows were directed mainly **from developed towards developing countries**

- Over half of the bulk of FDI was directed towards **resource-based industries**, agriculture, raw material extraction and related infrastructure

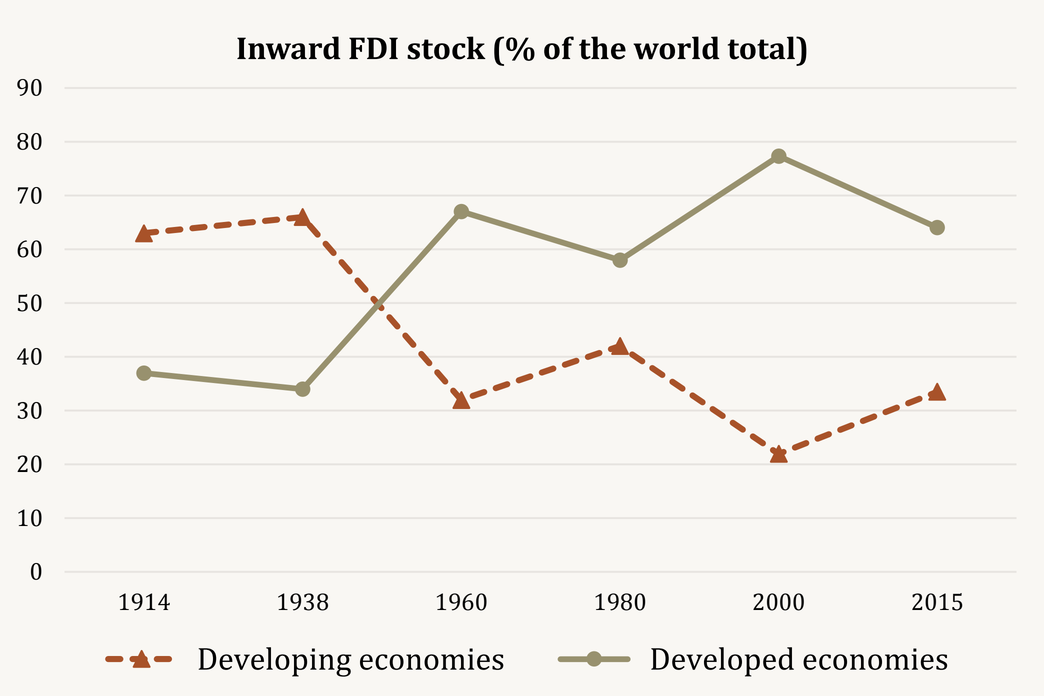
- Manufacturing investments were mostly of a market-seeking type and were mainly concentrated between developed countries

Historical overview of FDI movements (3/4)

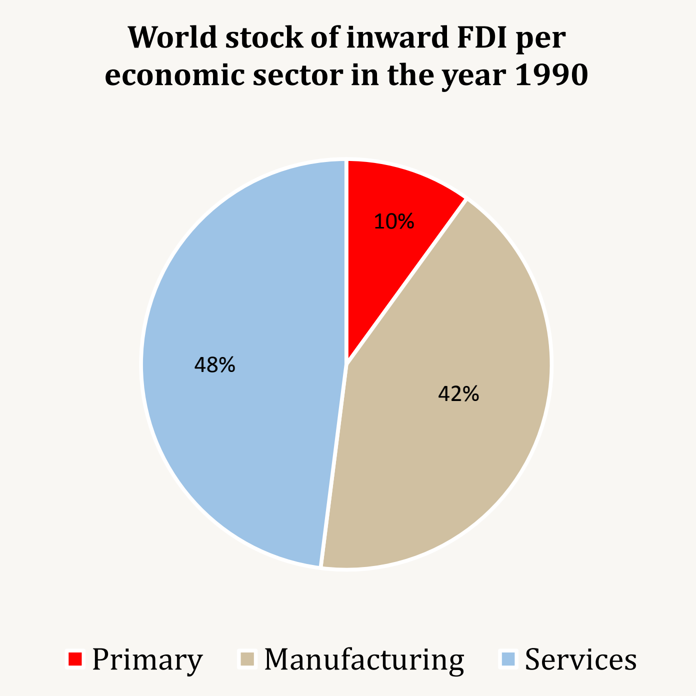
After 1945

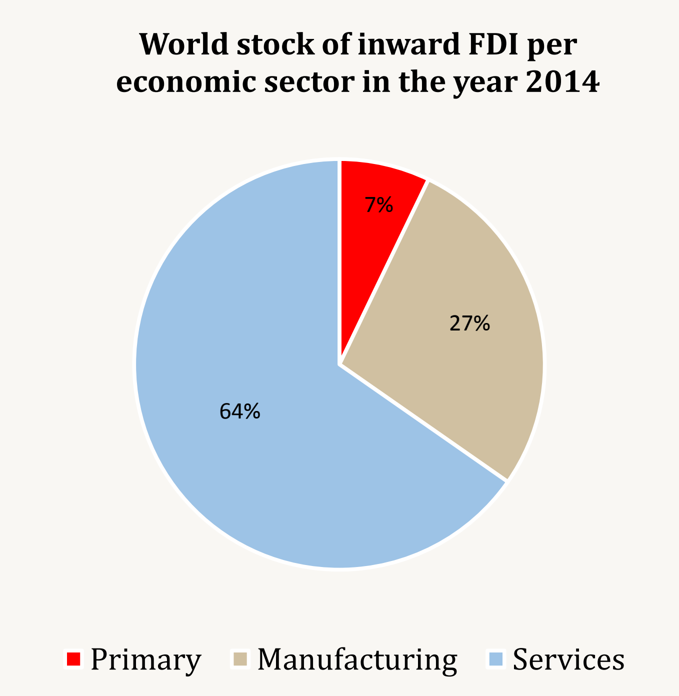
- A **double shift** takes place in the **direction of FDI**
- FDI flows concentrate mainly **between developed countries**
- FDI flows are directed mostly towards the **industrial and service sectors**
- According to recent data, similar trends in FDI movements continue on today (UNCTAD: World Investment Reports)

Historical overview of FDI movements (4/4)



Sources: Dunning & Lundan 2008; UNCTAD





Source: UNCTAD World Investment Reports

- Why did this double shift in the direction of FDI take place?

Theoretical framework (1/17)

- **Which are the main national economic factors that attract FDI?**
- According to Marx **capital is sent abroad**, not because it absolutely cannot be applied at home, but **because it can be 'employed at a higher rate of profit in a foreign country'** (Marx 1894)
- FDI will, therefore, *ceteris paribus*, be attracted by countries which have a relatively higher (national or sectoral) rate of profit

Theoretical framework (2/17)

- Early 20th century classical Marxist writers argued that capital is usually exported from advanced capitalist economies towards backward countries where profits are usually high due to capital scarcity, lower wages and cheap raw materials (Hilferding 1910; Lenin 1917; Bukharin 1917)
- However, although most classical Marxist theories seem to explain the general trend of FDI movements prior to 1938, they do not perform well in explaining FDI patterns during the post-war period

Theoretical framework (3/17)

- Throughout the post-war period FDI is primarily directed towards developed countries
- Interestingly, low wages do not appear to be the key location advantage regarding internationally integrated production (Rugman and Verbeke 2009)
- Wages cannot be seen independently of productivity as a factor in attracting FDI (Cohen 2007; Dunning & Lundan 2008)

Theoretical framework (4/17)

- Over the long run, real wages tend to move with trends in labour productivity growth (Samuelson and Nordhaus 2010; Krugman et al. 2012)
- If, however, the growth in productivity is more rapid than the growth in wages, profitability will, *ceteris paribus*, tend to rise thus leading to a probable increase in FDI
- Therefore, **productivity** - and not a low wage rate - seems to be **the crucial factor in attracting FDI**

Theoretical framework (5/17)

Productivity and inward FDI

- According to Adam Smith (1776) the primary cause of the rise in a nation's productivity is the ***division of labour***

'**The greatest improvement in the productive powers of labour**, and the greater part of the skill, dexterity, and judgement with which it is anywhere directed, or applied, seem to **have been the effects of the division of labour**.'

Smith: Wealth of Nations, Book I, p. 13

Theoretical framework (6/17)

Productivity and inward FDI

- The division (specialization) of labour enables the development of complicated combined production processes and sophisticated means of production which in turn enable a further increase in productivity

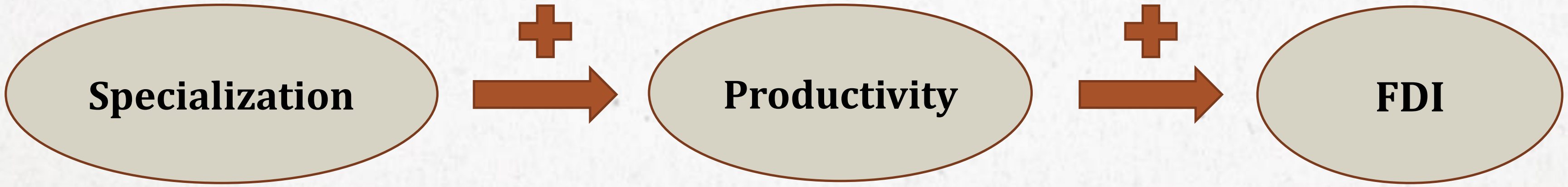
‘[I]t is only **the experience of the combined labourer** which discovers and **reveals the where and how** of saving, the simplest methods **of applying the discoveries**, and the ways to overcome the practical frictions arising from carrying out the theory - in its application **to the production process**.’

Marx: Capital, Volume III, p. 74

Theoretical framework (7/17)

Productivity and inward FDI

- The rise in productivity, caused by specialization, *ceteris paribus*, will tend to increase profitability which in turn will probably attract FDI



Theoretical framework (8/17)

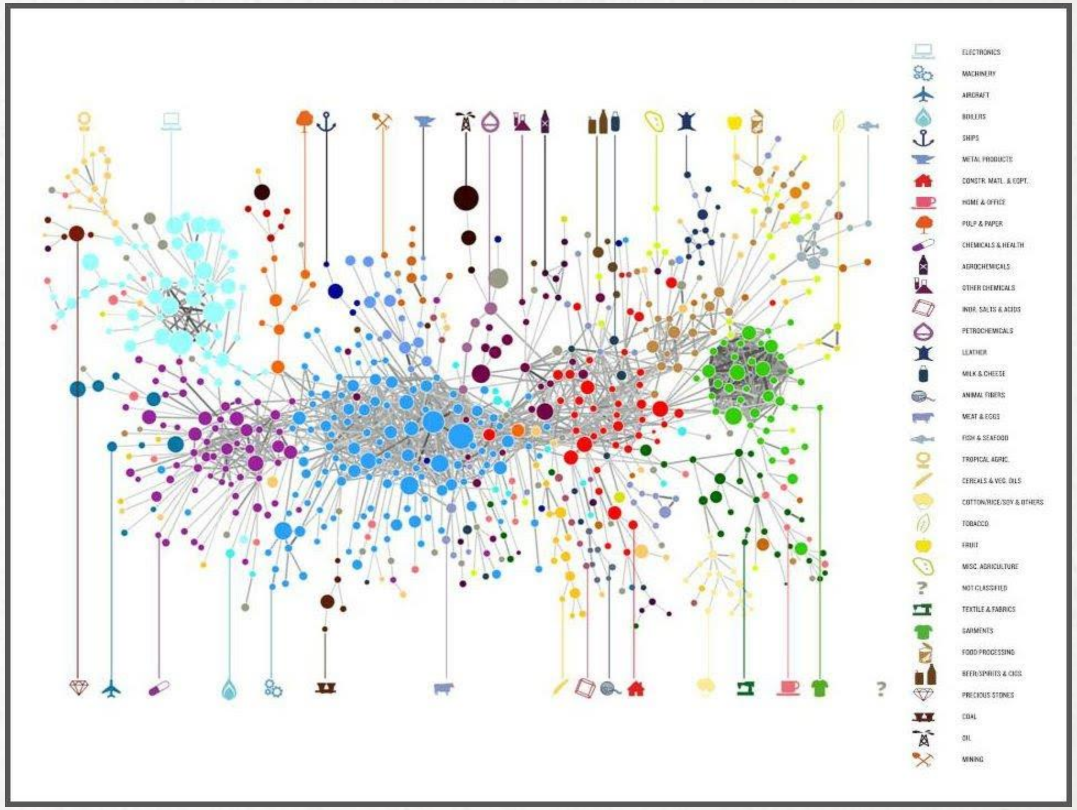
Economic complexity, productivity and FDI

- Productivity does not depend **solely** on specialization *per se*
- It depends on ***how*** and on ***which*** productive sectors an economy specializes
- It also depends on the way in which a country's **productive sectors interact** with each other in order to produce their final products

Theoretical framework (9/17)

Economic complexity, productivity and FDI

- ❖In other words, national productivity depends on a country's ***economic complexity*** (Hidalgo and Hausmann 2009; Hidalgo 2009; Hausmann-Hidalgo et al. 2011)



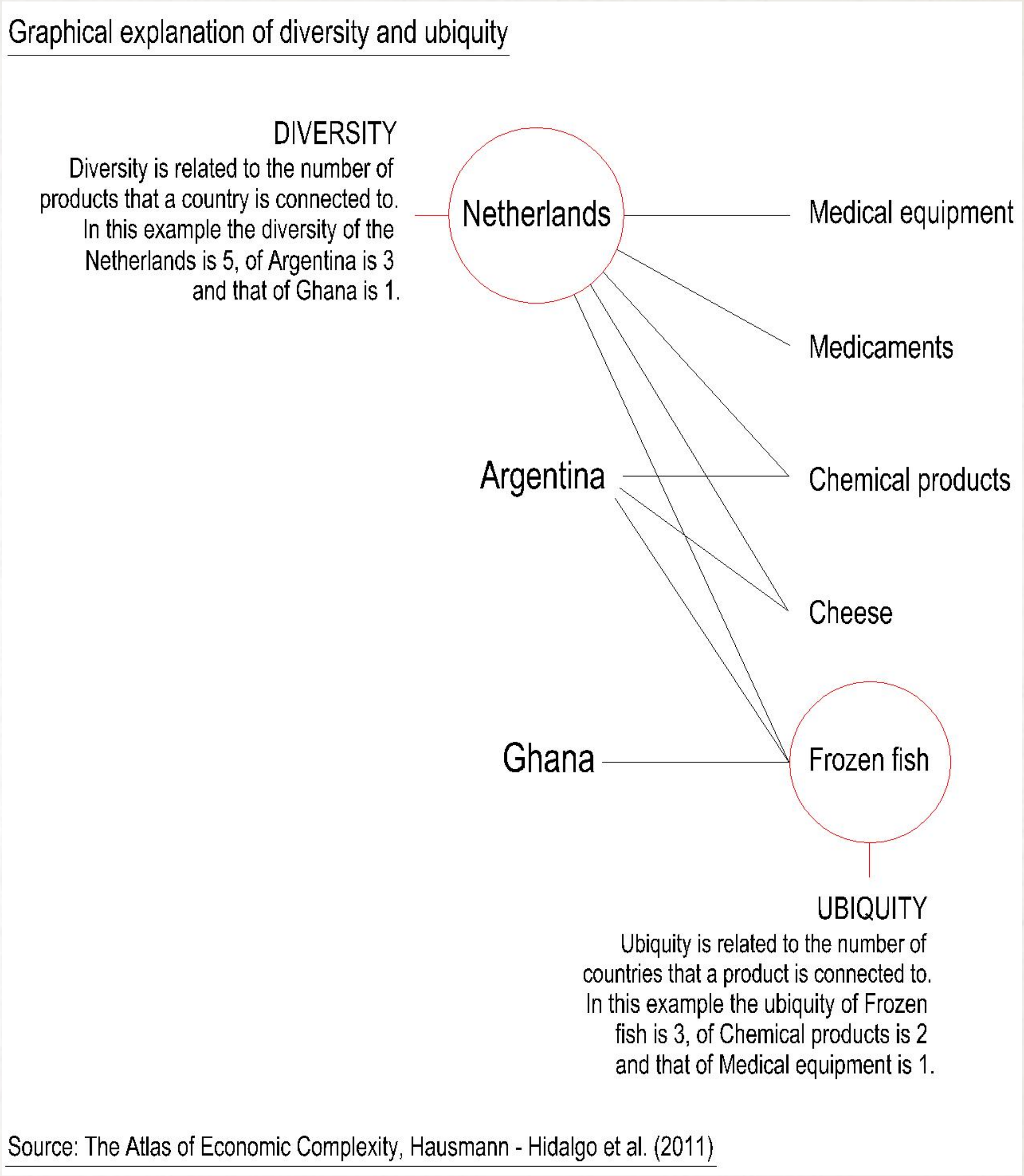
Source: Observatory of economic complexity
http://atlas.media.mit.edu

Theoretical framework (10/17)

Economic complexity

- ❖In 2009, Hidalgo and Hausmann introduced an empirically measurable index which shows the complexity of national economies

- ❖***Economic complexity*** is a function of a country's productive ***diversity*** and product ***ubiquity***



Theoretical framework (11/17)

Economic complexity, productivity and FDI

- Increased economic complexity leads to a rise in national productivity
- Therefore, countries with a relatively higher level of economic complexity, *ceteris paribus*, will tend to attract more FDI

Theoretical framework (12/17)

Economic complexity and future profit prospects

- Furthermore, Hidalgo & Hausmann (2009, 2011) argue that economic complexity, apart from being a reliable indicator of current national productivity, can be used as a predictor of future economic growth

- Dunning (1998) and Cohen (2007) argue that **one of the most important reasons** for an MNC to choose **to invest** in a specific foreign country **is the country's current and projected growth potential**

- Therefore, MNCs may see economic complexity also as a sign of future profit prospects

Theoretical framework (13/17)

The size of the market, economic complexity and FDI

- Market size is considered to be one of the most important factors of inward FDI (Vernon 1966; Dunning 1977, 1981, 1998; Lim 2001; Dunning & Narula 1996; Cohen 2007; Dunning & Lundan 2008)
- *Ceteris paribus*, increased GDP and GDP per capita will tend to attract more FDI
- However, **increased GDP and GDP per capita are closely related to national productivity** (Smith 1776; Porter 1998;) **and thus to economic complexity** (Hidalgo & Hausmann 2009)

Theoretical framework (14/17)

The size of the market, economic complexity and FDI

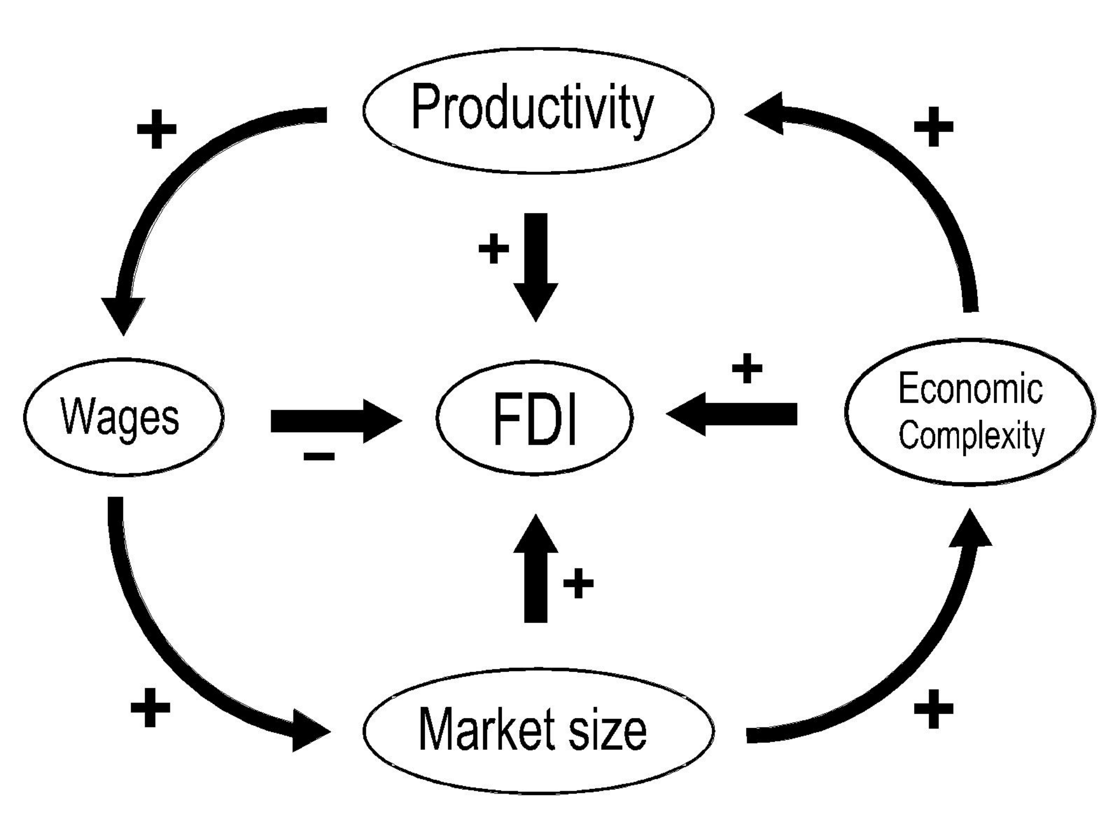
- A larger market may in turn promote greater economic complexity
- According to Adam Smith, the size of the market plays a crucial role in the extension of the division of labour (economic complexity)

‘As it is the power of exchanging that gives occasion to the division of labour, so **the extent of this division must always be limited by** the extent of that power, or, in other words, by **the extent of the market.**’

Smith: Wealth of Nations, Book I, p. 31

Theoretical framework (15/17)

Overall graphical presentation



Theoretical framework (16/17)

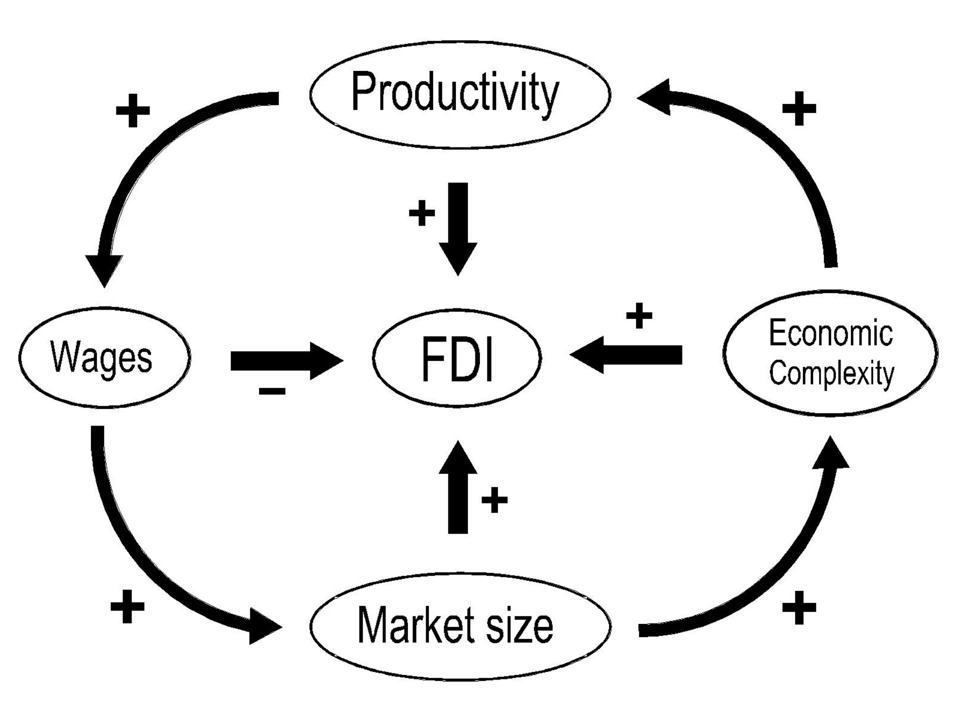
National protectionist policies and FDI

- National trade and monetary protectionist policies may potentially also increase FDI (Bukharin 1917; Busch et al. 1984)
- Profit losses caused by reduced trade, following the imposition of tariffs or the depreciation of a domestic currency, may trigger FDI in order to restore lost profits

Theoretical framework (17/17)

THEORETICAL ASSUMPTIONS

1) An increased market size will tend to attract a greater amount of FDI
2) FDI will tend to be distributed among countries which have a good relation between productivity and wages
3) FDI will tend to be attracted by countries which demonstrate a relatively higher level of economic complexity
4) Economic integration will tend to reduce FDI among members



Empirical evidence from the European South (1/5)

Factors examined

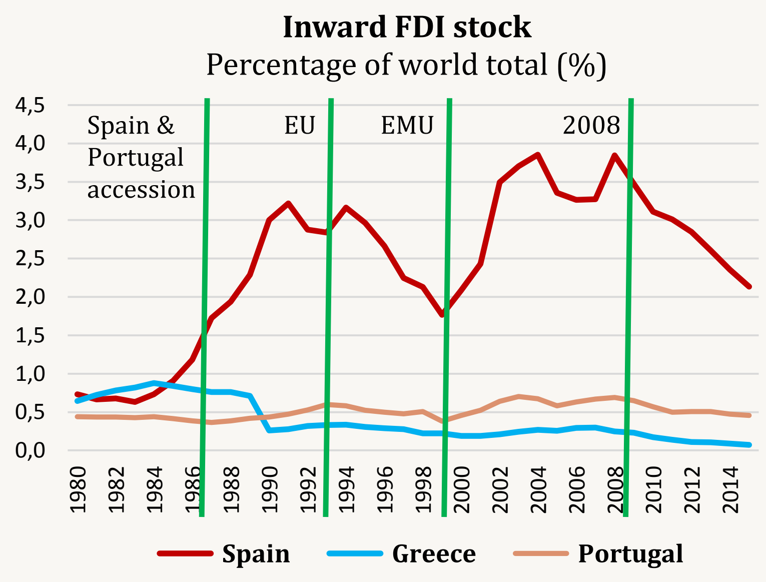
1) Market size (GDP and GDP per capita)
2) Relation between productivity and wages (GDP per hour worked and wages)
3) Economic complexity (ECI)
4) Impact of European trade and monetary integration (EU and EMU)

Countries examined

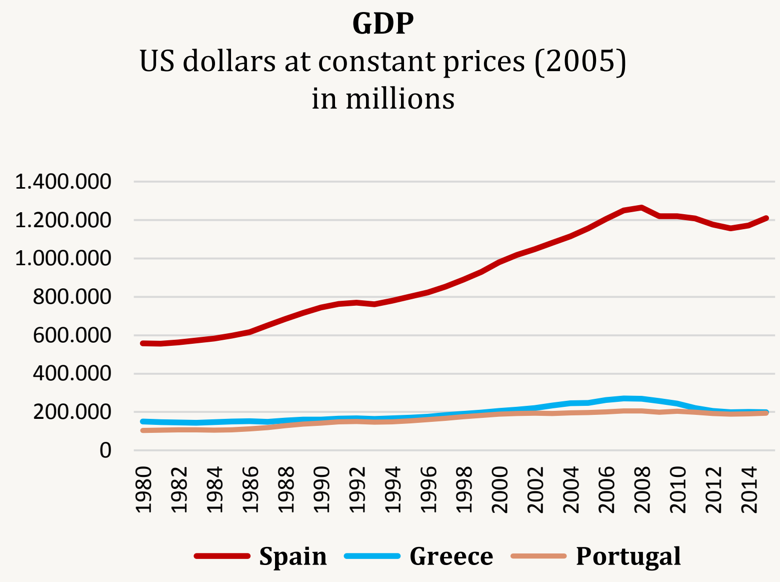
- Spain
- Greece
- Portugal

Empirical evidence from the European South (2/5)

Market size and FDI in the European South



Source: UNCTAD



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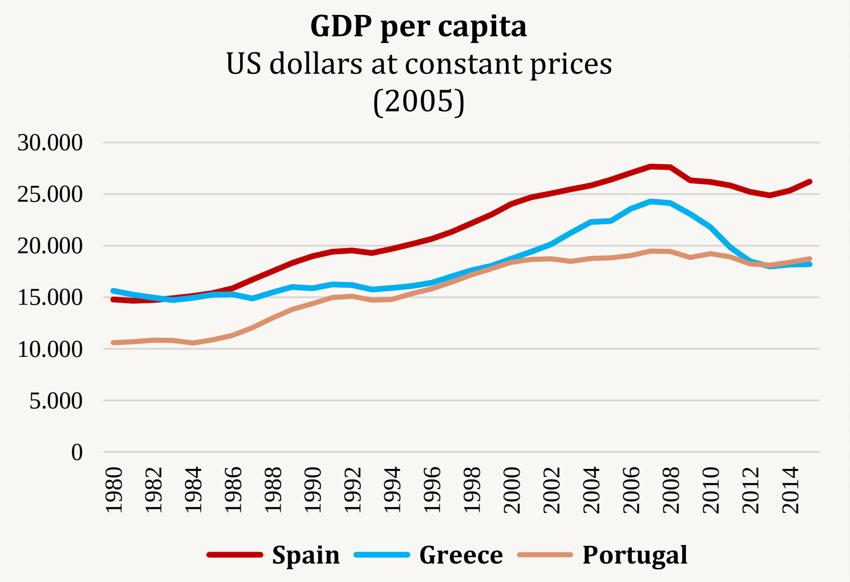
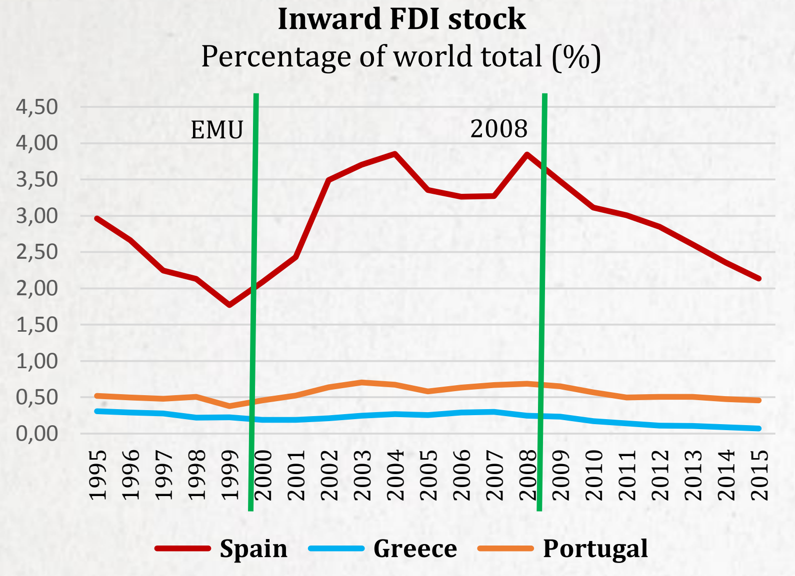


Source: UNCTAD

- ❖ Size matters for FDI (Spain)
- ❖ What about similar market sizes? (Greece, Portugal)

Empirical evidence from the European South (3/5)

Productivity, wages and FDI in the European South



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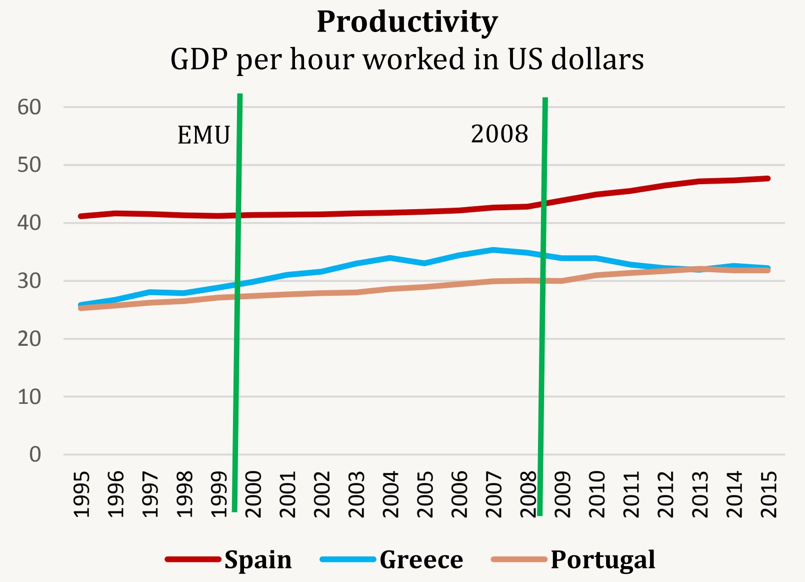
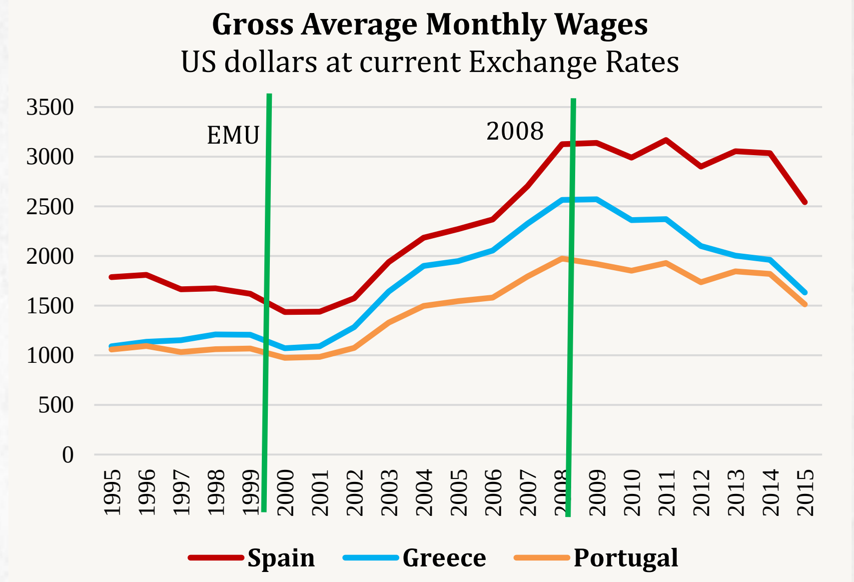


Source: OECD



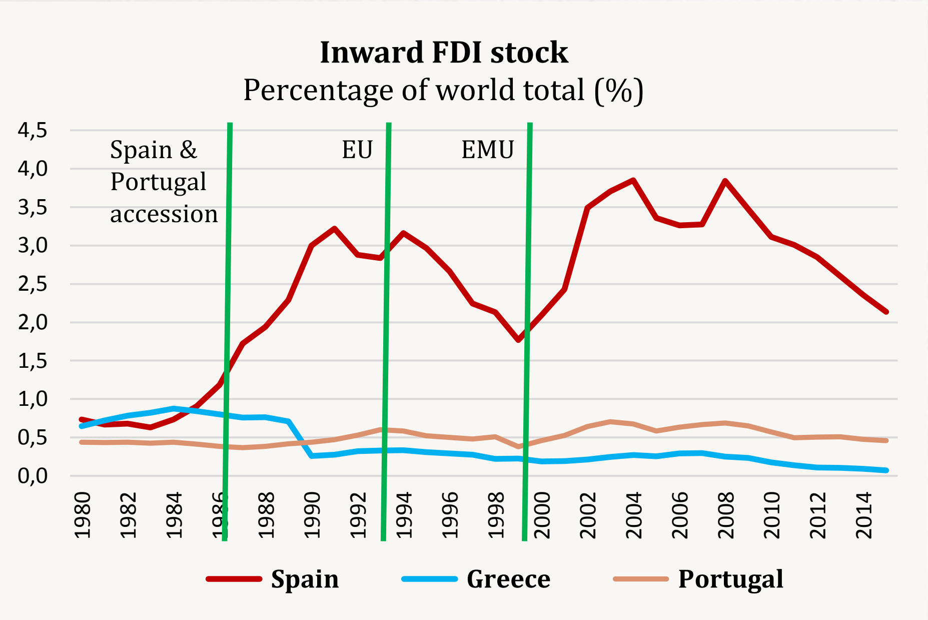
Source: UNECE

Productivity differentials: Spain>Greece (37%), Spain>Portugal (49%), Greece>Portugal (9%)
Wage differentials: Spain>Greece (34%), Spain>Portugal (57%), Greece>Portugal (18%)

- Portugal has a better relation between productivity and wages than Greece

Empirical evidence from the European South (4/5)

Economic complexity and FDI in the European South



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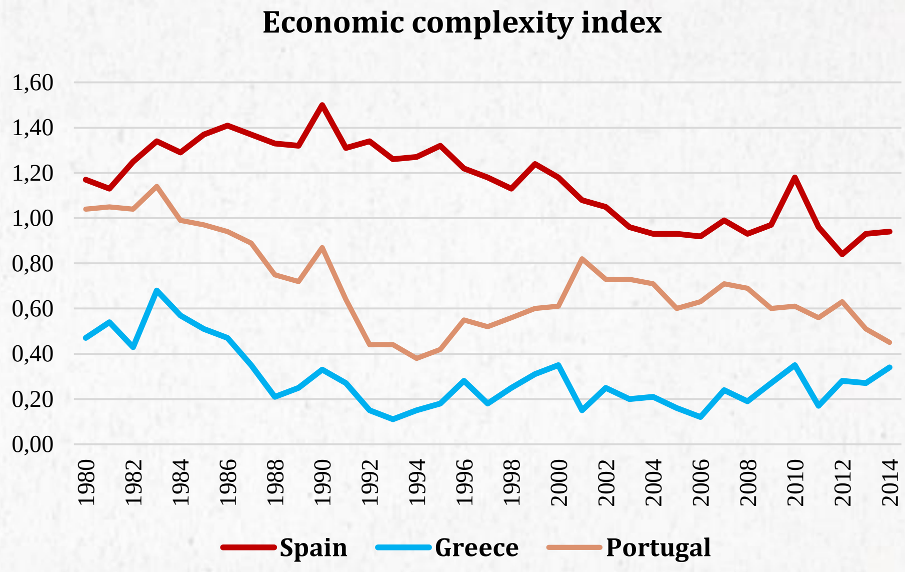


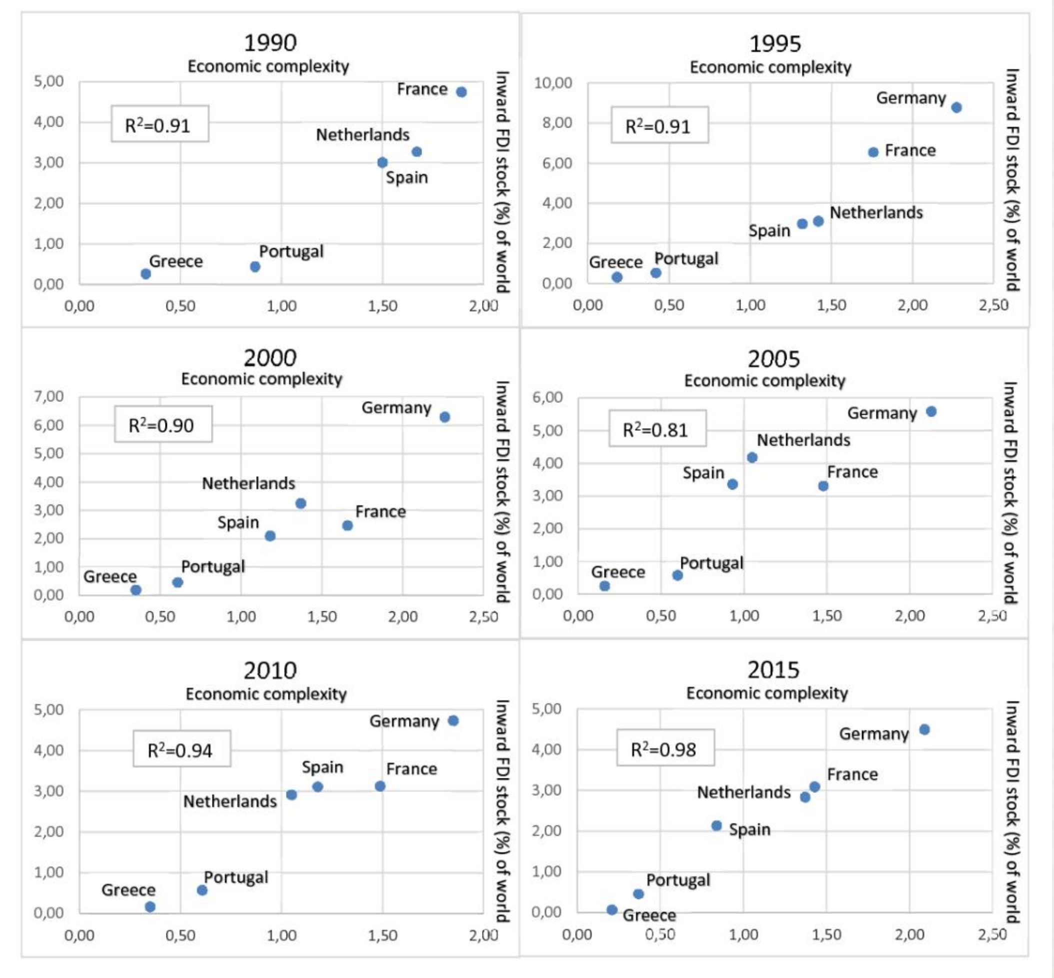
Source: Observatory of economic complexity
http://atlas.media.mit.edu

- In the case of Spain, Greece and Portugal, FDI seems to be attracted by a relatively higher level of economic complexity

Some general empirical findings

Economic complexity and FDI in the EU

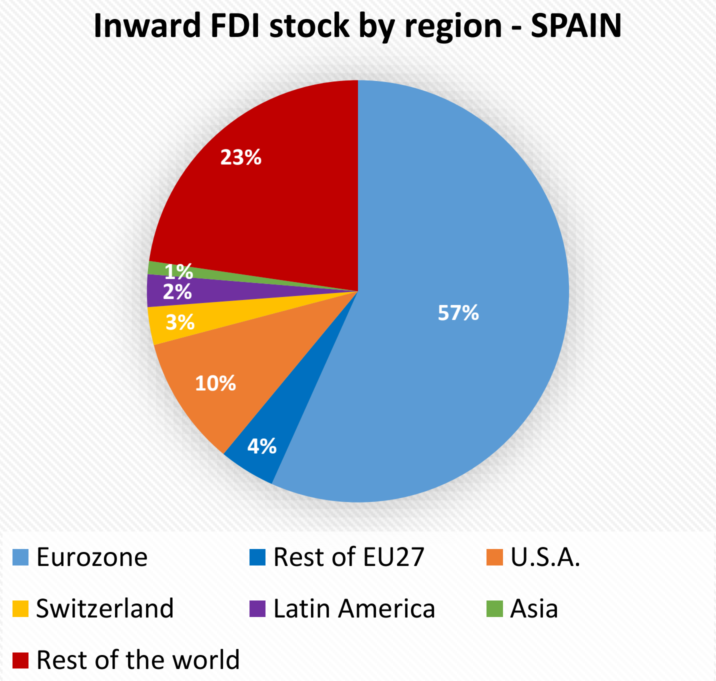
❖ When comparing countries at a very different level of development, economic complexity seems to be able to explain differences in FDI attractiveness



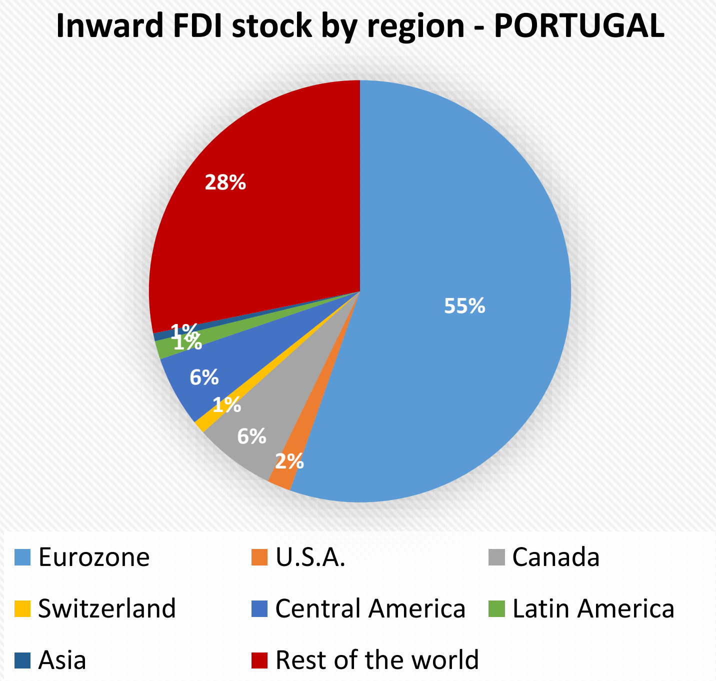
Sources: UNCTAD & Observatory of Economic Complexity

Empirical evidence from the European South (5/5)

FDI in the European South by partner countries



Source: OECD



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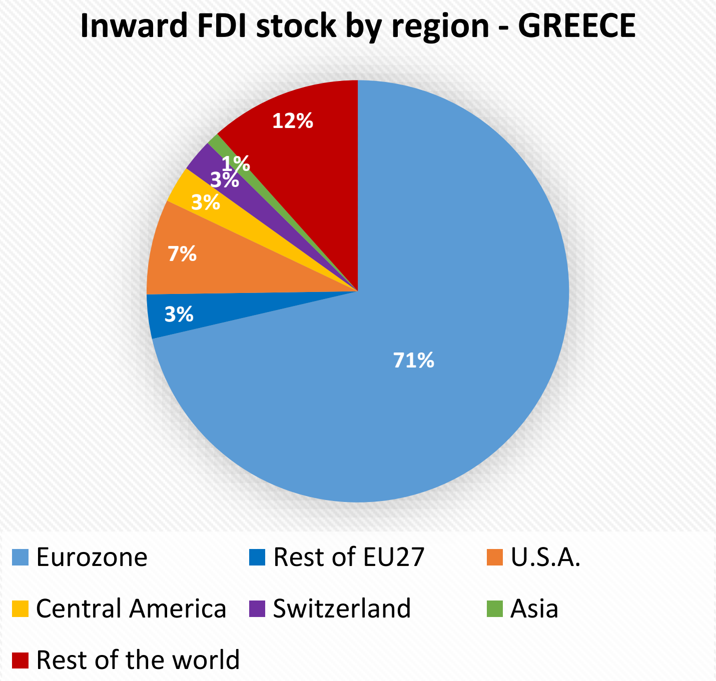


Source: OECD

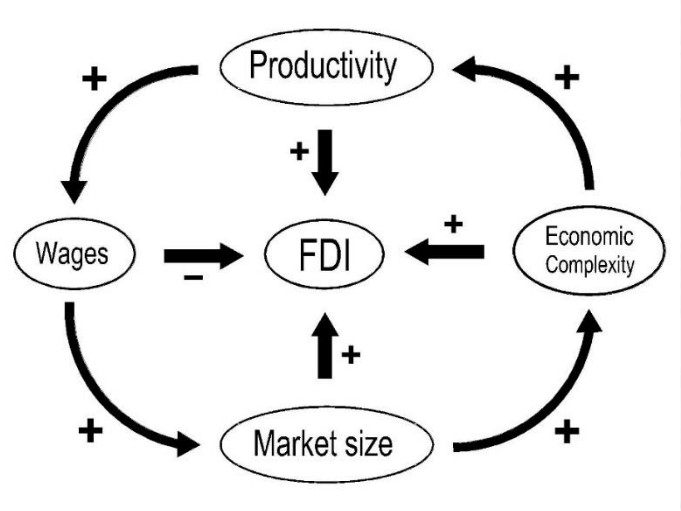
Greece has a relatively greater dependence on FDI from the EU

Conclusions (1/4)

❖ FDI is not primarily attracted by low wages

❖ A country's FDI attractiveness is **co-determined** by its:

- National productivity
- Average wage rate
- Market size
- Economic complexity



❖ Economic complexity seems to be a main factor of increased national productivity and potentially of increased inward FDI

Conclusions (2/4)

- In the case of Spain, the **accession to the EU and the Eurozone** seems to have an overall **positive effect** in attracting FDI
- Although under a decreasing level of protection, Spain seems to attract more FDI due to its:
  - Larger market
  - Higher economic complexity
  - Good relation between productivity and wages
  - Medium dependence on FDI coming from the EU (61%)

Conclusions (3/4)

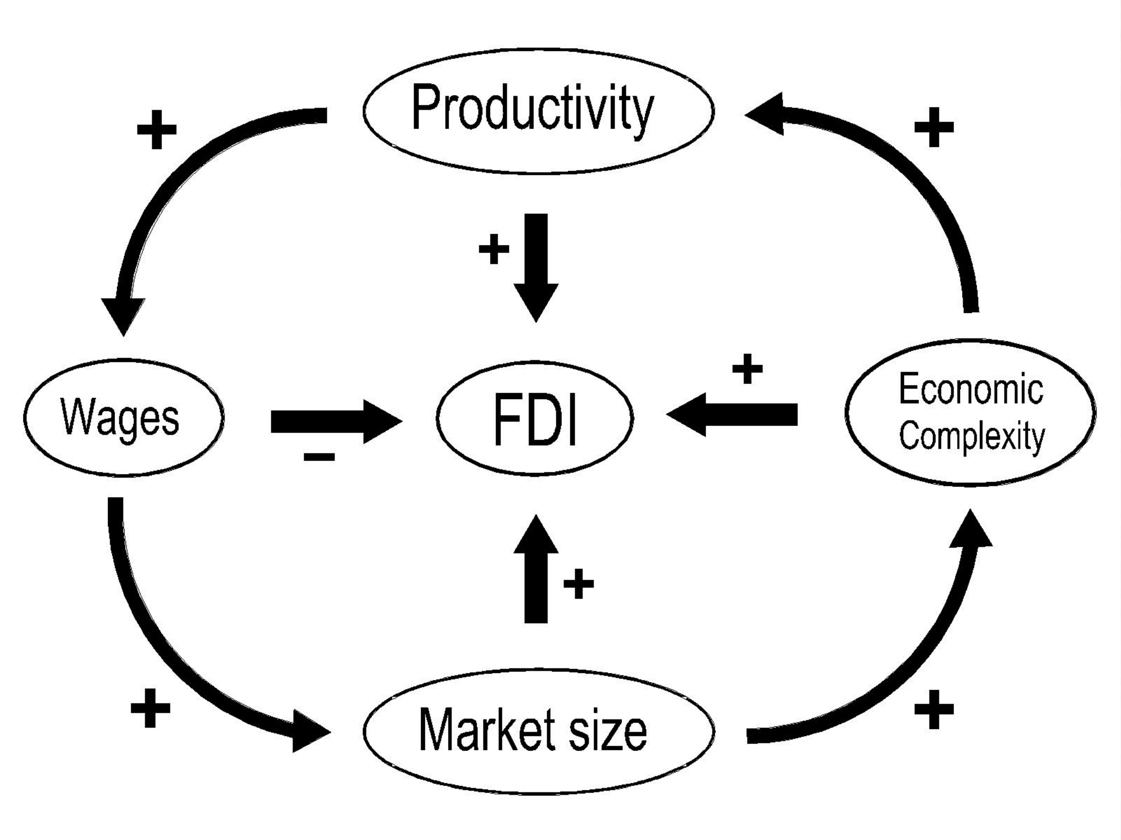
- In the case of Portugal, the **accession to the EU and the Eurozone** seems to have an overall **neutral effect** in attracting FDI
- Although under a decreasing level of protection, and small market size, Portugal's FDI attractiveness seems to have remained stable due to its:
  - Medium economic complexity
  - Good relation between productivity and wages
  - Medium dependence on FDI coming from the EU (55%)

Conclusions (4/4)

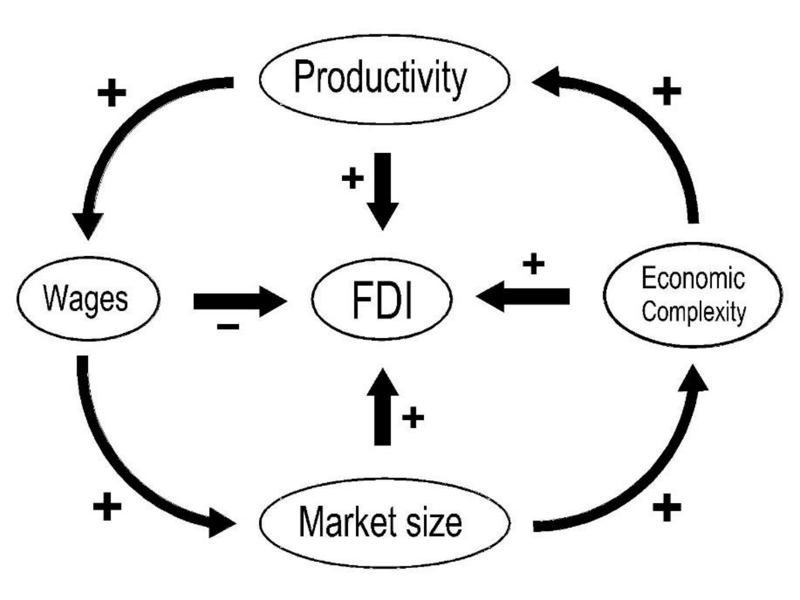
- In the case of Greece, the **accession to the EU and the Eurozone** seems to have an overall **negative effect** in attracting FDI

- Under a decreasing level of protection, Greece’s FDI attractiveness seems to have declined due to its:
  - Small market size
  - Lower economic complexity (compared to both Spain & Portugal)
  - Poor relation between productivity and wages
  - Higher dependence on FDI coming from the EU (74%)

Overall graphical presentation



Thank you for your time



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UNECE: www.unece.org

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