Economic Analysis of Foreign Direct Investment and Exports

A Case Study of the U.S. Food Manufacturing Industry

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I. INTRODUCTION

Foreign direct investment (FDI) refers to investment through ownership of assets in an affiliate by a foreign firm for the purpose of exercising control over the use of those assets. FDI may occur through either a vertical or a horizontal link with the parent firm.1 Most FDI occurs by acquisition or merger rather than by building new facilities, the latter known as greenfield investment. It is generally known that the country hosting FDI gains from the investing firm’s knowledge in technology, marketing, management, finance and information services. The gain in employment and economic activity is most obvious from greenfield investment, but even when FDI occurs by acquisitions, the parent firm likely upgrades the acquired firm’s production processes and equipment, quality and environmental controls, procurement practices, packaging and distribution systems. The FDI-supplying countries, on the other hand, have some unique assets that give them an exclusive edge over the competing firms in the hosting country and enable them to generate a flow of income and profits.

The United States is the single largest FDI-supplying as well as hosting country in the world market if we take the European Union to be not a single country. As shown in Table 1, the annual average FDI flow figures into/from the United States for the 1989–1994 period amounted to US$ 43 billion and US$ 49 billion, respectively, which indicate that the average annual FDI outflow from the United States outpaced inflow. Since 1996, however, the pattern of FDI flows has gradually shifted toward greater inflows into than outflows from the United States. The Triad, consisting of the United

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1 An example of vertical FDI is a parent firm investing in successive stages of production, either upstream or downstream. An example of upstream FDI by a meat packing company would be investing in a cattle ranch; downstream FDI would include a meat packing company investing in retail food or meat specialty stores.
States, Japan and the EU, dominated world FDI flows, accounting for 61 percent of FDI inflows and 81 percent of outflows for the period 1989–1994. The ratio of Triad to world total FDI remained virtually the same in the 1995–2000 period. Although inflows and outflows of FDI have rapidly increased in absolute value terms—three times or more—during the 1995–2000 period in comparison with the 1989–1994 period, the share of the Triad in world total FDI for both inflows and outflows has remained virtually the same.

As hundreds of billions of dollars of capital (annually) has been attracted into the United States and invested abroad by the United States, it is important to identify the major factors affecting flows of FDI. At the same time, it is important to understand the extent to which outflows of FDI influence U.S. exports to the FDI-hosting countries as trade deficits in the United States continue to grow at a faster pace.

With respect to the determinants of FDI, studies undertaken by Caves (1974) and Grubaugh (1987) investigated factors affecting the levels and locations of U.S. FDI for industrial goods. Ning and Reed (1995), on the other hand, examined determinants of U.S. FDI in the manufactured food sector for a sample of six developed countries. These studies revealed that cultural linkage and trading bloc memberships are major incentives for FDI, followed by fast foreign market growth and relatively low income tax rates in the hosting country.

With respect to the relationship between FDI and exports by the FDI-supplying countries, there are two main conflicting views on the impact of FDI on the volume of exports to the hosting countries. They are as follows: