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Implications of the Theory of Internalization for Corporate International Finance

Internalization of Financial Market Imperfections

Several of the concepts from corporate international finance may need to be rethought once the theory of internalization is accepted as a general theory of foreign direct investment (FDI). It can be seen that the modifications to corporate international finance theory developed in this chapter fall into a common pattern and that internalization serves to unify and integrate many of the existing areas of the field. This common pattern emerges once attention is directed towards the imperfect nature of international financial markets.

The theory of international production can be extended in an important direction by recognizing that imperfect financial markets exist in addition to imperfect goods and factor markets. Although it has been traditional to assume that international financial markets are well integrated it should be recognized that they are not perfectly integrated. This is due primarily to regulations on capital movements between nations. In fact, most countries impose capital controls and taxes on international monetary transactions for balance of payments reasons.

Given that there is not a perfect international capital market, an important implication arises for the theory of internalization. It is now well known that there are gains to be made from holding an efficient portfolio of international assets. It follows that individuals with risk aversion in their utility functions will seek to reduce the systematic risk of any one nation’s market portfolio by searching for appropriate international assets, and that they will desire to purchase shares in foreign corporations as well as to hold other foreign assets.
Since there are barriers to international diversification by financial investment these individuals will be frustrated as they seek to construct an efficient international portfolio of shares and assets. Instead, they can either purchase shares in world mutual funds, or in multinational enterprises (MNEs). The world mutual funds may still be faced by national financial market barriers which only an MNE can overcome. It is able to produce in various nations, and use its internal accounts to transmit to the parent firm the advantages of stable international production. In this manner the MNE is a vehicle for international diversification. The MNE is engaged in internalization in the financial market in much the same way as it internalizes the goods and factor markets for information.

The theme of this section is that international production occurs in response to imperfect markets in information and knowledge by internalization, i.e. the MNE creates a market within its own organizational structure. This section will develop theoretical applications of internalization in three areas of imperfect international markets:

(a) in control of the information,
(b) in international locations of the information,
(c) in international transfer (trade) of the information.

These three areas can be integrated into a general theory of international production once it is realized that the common element to each of them is the lack of an efficient market. This is the crucial factor motivating the analysis of internalization as it applies to international finance.

It is found that internal marketing of information by an MNE can be an efficient substitute for an external market. There are interesting distributional effects, but no general finding that the MNE can appropriate surplus profits when it acts as an agent for information transfer.

Many others have written about the imperfections in international financial markets (that is, the degree of segmentation or integration of national capital markets) – for recent surveys see Aliber (1978b) and Lessard (1979). Here it is simply assumed that the international capital market is not perfectly integrated (in contrast to the domestic capital market of the United States, or any other major industrialized nation, which is assumed to be perfect). The degree of capital market