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The sensitivity of U.S. multinational enterprises to political and macroeconomic uncertainty: A sectoral analysis

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Abstract

This paper confronts two alternative approaches for explaining U.S. foreign direct investment (FDI) pattern in developing countries. According to the real options (RO) approach, FDI in capital-intensive industries should be particularly deterred by political and macroeconomic uncertainty. On the other hand, the supply chain risk management (SCRM) approach puts forward that multinational enterprises in vertically integrated industries are unlikely to locate their foreign activities in risky countries. Thanks to the use of sectoral data, it is demonstrated that the SCRM approach explains much better the pattern of U.S. FDI in developing countries than the RO approach.

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1. Introduction

> Few economists or laymen would deny that political events can have an important, sometimes even overwhelming, impact on economic decisions in general, and investment decisions in particular. (Stevens, 2000, p. 179).

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Many studies have put forward the strong negative impact of political risk and, to a lesser extent, of macroeconomic uncertainty, on aggregate foreign direct investment (FDI) in developing countries.[1] At the disaggregated level, the evidence seems to be less clear-cut; Wheeler and Mody (1992) and Raff and Srinivasan (1998) do not find that FDI in the U.S. electronic industry is deterred by politically related uncertainty and Campa (1994) fails to uncover a link between capacity expansions by multinationals in the chemical industry and macroeconomic uncertainty. In Aizenman and Marion (2004), supply-side macroeconomic uncertainty exerts no impact on horizontal FDI but strongly influences the location of vertical FDI. These mixed results suggest that the impact of political and macroeconomic uncertainty on FDI is largely governed by industry-specific characteristics.

This paper contributes to the literature by confronting two alternative approaches for explaining U.S. FDI pattern in developing countries. According to the real options (RO) approach, FDI in capital-intensive (CI) industries should be particularly deterred by political and macroeconomic uncertainty. On the other hand, the supply chain risk management (SCRM) approach puts forward that multinational enterprises (MNEs) in vertically integrated (VI) industries are unlikely to locate their foreign activities in risky countries. Thanks to the use of sectoral data, available for 19 developing countries over the 1984–1996 period, it is demonstrated that the SCRM approach explains much better the pattern of U.S. FDI in developing countries than the RO approach. Whereas fragmentation of the production process makes an MNE highly vulnerable to international supply chain disruptions, replication of identical production facilities provides "operational flexibility" (Kogut, 1985b), by reducing the risk exposure of an MNE confronted to political or economic uncertainty. Hence, not all organisational forms of multinationality generate an instrument hedge against risk and the impact of country-specific uncertainty on the investment of an MNE cannot be assessed without knowing beforehand the global strategy of the firm.

This paper is organised as follows. Section 2 reviews two alternative approaches for explaining the impact of uncertainty on FDI; they both underline that the sensitivity of FDI to uncertainty is industry specific, though for different reasons. Section 3 presents the model specification and data used to confront these two theories. In Section 4, empirical results are given. Section 5 provides a discussion of the results by highlighting that the manufacturing presence of U.S. MNEs in the developing world is largely shaped by industry-specific characteristics. Section 6 concludes and puts forward two implications for managers.

2. The theoretical impact of uncertainty on FDI

2.1. Real options approach

The option approach to investment[2] is based on the idea that the investment of an MNE exhibits three important features: a partial irreversibility, an uncertainty over its future return and a possibility to choose its timing (Rivoli and Salorio, 1996). Uncertainty is assumed to be fully exogenous to the investment decision of the MNE and therefore proceeding now to a Kogut and Kulatilaka (1994)'s "platform investment" will not expand

[1] See for instance Mody and Srinivasan (1998), Wei (2000), Bénassy-Quére et al. (2001) or Globerman and Shapiro (2002, 2003).

[2] The reader is referred to Dixit and Pyndick (1994) for an exhaustive discussion on this subject.

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