



The effects of multinational activities on the measurement of home bias

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Foreign products reach domestic consumers via cross-border trade and by the production of foreign affiliates of multinational enterprises. The conventional measurement of home bias in consumption of national products relative to foreign products does not recognize the role of multinational activities. In this paper, a gravity-based model that accounts for trade and the operation of foreign affiliates as alternative channels of accessing foreign markets is derived. This gravity-based model is used to theoretically demonstrate that disregarding the activities of multinational enterprises leads to an upward bias in the measurement of home bias. Our empirical application is conducted on a subset of OECD countries in the manufacturing sector. The benchmark results indicate that home bias is overstated by a factor of 1.7 when disregarding the multinational activities. *J. Japanese Int. Economies* 22 (3) (2008) 401–416. Center for Research on the Economics of Agri-food (CREA), 4424-D Pavillon Paul-Comtois, Laval University, Quebec City, PQ, Canada G1K 7P4; Department of Agricultural Economics, University of Saskatchewan, 51 Campus Drive, Saskatoon, SK, Canada S7N 5A8.

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1. Introduction

The potential role of foreign direct investment (FDI) as an alternative channel to trade in accessing foreign markets is well discussed in the literature (Markusen, 2002; Barba-Navaretti and Venables, 2004). In the context of the proximity-concentration trade-off hypothesis (Brainard, 1993, 1997),¹ FDI is the result of a strategy undertaken by multinational enterprises (MNEs) to “jump” trade barriers when accessing foreign markets. As such, FDI can be seen as a mechanism that lessens the significance of international borders, and hence reflects one prominent aspect of integration of world markets. One common measurement of the extent of integration of world markets is home bias in consumption of national products relative to foreign products. Home bias occurs as a result of border costs and consumer preferences that are inclined toward the national products. Home bias is commonly assessed by employing a gravity equation that relates trade to the size of the source and destination countries, and trade barriers such as distance separating the trading partners (Wei, 1996). As foreign products reach domestic consumers via trade but also by the production of foreign affiliates of MNEs, multinational activities must be accounted for when measuring home bias. Hitherto, the conventional measurement of home bias has disregarded their role.

McCallum (1995) pioneered an approach that applies the gravity equation to measure the magnitude of trade barriers between Canada and the US. McCallum (1995) contrasted Canadian inter-provincial trade with trade between Canadian provinces and US states. The difference between the inter-provincial and international trade flows, after controlling for distance and economic size, was dubbed “border effect”. Following McCallum, Wei (1996) employed the initial concept of border effect to measure “home bias” in the Organization for Economic Cooperation and Development (OECD) countries by contrasting their intranational trade to international trade between them.² These early papers motivated a large volume of literature measuring border effect/home bias for different economic units and at various levels of industrial classification.³

Theoretical and empirical refinements to the measurement of border effect/home bias have been proposed by a number of authors. Hillberry (1999, 2002), Wolf (2000) and Hummels (2001) showed that the decision on the production location, which is determined by international trade, industrial mix and agglomeration, is a constituent factor that influences the measurement of border effect/home bias. Anderson and van Wincoop (2003) highlighted critical shortcomings in the conventional measurement of border effect/home bias by recognizing the theoretical basis of the gravity equation. They showed that the conventional measurement of border effect/home bias suffered from an empirical misspecification that lead to the surprisingly large measure of the Canada–US border effect by McCallum (1995).

Some gravity literature brought the activities of MNEs into the analysis of border effect/home bias. Hillberry (1999) regressed the estimated border effect between the US and its trading partners on a proxy capturing the activities of foreign affiliates and found no statistical significance. Evans (2001b) investigated whether the border effect is attributable to location factors such as

¹ The proximity-concentration trade-off hypothesis states that cross-border horizontal expansion of production is more likely to occur the higher the costs associated with trade (tariffs and transportation costs) and the lower the barriers of investing abroad and scale economies at the plant level relative to the corporate level.

² McCallum’s border effect is measured from the outward trade direction, whereas Wei (1996) carried out his border effect measurement, coined home bias, from the inward trade direction.

³ See among others, Helliwell (1996, 1998), Hillberry (1999), Head and Mayer (2000), Nitsch (2000), Wolf (2000), Evans (2001a, 2001b), Hummels (2001), and Chen (2004).

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