Performance of U.S. FDI in different world regions

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This study analyzes the risk-return performance of U.S. firms that emphasize investments in developing regions versus others that invest in their home market or other developed countries. The test results indicate that U.S. firms active in the Asia-Pacific region are likely to perform better than U.S. firms active in other world regions in both profitability and risk. This implies that Asia and the Pacific provide greater opportunities for U.S. firms to achieve a better risk-return performance when their ownership advantages are well integrated into a conducive environment.

1. INTRODUCTION

There has been a dramatic change in the pattern of foreign direct investment (FDI) in recent years. The outstanding feature of that pattern has been the rapid growth of FDI in developing countries, culminating in inflows of US$53.7 billion in 1990 and an estimated US$99.7 billion in 1993 (The United Nations 1995). The share of developing countries in FDI inflows has continued to increase since the end of the 1980s and reached the peak of 39% in 1994.1 More significantly, East Asia and the Pacific have become the most important destinations for FDI due to their rapid economic growth over the last few decades.

Despite the importance of inflows to developing countries, however, relatively little empirical research has dealt with the risk-return performance of developed country firms’ investments in different developing economies relative to their investments either in their home country or in other developed countries. This study intends to examine the risk-return performance of U.S. firms that invest in different world regions. The objective is to assess how the relative performance of U.S. firms is related to geographic regions in which they invest. This is not only of academic interest but also of importance to firms with overseas operations, the institutions which finance these operations and to investors who invest in these firms.

1The share of 1995 (32%) was lower than that of 1994, but much higher than that of both the 1980s and early 1990s.
This paper is organized as follows. In the second section, the relevant literature on ownership advantages, international diversification and their relationships to the risk-return performance is reviewed. In the next section, the economic environment and FDI inflows to developing countries are analyzed. We then examine the issue of unfavorable investment environment hindering the realization of ownership advantages. The hypotheses are proposed in the fifth section. The methodology and data are discussed in the sixth section. The results of empirical analysis are presented in the seventh section. In the final section of this paper, the summary and conclusions are presented. We also discuss the implications of our findings and the limitations of the study.

2. FDI AND OWNERSHIP ADVANTAGES

It is widely suggested that successful international operations of a firm depend on the ownership advantages it possesses and the local environment host countries provide (Qian 1994, 1996). These can be regarded as necessary conditions for achieving higher profits and lower risks in international operations. Firms will select foreign locations in which they can exploit their ownership advantages.

According to FDI theory, firms must possess ownership advantages not available to existing and potential local competitors when they invest in overseas markets (Buckley and Casson 1976; Caves 1971, 1982; Dunning 1973, 1979; Errunza and Senbet 1981; Hood and Young 1979; Hymer 1960, 1976; Kim et al. 1989; Kindleberger 1969; Markides and Ittner 1994; Yu and Ito 1988). These ownership advantages, largely in the form of intangible assets, represent a range of competitive strengths which are essential to their continued growth and ultimately to their survival (Dunning 1993). The advantages provide these firms an edge over their competitors in similar locations and thus serve to compensate for the additional costs of operating across national boundaries.

Firm-specific advantages of MNCs (e.g. technical expertise) can be made available to subsidiaries in developing countries at a low cost whereas a local firm would have to bear the full cost of obtaining them. These significant advantages can be transferred with little additional cost to the parent firm and help subsidiaries exploit developing country markets to a great extent (Rugman 1981). It is therefore expected that these firms can achieve higher profits when they invest in developing countries than in developed countries or in the home country.

3. INTERNATIONAL DIVERSIFICATION

The concept of corporate international diversification has often been linked with risk reduction. It has therefore been argued that one of the important functions of international diversification through FDI is to reduce total risk at the firm level (e.g. Rugman 1977, 1979).