Surviving the Global Financial Crisis: The Role of Foreign Ownership

Some links between foreign subsidiaries and parent firms could potentially ease the impact of a crisis in host countries

The 2008–09 global financial crisis was notable for its speed, severity, and international span. The crisis, triggered by a liquidity shortfall in the U.S. banking system in 2007, soon spread to nonfinancial sectors and economies around the world. Many countries experienced substantial declines in output, employment, and trade.

The severity of the crisis led many economists to explore its patterns and causes. In a new paper Alfaro and Chen investigate the micro responses to the crisis, an aspect receiving less attention. They examine differences in the performance of establishments during the crisis, with an emphasis on how foreign ownership affected resilience to negative shocks.

Evaluating the role of foreign ownership during economic crises poses several challenges. First, it is difficult to disentangle the effect of foreign ownership from the effects of other establishment characteristics and macroeconomic factors. Second, foreign ownership could have opposite effects on establishment performance. For example, the ability of multinationals to shift production across countries can lead to more volatility while market diversification can result in greater stability. Finally, foreign ownership can affect establishment performance in both crisis and noncrisis periods.

To disentangle the effect of foreign ownership from those of other factors, the authors use a worldwide panel data set that reports detailed information on the operations, location, and industry of more than 12 million establishments in 2005–08. They adopt a matching technique that pairs each foreign subsidiary with a local establishment, operating in the same country and industry, that shares similar characteristics. This matching controls for observable and unobservable differences between foreign subsidiaries and local establishments, and the effect of foreign ownership is thus inferred from the divergence in their performance paths.

To shed light on why foreign ownership could lead to divergent performance, the authors explore two aspects of foreign ownership highlighted in the theoretical literature: the production and financial links between foreign subsidiaries and parent firms. When a host country experiences a decline in demand, the ability of horizontal subsidiaries (which duplicate production activities of parent firms) to shift production back home will likely result in more volatile performance. For vertical subsidiaries (which share an input-output link with parent firms), however, the intrafirm demand from parent firms will help absorb the negative demand shock in the host country, leading to more resilient responses to the crisis. The authors construct a measure of production links by examining the input-output relationship between the primary products of subsidiaries and parent firms. Subsidiaries sharing stronger vertical production links with their parent firm are expected to show more resilience during the crisis.

The authors also consider how multinationals’ internal capital markets lower subsidiaries’ dependence on host-country credit conditions, an advantage particularly important during credit crunches. They construct measures of financial links between parents and subsidiaries in each industry using the ratio of investments in subsidiaries to total assets and a measure of sectoral financial dependence using the share of capital expenditure not financed with cash flows from operations. According to their hypothesis, foreign ownership should have a more pronounced, positive effect on establishment responses to credit crunches in industries with stronger intrafirm financial links and greater financial dependence.

The authors explore the time variation of the data and separately consider noncrisis (2005–06) and crisis (2007–08) periods. Comparing the effect of foreign ownership during the crisis with its effect in noncrisis years makes it possible to identify the role of production and financial links in increasing the resilience of foreign subsidiaries to negative demand and financial shocks.

The findings suggest that on average foreign subsidiaries responded better to the global financial crisis than local control plants with similar economic characteristics. But while foreign ownership had a pronounced advantage during the crisis, it had a relatively muted one during noncrisis years: foreign subsidiaries did not perform significantly better than local controls during normal economic periods. Foreign subsidiaries with stronger vertical production links with their parent firm performed better than the control establishments during the crisis, however, those with horizontal links did not. The same pattern is not observed in noncrisis years.

Similarly, foreign subsidiaries operating in industries with greater intrafirm financial links had a greater advantage over local controls. The role of financial links was also significant only during the crisis period, especially in host countries with worsened credit conditions.

The findings have important implications for the academic and policy debates on the role of foreign direct investment. In many countries there are growing concerns that foreign direct investment is more volatile than domestic investment, leading to greater vulnerabilities—especially during crises. The analysis suggests that while multinationals’ footloose behavior might lead to greater volatility, vertical production and financial links between foreign subsidiaries and parent firms could potentially alleviate the impact of a crisis in host countries.