FDI: THE NEGLECTED TWIN OF TRADE
-- A SUBSTITUTE OR A COMPLEMENT?

Abstract:

Chapter III asks whether foreign direct investment (FDI) is a substitute or complement for international trade, since both possibilities are modelled in the theory of multinational firms. A gravity model estimates the cumulative effect for a sample of 63 countries and suggests that FDI inflows reduce overall trade and in some cases deteriorate the trade balance. Three channels are identified in case studies of Spain, Mexico, and Thailand but need to be quantified in further research. Predictions should not be based on the gravity model because it appears structurally unstable.

Keywords: foreign direct investment; international trade; multinational firms; empirical modeling; gravity model.
CHAPTER III: FDI: THE NEGLECTED TWIN OF TRADE

1. INTRODUCTION

Foreign Direct Investment\(^1\) (FDI) is becoming increasingly important, yet it is widely misunderstood. Characteristics range from "technology vehicle for growth" to "source of deficit financing" and "job-killer from abroad". Recently, attitudes in many countries have shifted much in favor of FDI, and in some cases FDI inflows account for more than 3\% of GNP (Spain, Mexico, Thailand). Indeed, growth rates for FDI during the 1980s were more than twice the growth rates of trade and GNP.

The positive effects of foreign direct investment are widely understood, they include easing of the external constraint, lowering the domestic interest rates, increasing productivity, and often higher investment and growth. However, foreign capital inflows and especially FDI can have some drawbacks: increasing foreign ownership, risk of reversal and repatriation of profits, initial appreciation of the real exchange rate, and a deterioration of the trade balance. These drawbacks have long been neglected, and this essay looks at the implications of FDI on trade, first by reviewing the main propositions from microeconomic

\(^1\) FDI is defined as "investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise" (IMF, 1977, par. 408). Most countries require 10\% ownership as minimum of "an effective voice", but that ratio varies widely, for instance it is 20\% in France and Britain and 25\% in Germany.