Comment for

"FDI Contribution to Capital Flows and Investment in Capacity," Assaf Razin

Presented at NBER Thirteenth Annual East Asian Seminar on Economics, Productivity, June 20-22, Melbourne, Australia.

Kyoji Fukao

Hitotsubashi University

and

RIETI

Assaf Razin's paper proposes an interesting new theory of foreign direct investment (FDI). The new theory is based on the following two assumptions.

Assumption 1: Some foreign investors can get information on the optimal investment level of local firms at a lower fixed cost than firms in the host country.

Assumption 2: A potential buyer needs to acquire the local firm in order to apply its technology.

According to Razin, FDI is the result of informational advantages of foreign firms. In contrast with this, the standard theory regards FDI as international movements of intangible assets, such as the stock of technological knowledge or marketing know-how.[1] Foreign firms conduct direct investment because they can carry out production at a lower cost or have better marketing skills. Since international mergers and acquisitions (M&A) have increased substantially in the last decade and asymmetric information issues seem to play an important role in M&A processes, Razin's new theory is very timely and provides a useful contribution to the study on international M&As.

I have three comments. My first comment is on the applicability of the new theory to "green field" investments. Although cross border M&As have rapidly increased especially in the case of FDI among developed economies, the majority of direct investments into developing economies are still of the "green field" type. Table 1 shows the share of M&A type investments in total FDI flows in each region during the period from 1997–to 1999. According to this table, in the case of FDI inflows into

[1] On the standard theory of FDI, see Caves (1971) and Dunning (1977).

developing Asia, only 21 percent of total FDI consisted of M&As. In Razin's paper the new theory is applied to the empirical study based on data of total FDI flows. I think that the author had better elaborate on the applicability of his new theory to "green field" investments.

Insert Table 1

My second comment concerns the identification problem. In the empirical part of the paper, the author provides several interesting pieces of evidence which are consistent with the prediction of the theory: compared with portfolio investment, inward FDI has a larger positive effect on domestic investment and economic growth in the host country. Although such findings are interesting, the "evidence" provided does not prove the validity of the new theory since we can also explain these phenomena using the standard theory. According to the standard theory, FDI will increase the stock of intangible assets, such as technological knowledge or marketing know-how in the host country, which will enhance domestic investment and economic growth. I hope that in future the author provides us with some new implications and tests by which we can empirically distinguish the new theory from the standard theory.

My last comment is on the relationship between a parent and its affiliates abroad. In East Asian manufacturing industry, there exist close linkages and coordination between parents and their affiliates. Production processes are commonly fragmented within an enterprise group and unskilled labor-intensive processes are located in developing countries such as China.[2] Multinationals engage in FDI in developing East Asia not to make profits from their superior knowledge on investment timing but to establish efficient global production networks by combing their advanced technologies with developing countries' cheap labor.

To sum up my comments, Razin's paper gives us important new insights on FDI, especially on M&As, but it seems that we cannot directly apply his theory to efficiency seeking "green field" type FDI in manufacturing industries, which is the dominant form of FDI in East Asia.

---

[2] On Japanese firms' intra-firm-group fragmentation of production processes, see Kimura (2001).

References

Caves, Richard E. (1982) *Multinational Enterprise and Economic Analysis,* Cambridge, U.K.: Cambridge University Press.

Dunning, J.H. (1977) “Trade, Location of Economic Activity and the Multinational Enterprise: A Search for an Eclectic Approach,” in B. Ohlin, P.O. Hesselborn, and P.M. Wijkman (eds.), *The International Allocation of Economic Activity*, London, U.K.: Macmillan.

Fukunari Kimura (2001) “Fragmentation, Internalization, and Inter-firm Linkages: Evidence from the Micro Data of Japanese Manufacturing Firms.” In Leonard K. Cheng and Henryk Kiezkowski, eds., Global Production and Trade in East Asia, Boston: Kluwer Academic Publishers.

Table 1. Cross-border M&As as a percentage of FDI inflows, 1997-99

(%)

U.S.	78
Western Europe	79
Latin America	59
Central and Eastern Europe	34
Developing Asia	21
Developing Countries Total	30

Source: UNCTAD, 'World Investment Report 2000,' 2000.