

# Host-Country Financial Development and Multinational Activity<sup>\*</sup>

L. Kamran Bilir<sup>†</sup>

*University of Wisconsin – Madison*

Davin Chor

*National University of Singapore*

Kalina Manova

*University of Oxford,  
Stanford University and NBER*

December 10, 2015

## Abstract

This paper evaluates the influence of financial development on the global operations of multinational firms. Using detailed U.S. data, we provide evidence that host-country financial development increases entry by multinational affiliates, while also influencing affiliates' incentives to sell in the local market, the parent country, and third-country destinations. We rationalize these patterns with a model that emphasizes the interaction of two effects of financial development: 1) a *competition effect* that reduces affiliate revenues in the host market due to increased entry by domestic firms, and 2) a *financing effect* that encourages affiliate entry and activity in the host country.

*Keywords:* Financial development, multinational activity, FDI, heterogeneous firms, credit constraints.

*JEL Classification:* F12, F23, F36, G20

---

<sup>\*</sup>We thank Pol Antràs, Bruce Blonigen, Elhanan Helpman, Beata Javorcik, Catherine Mann, Marc Melitz, Daniel Treffer, Jonathan Vogel, David Weinstein, Daniel Xu, Stephen Yeaple and Bill Zeile for their valuable feedback. Thanks also to audiences at Georgetown, Harvard, LMU Munich, Toronto, the World Bank, CUHK, HKPU, UIBE, the 2008 CESifo-NORFACE Seminar, the 2009 Asia Pacific Trade Seminars, the 2009 Midwest International Economics Group Meeting, the 2012 AEA Annual Meeting, the 2013 West Coast Trade Workshop, the 2013 Princeton IES Workshop, the 2013 NBER ITI Summer Institute, the 2013 Brandeis Summer Workshop, and ERWIT 2014. We acknowledge C. Fritz Foley and Stanley Watt, who contributed to earlier versions of this paper. The statistical analysis was conducted at the Bureau of Economic Analysis, U.S. Department of Commerce, under arrangements that maintain legal confidentiality requirements. The views expressed are those of the authors and do not reflect official positions of the U.S. Department of Commerce.

<sup>†</sup>L. Kamran Bilir: University of Wisconsin – Madison, kbilir@ssc.wisc.edu. Davin Chor: National University of Singapore, davinchor@nus.edu.sg. Kalina Manova (corresponding author): Department of Economics, University of Oxford, Manor Road Building, Manor Road, OX1 3UQ, UK, manova@stanford.edu.

# 1 Introduction

Multinational corporations (MNCs) manage complex global operations, basing offshore affiliates in multiple countries and serving multiple markets from each location. As multinationals not only strongly influence patterns of international trade, but also channel technology transfer and capital flows across borders, it remains a policy priority to understand what forces shape their activity.

The prior literature has identified horizontal, vertical and export-platform motives for multinational activity, which are reflected in part by affiliate sales to the host country, parent country and third-country destinations, respectively.<sup>1</sup> However, evidence indicates that multinationals do not conform to this strict categorization and instead display features of all three motives: The average offshore affiliate of a U.S. multinational sells 75% of its output in the host economy, ships 7% back to the United States, and exports the remaining 18% to other markets (see Table 1).<sup>2</sup> In this paper, we isolate systematic empirical patterns in MNC operations and affiliate sales across countries. We show that host-country financial development influences multinationals' choices over affiliate entry and sales destinations, as foreign and domestic firms compete in the presence of financial frictions.

We establish four empirical regularities using detailed data from the Bureau of Economic Analysis (BEA) on U.S. multinational firms during 1989-2009. First, countries with higher levels of financial development attract more subsidiaries from the United States. Second, stronger financial institutions in the host country raise aggregate sales by affiliates to the local market, to the United States and to third-country destinations. At the level of the individual affiliate, by contrast, exports to the United States and other markets are increased, but local sales are reduced. Third, the share of affiliates' local sales in total sales declines with host-country financial development, while the shares of return sales to the United States and export-platform sales to other countries rise. These patterns hold both in the aggregate and at the individual affiliate level. Finally, the share of affiliate sales to third-country markets responds (weakly) more to local financial conditions than the share of return sales to the United States.

We demonstrate that these empirical regularities are consistent with a three-country model in which heterogeneous firms face imperfect capital markets. In the model, the world comprises two symmetric economies (West and East) and a lower-wage third country (South). Similar to Helpman et al. (2004) and Grossman et al. (2006), each firm draws a productivity level upon entry and subsequently chooses where to manufacture and market its goods. Relatively productive Western and Eastern firms both sell at home and export abroad, while the most efficient Western and Eastern firms base a production plant in South and use it to serve all three markets as a multinational firm.

Financial institutions shape the pattern of multinational activity in the model because firms require external finance to fund their fixed costs of operation. We first consider a baseline model in which only Southern firms encounter limits in their access to capital due to imperfect Southern credit markets. In this

---

<sup>1</sup>See Markusen (1984), Brainard (1997), Markusen and Venables (2000), and Helpman et al. (2004) on horizontal FDI; Helpman (1984), Hummels et al. (2001), Hanson et al. (2001, 2005), and Yeaple (2003a) on vertical FDI; Hanson et al. (2001), Neary (2002), and Ekholm et al. (2007) on export-platform FDI; and Blonigen (2005) and Yeaple (2013) for surveys.

<sup>2</sup>This is consistent with the breakdown of sales reported in Ramondo et al. (2014) for U.S. multinationals abroad. Baldwin and Okubo (2012) find a similar pattern for Japanese multinationals, where platform sales reach a slightly higher 25%.

setting, financial development in South encourages entry by domestic firms, reducing the competitiveness of foreign multinationals in the host market. Thus, although multinationals are not directly affected by financial development, the indirect effect of competition results in a response: For each affiliate, local sales to South decline, while exports to other destinations rise, both in levels and as shares of the affiliate’s total sales (*competition effect*). We then extend the model to allow multinational affiliates to fund operations in part using the host-country capital market, consistent with evidence in Feinberg and Phillips (2004), Desai et al. (2004) and Antràs et al. (2009) that multinational parents provide financing for only a fraction of affiliate assets. While still lowering local demand for each affiliate’s output, Southern financial development now has an additional effect: It attracts more multinationals and thus increases *aggregate* levels of multinational sales to all three destinations (*financing effect*). In a second extension, we accommodate differential adjustments in affiliate sales to third-country markets and the parent country by introducing a *home-bias effect* in consumption.

The model guides our empirical analysis of U.S. multinational firms’ global activity. We evaluate the effects of host-country financial development on the various dimensions of MNC activity that the model indicates respond differently to financial conditions. We also show that in the model, the aggregate value of external finance firms raise as a share of total output moves monotonically with the model parameter that governs financial frictions. This motivates our use of the observed share of private credit in GDP as a primary measure of host countries’ financial development; we find similar results with alternative measures. Finally, our estimation approach incorporates control variables prescribed by the model. These include measures of host-country GDP and GDP per capita, as well as entry, export, and FDI costs.

The data reveal that multinational firms’ response to host-country financial development is consistent with both the competition and financing effects. Our estimates indicate that improving a country’s financial conditions by one standard deviation is on average associated with a 10.6% increase in the number of foreign affiliates and a 17.4% expansion in aggregate affiliate sales. As sales adjust differentially across markets, the share of affiliate sales remaining in the local market falls by 2.5 percentage points, while the shares of exports to the United States and to third-country destinations rise by 1 and 1.5 percentage points respectively. This latter difference in the size of the response of return versus platform sales is consistent with the home-bias effect.

To address the possible endogeneity of financial development, we introduce variation in external finance dependence across sectors, similar to Rajan and Zingales (1998). The premise of this identification strategy is that the technologically determined reliance on outside capital defines firms’ sensitivity to credit availability, but less so to general institutional or economic conditions. We show in a multi-sector extension of our model that the competition and financing effects of host-country financial development are magnified in financially more vulnerable industries, and this is indeed what we find in the data. For example, the number of foreign affiliates and aggregate affiliate sales grow respectively 4.3% and 10.2% more in the industry at the 75<sup>th</sup> percentile by external finance dependence relative to that at the 25<sup>th</sup> percentile. To accommodate unobserved country or firm characteristics, we also introduce sales-shares specifications that include country, country-year or firm fixed effects. These results confirm that host-

country financial conditions contribute to the variation in multinational activity observed across sectors and time within countries, as well as across countries and sectors within firms.

This paper contributes to a growing literature studying the impact of financial frictions on firm operations. Existing evidence indicates that financial development improves aggregate growth by increasing entry by credit-constrained firms, as well as encouraging technology adoption and expansion along the intensive margin (King and Levine 1993, Rajan and Zingales 1998, Beck 2003, Beck et al. 2005, Aghion et al. 2007, Hsu et al. 2014). Financial reform also raises firms' export participation and aggregate export volumes (Manova 2008, Amiti and Weinstein 2011, Manova 2013), with effects concentrated among small firms and in sectors relatively reliant on external capital. We incorporate these insights into our model of financial market imperfections, and consider their implications for the competitive environment and multinational firms' activity across countries with different levels of financial development.

We also extend a separate line of research on the role of host-country financial conditions for FDI. Even though MNC affiliates are less constrained and more disposed to growth opportunities compared to domestic firms (Desai et al. 2008, Manova et al. 2015), it is nevertheless the case that affiliates are responsive to local financing conditions. For example, multinationals are known to use financial markets opportunistically: They raise external finance in the host economy when possible, and access capital markets abroad or direct financing from the parent company otherwise (Feinberg and Phillips 2004). Parent funding, however, compensates for only three-quarters of the shortfall in local financing in host countries with weak financial systems (Desai et al. 2004).<sup>3</sup> We build on these earlier papers by considering not only MNCs' financing practices, but also their entry and sales decisions. In the model that we develop, credit constraints will forestall the entry of a margin of prospective multinationals, this being the set of firms who fall just shy of the (endogenous) FDI productivity cutoff. Active multinationals, on the other hand, will not be constrained in their ability to obtain local financing, since they will be productive enough to credibly commit to repaying their liabilities to host-country financial institutions.<sup>4</sup>

Our paper adds to recent studies examining multinational firms' complex global strategies. Ramondo et al. (2014) for example analyze the importance of horizontal, vertical and export-platform motives for U.S. multinationals. This literature has sought to develop models that accommodate these hybrid activities and deliver predictions for trade flows and multinational operations that can be evaluated empirically (Yeaple 2003a,b, Markusen and Venables 2007, Ramondo and Rodriguez-Clare 2012, Arkolakis et al. 2012, Tintelnot 2012, Irarrazabal et al. 2013). Our work indirectly speaks to the relative importance of these three FDI motives: One interpretation of our findings is that, *ceteris paribus*, stronger financial institutions in the host nation reduce the incentives to pursue FDI for horizontal motives, and instead

---

<sup>3</sup>Firms with the capacity to do so may in fact be inclined to vertically integrate their suppliers located in financially less-developed countries, to alleviate the constraints that their suppliers face (Bustos 2007, Antràs et al. 2009, Carluccio and Fally 2012). See also Buch et al. (2009) who argue that financially-constrained firms are less likely to choose horizontal FDI over direct exporting because of the higher associated fixed costs.

<sup>4</sup>Our analysis also contributes to research on the impact of broader institutional frictions on FDI. While we focus on financial frictions, other recent studies have emphasized the effects of contractual imperfections, investor protection laws and intellectual property rights on multinational activity (Antràs 2003, Branstetter et al. 2006, Bénassy-Quéré et al. 2007, Bernard et al. 2010, Antràs and Chor 2013, Bilir 2013). Similar to Antràs and Caballero (2009), our approach emphasizes the equilibrium interaction between FDI and trade flows in the presence of financial frictions.

favor vertical and export-platform motives.

Finally, the competition effect we highlight relates to prior work on the interaction between foreign affiliates and domestic firms in FDI recipient countries. Multinationals may crowd out local producers by raising competition (Aitken and Harrison 1999, De Backer and Sleuwaegen 2003), but they can also generate productivity spillovers and nudge indigenous companies to remove X-inefficiencies, especially when local financial markets are strong (Alfaro et al. 2004, Javorcik and Spatareanu 2009, Arnold et al. 2011). While these papers explore the impact of FDI on the host economy, we instead evaluate the effects of local financial development and increased competition by domestic firms on foreign multinationals.

The rest of the paper proceeds as follows. Section 2 sets up the baseline model, while Section 3 develops several extensions. Section 4 outlines our estimation strategy and Section 5 describes the data. Sections 6 and 7 report our empirical results. The last section concludes.

## 2 Baseline Model

We develop a three-country model with heterogeneous firms to analyze how host-country financial institutions affect the entry and sales decisions of multinational affiliates. The model setup is stylized to highlight the theoretical results that correspond to our empirical analysis. We first build a baseline model in which only Southern firms are exposed to credit constraints in order to isolate the *competition effect*. In Section 3, we extend this setup by requiring multinationals to finance affiliate operations in part using capital raised in the host country; this reveals the *financing effect*. Further extensions that will be important for our empirical analysis also appear in Section 3.

### 2.1 The basic environment

Consider a world with three countries, West, East, and South. There are two sectors in each country, one producing a homogeneous good and the other featuring a continuum of differentiated varieties. Labor is the only factor. The homogeneous good is manufactured under constant returns to scale. This good is freely tradable across borders, and thus serves as the global numeraire. In each country, the labor force is sufficiently large so that a strictly positive amount of the homogeneous good is produced in equilibrium. We assume for simplicity that West and East are symmetric in their underlying economic structure. However, South is less productive in the homogeneous good sector than West and East: While  $1/\omega$  workers are needed to make each unit of the numeraire in South (where  $\omega < 1$ ), only one worker is required in West and East. The nominal wage in West and East is thus 1, while the wage in South is  $\omega$ . Firms manufacturing in South therefore face lower production costs.<sup>5</sup>

---

<sup>5</sup>It is known that many factors influence the relative profitability of manufacturing across locations (e.g. Caves 2007), including not only factor prices, but also institutions, trade costs, and coordination costs. We focus on a model with wage differences for simplicity, and assume that these differences are exogenous. However, we have evaluated numerically a more general setting in which the homogeneous good sector is absent and  $\omega$  is endogenously determined. We have found that the competition effect we emphasize remains active even when Southern wages adjust (results available on request).

The utility function of a representative consumer in West and East (subscript  $n = w, e$ ) is given by:

$$U_n = y_n^{1-\mu} \left( \sum_{j \in \{e, w\}} \int_{\Omega_{nj}} x_{nj}(a)^\alpha dG_j(a) \right)^{\frac{\mu}{\alpha}}, \quad (2.1)$$

while the utility function for Southern consumers (subscript  $s$ ) is:

$$U_s = y_s^{1-\mu} \left( \sum_{j \in \{e, w, s\}} \int_{\Omega_{sj}} x_{sj}(a)^\alpha dG_j(a) \right)^{\frac{\mu}{\alpha}}, \quad 0 < \alpha, \mu < 1. \quad (2.2)$$

Utility in country  $i$  ( $i \in \{w, e, s\}$ ) is thus a Cobb-Douglas aggregate over consumption of the homogeneous good ( $y_i$ ) and differentiated varieties ( $x_{ij}(a)$ ), where the expenditure share of the latter equals  $\mu$ . The sub-utility derived from differentiated varieties is a Dixit-Stiglitz aggregate with a constant elasticity of substitution  $\varepsilon = \frac{1}{1-\alpha} > 1$ .<sup>6</sup>

We let  $x_{ij}(a)$  denote the quantity of a country- $j$  differentiated variety that is consumed in country  $i$ , and label the set of such varieties  $\Omega_{ij}$ . When  $i \neq j$ , this set consists of all varieties exported by country  $j$ 's firms to  $i$ , as well as any varieties produced and sold locally by country  $j$ 's multinational affiliates in  $i$ . Analogously, when  $i = j$ ,  $\Omega_{ii}$  represents all indigenous varieties produced domestically, and all varieties produced by country  $i$ 's multinational affiliates abroad that are then exported back to the home market. Notice that South demands varieties from all three countries, while Southern varieties do not enter the utility function of West and East. This assumption simplifies our analysis but does not detract from our main results below (see Section 3.3).

Consumer preferences (2.1) and (2.2) imply that demand in country  $i$  for each country- $j$  variety is  $x_{ij}(a) = A_{ij} p_{ij}(a)^{-\varepsilon}$ , where  $p_{ij}(a)$  denotes the price of that variety in  $i$ . Given the symmetry between West and East, aggregate demand levels,  $A_{ij}$ , in country  $i$  for varieties from  $j$  are:

$$A_{ww} = A_{ee} = A_{ew} = A_{we} = \frac{\mu E_n}{P_{ww}^{1-\varepsilon} + P_{we}^{1-\varepsilon}}, \quad \text{and} \quad (2.3)$$

$$A_{sw} = A_{se} = A_{ss} = \frac{\mu E_s}{P_{ss}^{1-\varepsilon} + 2P_{sw}^{1-\varepsilon}}, \quad (2.4)$$

where  $P_{ij}^{1-\varepsilon} = \int_{\Omega_{ij}} p_{ij}(a)^{1-\varepsilon} dG_j(a)$  is the ideal price index for country- $j$  varieties in  $i$ ; since West and East are symmetric, this guarantees that  $P_{ww}^{1-\varepsilon} = P_{ee}^{1-\varepsilon}$ ,  $P_{ew}^{1-\varepsilon} = P_{we}^{1-\varepsilon}$  and  $P_{sw}^{1-\varepsilon} = P_{se}^{1-\varepsilon}$ . Here,  $E_i$  is the total expenditure of consumers in  $i$  and  $E_w = E_e = E_n$ . These expenditure levels are exogenous and equal to aggregate labor income in each country.

## 2.2 The differentiated varieties industry

There is a continuum of firms in each country's differentiated varieties sector. Upon paying a fixed entry cost, each firm in country  $j$  draws a unit labor requirement  $a$  for producing its distinct variety from a distribution  $G_j(a)$  that represents the technological possibilities in  $j$ . The productivity level of firm  $a$  is therefore  $1/a$ .

---

<sup>6</sup>For now, this elasticity is the same regardless of varieties' country of origin, but we discuss in Section 3.2 a more flexible specification in which varieties from the same country are closer substitutes than varieties from different countries.

### A. Financially unconstrained firms in West and East

Consider the differentiated varieties sector in West; conditions are symmetric in East.<sup>7</sup> After observing its unit cost draw  $a$ , each entrant firm in West decides whether to commence production or exit. Should the firm choose to stay in, production for the home economy incurs a per-period fixed cost of  $f_D$  units of Western labor. One can interpret this as the recurring cost of operating a manufacturing plant in West. Firms need to pay  $f_D$  upfront at the beginning of each period, but they cannot use retained earnings from previous periods because management has no control rights over these revenues and must transfer them as dividends or profits to the firm's owners. Firms therefore raise external finance by borrowing at a (gross) interest rate of  $R > 1$ , which is set exogenously in an international capital market. However, there are no financial frictions and hence no credit rationing in West and East.

Firms charge a constant markup over marginal costs, so that the home price for a Western variety is  $p_{ww}(a) = \frac{a}{\alpha}$ . Individual producers take the aggregate demand levels in each country as given. Profits from domestic sales in West thus equal:

$$\pi_D(a) = (1 - \alpha)A_{ww} \left( \frac{a}{\alpha} \right)^{1-\varepsilon} - Rf_D. \quad (2.5)$$

**The export decision:** Western firms may export to East or South (or both). Exporting to a foreign market incurs a per-period fixed cost of  $f_X$  units of Western labor (for maintaining an overseas distribution network) and a variable iceberg transport cost,  $\tau > 1$ . Profits from exporting to East and South are thus respectively:

$$\pi_{XN}(a) = (1 - \alpha)A_{ew} \left( \frac{\tau a}{\alpha} \right)^{1-\varepsilon} - Rf_X, \quad \text{and} \quad (2.6)$$

$$\pi_{XS}(a) = (1 - \alpha)A_{sw} \left( \frac{\tau a}{\alpha} \right)^{1-\varepsilon} - Rf_X. \quad (2.7)$$

**The FDI decision:** Western firms may also choose to become multinationals by locating production abroad. A multinational firm would save on shipping costs on sales in its host-country market, and would moreover lower its wage bill if it locates an affiliate in South. Such a firm could use its foreign subsidiary not only to supply the host economy, but also to export back to its parent country (West) or to the third-country market; we refer to these as local, return and export platform sales, respectively. An affiliate exporting to either market incurs the fixed and variable trade costs,  $f_X$  and  $\tau$ , as above.

Establishing a foreign subsidiary requires an upfront per-period fixed cost of  $f_I$  units of Western labor, in order to set up and maintain production facilities, as well as to manage operations remotely. While financial conditions are identical in West and East, there are financial frictions in South and the implied cost of capital there (weakly) exceeds  $R$ , in the sense that not all firms that seek financing in South will successfully obtain it. A multinational company thus has no incentive to raise capital abroad as long as Western financiers are willing to fully fund  $f_I$ . (We relax this in Section 3.1.)

A Western multinational faces a wide array of options for its export-versus-FDI decision over the three markets. For this reason, multi-country models of FDI with export platforms are analytically

---

<sup>7</sup>The corresponding equations for East can be obtained by replacing the subscript 'w' with 'e' and vice versa.

complex (Yeaple 2003a,b, 2013, Antràs et al. 2014). To illustrate the competition effect as transparently as possible, we therefore focus here on the case where: (i) Western multinationals locate affiliates only in South; and (ii) Western multinationals use the Southern plant as a global production center to serve all three markets. For this case, we derive testable implications with a clear mapping between theoretical expressions and observable data. We show in the Appendix that two conditions on parameters guarantee that the FDI pattern we consider is indeed the optimal strategy for Western multinationals:  $\tau\omega < 1$  and  $f_X < f_D < f_I$ . Intuitively, the fixed export cost ( $f_X$ ) and the Southern wage after adjusting for transport costs ( $\tau\omega$ ) must both be low for MNCs to optimally use South as their global production center. In Section 3.4 below, we demonstrate that the same essential logic operates both here and in settings that allow for more flexible FDI production arrangements.

Under these parameter assumptions, and taking into account revenues from all three markets, profits from FDI in South for a firm with productivity  $1/a$  are therefore:

$$\pi_I(a) = (1 - \alpha)A_{sw} \left( \frac{a\omega}{\alpha} \right)^{1-\varepsilon} + (1 - \alpha)(A_{ww} + A_{ew}) \left( \frac{\tau a\omega}{\alpha} \right)^{1-\varepsilon} - R(f_I + 2f_X). \quad (2.8)$$

**Patterns of production:** Each firm's productivity level determines where it manufactures and in which markets it sells its goods. Firms produce at home for the domestic market if profits from (2.5) are positive. Solving  $\pi_D(a) = 0$  pins down  $a_D$ , the maximum labor input requirement at which domestic production is profitable. Similarly, setting  $\pi_{XN}(a) = 0$  yields a cutoff level,  $a_{XN}$ , below which exporting to East is profitable. Solving  $\pi_{XS}(a) = 0$  delivers the analogous cutoff,  $a_{XS}$ , for exporting to South. These three thresholds are given by:

$$a_D^{1-\varepsilon} = \frac{Rf_D}{(1 - \alpha)A_{ww}(1/\alpha)^{1-\varepsilon}}, \quad (2.9)$$

$$a_{XN}^{1-\varepsilon} = \frac{Rf_X}{(1 - \alpha)A_{ew}(\tau/\alpha)^{1-\varepsilon}}, \quad \text{and} \quad (2.10)$$

$$a_{XS}^{1-\varepsilon} = \frac{Rf_X}{(1 - \alpha)A_{sw}(\tau/\alpha)^{1-\varepsilon}}. \quad (2.11)$$

A fourth cutoff,  $a_I$ , delineates when FDI is feasible. Becoming a multinational is more profitable than basing production in West when  $\pi_I(a) > \pi_D(a) + \pi_{XN}(a) + \pi_{XS}(a)$ . Solving this as an equality delivers the following expression for  $a_I$ :

$$a_I^{1-\varepsilon} = \frac{R(f_I - f_D)}{(1 - \alpha)[A_{ww}((\frac{\tau\omega}{\alpha})^{1-\varepsilon} - (\frac{1}{\alpha})^{1-\varepsilon}) + A_{ew}((\frac{\tau\omega}{\alpha})^{1-\varepsilon} - (\frac{\tau}{\alpha})^{1-\varepsilon}) + A_{sw}((\frac{\omega}{\alpha})^{1-\varepsilon} - (\frac{\tau}{\alpha})^{1-\varepsilon})]}. \quad (2.12)$$

Note that the conditions  $f_I > f_D$ ,  $\tau\omega < 1$ ,  $\omega < 1 < \tau$  and  $\varepsilon > 1$  ensure that  $a_I > 0$ .

Following common practice in the literature, we consider the industry equilibrium in which  $0 < a_D^{1-\varepsilon} < a_{XN}^{1-\varepsilon} < a_{XS}^{1-\varepsilon} < a_I^{1-\varepsilon}$ , using  $a^{1-\varepsilon}$  as a proxy for firm productivity. This describes a sorting of Western firms across production modes that is in line with prior evidence that exporting firms tend to be more productive than non-exporters, while multinationals are on average more productive than either (e.g. Helpman et al. 2004). The least efficient firms with  $a^{1-\varepsilon} < a_D^{1-\varepsilon}$  have labor input requirements that are too high and exit the industry upon observing their productivity draw. Firms with productivity



levels between  $a_D^{1-\varepsilon}$  and  $a_{XN}^{1-\varepsilon}$  supply only the domestic Western market. Using (2.9) and (2.10), the assumption that  $a_D^{1-\varepsilon} < a_{XN}^{1-\varepsilon}$  reduces to  $\tau^{\varepsilon-1} \left( \frac{f_X}{A_{ew}} \right) > \frac{f_D}{A_{ww}}$ , so that export costs must be sufficiently bigger than the fixed cost of domestic production.<sup>8</sup> Next, those firms that are even more productive, with  $a_{XN}^{1-\varepsilon} < a^{1-\varepsilon} < a_{XS}^{1-\varepsilon}$ , are able to overcome the additional costs of exporting to East, but not to South; based on (2.10) and (2.11), this simply requires that market demand for Western varieties be greater in East than in South,  $A_{ew} > A_{sw}$ . Firms with  $a_{XS}^{1-\varepsilon} < a^{1-\varepsilon} < a_I^{1-\varepsilon}$  can further export to the smaller Southern market.<sup>9</sup> Finally, the most productive firms with  $a^{1-\varepsilon} > a_I^{1-\varepsilon}$  conduct FDI in South. Figure 1 provides an illustration of this industry structure that focuses on the economic relations in our three-country world. Firms with  $a^{1-\varepsilon} < a_I^{1-\varepsilon}$  base their production activity in West, and export to East and possibly also to South if they are productive enough (upper panel). On the other hand, the most efficient firms with  $a^{1-\varepsilon} > a_I^{1-\varepsilon}$  become multinationals. While these firms are still headquartered in West, their production is located in South, from where they service all three markets (lower panel).

## B. Credit-constrained firms in South

The structure of South's differentiated varieties sector is simpler, with Southern firms producing only for domestic consumption in this baseline model. The fixed cost of domestic production is  $f_S$  units of Southern labor, and we assume as above that Southern firms borrow at the start of each period to finance these fixed costs.

However, Southern firms face credit constraints, arising from institutional weaknesses that lead to imperfect protection for lenders against default risk. Following Aghion et al. (2005), we model this moral hazard problem by assuming that firms lose a fraction  $\eta \in [0, 1]$  of their appropriable profits if they choose to default. For simplicity, we take these appropriable profits to be the revenues of the firm less the variable costs that it must pay to its production workers. Thus, while it is tempting to default to avoid loan repayment, this is a costly option. The parameter  $\eta$  can be viewed as the pecuniary cost of actions taken to hide the firm's financial resources from lenders. We therefore interpret  $\eta$  as capturing the degree of financial development in South: When credit institutions are stronger,  $\eta$  is higher and it is more costly for firms to hide their profits and assets. A Southern firm with input coefficient  $a$  would default if and only if the associated profit loss is smaller than the cost of repaying the loan:

$$\eta(1 - \alpha)A_{ss} \left( \frac{a\omega}{\alpha} \right)^{1-\varepsilon} < Rf_S\omega.$$

The above condition yields a productivity threshold above which firms have access to credit:

$$a_S^{1-\varepsilon} = \frac{1}{\eta} \frac{Rf_S\omega}{(1 - \alpha)A_{ss}(\omega/\alpha)^{1-\varepsilon}}. \quad (2.13)$$

We assume that lenders can observe  $a$ , and hence only Southern firms with  $a^{1-\varepsilon} > a_S^{1-\varepsilon}$  are able to commence production. When  $\eta = 1$ ,  $a_S^{1-\varepsilon}$  is the cutoff for domestic entry that would prevail in the

<sup>8</sup>Under the utility specification in (2.1) and (2.2) with a single elasticity of substitution, we have  $A_{ww} = A_{ew}$ , so this condition simplifies further to  $\tau^{\varepsilon-1} f_X > f_D$ . Note that this is not inconsistent with the earlier requirement that  $f_X < f_D$ .

<sup>9</sup>The parameter restriction that guarantees that  $a_{XS}^{1-\varepsilon} < a_I^{1-\varepsilon}$  does not simplify neatly. Intuitively, it requires that the fixed cost of FDI,  $f_I$ , be sufficiently large so that FDI is only considered by the most productive firms.

absence of credit market imperfections. When  $\eta < 1$ , however, the productivity cutoff is higher, as some firms with productivity below  $a_S^{1-\varepsilon}$  would earn positive profits following entry, but are prevented from doing so because they are unable to credibly commit to repaying their loans. As  $\eta$  increases toward 1, this distortion from credit constraints vanishes.

### C. Industry equilibrium

We now close the model by specifying the conditions that govern firm entry in each country. For this, it is convenient to define  $V_i(a) = \int_0^a \tilde{a}^{1-\varepsilon} dG_i(\tilde{a})$ , since this expression will show up repeatedly.

Prospective entrants in country  $i$ 's differentiated varieties sector incur an upfront entry cost equal to  $f_{Ei}$  units of country  $i$  labor. This is a once-off cost that firms pay before they can obtain their productivity draw.<sup>10</sup> On the exit side, firms face an exogenous probability,  $\delta \in (0, 1)$ , of “dying” and leaving the industry in each period. For an equilibrium with a constant measure of firms in each country, the cost of entry must equal expected profits. Using the profit functions (2.5)-(2.8) and the cutoffs (2.9)-(2.12), and integrating the expressions for expected profits over the distribution  $G_i(a)$ , one can write down the free-entry conditions for Western/Eastern ( $n = w, e$ ) and Southern firms as:

$$\delta f_{En} = (1 - \alpha) A_{ww} \left( \frac{1}{\alpha} \right)^{1-\varepsilon} (V_n(a_D) - V_n(a_I)) - R f_D (G_n(a_D) - G_n(a_I)) \quad (2.14)$$

$$+ (1 - \alpha) A_{ew} \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} (V_n(a_{XN}) - V_n(a_I)) - R f_X (G_n(a_{XN}) - G_n(a_I))$$

$$+ (1 - \alpha) A_{sw} \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} (V_n(a_{XS}) - V_n(a_I)) - R f_X (G_n(a_{XS}) - G_n(a_I))$$

$$+ (1 - \alpha) \left( A_{ww} \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} + A_{ew} \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} + A_{sw} \left( \frac{\omega}{\alpha} \right)^{1-\varepsilon} \right) V_n(a_I) - R(f_I + 2f_X) G_n(a_I), \quad \text{and}$$

$$\delta f_{Es\omega} = (1 - \alpha) A_{ss} \left( \frac{\omega}{\alpha} \right)^{1-\varepsilon} V_s(a_S) - R f_S \omega G_s(a_S). \quad (2.15)$$

Finally, we denote the measure of firms in country  $i$ 's differentiated varieties sector by  $N_i$ .<sup>11</sup> The definition of the ideal price index then implies:

$$P_{ww}^{1-\varepsilon} = N_n \left[ \left( \frac{1}{\alpha} \right)^{1-\varepsilon} (V_n(a_D) - V_n(a_I)) + \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} V_n(a_I) \right], \quad (2.16)$$

$$P_{ew}^{1-\varepsilon} = N_n \left[ \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} (V_n(a_{XN}) - V_n(a_I)) + \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} V_n(a_I) \right], \quad (2.17)$$

$$P_{sw}^{1-\varepsilon} = N_n \left[ \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} (V_n(a_{XS}) - V_n(a_I)) + \left( \frac{\omega}{\alpha} \right)^{1-\varepsilon} V_n(a_I) \right], \quad \text{and} \quad (2.18)$$

$$P_{ss}^{1-\varepsilon} = N_s \left[ \left( \frac{\omega}{\alpha} \right)^{1-\varepsilon} V_s(a_S) \right]. \quad (2.19)$$

<sup>10</sup>Our results are robust to subjecting the fixed cost of entry in South,  $f_{Es}$ , to borrowing constraints too. Intuitively, an improvement in financial development in South would still spur more entry by Southern firms, which works in the same direction as the effects in our baseline model.

<sup>11</sup>Following Melitz (2003), for  $N_i$  to be constant, the expected mass of successful entrants,  $N_i^{ent}$ , needs to equal the mass of firms that dies exogenously in each period, namely:  $N_i^{ent} = \delta N_i$ , for  $i = w, e, s$ .

The equilibrium of the model is thus pinned down by the system of equations (2.3)-(2.4) and (2.9)-(2.19) in the 15 unknowns,  $A_{ww}$ ,  $A_{ew}$ ,  $A_{sw}$ ,  $A_{ss}$ ,  $a_D$ ,  $a_{XN}$ ,  $a_{XS}$ ,  $a_I$ ,  $a_S$ ,  $N_n$ ,  $N_s$ ,  $P_{ww}$ ,  $P_{ew}$ ,  $P_{sw}$  and  $P_{ss}$ . While we cannot solve for all of these variables in closed form, we are able to derive comparative statics results that directly inform our empirical analysis. For convenience, we will explicitly parameterize the technology distribution in the differentiated varieties sector, but this parameterization is not material to our qualitative results. As is common in this literature, we assume that productivity  $1/a$  follows a Pareto distribution with shape parameter  $k$  and support  $[1/\bar{a}_i, \infty)$  for each country  $i$ .<sup>12</sup> The associated expressions for  $G_i$  and  $V_i$  are thus:  $G_i(a) = \left(\frac{a}{\bar{a}_i}\right)^k$  and  $V_i(a) = \frac{k}{k-\varepsilon+1} \left(\frac{a^{k-\varepsilon+1}}{\bar{a}_i^k}\right)$ . We adopt the standard assumption that  $k > \varepsilon - 1$ , which ensures that the distribution of firm sales has a finite variance.

## 2.3 The competition effect

### A. Impact on industry cutoffs and market demand levels

We next derive how financing conditions in the host country affect various dimensions of multinational activity, by establishing how an improvement in  $\eta$  systematically shifts the productivity cutoffs and aggregate demand levels in each market. Note that equations (2.13) and (2.15) pin down  $A_{ss}$  and  $a_S$  for the industry equilibrium in South. By totally differentiating these two equations, we obtain:

**Lemma 1:** (i)  $\frac{da_S}{d\eta} > 0$ ; and (ii)  $\frac{dA_{ss}}{d\eta} < 0$ .

We relegate all detailed proofs to the Appendix, and focus instead on conveying the intuition here. When  $\eta$  rises, the higher cost of default in South helps to alleviate the moral hazard problem, and hence more Southern firms gain access to credit. This lowers the productivity cutoff,  $a_S^{1-\varepsilon}$ , for entry into the Southern differentiated varieties sector, as illustrated in the bottom panel of Figure 2. However, the free-entry condition (2.15) requires that the expected profitability of a Southern firm remain constant. Average demand for each Southern product,  $A_{ss}$ , must subsequently fall.

Since Western, Eastern and Southern varieties are substitutes in consumption in South, the entry of more domestic firms in South will affect the differentiated varieties sector in West and East. The consequent effects on the productivity cutoffs and demand levels relevant to Western firms are described in the following lemma; by symmetry, these comparative statics also apply to the Eastern industry:

**Lemma 2:** When MNCs do not require host-country financing, (i)  $\frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} < \frac{1}{a_I} \frac{da_I}{d\eta} < 0$ ; (ii)  $\frac{1}{a_{XN}} \frac{da_{XN}}{d\eta} = \frac{1}{a_D} \frac{da_D}{d\eta} > 0$ ; (iii)  $\frac{1}{A_{sw}} \frac{dA_{sw}}{d\eta} < 0$ ; and (iv)  $\frac{1}{A_{ew}} \frac{dA_{ew}}{d\eta} = \frac{1}{A_{ww}} \frac{dA_{ww}}{d\eta} > 0$ .

The key shifts in Lemma 2 are illustrated in the upper panel of Figure 2. An improvement in host-country financial development leads to the entry of more Southern varieties, and the resulting tougher competition decreases South's demand for each Western variety,  $A_{sw}$ . This raises the productivity cutoffs,  $a_{XS}^{1-\varepsilon}$  and  $a_I^{1-\varepsilon}$ , for Western firms seeking to penetrate the Southern market either through exports or

<sup>12</sup>We require that  $\bar{a}_s$  and  $\bar{a}_n$  both be sufficiently large, so that all relevant cutoffs lie within the interior of the support of the distributions that they are drawn from. Also, our proofs do not require the same shape parameter in West and South, but we have assumed this to simplify notation.

FDI. However, since the fixed cost of entry,  $f_{En}$ , remains constant, the free-entry condition (2.14) implies that total profits from sales in West and East must increase. This tilts Western firms toward serving those markets: The productivity cutoffs,  $a_D^{1-\varepsilon}$  and  $a_{XN}^{1-\varepsilon}$ , both fall, while aggregate demand levels in West and East,  $A_{ww}$  and  $A_{ew}$ , both rise.<sup>13</sup>

## B. Impact on multinational affiliate sales

These shifts in the productivity cutoffs and aggregate demand levels in turn determine the impact of host-country financial development on affiliate sales. We define several sales variables of interest that are observable in the data, and which are also illustrated in the lower panel of Figure 1. For a given MNC affiliate in South with productivity  $1/a$ , its sales to the local market are:  $HOR(a) \equiv A_{sw} \left(\frac{a\omega}{\alpha}\right)^{1-\varepsilon}$ . We refer to these as horizontal sales, since they allow the multinational to avoid transport costs while servicing the Southern market. Export-platform sales to third-country destinations (in our case, East) are defined as:  $PLA(a) \equiv A_{ew} \left(\frac{\tau a\omega}{\alpha}\right)^{1-\varepsilon}$ . Finally, return sales back to the Western home market are:  $RET(a) \equiv A_{ww} \left(\frac{\tau a\omega}{\alpha}\right)^{1-\varepsilon}$ . The affiliate's total sales are:  $TOT(a) \equiv HOR(a) + PLA(a) + RET(a)$ .

Integrating these firm-level sales over the set of Western multinationals (with  $a^{1-\varepsilon} > a_I^{1-\varepsilon}$ ) delivers the following expressions for the aggregate levels of horizontal, platform and return sales ( $n = w, e$ ):

$$HOR \equiv N_n \int_0^{a_I} HOR(a) dG_n(a) = N_n A_{sw} \left(\frac{\omega}{\alpha}\right)^{1-\varepsilon} V_n(a_I), \quad (2.20)$$

$$PLA \equiv N_n \int_0^{a_I} PLA(a) dG_n(a) = N_n A_{ew} \left(\frac{\tau\omega}{\alpha}\right)^{1-\varepsilon} V_n(a_I), \quad \text{and} \quad (2.21)$$

$$RET \equiv N_n \int_0^{a_I} RET(a) dG_n(a) = N_n A_{ww} \left(\frac{\tau\omega}{\alpha}\right)^{1-\varepsilon} V_n(a_I). \quad (2.22)$$

The measure of multinational firms is in turn given by:  $N_n \int_0^{a_I} dG_n(a) = N_n G_n(a_I)$ .

Using these definitions, we construct three sales shares that describe the breakdown of affiliate sales by destination:

$$\frac{HOR(a)}{TOT(a)} = \frac{HOR}{TOT} = \left(1 + \tau^{1-\varepsilon} \frac{A_{ew}}{A_{sw}} + \tau^{1-\varepsilon} \frac{A_{ww}}{A_{sw}}\right)^{-1}, \quad (2.23)$$

$$\frac{PLA(a)}{TOT(a)} = \frac{PLA}{TOT} = \left(1 + \tau^{\varepsilon-1} \frac{A_{sw}}{A_{ew}} + \frac{A_{ww}}{A_{ew}}\right)^{-1}, \quad \text{and} \quad (2.24)$$

$$\frac{RET(a)}{TOT(a)} = \frac{RET}{TOT} = \left(1 + \tau^{\varepsilon-1} \frac{A_{sw}}{A_{ww}} + \frac{A_{ew}}{A_{ww}}\right)^{-1}. \quad (2.25)$$

Note that these sales shares depend crucially on the pairwise ratios of the aggregate demand levels for Western varieties across the three different markets.

The following result states the effect of host-country financial development on each of the above measures of multinational activity.<sup>14</sup>

**Proposition 1** *When MNCs do not require host-country financing, in response to a small improvement in financial development,  $\eta$ , in South:*

<sup>13</sup>That the proportional shifts in  $A_{ww}$  and  $A_{ew}$  are equal is a feature that is relaxed in the extension in Section 3.2.

<sup>14</sup>All results regarding affiliate-level sales pertain to firms that remain multinationals after the change in  $\eta$ .

- (i)  $HOR(a)$  decreases, while both  $PLA(a)$  and  $RET(a)$  increase;
- (ii)  $\frac{HOR(a)}{TOT(a)} = \frac{HOR}{TOT}$  decreases, while both  $\frac{PLA(a)}{TOT(a)} = \frac{PLA}{TOT}$  and  $\frac{RET(a)}{TOT(a)} = \frac{RET}{TOT}$  increase; and
- (iii)  $N_n$ ,  $N_n G_n(a_I)$ ,  $HOR$ ,  $PLA$  and  $RET$  all decrease.

Proposition 1 builds directly on the logic of Lemma 2. When credit constraints are eased, the demand in South for Western goods drops due to the competition effect following the entry of more local firms. For each affiliate, this leads horizontal sales to South, as well as their share in total sales, to both decline. At the same time, demand levels in East and West rise in equilibrium, so that each affiliate re-directs its sales toward those markets. This prompts an increase in platform and return sales, both in absolute levels and relative to total sales.

The competition effect also reduces the *ex ante* expected profits of Western firms. This leads to a decrease in both the measure of these firms,  $N_n$ , and the measure of multinationals,  $N_n G_n(a_I)$ , as stated in part (iii) of the proposition. To see how this in turn affects aggregate sales levels, we refer back to equations (2.20)-(2.22). On the extensive margin, a higher  $\eta$  lowers  $HOR$ ,  $PLA$  and  $RET$ , by reducing  $N_n$  and raising the productivity cutoff for FDI so that  $V_N(a_I)$  drops; both of these shifts reflect the exit of Western MNCs from South. In the case of horizontal sales, this negative effect is reinforced by the reduction in  $A_{sw}$ , and  $HOR$  clearly falls. As for platform and return sales, it can be shown that the decline on the extensive margin dominates the increases on the intensive margin from  $A_{ew}$  and  $A_{ww}$ , so that both  $PLA$  and  $RET$  fall as well. These predictions in part (iii), however, depend on the assumptions concerning affiliate financing practices. We consider this issue next.

### 3 Enriching the Baseline Model

In this section, we develop a series of extensions to highlight a number of additional effects of host-country financial development; the most important of these will be the financing effect. At the same time, these extensions highlight the robustness of the underlying competition effect even as the model is enriched.

#### 3.1 The financing effect

In our baseline setup, Western and Eastern firms are able to secure all the outside finance they need from their home country. We now examine what happens when we consider multinationals that use some Southern financing to cover their FDI costs. Host-country financial development can now affect MNC activity not only through the competition effect, but also through a direct financing channel. Such host-country financing is important in practice. For example, Feinberg and Phillips (2004) report that between 1983-1996, close to two-thirds of the debt of U.S. multinational subsidiaries abroad was raised locally.<sup>15</sup> Moreover, limited access to capital in the host economy is not perfectly compensated for by alternative sources of funding such as the parent company or other financial markets. Desai et al. (2004) document that financing from the parent makes up only three-quarters of the shortfall in capital raised

<sup>15</sup>See their Table 1. Funding from U.S. parent firms accounted for an additional 16% of affiliates' debt.

by subsidiaries from local financiers in host countries with weak financial systems. On a similar note, Feinberg and Phillips (2004) find that affiliates located in countries with weak capital markets are affected adversely in their growth rates when their parent firm experiences a positive demand shock, consistent with such affiliates being resource-constrained and particularly vulnerable when reallocation decisions internal to the multinational firm are made.

These patterns suggest that while MNCs can use internal capital markets to some degree, there exist market or institutional frictions that prevent them from doing so perfectly. First, fixed assets in a Southern plant might not be fully collateralizable, due to expropriation risk or difficulties in enforcing cross-border claims. Second, there might be asymmetric information between lenders and borrowers because lenders do not observe how firms manage operations or customize production processes to local conditions. If creditors can more effectively monitor debtors' activities at home than across borders, Western financiers would be at a disadvantage when assessing the value of multinationals' assets in South compared to Southern financiers. In both cases, Western financiers would either not be willing to fund all MNC operations in South or would seek higher interest rates for the financing of production in South than in West.

To incorporate this feature, we assume Western financiers are willing to fully fund the domestic and export activities of Western firms, but only a fraction  $f_D/f_I$  of fixed FDI costs. What will be important is that the multinational must raise funding for part of  $f_I$  from South; that this amount equals  $f_I - f_D$  is convenient, but not material for the financing effect to operate.<sup>16</sup> In this environment, MNCs will optimally raise the maximum possible amount of external finance  $f_D$  in West, and borrow the shortfall  $f_I - f_D$  in South's imperfect capital markets. As in Section 2.2.B, defaulting on Southern debt obligations costs a fraction  $\eta \in [0, 1]$  of appropriable profits. Since the firm's outside option is to move production back to West, we assume appropriable profits from the perspective of Southern lenders are simply operating profits from FDI less operating profits from manufacturing in West.<sup>17</sup> A multinational with productivity  $a^{1-\varepsilon}$  would therefore default on its Southern loan if:

$$\eta(1-\alpha) \left[ A_{ww} \left( \left( \frac{\tau a \omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{a}{\alpha} \right)^{1-\varepsilon} \right) + A_{ew} \left( \left( \frac{\tau a \omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{\tau a}{\alpha} \right)^{1-\varepsilon} \right) + A_{sw} \left( \left( \frac{a \omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{\tau a}{\alpha} \right)^{1-\varepsilon} \right) \right] < R(f_I - f_D),$$

when the cost of default on the left-hand side is less than the cost of repaying creditors. Setting the above as an equality and rearranging, one obtains a modified FDI cutoff,  $\tilde{a}_I^{1-\varepsilon}$ , given by:

$$\tilde{a}_I^{1-\varepsilon} = \frac{1}{\eta} a_I^{1-\varepsilon}, \quad (3.1)$$

where  $a_I^{1-\varepsilon}$  is the FDI threshold from (2.12) in the baseline model. Since  $\eta \in [0, 1]$ , credit market imperfections in the host country (weakly) raise the productivity cutoff that Western firms need to clear before FDI becomes feasible.<sup>18</sup> Western firms with  $a^{1-\varepsilon} > \tilde{a}_I^{1-\varepsilon}$  are able to obtain local financing, and

<sup>16</sup>Our results would be reinforced if the fraction of financing raised in South,  $f_D/f_I$ , were to plausibly increase with the level of Southern financial development.

<sup>17</sup>While there are alternative ways of defining what constitutes appropriable profits, our general insights would hold so long as the productivity cutoff for FDI by Western firms is higher the more severe financial constraints in South are.

<sup>18</sup>We therefore maintain our assumption on the ordering of the productivity cutoffs:  $0 < a_D^{1-\varepsilon} < a_{XN}^{1-\varepsilon} < a_{XS}^{1-\varepsilon} < \tilde{a}_I^{1-\varepsilon}$ .

hence undertake FDI. But there is a margin of prospective MNCs – firms with productivity between  $a_I^{1-\varepsilon} < a^{1-\varepsilon} < \tilde{a}_I^{1-\varepsilon}$  – who find the credit constraints to be binding, as they are unable to raise the necessary funds from Southern lenders to set up an affiliate in South. Note that this formulation represents one particular way to model why MNC financing practices would respond to host-country financial conditions, and there are potentially other ways to approach this. What is key is that even if credit constraints do not operate in the particular way described above, the composition of multinationals' total financing could still shift towards the host country when local financial conditions there improve. This would be the case, for example, if multinationals arbitrage differences in the cost of capital across countries, subject to information and contractual frictions between lenders and borrowers across borders. This would generate similar theoretical predictions as Proposition 2 below.

### A. Impact on industry cutoffs and market demand levels

In this setting, an increase in  $\eta$  continues to facilitate entry by Southern firms, and also has further implications for the Western industry:

**Lemma 3:** *When MNC affiliates require host-country financing, (i)  $\frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} > 0$ ; (ii)  $\frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} < 0$ ; (iii)  $\frac{1}{a_{XN}} \frac{da_{XN}}{d\eta} = \frac{1}{a_D} \frac{da_D}{d\eta} > \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta}$ ; (iv)  $\frac{1}{A_{sw}} \frac{dA_{sw}}{d\eta} < 0$ ; and (v)  $\frac{1}{A_{ew}} \frac{dA_{ew}}{d\eta} = \frac{1}{A_{ww}} \frac{dA_{ww}}{d\eta} > \frac{1}{A_{sw}} \frac{dA_{sw}}{d\eta}$ .*

Compared with Lemma 2, a key difference is that an improvement in host-country financial development now leads instead to a *leftward* shift in the FDI cutoff,  $\tilde{a}_I^{1-\varepsilon}$ , as illustrated in Figure 3. This occurs because an increase in  $\eta$  has a *financing effect* that makes credit accessible and FDI feasible for a larger margin of Western firms. It is nevertheless still the case that  $\frac{da_{XS}}{d\eta} < 0$  and  $\frac{dA_{sw}}{d\eta} < 0$ : Overall, the Southern market does become more competitive, not only because of the entry of more local firms, but also because there are now more MNC affiliates present there. The productivity cutoff for Western firms exporting to South,  $a_{XS}^{1-\varepsilon}$ , thus shifts to the right, while the market demand level faced by each Western firm in South falls. While the direction of change for  $a_D^{1-\varepsilon}$  and  $a_{XN}^{1-\varepsilon}$  depends on parameter values, it can be shown that the impact on  $a_D$  and  $a_{XN}$  is less negative than that on  $a_{XS}$ .<sup>19</sup> This in turn allows us to compare the proportional changes in  $A_{ww}$ ,  $A_{ew}$  and  $A_{sw}$ . Intuitively, the response of the  $a_D^{1-\varepsilon}$  and  $a_{XN}^{1-\varepsilon}$  cutoffs is muted compared to that of  $a_{XS}^{1-\varepsilon}$ , as the former two correspond to Western firms that are less directly affected by the degree of competition in South.

### B. Impact on multinational affiliate sales

What does the above imply for the pattern of affiliate sales? By inspecting (2.23)-(2.25) and applying Lemma 3, one can see that the relative shifts in  $A_{ww}$ ,  $A_{ew}$  and  $A_{sw}$  induced by an improvement in  $\eta$

<sup>19</sup>For example, setting  $R = 1.07$ ,  $\varepsilon = 3.8$ ,  $L_n = L_s = 1$ ,  $f_D = 0.2$ ,  $f_X = 0.15$ ,  $f_I = 4$ ,  $f_S = 0.1$ ,  $f_{En} = f_{Es} = 1$ ,  $\tau = 1.4$ ,  $\omega = 0.6$ ,  $\tilde{a}_N = \tilde{a}_S = 25$ ,  $k = 4$ ,  $\delta = 0.1$ ,  $\mu = 0.5$  and  $\eta = 0.5$  delivers an equilibrium with the desired sorting pattern of the productivity cutoffs ( $a_D = 13.42$ ,  $a_{XN} = 10.62$ ,  $a_{XS} = 6.30$  and  $\tilde{a}_I = 5.25$ ), in which:  $\frac{1}{a_D} \frac{da_D}{d\eta} = \frac{1}{a_{XN}} \frac{da_{XN}}{d\eta} = -4.34 < 0$ . However, when we raise  $\omega$  to 0.8 and lower  $\tau$  to 1.2 (holding the other parameter values constant), we obtain  $a_D = 13.57$ ,  $a_{XN} = 12.53$ ,  $a_{XS} = 10.87$ ,  $\tilde{a}_I = 4.27$ , and  $\frac{1}{a_D} \frac{da_D}{d\eta} = \frac{1}{a_{XN}} \frac{da_{XN}}{d\eta} = 0.83 > 0$ . The Matlab code for computing the equilibrium is available on request.

once again lead to a decrease in the horizontal sales share,  $\frac{HOR(a)}{TOT(a)}$ , as well as an increase in the platform and return sales shares,  $\frac{PLA(a)}{TOT(a)}$  and  $\frac{RET(a)}{TOT(a)}$ . These responses are aligned with the baseline model and indicative of the competition effect. While the increase in  $\eta$  lowers the horizontal sales levels,  $HOR(a)$ , of individual affiliates, the model does not deliver a similarly sharp prediction for the effects on platform sales  $PLA(a)$  or return sales  $RET(a)$ .

Importantly, the financing effect alters the behavior of *aggregate* multinational activity from the baseline model in Section 2. An improvement in host-country financial development now facilitates the entry of more MNC affiliates into South, as indicated by the leftward shift in the  $\tilde{a}_I^{1-\varepsilon}$  cutoff described in Lemma 3. We show in the Appendix that this increase in multinational activity on the extensive margin can be large enough to dominate any shifts in the respective market demand levels,  $A_{sw}$ ,  $A_{ew}$  and  $A_{ww}$ , in the expressions for  $HOR$ ,  $PLA$  and  $RET$  in (2.20)-(2.22), so that the net effect is an increase in all three aggregate sales levels. In particular, this will always turn out to be the case when the initial level of financial development in the host country is sufficiently high. This stands in direct contrast to the earlier predictions in part (iii) of Proposition 1 of the baseline model; there, with only the competition effect operative, an increase in  $\eta$  could only result in the exit of Western MNCs on the extensive margin and hence a decline in the aggregate level of multinational activity.

We summarize our results in the presence of host-country borrowing as follows:

**Proposition 2** *When MNC affiliates require host-country financing, in response to a small improvement in financial development,  $\eta$ , in South:*

- (i)  $HOR(a)$  decreases, while the effects on both  $PLA(a)$  and  $RET(a)$  are ambiguous;
- (ii)  $\frac{HOR(a)}{TOT(a)} = \frac{HOR}{TOT}$  decreases, while both  $\frac{PLA(a)}{TOT(a)} = \frac{PLA}{TOT}$  and  $\frac{RET(a)}{TOT(a)} = \frac{RET}{TOT}$  increase; and
- (iii) if the initial level of host-country financial development is sufficiently high,  $N_n G_n(\tilde{a}_I)$ ,  $HOR$ ,  $PLA$  and  $RET$  all increase.

The sufficient condition specified in part (iii) of this proposition warrants some discussion. Intuitively, when the initial level of  $\eta$  is high, improvements in host-country financial development trigger a modest amount of entry by Southern firms, as the initial distortion imposed by financial frictions is small. The decline in Southern demand for Western varieties,  $A_{sw}$ , is in turn too small to counteract the tendency for more Western multinationals to locate in South as credit there becomes more accessible. The competition effect will then be dominated by the financing effect, so that aggregate levels of multinational activity increase. Note that this sufficient condition is very mild in practice. In footnote 19, we have already provided an example of a valid parametrization of the model with  $\eta = 0.5$  (much below the upper bound of 1), in which  $N_n G_n(\tilde{a}_I)$ ,  $HOR$ ,  $PLA$  and  $RET$  all rise with small increases in  $\eta$ .<sup>20</sup> Our extensive quantitative explorations indicate that  $\eta$  needs to be even lower *and* one of the other parameters has to lie far outside of conventional ranges in order to generate a numerical counter-example in which part (iii) of Proposition 2 does not hold (see the Appendix for a more detailed discussion).

<sup>20</sup>For the first parametrization in footnote 19, we get:  $\frac{d}{d\eta} N_n G_n(\tilde{a}_I) = 0.57$ ,  $\frac{d}{d\eta} HOR = 0.72$  and  $\frac{d}{d\eta} PLA = \frac{d}{d\eta} RET = 2.06$ .



### 3.2 The home-bias effect

In our baseline model, platform and return sales respond identically to host-country financial development, even though this does not hold strictly in the data. While there are various ways to relax this from a modeling perspective, we take the approach of introducing home bias in consumer preferences which preserves much of the underlying symmetry of our framework. Specifically, assume the utility functions in each country are ( $n = w, e$ ):

$$U_n = y_n^{1-\mu} \left[ \sum_{j \in \{e, w\}} \left( \int_{\Omega_{nj}} x_{nj}(a)^\alpha dG_j(a) \right)^\alpha \right]^{\frac{\mu}{\beta}}, \text{ and} \quad (3.2)$$

$$U_s = y_s^{1-\mu} \left[ \sum_{j \in \{e, w, s\}} \left( \int_{\Omega_{sj}} x_{sj}(a)^\alpha dG_j(a) \right)^\alpha \right]^{\frac{\mu}{\beta}}. \quad (3.3)$$

In contrast to (2.1) and (2.2), the sub-utility derived from differentiated varieties is now a two-tiered CES function. We assume that the elasticity of substitution for varieties from the same country exceeds the elasticity of substitution for varieties from different countries, ( $\varepsilon = \frac{1}{1-\alpha} > \phi = \frac{1}{1-\beta} > 1$ ). This translates into home bias, as varieties are closer substitutes if they bear the same nationality.

Under this richer utility specification, an improvement in Southern financial development once again spurs entry by domestic firms and increases competition for Western varieties. However, we can show that demand for Western products now increases proportionally more in East than in West ( $\frac{1}{A_{ew}} \frac{dA_{ew}}{d\eta} > \frac{1}{A_{ww}} \frac{dA_{ww}}{d\eta} > 0$ ), while the  $a_{XN}^{1-\varepsilon}$  cutoff falls proportionally more than the  $a_D^{1-\varepsilon}$  cutoff ( $\frac{1}{a_{XN}} \frac{da_{XN}}{d\eta} > \frac{1}{a_D} \frac{da_D}{d\eta} > 0$ ). In the online Supplementary Appendix, we prove that Proposition 1 remains true in its entirety. However, we now have a further prediction:

**Proposition 3** *With home bias in consumer preferences, (i)  $\frac{d}{d\eta} PLA(a) > \frac{d}{d\eta} RET(a)$ ; (ii)  $\frac{d}{d\eta} \frac{PLA(a)}{TOT(a)} = \frac{d}{d\eta} \frac{PLA}{TOT} > \frac{d}{d\eta} \frac{RET(a)}{TOT(a)} = \frac{d}{d\eta} \frac{RET}{TOT}$ ; and (iii)  $\frac{d}{d\eta} PLA > \frac{d}{d\eta} RET$ .*

The increase in multinational affiliates' export-platform sales now exceeds that of their return sales to West. Intuitively, a Western MNC faces tougher competition in its own home market than in East. This occurs because other Western varieties are closer substitutes in consumption than Eastern varieties, and a margin of Western firms (with productivity  $a_D^{1-\varepsilon} < a^{1-\varepsilon} < a_{XN}^{1-\varepsilon}$ ) sell only at home but not in East.

### 3.3 Southern exports

We next extend the model to allow Western and Eastern consumers to demand Southern varieties. With this feature, Southern firms can now exert competitive pressure on Western and Eastern manufacturers not only in South, but also in their respective home markets. Below, we briefly sketch how we incorporate Southern exporting, and discuss how this qualifies some of our previous predictions; a detailed exposition is in the Supplementary Appendix.

Assume that Southern firms can export by incurring the iceberg trade cost,  $\tau > 1$ , as well as an upfront fixed cost of  $f_{X,ws}$  units of Southern labor to serve each of the markets West and East. Exporting firms

require external finance for  $f_{X,ws}$ , and face credit constraints in raising this capital just as they do for their domestic operations. Financial development in South thus increases domestic firm entry, and also enables more Southern firms to export to West and East. This raises competition in the goods markets in all three countries, but to different degrees. Because the equilibrium in South's differentiated varieties sector now includes a feedback effect from demand in West and East, we analyze this case through computational examples.<sup>21</sup>

In the baseline where multinationals do not use host-country finance, the presence of Southern exports may weaken but in general preserves the results described in Proposition 1. Improving financial institutions in South continues to increase competition in that market, so that affiliates direct sales away from the local economy and toward other countries. This competition effect remains operative even when we extend the model to require multinationals to seek host-country financing. The conclusions in parts (i) and (ii) of Proposition 2 for the sales levels and sales shares of individual affiliates, as well as for the aggregate sales shares, are thus qualitatively unaffected. However, the effects on the aggregate levels of MNC activity are now ambiguous: The direct competition that Southern exports pose in West and East can lead to a decline in  $N_n$ , so that the number of affiliates and the aggregate sales levels can decrease. Our numerical exercises indicate that this is more likely to happen when Southern firms face a lower trade cost  $f_{X,ws}$ , since Southern exports would then have a larger impact on competition in West.

### 3.4 Multiple host countries

In a last extension, we show how the key insights we have derived can also be applied in a setting with multiple host countries. Consider a setup that maintains the structure of West and East from Section 2.2.A, but that now allows for two Southern countries ( $s1$  and  $s2$ ) as potential FDI hosts. Assume  $s1$  is more financially developed than  $s2$  ( $0 < \eta_{s2} < \eta_{s1} < 1$ ), but that  $s1$  and  $s2$  are identical in all other respects. As in the baseline model, let  $s1$  and  $s2$  each have a differentiated varieties industry whose products are in demand only in their respective domestic markets. We consider situations in which multinationals from West (likewise East) choose to undertake FDI in either  $s1$  or  $s2$ , and subsequently use the Southern production plant to serve all four economies. Horizontal and return sales in either  $s1$  or  $s2$  are defined once again as sales in the local market and to the parent country (West) respectively; however, platform sales now comprise the sum of exports to East and to the other Southern country.

In the Supplementary Appendix, we show that the competition effect – in particular, its implications for the horizontal, return and platform sales shares – directly applies to the variation across the host countries. Because of its higher financial development,  $s1$  will feature more local firms than  $s2$ , and be a more competitive market environment for multinational affiliates based there. As a result, the horizontal sales share in  $s1$  will be smaller than that in  $s2$ , while the return and platform sales shares will instead be larger. We further show how a comparison of affiliate sales levels between  $s1$  and  $s2$  can be made, once some additional structure is introduced that allows firms with the same productivity level to potentially

---

<sup>21</sup>We build these examples using the parameterizations in footnote 19. In particular, we examine values of  $f_{X,ws}$  that lie between the fixed cost of exporting for Western firms ( $f_X$ ) and the fixed cost of FDI ( $f_I$ ).

undertake FDI in either host economy. This is the case when each prospective multinational observes an idiosyncratic profit shock in each host country that influences the location it ultimately chooses for its affiliate. In this setting, the qualitative predictions of Propositions 1 and 2 regarding sales levels extend to the cross-section of countries with different levels of financial development.

## 4 Empirical Strategy

The model described in Section 3 delivers specific predictions for the effects of host-country financial conditions on multinational activity. This section describes the estimation framework that will be used to evaluate whether these predictions are consistent with observed patterns in the data.

### 4.1 First estimating equation

We evaluate the influence of host-country financial institutions on multinational activity using the following baseline specification:

$$MNC_{ikt} = \alpha + \beta FD_{it} + \Gamma X_{it} + \varphi_k + \varphi_t + \epsilon_{ikt}, \quad (4.1)$$

where  $MNC_{ikt}$  characterizes the activity of U.S.-based multinational firms in host country  $i$  and sector  $k$  during year  $t$ , and  $FD_{it}$  is the financial development of country  $i$  in year  $t$ . The main coefficient of interest,  $\beta$ , captures the impact of host-country financial conditions on multinational activity.

Following Propositions 1-3, we estimate equation (4.1) with three sets of outcome variables,  $MNC_{ikt}$ : 1) the number of foreign affiliates,  $N_n G_n(a_{Ikt})$ ; 2) aggregate affiliate sales to each destination market,  $HOR_{ikt}$ ,  $PLA_{ikt}$  and  $RET_{ikt}$ , and across all markets,  $TOT_{ikt}$ ; and 3) the share of aggregate affiliate sales to each destination,  $\frac{HOR_{ikt}}{TOT_{ikt}}$ ,  $\frac{PLA_{ikt}}{TOT_{ikt}}$  and  $\frac{RET_{ikt}}{TOT_{ikt}}$ . We assess the model's implications for individual firms with a firm-level version of (4.1) using two additional sets of outcomes: 4) affiliate-level sales by destination,  $HOR_{ikt}(a)$ ,  $PLA_{ikt}(a)$  and  $RET_{ikt}(a)$ , and across all markets,  $TOT_{ikt}(a)$ ; and 5) the share of affiliate-level sales to each destination,  $\frac{HOR_{ikt}(a)}{TOT_{ikt}(a)}$ ,  $\frac{PLA_{ikt}(a)}{TOT_{ikt}(a)}$  and  $\frac{RET_{ikt}(a)}{TOT_{ikt}(a)}$ .

Propositions 1-3 imply distinct effects of host-country financial development on multinational activity across the above outcome variables. These depend on the potential mechanisms highlighted by the theory: the competition effect, the financing effect and the home-bias effect. To determine how consistent the data are with these mechanisms, we examine the extent to which the estimated coefficient for  $\beta$  in (4.1) is aligned with Propositions 1-3 both in sign and relative magnitude for each outcome  $MNC_{ikt}$ . To keep things clear in our discussion below, we label the coefficient  $\beta$  for regressions involving multinationals' horizontal, platform and return sales as  $\beta_{HOR}$ ,  $\beta_{PLA}$  and  $\beta_{RET}$ , respectively.

First, the competition effect arises as host-country financial development induces entry by domestic firms. Propositions 1 and 2 indicate that the resulting increase in local competition reduces affiliate-level sales revenues earned in the host country  $HOR_{ikt}(a)$ , consistent with  $\beta_{HOR} < 0$ . Furthermore, financial development in South lowers the share of affiliate-level and aggregate sales to the host market,  $\frac{HOR_{ikt}(a)}{TOT_{ikt}(a)}$  and  $\frac{HOR_{ikt}}{TOT_{ikt}}$ , while raising the share of export sales to the parent country and to third-country

destinations,  $\frac{RET_{ikt}(a)}{TOT_{ikt}(a)}$ ,  $\frac{RET_{ikt}}{TOT_{ikt}}$ ,  $\frac{PLA_{ikt}(a)}{TOT_{ikt}(a)}$  and  $\frac{PLA_{ikt}}{TOT_{ikt}}$ . These latter effects are consistent with  $\beta_{HOR} < 0$ ,  $\beta_{PLA} > 0$  and  $\beta_{RET} > 0$  for the affiliate-level and aggregate sales shares.<sup>22</sup>

Second, the financing effect implies that host-country financial development raises the aggregate level of multinational activity, as Western firms can access more capital in the host country when credit conditions there improve. According to Proposition 2, the number of offshore affiliates,  $N_n G_n(a_{Ikt})$ , and aggregate affiliate sales to each destination,  $HOR_{ikt}$ ,  $PLA_{ikt}$ ,  $RET_{ikt}$  and  $TOT_{ikt}$ , are therefore all positively related to financial development in  $i$ . Finding  $\beta > 0$  for each of these outcome variables would therefore be consistent with Proposition 2 and indicative of the financing effect. By contrast, Proposition 1 would predict  $\beta < 0$  in these regressions if the financing effect is not present.

Finally, we briefly discuss the extent to which the data are consistent with Proposition 3. We compare the impact of host-country financial development on sales to third-country destinations with the impact on return sales to the United States; finding a larger coefficient on platform sales ( $\beta_{PLA} > \beta_{RET}$ ) would be consistent with the home-bias effect in Section 3.2.

The baseline specification (4.1) includes a number of important controls. Host-country covariates  $X_{it}$  reflect local characteristics other than  $FD_{it}$  that affect multinational activity in the model. These include aggregate expenditure,  $E_S$ ; wages,  $\omega$ ; fixed entry, production and FDI costs,  $f_{ES}$ ,  $f_S$  and  $f_I$ ; and trade costs,  $f_X$  and  $\tau$ . Since our empirical analysis focuses on the global activity of U.S.-based firms, all relevant characteristics of the parent country are subsumed by year fixed effects,  $\varphi_t$ , which also account for temporal changes in global macroeconomic conditions. Finally, the industry fixed effects,  $\varphi_k$ , absorb cross-sector differences in aggregate expenditure shares,  $\mu$ , and demand elasticities,  $\varepsilon$  and  $\phi$ , as well as in production, exporting and FDI costs. The error term  $\epsilon_{ikt}$  captures any residual factors that shape MNCs' global operations. We cluster standard errors by host country in all reported results, to allow for correlated shocks across observations at the country level.

## 4.2 Second estimating equation

In equation (4.1),  $\beta$  is identified from the variation in financial institutions across host countries and over time. The  $X_{it}$  controls absorb the role of country characteristics that affect multinational activity and that may be correlated with financial development. If all such covariates are included in  $X_{it}$ ,  $\beta$  isolates the independent effect of  $FD_{it}$  on  $MNC_{ikt}$  and is not subject to omitted variable bias. Separately, reverse causality is less likely to be an empirical concern given the range of dependent variables  $MNC_{ikt}$  we consider: Even should  $FD_{it}$  respond to aggregate MNC activity ( $N_n G_n(a_{Ikt})$  and  $TOT_{ikt}$ ), it is less clear how the shares of affiliate sales by destination market would affect  $FD_{it}$ . Moreover, host-country financial development is plausibly exogenous from the perspective of an individual affiliate.

Nevertheless, a realistic concern is that countries strengthen financial institutions while implementing

---

<sup>22</sup>The affiliate-level and aggregate sales shares sum to 1 by definition. Accordingly, the coefficients on any given right-hand side variable must and do sum to 0 across the specifications for the three sales shares. However, each regression still delivers independent information, namely whether the effect of financial development on each outcome is significantly different from 0. There are no efficiency gains from estimating the three equations simultaneously as seemingly unrelated regressions, since each includes the same set of explanatory variables and is run on the same set of observations.

broader institutional or economic reforms that also affect multinational firms. If the latter changes are unobserved, estimates of  $\beta$  may reflect the influence of both financial development and these omitted country characteristics.<sup>23</sup> To establish the causal effect of financial development on MNC activity, we therefore introduce a second estimating equation that incorporates cross-industry variation in sensitivity to financial development:

$$MNC_{ikt} = \alpha + \beta FD_{it} + \gamma FD_{it} \times EFD_k + \Gamma X_{it} + \varphi_k + \varphi_t + \epsilon_{ikt}. \quad (4.2)$$

Here,  $EFD_k$  identifies the external finance dependence of sector  $k$ , and the coefficients  $\beta$  and  $\gamma$  jointly capture the impact of  $FD_{it}$  on  $MNC_{ikt}$ . Following Rajan and Zingales (1998), this approach builds on the premise that technological differences across industries generate differential requirements for outside capital. Firms in sectors with high external finance dependence tend to face high upfront costs, which impose liquidity constraints and raise the need for outside funding. Our theoretical model can be readily extended to reflect this dimension of industry heterogeneity, by featuring  $K > 1$  differentiated-varieties sectors with different fixed entry costs for Southern firms,  $f_S$ . This can be done by generalizing the utility functions in (2.1) and (2.2) to be Cobb-Douglas over the consumption of the homogeneous good and the CES aggregates for the  $K$  differentiated-varieties sectors. We show in the Appendix that the effects of host-country financial development on multinational activity are systematically larger for industries that are more dependent on external finance as reflected in cross-industry differences in  $f_S$ .

We thus expect the coefficients  $\beta$  and  $\gamma$  to share the same predicted sign across all outcome variables. Importantly,  $\gamma$  has a clear interpretation even in the presence of omitted country characteristics. In addition, in Section 7.4, we report results from estimating (4.2) with country-year fixed effects  $\varphi_{it}$ , in which  $\gamma$  isolates the effect of financial development separately from the effects of both observed and unobserved country-year covariates.

We view equations (4.1) and (4.2) as providing complementary evidence. Specification (4.1) estimates the impact of  $FD_{it}$  on the average sector in an economy. This is relevant for aggregate welfare, but potentially subject to estimation biases. Specification (4.2) by contrast offers cleaner identification in view of potential omitted variables and reverse causality, but is less relevant to welfare since it reflects only differential (i.e. reallocation) effects across sectors.

## 5 Data Description

Implementing the empirical framework in Section 4 requires measures of multinational activity, host-country financial institutions, and sectors' external finance dependence. The data and measurement approach are described below.

---

<sup>23</sup>Note however that  $X_{it}$  will include GDP per capita and rule of law, alleviating concerns that  $\beta$  captures the effect of overall economic development and broader institutional reforms rather than the effect of financial development.

## 5.1 U.S. multinational activity

We construct the dependent variables,  $MNC_{ikt}$ , in specifications (4.1) and (4.2) using firm-level data on the global operations of U.S.-based multinationals from the Bureau of Economic Analysis (BEA). The BEA Survey of U.S. Direct Investment Abroad provides information on U.S. parent firms and their foreign affiliates on an annual basis during our sample period, 1989-2009. The data are most comprehensive in scope and coverage in benchmark years, namely 1989, 1994, 1999, 2004 and 2009.<sup>24,25</sup> We therefore compute aggregate outcome variables for benchmark years only, but study the entire panel in affiliate-level regressions.<sup>26</sup>

An important element of this dataset is its detailed record of U.S. multinationals' affiliate sales. In addition to each subsidiary's total revenues,  $TOT(a)$ , the BEA reports: 1) local sales in the host country,  $HOR(a)$ , 2) exports to the United States,  $RET(a)$ , and 3) exports to other destinations,  $PLA(a)$ .<sup>27</sup> We use these as direct measures of horizontal, return and export-platform sales, as well as to calculate sales shares. Because we observe the primary industry affiliation of each parent company, we are also able to compute aggregate outcomes  $MNC_{ikt}$  by host country and year for 220 NAICS 4-digit industries.

Table 1 summarizes multinational activity in the data. In aggregate, the total revenues of U.S. multinational affiliates amount to \$561 million in the average country-industry-year triplet. The typical affiliate sells primarily to its local market (75%), while earning a smaller share of revenues from exports to the United States (7%) and to third countries (18%). This composition varies substantially across affiliates and years: The standard deviations around these three means are 36%, 20% and 31%, respectively. Subsidiaries selling only in a single market capture 22% of global MNC sales, while affiliates serving all three destinations contribute over 52%. Multinational firms also locate production facilities across a broad set of countries. In 2009 for example, 1,892 parent companies operated 14,804 affiliates in 142 countries. In an average year, 1,465 U.S. parents manage 4.18 foreign affiliates, with some large corporations maintaining more subsidiaries (standard deviation: 9.78).

## 5.2 Host-country financial development

Our theoretical framework provides guidance regarding an appropriate measure of host-country financial development, even though  $\eta$  itself is not directly observed. In the model, financial development in

---

<sup>24</sup>Data coverage is nearly complete: In a typical benchmark year, the survey covers over 99% of affiliate activity by total assets, total sales and total U.S. FDI. In case of missing survey responses, the BEA may report imputed values; these are flagged and we exclude them from the analysis.

<sup>25</sup>Any U.S. person having direct or indirect ownership or control of ten percent or more of the voting securities of an incorporated foreign business enterprise or an equivalent interest in an unincorporated foreign business enterprise at any time during a benchmark fiscal year is considered to have a foreign affiliate. However, for very small affiliates that do not own another affiliate, parents are exempt from reporting with the standard survey form. Foreign affiliates are required to report separately unless they are in both the same country and three-digit industry. Each affiliate is considered to be incorporated where its physical assets are located.

<sup>26</sup>We have verified that the affiliate-level results also hold in the sample restricted to benchmark years.

<sup>27</sup>Affiliate sales by destination are observed only for majority-owned affiliates. We therefore restrict the sample to affiliates for which the U.S. parent firm has direct or indirect ownership or control of more than 50 percent of the voting securities. There are changes over time in the affiliate size thresholds above which sales by destination need to be reported, but we have checked that our findings hold even when we run our analysis restricting to observations from each benchmark year.

South attracts entry by new domestic firms (and multinational affiliates if they borrow locally). We formally establish in the Appendix that the ratio of aggregate credit-financed fixed costs to GDP in South is increasing in the parameter  $\eta$ , both in the baseline model and in the extension with host-country financing. A model-consistent proxy for  $\eta$  is therefore the total amount of bank credit extended to the private sector as a share of GDP in the host country. We use this variable from Beck et al. (2009) as our primary measure of financial development. This is an outcome-based measure that captures the actual availability of external capital in an economy, and also implicitly reflects the extent to which local institutions support formal lending activity and enforce financial contracts.

Financial development varies significantly across the 95 host countries and 21 years in our sample (Table 1, Appendix Table 1). The mean value of  $FD_{it}$  in the panel is 0.51, with a standard deviation of 0.44. Notice that the cross-sectional dispersion of  $FD_{it}$  exceeds its time-series variation: While the standard deviation of private credit across countries was 0.62 in 2009, it was only 0.15 for the average economy over the 1989-2009 period. We consider several alternative measures for financial development in Section 7.1.

### 5.3 Sectors' external finance dependence

Sectors' external finance dependence,  $EFD_k$ , is measured following Rajan and Zingales (1998). We calculate  $EFD_k$  as the share of capital expenditures not financed with internal cash flows from operations using data on all publicly-listed U.S. companies in sector  $k$  from Compustat.<sup>28</sup> This aims to capture industries' inherent need for outside capital given technologically-determined cash flow and investment structures. There is significant variation in observed external finance dependence across the 220 industries in the sample (mean: 0.42, standard deviation: 2.74).

Constructing  $EFD_k$  with U.S. data has three distinct advantages. First, the United States has a well-developed financial system; companies' observed behavior thus plausibly approximates optimal financing practices. Second, sectors' financial sensitivity is not measured endogenously with respect to host-country financial conditions. Finally, estimating  $\gamma$  in (4.2) requires only that the true rank ordering of sectors' external finance dependence remains relatively stable across countries. The level of  $EFD_k$  may therefore differ across countries without impacting the interpretation of  $\gamma$ , although measurement error could bias our results downwards.

## 6 Main Results

### 6.1 Affiliate presence and number of multinational affiliates

We first examine how the financial environment of the host country affects the number of U.S. multinational affiliates. Columns 1 and 6 of Table 2 provide estimates of equations (4.1) and (4.2), in which  $MNC_{ikt}$  is an indicator equal to one if at least one foreign subsidiary is active in country  $i$  and sector

---

<sup>28</sup>We first compute the external finance dependence ratio for each firm over the 1996-2005 period. We calculate  $EFD_k$  as the median such ratio across all firms in sector  $k$ ; sectors with fewer than ten firms were dropped.

$k$  during year  $t$ .<sup>29</sup> Economies with strong financial institutions are significantly more likely to attract multinational activity. Moreover, the effect of financial development is systematically stronger in industries more reliant on external finance. We report OLS regressions in Table 2, but the results are nearly identical if we instead adopt a probit specification. We observe similar patterns in Columns 2 and 7, where the dependent variable is the log number of affiliates in country  $i$  and industry  $k$  during year  $t$ . This outcome corresponds to the measure of foreign subsidiaries in our model,  $N_n G_n(a_{Ikt})$ . Conditional on multinational presence, financially advanced countries host more affiliates, particularly in financially more dependent sectors.

These results are aligned with the predictions of part (iii) of Proposition 2, and are thus consistent with the presence of the financing effect. They are also both statistically and economically significant. A one-standard-deviation increase in private credit generates (on average) a 10.6% increase in the number of MNC subsidiaries. This impact is 4.3% higher in the industry at the 75<sup>th</sup> percentile by external finance dependence relative to the industry at the 25<sup>th</sup> percentile. While all foreign affiliates sell locally, to their home country and to third-country destinations in the model, in the data some instead supply only one or two of these markets. Columns 3-5 and 8-10 nevertheless confirm empirically that  $FD_{it}$  has a similar positive association with the number of subsidiaries that sell to each of these three destinations.

## 6.2 Level of aggregate affiliate sales

We next evaluate the impact of host-country credit conditions on the scale of MNC operations at the aggregate level. In Table 3, we estimate (4.1) and (4.2) defining  $MNC_{ikt}$  to be the combined log revenues  $TOT_{ikt}$  of all foreign affiliates in country  $i$  and industry  $k$  during year  $t$ . We also consider log aggregate sales separately by destination,  $HOR_{ikt}$ ,  $PLA_{ikt}$  and  $RET_{ikt}$ .<sup>30</sup>

The results suggest that the local financing mechanism is active: Consistent with part (iii) of Proposition 2, aggregate MNC sales increase in local financial development, both in total and to each market. The economic magnitudes of these relationships are substantial. A one-standard-deviation improvement in  $FD_{it}$  expands global affiliate revenues by 17.4% in the average industry (Column 4). These effects are magnified in financially dependent sectors, with an additional differential increase of 10.2% between the 75<sup>th</sup> and 25<sup>th</sup> percentile industries based on  $EFD_k$  (Column 8). Breaking down these aggregate revenues by destination, we also observe positive coefficients for local sales, third-country platform sales and return sales to the United States. While the level effect of  $FD_{it}$  is precisely estimated only for return and total sales, the interaction terms are highly significant across all four sales measures.

<sup>29</sup>The regression sample in Columns 1 and 6 includes all country-sector-year triplets that host at least one MNC affiliate in at least one year in the panel. In all other columns, the sample includes all country-sector-year triplets with a positive number of MNC affiliates.

<sup>30</sup>The sum of the reported local, U.S. and third-country sales falls short of the total sales recorded for a handful of affiliates. To ensure that the sales shares described below sum to one across sales destinations, we calculate total sales by summing the three sales components and use this sum in our analysis. All results are robust to instead using the raw data.



### 6.3 Composition of aggregate affiliate sales

We also assess the influence of host-country financial development on the composition of aggregate MNC sales across destinations. According to part (ii) of Propositions 1 and 2, subsidiaries become more export-oriented following financial reform in South, selling a smaller share of their output to the local market as competition there intensifies. Importantly, this theoretical result holds whether or not multinationals rely on local credit for their operations. Table 4 provides corresponding estimates.

The three dependent variables in Table 4 capture the fraction of aggregate affiliate sales destined for the local market,  $\frac{HOR_{ikt}}{TOT_{ikt}}$ , the United States,  $\frac{RET_{ikt}}{TOT_{ikt}}$ , and third countries,  $\frac{PLA_{ikt}}{TOT_{ikt}}$ . We find evidence strongly consistent with the competition channel in the model: MNC subsidiaries direct a smaller share of their sales to the local economy when it has mature credit markets, while sending a larger share to the United States and to third countries. These patterns are more pronounced in financially more vulnerable sectors (Columns 4-6). As for the magnitude of these effects, consider a host nation where access to capital improves from the 10<sup>th</sup> to the 90<sup>th</sup> percentile in the sample. This change would be associated with a decline in the share of horizontal sales by 5.4 percentage-points in the typical industry, with the impact 1.9 percentage-points bigger for a sector at the 90<sup>th</sup> percentile by external finance dependence relative to a sector at the 10<sup>th</sup> percentile. The corresponding increase in the shares of platform and return sales to the U.S. would be 3.2 and 2.2 percentage-points on average. Our point estimates further indicate differences between return and platform sales in line with the home-bias mechanism described in Proposition 3 (i.e.  $\beta_{PLA} > \beta_{RET}$ ), although the difference in magnitude between these coefficients is not always statistically significant.

### 6.4 Level of individual affiliate sales

Beyond aggregate outcomes, our model has implications for affiliate-level sales that can be examined directly in the data. Specifically, part (i) of Propositions 1 and 2 imply that subsidiaries in financially more advanced hosts sell less locally due to the competition mechanism. In the absence of the financing effect, such subsidiaries also sell more to the United States and to third countries (Proposition 1). With local financing, these two export flows still move in the same direction, but the sign becomes theoretically ambiguous (Proposition 2).

The results in Table 5 are consistent with these implications of the competition effect. At the affiliate level, log local sales,  $HOR_{ikt}(a)$ , decrease significantly in host-country financial development. By contrast, log sales to the United States,  $RET_{ikt}(a)$ , and to third-country destinations,  $PLA_{ikt}(a)$ , both rise with  $FD_{it}$ , for a combined impact on log total sales,  $TOT_{ikt}(a)$ , that is indistinguishable from zero. These effects become larger in financially more sensitive industries. It is also instructive to compare the pattern of response in affiliate-level sales in Table 5 against that for aggregate sales in Table 3. The difference between these two tables in the signs of the coefficients for horizontal and total sales (Columns 1, 4, 5 and 8), as well as the evidence for the extensive margin of FDI in Table 2, together suggest that the data are consistent with the presence of both the financing and the competition effects.

## 6.5 Composition of individual affiliate sales

Finally, we study the shares of affiliate-level sales across destinations in view of part (ii) of Propositions 1 and 2. In Table 6, we estimate (4.1) and (4.2) setting the dependent variable to be the share of subsidiary revenues earned in the host country,  $\frac{HOR_{ikt}(a)}{TOT_{ikt}(a)}$ , in the United States,  $\frac{RET_{ikt}(a)}{TOT_{ikt}(a)}$ , and in third markets,  $\frac{PLA_{ikt}(a)}{TOT_{ikt}(a)}$ . The results are strongly consistent with the competition effect: Affiliates based in financially more advanced countries sell a smaller fraction of output locally compared with affiliates in financially less developed economies. By contrast, affiliates export a higher proportion of output to third-country destinations and to the United States, with platform sales responding slightly more than return sales. These patterns are amplified in sectors with higher requirements for external capital.

In our model, the level of affiliate sales increases monotonically with firm productivity, but their spatial composition is invariant across the productivity distribution and equal to the aggregate sales shares. As a result, host-country financial development exerts the same marginal effect on the aggregate sales share and the sales shares of all surviving affiliates regardless of their productivity level. Our regression results are consistent with this implication: The point estimates on financial development in Table 6 are slightly smaller than those in Table 4, but the difference is typically not statistically significant. In other words, while the sales shares might vary across affiliates in the same host country for reasons outside our model, their sensitivity to financial conditions does not appear to be too different on average.

## 6.6 Control variables

The results above obtain in the presence of an extensive set of controls,  $X_{it}$ . We briefly discuss now the estimated effects that we find for these controls. Across Tables 2-6, we document a pervasive role for host-country aggregate demand,  $E_{it}$ , as measured by GDP from the Penn World Tables (PWT) Version 7.0. Large economies attract more multinational activity (Tables 2, 3 and 5) and capture a bigger share of foreign affiliates' sales (Tables 4 and 6). This is consistent with a market-size effect that raises the propensity for horizontal FDI. We proxy wages in the recipient country,  $\omega_{it}$ , by its log GDP per capita from the PWT. We also indirectly account for the cost of other input factors in production outside our model by conditioning on the stocks of physical and human capital per worker.<sup>31</sup> We record positive coefficients for income per capita in the sales level regressions (Table 3), but little role for factor endowments. Of note, controlling for GDP per capita helps ensure that we identify the impact of financial development separately from that of overall economic development.

We allow fixed and variable trade costs,  $f_{Xit}$  and  $\tau_{it}$ , to differ for trade between the U.S. and host country  $i$ , and between  $i$  and other destinations. We control for the former with  $i$ 's log bilateral distance to the United States (from CEPII) and a set of 11 time-varying dummy variables for regional trade agreements (RTAs) between the U.S. and  $i$ , such as NAFTA. For the latter, we use indicators for  $i$ 's

---

<sup>31</sup>We construct these covariates following the methodology of Hall and Jones (1999). For physical capital, we applied the perpetual inventory method to data from the PWT, setting the initial capital stock equal to  $I_0/(g + d)$ , where  $I_0$  is investment in the initial year,  $g$  is the average growth rate of investment over the first ten years, and  $d = 0.06$  is the assumed depreciation rate. For human capital, this was calculated as the average years of schooling from Barro and Lee (2010), weighted by the Mincerian returns to education function adopted by Hall and Jones (1999).

membership in 8 major multilateral agreements, such as the E.U.<sup>32</sup> The estimates suggest that distance to the United States deters the level of multinational activity (Tables 2 and 3), but has only a limited impact on the composition of MNC sales (Table 4). Although we do not report these in full, the RTA coefficients tend to conform to expected patterns. For example, we find a positive and significant effect of E.U. membership on the export-platform share of affiliate revenues, with a consequent decrease in the shares of both horizontal and return sales. By contrast, affiliates located in NAFTA member countries report a significantly higher share of return sales to the U.S.

Host-country FDI costs,  $f_{It}$ , are captured using two proxies: the average corporate tax rate faced by foreign firms, computed using BEA data on observed tax incidence, and a rule of law index from the *International Country Risk Guide* which gauges the security of foreign direct investments. Consistent with profit-shifting motives, multinationals appear more likely to direct sales away from host countries with high corporate taxes towards the United States instead. Similarly, rule of law tends to be positively correlated with the share of local sales, but negatively associated with export sales shares.

Finally, year fixed effects,  $\varphi_t$ , implicitly account for the fixed cost of firm entry in the United States,  $f_{Ent}$ . To the extent that the fixed costs of firm entry and production in South are a function of local factor costs and market size, our measures for  $\omega_{it}$  and  $E_{it}$  also reflect  $f_{ESit}$  and  $f_{Sit}$ . The size of all third-country markets potentially served by an affiliate in  $i$ ,  $E_{-it}$ , is indirectly covered by the combination of  $i$ 's own GDP and year fixed effects that subsume global and U.S. GDP.

## 7 Alternative Specifications and Robustness

The results described in Section 6 are robust to a wide set of alternative specifications. In the interest of space, we present in this section additional evidence for aggregate and affiliate-level sales shares only, as the theoretical predictions for these outcomes are most stable across model extensions in Sections 2 and 3. Corresponding sensitivity analyses for affiliate presence and sales levels are available upon request.

### 7.1 Alternative measures and additional controls

We first demonstrate in Table 7 that the results are robust to alternative measures of host-country financial development. As a broader indicator of access to debt financing, we use credit by both banks and other financial institutions as a share of GDP (from Beck et al. 2009). Since equity financing provides an alternative source of capital, we also study stock market capitalization, defined as the total value of publicly-listed shares normalized by GDP (from Beck et al. 2009). Finally, we exploit a binary variable equal to one in all years after a country has undergone various financial reforms deemed necessary for a well-functioning financial system (from Abiad et al. 2010). We find similar results using each measure.

---

<sup>32</sup>The United States participates in 11 RTAs: US-Israel, NAFTA, US-Jordan, US-Singapore, US-Chile, US-Australia, US-Morocco, CAFTA-DR (Dominican Republic-Central America), US-Bahrain, US-Peru, US-Oman. The multilateral trade agreements included are: GATT/WTO, EU = European Union, EFTA = European Free Trade Area, CARICOM = Caribbean Community, CACM = Central American Common Market, ASEAN = Association of Southeast Asian Nations, ASEAN-China, Mercosur. All information on membership in trade agreements is from Rose (2004), augmented with direct reference to the World Trade Organization's website.

In Appendix Table 2, we address the fact that many affiliates report zero activity in one of the three sales categories. Specifically, we verify that our results hold under tobit estimation. We have also confirmed that our findings are not driven by the behavior of small firms contributing little to overall multinational activity. We record comparable coefficients in Appendix Table 3 when we adopt weighted least squares estimation with log total affiliate sales as weights.

Table 8 further shows the results to be robust to introducing three additional controls. These serve as alternative proxies for variables included in  $X_{it}$ . To capture the export-platform potential of country  $i$ , we construct the log average GDP of all destinations excluding  $i$  and the United States, weighted by the inverse bilateral distance from  $i$  (à la Blonigen et al. 2007). In terms of our model, this measure of export-platform potential combines elements of both the size of third-country markets ( $E_{-it}$ ) and the cost of serving them from an affiliate in  $i$  ( $f_{Xit}$  and  $\tau_{it}$ ). We find that affiliates in hosts with greater export-platform potential indeed sell a smaller share of output locally and a larger share to third countries, with no corresponding effect on the share of return sales to the United States.

We also exploit information on barriers to firm entry in host nation  $i$  from the World Bank *Doing Business Report*. We use the first principal component of the log nominal cost (scaled by GDP per capita), the log number of procedures and the log number of days required to establish a new business in  $i$  as an additional control.<sup>33</sup> These directly measure the cost of domestic firm entry in South ( $f_{Sit}$ ), and are plausibly also correlated with the fixed cost of FDI ( $f_{Iit}$ ). Similarly, we include the first principal component of the log nominal cost per shipping container, the log number of procedures and the log number of days involved in exporting from country  $i$ .<sup>34</sup> This provides another proxy for the fixed and variable trade costs ( $f_{Xit}$  and  $\tau_{it}$ ) incurred by affiliates located in  $i$  when selling to other markets. We find no evidence that these bureaucratic barriers shape the composition of MNC sales.

## 7.2 Alternative explanations: entry barriers and export finance

Economies with advanced financial markets tend also to have low barriers to firm entry. The composition of multinationals' affiliate sales across destinations may therefore respond to competition affiliates face from domestic producers due to these low entry costs. While still consistent with the idea that competition in the host-country consumer market determines the nature of FDI activity, such an effect would be unrelated to credit conditions. The results in Table 8 indicate that this alternative mechanism is unlikely to explain our findings, since we control directly for entry costs with the cost of doing business.<sup>35</sup>

Separately, the prior literature has documented that firms' export activity is more dependent on external capital than is production for the domestic market (Manova 2013). Moreover, our estimates above (as well as Desai et al. 2004) suggest that multinationals rely in part on host-country capital to finance foreign operations. Should financial development in the host improve access to capital, affiliates

---

<sup>33</sup>These data are available for a subset of the countries in our sample starting in 2003. We use the average 2003-2009 value for each country in our regressions for the full 1989-2009 panel of BEA data.

<sup>34</sup>These data are available for a subset of the countries in our sample starting in 2006. We use the average 2006-2009 value for each country in our regressions for the full 1989-2009 panel of BEA data.

<sup>35</sup>This is in the spirit of Nunn and Treffer (2013) who advocate for distinguishing between the effects of entry costs and financial development in explaining country export patterns.

may be not only more likely to enter, but also more export-intensive conditional on entry. Importantly, this would result from the higher sensitivity of exporting to financial frictions, rather than from the competition effect *per se*.

Beyond the robust evidence we presented in Table 8 when conditioning on export costs from each host country, we further consider the export-finance mechanism by controlling for multinationals' affiliate-level financing practices in equations (4.1) and (4.2). The BEA records each subsidiary's total current liabilities and long-term debt, as well as the fraction of this debt held by the U.S. parent firm, host-country persons, or other entities. Should the credit environment in the host country determine affiliates' export intensity purely through the export-finance mechanism described above, controlling for affiliate financing practices should eliminate the significance of coefficients  $\beta$  and  $\gamma$ . Table 9, however, indicates that the effect of financial development on the composition of affiliate sales across markets remains qualitatively the same when we control for the fraction of local borrowing.<sup>36</sup>

### 7.3 Unobserved firm heterogeneity

A potentially important category of omitted variables pertains to unobserved parent-firm characteristics. In the model, this heterogeneity arises from differences in firm productivity draws, but multinationals might in reality differ along other dimensions that affect production and sales decisions (e.g. managerial practices, labor skill, R&D intensity, financial health). Such unobservable efficiency or product-appeal advantages in specific markets may influence the composition of firm sales across destinations.

To accommodate this possibility, Table 10 adds parent-firm fixed effects to our baseline specifications. The role of financial development is now identified primarily from the variation in credit conditions across the affiliates of the same multinational that are based in different countries. We continue to observe coefficients for the main effect of  $FD_{it}$  that are consistent with the earlier Table 6 results, although only the effect on the local sales share is significant at the 10% level, while that for the platform and return sales shares is marginally insignificant (Columns 1-3). Nevertheless, we obtain strongly significant results for all three sales shares when examining the differential effect across sectors with different degrees of external financing needs (Columns 4-6).<sup>37</sup> In other words, a given multinational tends to orient its affiliates in financially advanced economies towards return sales and export-platform activities. By contrast, it uses subsidiaries in financially less developed host countries to serve the local market to a greater degree.

### 7.4 Cross-section vs time-series variation

We conclude by exploring the relative importance of the cross-country and time-series variation in financial development for observed FDI patterns. In Table 11, we add host-country fixed effects to baseline specifications (4.1) and (4.2). For the average sector, we find that this leads to imprecise estimates for the effects on the local and third-country sales shares, while the effect on the U.S. sales share remains

---

<sup>36</sup>We have verified that these results are robust to controlling instead for affiliates' total leverage (scaled by total assets) or the share of loans provided by the parent company. The sample size in Table 9 is substantially reduced because only affiliates above a minimum size threshold report their financing practices.

<sup>37</sup>We obtain similar results when restricting the sample to parent firms with five or more affiliates.

significant (Columns 1-3). When we further take into account the cross-sector variation in external finance dependence, we uncover large and significant impacts of  $FD_{it}$  on all three sales shares that are in line with the competition effect (Columns 4-6). Moreover, the interaction terms retain their signs and significance when we include both industry dummies and country-year fixed effects (Columns 7-9), where the latter subsume the main effect of  $FD_{it}$ .<sup>38</sup>

These findings suggest that financial market imperfections explain the pattern of multinational activity across countries and sectors, as well as across sectors within a country over time or within a country-year pair. Improvements in host-country financial development thus appear associated with reallocations in the composition of affiliate sales across industries, with the direct effect on the average industry being more moderate. The latter may, however, also be substantial if financial reforms are more dramatic than those typically seen in the data. This caveat is warranted since our identification power hinges on the much larger variance in  $FD_{it}$  across countries, compared to the average within-country experience (Appendix Table 1).

## 8 Conclusion

This paper contributes to the literature examining how conditions in recipient countries affect multinational activity. Using comprehensive data on U.S. multinational activity abroad, we uncover several novel effects of financial development in the host economy. Financially advanced countries attract more MNC subsidiaries. Strong financial institutions in the host country also raise aggregate affiliate sales to the local market, to the United States and to third-country destinations. For individual affiliates, however, exports to the United States and to other markets are increased, but local sales are reduced. Yet both in the aggregate and at the affiliate levels, the share of local sales in total affiliate sales falls with host-country financial development, while the shares of U.S. and third-country sales increase.

We develop a model of multinational activity under imperfect capital markets that explains these empirical regularities. The data are consistent with two effects of financial development highlighted by the model: 1) a *competition effect* that reduces affiliate revenues in the local market due to increased entry by domestic firms; and 2) a *financing effect* that encourages MNC entry in the host country. These effects point to important factors governing MNCs' global operations, and have policy implications for developing countries seeking to attract FDI as a means to technology transfer and foreign capital inflows.

There remains much scope for further research. While we have focused on the effects of local credit conditions on FDI patterns, more work is needed to understand how foreign affiliates and domestic firms interact in capital markets. Our findings also suggest that the state of the financial system in different countries might affect the organizational and operational structure of global supply chains. A promising direction for future work is to examine the effects of local economic conditions and financial policy on multinational firm behavior, taking into account these firms' global affiliate networks.

---

<sup>38</sup>We have also verified that consistent patterns obtain in the cross-section of countries within a given benchmark year, as well as if we isolate the pure time-series dimension with country fixed effects but no time dummies.

## 9 References

- Abiad, Abdul, Enrica Detragiache, and Thierry Tresselt, (2010), "A New Database of Financial Reforms," *IMF Staff Papers* 57(2): 281-302.
- Aghion, Philippe, Thibault Fally, and Stefano Scarpetta, (2007), "Credit Constraints as a Barrier to the Entry and Post-Entry Growth of Firms," *Economic Policy* 22(52): 731-779.
- Aghion, Philippe, Peter Howitt, and David Mayer-Foulkes, (2005), "The Effect of Financial Development on Convergence: Theory and Evidence," *Quarterly Journal of Economics* 120(1): 173-222.
- Aitken, Brian J., and Ann E. Harrison, (1999), "Do Domestic Firms Benefit from Foreign Direct Investment? Evidence from Venezuela," *American Economic Review* 89(3): 605-618.
- Alfaro, Laura, Areendam Chanda, Sebnem Kalemli-Ozcan, and Selin Sayek, (2004), "FDI and Economic Growth: The Role of Local Financial Markets," *Journal of International Economics* 64(1): 89-112.
- Amiti, Mary, and David Weinstein, (2011), "Exports and Financial Shocks," *Quarterly Journal of Economics* 126(4): 1841-1877.
- Antràs, Pol, (2003), "Firms, Contracts, and Trade Structure," *Quarterly Journal of Economics* 118(4): 1375-1418.
- Antràs, Pol, and Ricardo Caballero, (2009), "Trade and Capital Flows: A Financial Frictions Perspective," *Journal of Political Economy* 117(4): 701-744.
- Antràs, Pol, and Davin Chor, (2013), "Organizing the Global Value Chain," *Econometrica* 81(6): 2127-2204.
- Antràs, Pol, Mihir Desai, and C. Fritz Foley, (2009), "Multinational Firms, FDI Flows and Imperfect Capital Markets," *Quarterly Journal of Economics* 124(3): 1171-1219.
- Antràs, Pol, Teresa Fort, and Felix Tintelnot, (2014), "The Margins of Global Sourcing: Theory and Evidence from U.S. Firms," *Harvard University mimeo*.
- Arkolakis, Costas, Natalia Ramondo, Andrés Rodríguez-Clare, and Stephen Yeaple, (2013), "Innovation and Production in the Global Economy," NBER Working Paper #18972.
- Arnold, Jens M., Beata S. Javorcik, and Aaditya Mattoo, (2011), "Does Services Liberalization Benefit Manufacturing Firms? Evidence from the Czech Republic," *Journal of International Economics* 85(1): 136-146.
- Baldwin, Richard, and Toshihiro Okubo, (2012), "Networked FDI: Sales and Sourcing Patterns of Japanese Foreign Affiliates," NBER Working Paper #18083.
- Barro, Robert, and Jong-Wha Lee, (2010), "A New Data Set of Educational Attainment in the World, 1950-2010," NBER Working Paper #15902.
- Beck, Thorsten, (2003), "Financial Dependence and International Trade," *Review of International Economics* 11(2): 296-316.
- Beck, Thorsten, Asli Demirgüç-Kunt, and Ross Levine, (2009), "Financial Institutions and Markets across Countries and over Time – Data and Analysis," World Bank Policy Research Working Paper #4943.
- Beck, Thorsten, Asli Demirgüç-Kunt, and Vojislav Maksimovic, (2005), "Financial and Legal Constraints to Firm Growth: Does Size Matter?" *Journal of Finance* 60(1): 137-177.
- Bénassy-Quéré, Agnès, Maylis Coupet, Thierry Mayer, (2007), "Institutional Determinants of Foreign Direct Investment," *World Economy* 30(5): 764-782.
- Bernard, Andrew, J. Bradford Jensen, Stephen J. Redding, and Peter K. Schott, (2010), "Intrafirm Trade and Product Contractibility," *American Economic Review: Papers and Proceedings* 100(2): 444-448.
- Bilir, L. Kamran, (2013), "Patent Laws, Product Lifecycle Lengths, and Multinational Activity," *American Economic Review*, forthcoming.
- Blonigen, Bruce A., (2005), "A Review of the Empirical Literature on FDI Determinants," *Atlantic*

- Economic Journal* 33(4): 383-403.
- Blonigen, Bruce A., Ronald B. Davies, Glen R. Waddell, and Helen Naughton, (2007), "FDI in Space: Spatial Autoregressive Relationships in Foreign Direct Investment," *European Economic Review* 51(5): 1303-1325.
- Brainard, S. Lael, (1997), "An Empirical Assessment of the Proximity-Concentration Trade-off Between Multinational Sales and Trade," *American Economic Review* 87(4): 520-544.
- Branstetter, Lee, Raymond Fisman, and C. Fritz Foley, (2006), "Do Stronger Intellectual Property Rights Increase International Technology Transfer? Empirical Evidence from U.S. Firm-Level Panel Data," *Quarterly Journal of Economics* 121(1): 321-349.
- Buch, Claudia, Iris Kesternich, Alexander Lipponer, and Monika Schnitzer, (2009), "Financial Constraints and the Margins of FDI," CEPR Discussion Paper 7444.
- Bustos, Paula, (2007), "FDI as a Source of Finance in Imperfect Capital Markets: Firm-Level Evidence from Argentina," Pompeu Fabra University - CREI mimeo.
- Carluccio, Juan, and Thibault Fally, (2012), "Global Sourcing under Imperfect Capital Markets," *Review of Economics and Statistics* 94(3): 740-763.
- De Backer, Koen, and Leo Sleuwaegen, (2003), "Does Foreign Direct Investment Crowd Out Domestic Entrepreneurship?" *Review of Industrial Organization* 22(1): 67-84.
- Desai, Mihir A., C. Fritz Foley, and Kristin J. Forbes, (2008), "Financial Constraints and Growth: Multinational and Local Firm Responses to Currency Depreciations," *Review of Financial Studies* 21(6): 2857-2888.
- Desai, Mihir A., C. Fritz Foley, and James R. Hines Jr., (2004), "A Multinational Perspective on Capital Structure Choice and Internal Capital Markets," *Journal of Finance* 59(6): 2451-2487.
- Ekholm, Karolina, Rikard Forslid, and James R. Markusen, (2007), "Export-Platform Foreign Direct Investment," *Journal of the European Economic Association* 5(4): 776-795.
- Feinberg, Susan, and Gordon Phillips, (2004), "Growth, Capital Market Development and Competition for Resources within MNCs," NBER Working Paper #9252.
- Grossman, Gene, Elhanan Helpman, and Adam Szeidl, (2006), "Optimal Integration Strategies for the Multinational Firm," *Journal of International Economics* 70(1): 216-238.
- Hall, Robert, and Charles Jones, (1999), "Why Do Some Countries Produce So Much More Output Per Worker Than Others?" *Quarterly Journal of Economics* 114(1): 83-116.
- Hanson, Gordon, Raymond Mataloni, and Matthew Slaughter, (2001), "Expansion Strategies of U.S. Multinational Firms," in Dani Rodrik and Susan Collins, eds., *Brookings Trade Forum*, 2001: 245-282.
- Hanson, Gordon, Raymond Mataloni, and Matthew Slaughter, (2005), "Vertical Production Networks in Multinational Firms," *Review of Economics and Statistics* 87(4): 664-678.
- Helpman, Elhanan, (1984), "A Simple Theory of International Trade with Multinational Corporations," *Journal of Political Economy* 92(3): 451-471.
- Helpman, Elhanan, Marc J. Melitz, and Stephen R. Yeaple, (2004), "Exports Versus FDI with Heterogeneous Firms," *American Economic Review* 94(1): 300-316.
- Hsu, Po-Hsuan, Xuan Tian, and Yan Xu, (2014), "Financial Development and Innovation: Cross-Country Evidence," *Journal of Financial Economics* 112(1): 116-135.
- Hummels, David, Jun Ishii, and Kei-Mu Yi, (2001), "The Nature and Growth of Vertical Specialization in World Trade," *Journal of International Economics* 54(1): 75-96.
- Irrazabal, Alfonso, Andreas Moxnes, and Luca David Opmolla, (2013), "The Margins of Multinational Production and the Role of Intra-firm Trade," *Journal of Political Economy* 121(1): 74-126.
- Javorcik, Beata S., and Mariana Spatareanu, (2009), "Tough Love: Do Czech Suppliers Learn from Their Relationships with Multinationals?" *Scandinavian Journal of Economics* 111(4): 811-833.
- King, Robert, and Ross Levine, (1993), "Finance and Growth: Schumpeter Might Be Right," *Quarterly*



- Journal of Economics* 108(3): 717-737.
- Manova, Kalina, (2008), "Credit Constraints, Equity Market Liberalizations and International Trade," *Journal of International Economics* 76(1): 33-47.
- Manova, Kalina, (2013), "Credit Constraints, Heterogeneous Firms, and International Trade", *Review of Economic Studies* 80(2): 711-744.
- Manova, Kalina, Shang-Jin Wei, and Zhiwei Zhang (2015), "Firms Exports and Multinational Activity under Credit Constraints," *Review of Economics and Statistics* 97(3): 574-588.
- Markusen, James R., (1984), "Multinationals, Multi-Plant Economies, and the Gains from Trade," *Journal of International Economics* 16(3-4): 205-226.
- Markusen, James R., and Anthony Venables, (2000), "The Theory of Endowment, Intra-industry and Multi-national Trade," *Journal of International Economics* 52(2): 209-234.
- Markusen, James R., and Anthony Venables, (2007), "Interacting Factor Endowments and Trade Costs: A Multi-Country, Multi-Good Approach to Trade Theory," *Journal of International Economics* 73(2): 333-354.
- Melitz, Marc J., (2003), "The Impact of Trade on Intra-Industry Reallocations and Aggregate Industry Productivity," *Econometrica* 71(6): 1695-1725.
- Neary, Peter, (2002), "Foreign Direct Investment and the Single Market," *The Manchester School* 70(3): 291-314.
- Nunn, Nathan and Daniel Trefler (2013). "Domestic Institutions as a Source of Comparative Advantage." NBER Working Paper #18851.
- Rajan, Raghuram, and Luigi Zingales, (1998), "Financial Dependence and Growth," *American Economic Review* 88(3): 559-586.
- Ramondo, Natalia, Veronica Rappoport, and Kim Ruhl, (2014), "Horizontal versus Vertical Foreign Direct Investment: Evidence from U.S. Multinationals," mimeo.
- Ramondo, Natalia, and Andrés Rodríguez-Clare, (2013), "Trade, Multinational Production, and the Gains from Openness," *Journal of Political Economy* 121(2): 273-322.
- Rose, Andrew, (2004), "Do We Really Know that the WTO Increases Trade?" *American Economic Review* 94(1): 98-114.
- Tintelnot, Felix, (2012), "Global Production with Export Platforms," Penn State mimeo.
- Yeaple, Stephen R., (2003a), "The Role of Skill Endowments in the Structure of U.S. Outward Foreign Direct Investment," *Review of Economics and Statistics* 85(3): 726-734.
- Yeaple, Stephen R., (2003b), "The Complex Integration Strategies of Multinationals and Cross Country Dependencies in the Structure of Foreign Direct Investment," *Journal of International Economics* 60(2): 293-314.
- Yeaple, Stephen R., (2013), "The Multinational Firm," *Annual Review of Economics* 5: 193-217.

## Appendix – NOT FOR PUBLICATION

**The FDI decision.** We show that the two conditions,  $\tau\omega < 1$  and  $f_X < f_D < f_I$ , are sufficient to guarantee that the optimal strategy for Western multinationals will be as follows: (i) highly productive Western firms conduct FDI only in South but not in East; and (ii) Western multinationals use their Southern plant as a global production center to serve all three markets.

Consider first a Western firm that already operates a multinational affiliate in South. It is then automatically more profitable to use this affiliate as an export platform to East, rather than servicing East via direct exports from West, or via direct FDI in East. This follows from the inequality:

$$(1 - \alpha)A_{ew} \left( \frac{\tau a \omega}{\alpha} \right)^{1-\varepsilon} - Rf_X > \max \left\{ (1 - \alpha)A_{ew} \left( \frac{\tau a}{\alpha} \right)^{1-\varepsilon} - Rf_X, (1 - \alpha)A_{ew} \left( \frac{a}{\alpha} \right)^{1-\varepsilon} - Rf_I \right\},$$

which holds since  $\tau\omega < 1 < \tau$  and  $f_X < f_I$  (bearing in mind that  $1 - \varepsilon < 0$ ). In particular, this rules out the possibility of the MNC establishing affiliates in both South and East.

Next, conditional on setting up a Southern affiliate, we can further deduce that it is optimal to use this affiliate to supply even the firm's home market. This follows from:

$$(1 - \alpha)A_{ww} \left( \frac{\tau a \omega}{\alpha} \right)^{1-\varepsilon} - Rf_X > (1 - \alpha)A_{ww} \left( \frac{a}{\alpha} \right)^{1-\varepsilon} - Rf_D,$$

which holds since  $\tau\omega < 1$  and  $f_X < f_D$ . Thus, it is more profitable to produce in South and export to West than to incur the higher fixed cost and wages of production at home.

It remains to check that the optimal decision for a Western firm that becomes a multinational is to locate its overseas affiliate in South, rather than in East. For this, we compare the total profits from servicing all three countries out of an affiliate in South versus an affiliate in East:

$$\begin{aligned} & (1 - \alpha)A_{ww} \left( \frac{\tau a \omega}{\alpha} \right)^{1-\varepsilon} - Rf_X + (1 - \alpha)A_{ew} \left( \frac{\tau a \omega}{\alpha} \right)^{1-\varepsilon} - Rf_X + (1 - \alpha)A_{sw} \left( \frac{a \omega}{\alpha} \right)^{1-\varepsilon} - Rf_I \\ & > \max \left\{ (1 - \alpha)A_{ww} \left( \frac{a}{\alpha} \right)^{1-\varepsilon} - Rf_D, (1 - \alpha)A_{ww} \left( \frac{\tau a}{\alpha} \right)^{1-\varepsilon} - Rf_X \right\} \\ & \quad + (1 - \alpha)A_{ew} \left( \frac{a}{\alpha} \right)^{1-\varepsilon} - Rf_I + (1 - \alpha)A_{sw} \left( \frac{\tau a}{\alpha} \right)^{1-\varepsilon} - Rf_X. \end{aligned}$$

Note that if FDI is undertaken in East, the home market (West) can be supplied either through domestic production or exports from East, while South would be serviced by exports from either West or East. The expression on the right-hand side of the above inequality captures total profits from this alternative production mode. It is straightforward to check that the above inequality holds when  $\tau\omega < 1$ ,  $\omega < 1$ ,  $\omega < \tau$  and  $f_X < f_D$ . It is thus not optimal for a Western firm to conduct FDI in East.

In sum, the conditions  $\tau\omega < 1$  and  $f_X < f_D < f_I$  guarantee that the FDI decision is in effect a decision over whether to relocate the firm's global production center to South, with only headquarter activities retained in West. ■

**Proof of Lemma 1.** Log-differentiating (2.13) and (2.15), one obtains:

$$\begin{aligned} (\varepsilon - 1) \frac{da_S}{a_S} &= \frac{d\eta}{\eta} + \frac{dA_{ss}}{A_{ss}}, \quad \text{and} \\ 0 &= a_S^{\varepsilon-1} V_s(a_S) \frac{dA_{ss}}{A_{ss}} + [a_S^{\varepsilon-1} V'_s(a_S) - \eta G'_s(a_S)] da_S. \end{aligned}$$

To derive the second equation above, we used the fact that  $(1 - \alpha)A_{ss}(\omega/\alpha)^{1-\varepsilon} = (1/\eta)a_S^{\varepsilon-1} Rf_S \omega$ , which holds from the expression for  $a_S^{1-\varepsilon}$  in (2.13). Solving these two equations simultaneously yields:

$$\begin{aligned} \frac{da_S}{d\eta} &= \frac{1}{\eta(\varepsilon - 1)} \frac{a_S^{\varepsilon-1} V_s(a_S)}{a_S^{\varepsilon-2} V_s(a_S) + [a_S^{\varepsilon-1} V'_s(a_S) - \eta G'_s(a_S)]}, \quad \text{and} \\ \frac{dA_{ss}}{d\eta} &= -\frac{A_{ss}}{\eta} \frac{a_S^{\varepsilon-1} V'_s(a_S) - \eta G'_s(a_S)}{a_S^{\varepsilon-2} V_s(a_S) + [a_S^{\varepsilon-1} V'_s(a_S) - \eta G'_s(a_S)]}. \end{aligned}$$

Applying Leibniz's rule to  $V_s(a_S) = \int_0^{a_S} \tilde{a}^{1-\varepsilon} dG_s(\tilde{a})$ , we have:  $a_S^{\varepsilon-1} V'_s(a_S) = G'_s(a_S)$ . Hence,  $a_S^{\varepsilon-1} V'_s(a_S) - \eta G'_s(a_S) = (1 - \eta)G'_s(a_S) > 0$ , since  $\eta \in (0, 1)$  and  $G'_s(a) > 0$ . Since  $\varepsilon > 1$ , it follows that  $\frac{da_S}{d\eta} > 0$  and  $\frac{dA_{ss}}{d\eta} < 0$ .

While the above proof holds for any cdf  $G_s(a)$ , it is straightforward to show for the case of the Pareto distribution,  $G_s(a) = (a/\bar{a}_s)^k$ , that the above derivatives can be written more simply as:

$$\frac{da_S}{d\eta} = \frac{a_S}{\eta} \frac{1 - \rho_S}{\varepsilon - 1}, \quad \text{and} \tag{9.1}$$

$$\frac{dA_{ss}}{d\eta} = -\frac{A_{ss}}{\eta} \rho_S. \tag{9.2}$$

Here,  $\rho_S$  is a constant that depends only on parameter values:  $\rho_S \equiv \frac{(1-\eta) \frac{k-\varepsilon+1}{\varepsilon-1}}{1+(1-\eta) \frac{k-\varepsilon+1}{\varepsilon-1}} \in (0, 1)$ . These are convenient expressions that we use frequently in the rest of the proofs. ■

**Proof of Lemma 2.** We take the remaining equations that define the industry equilibrium in West – (2.3)-(2.4), (2.9)-(2.12), (2.14) and (2.16)-(2.19) – and differentiate them. First, log-differentiating (2.9)-(2.11) yields:

$$(\varepsilon - 1) \frac{da_D}{a_D} = \frac{dA_{ww}}{A_{ww}}, \tag{9.3}$$

$$(\varepsilon - 1) \frac{da_{XN}}{a_{XN}} = \frac{dA_{ew}}{A_{ew}}, \quad \text{and} \tag{9.4}$$

$$(\varepsilon - 1) \frac{da_{XS}}{a_{XS}} = \frac{dA_{sw}}{A_{sw}}. \tag{9.5}$$

Since  $A_{sw} = A_{ss}$ , it immediately follows from (9.2) and (9.5) that  $\frac{dA_{sw}}{d\eta} = \frac{dA_{ss}}{d\eta} < 0$ , and hence that:

$$\frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} = -\frac{1}{\eta} \frac{\rho_S}{\varepsilon - 1} < 0. \tag{9.6}$$

This establishes part (iii) of the lemma.

We next differentiate the free-entry condition for West, (2.14):

$$\begin{aligned}
0 = & \left[ (1-\alpha)A_{ww} \left( \left( \frac{1}{\alpha} \right)^{1-\varepsilon} V_n(a_D) + \left( \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{1}{\alpha} \right)^{1-\varepsilon} \right) V_n(a_I) \right) \right] \frac{dA_{ww}}{A_{ww}} \\
& + \left[ (1-\alpha)A_{ew} \left( \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} V_n(a_{XN}) + \left( \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} \right) V_n(a_I) \right) \right] \frac{dA_{ew}}{A_{ew}} \\
& + \left[ (1-\alpha)A_{sw} \left( \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} V_n(a_{XS}) + \left( \left( \frac{\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} \right) V_n(a_I) \right) \right] \frac{dA_{sw}}{A_{sw}} \\
& + \left[ (1-\alpha)A_{ww} \left( \frac{1}{\alpha} \right)^{1-\varepsilon} V'_n(a_D) - Rf_D G'_n(a_D) \right] da_D \\
& + \left[ (1-\alpha)A_{ew} \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} V'_n(a_{XN}) - Rf_X G'_n(a_{XN}) \right] da_{XN} \\
& + \left[ (1-\alpha)A_{sw} \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} V'_n(a_{XS}) - Rf_X G'_n(a_{XS}) \right] da_{XS} \\
& + \left[ (1-\alpha) \left( A_{ww} \left( \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{1}{\alpha} \right)^{1-\varepsilon} \right) + A_{ew} \left( \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} \right) \right. \right. \\
& \left. \left. + A_{sw} \left( \left( \frac{\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} \right) \right) V'_n(a_I) - R(f_I - f_D) G'_n(a_I) \right] da_I.
\end{aligned} \tag{9.7}$$

Focus first on the term involving  $da_D$  on the right-hand side of (9.7). We make use of the fact that: (i)  $(1-\alpha)A_{ww}(1/\alpha)^{1-\varepsilon} = a_D^{\varepsilon-1}Rf_D$ , which comes from equation (2.9); and (ii)  $a^{\varepsilon-1}V'_n(a) = G'_n(a)$  for all  $a \in (0, \bar{a}_n)$ , which holds from Leibniz's Rule. With these, one can show that the coefficient of  $da_D$  in (9.7) reduces to 0. An analogous argument implies that the coefficients of  $da_{XN}$ ,  $da_{XS}$  and  $da_I$  are all also equal to 0. Turning to the terms involving  $\frac{dA_{ww}}{A_{ww}}$ ,  $\frac{dA_{ew}}{A_{ew}}$  and  $\frac{dA_{sw}}{A_{sw}}$ , one can use the expressions for the price indices in (2.16)-(2.18) to re-write (9.7) as:

$$\rho_1 \frac{dA_{ww}}{A_{ww}} + (1-\rho_1) \frac{dA_{ew}}{A_{ew}} + \frac{1-\rho_2}{2} \frac{E_s}{E_n} \frac{dA_{sw}}{A_{sw}} = 0,$$

where we define:  $\rho_1 = \frac{P_{ww}^{1-\varepsilon}}{P_{ww}^{1-\varepsilon} + P_{ew}^{1-\varepsilon}}$  and  $\rho_2 = \frac{P_{ss}^{1-\varepsilon}}{P_{ss}^{1-\varepsilon} + 2P_{sw}^{1-\varepsilon}}$ . Note that  $\rho_1, \rho_2 \in (0, 1)$ . A quick substitution from (9.3)-(9.5) then implies:

$$\rho_1 \frac{da_D}{a_D} + (1-\rho_1) \frac{da_{XN}}{a_{XN}} + \frac{1-\rho_2}{2} \frac{E_s}{E_n} \frac{da_{XS}}{a_{XS}} = 0. \tag{9.8}$$

Intuitively, the free-entry condition requires that a rise in demand in any one market for the Western firm's goods must be balanced by a decline in demand from at least one other market. Since  $A_{ww} = A_{ew}$ , we have  $\frac{1}{A_{ww}} \frac{dA_{ww}}{d\eta} = \frac{1}{A_{ew}} \frac{dA_{ew}}{d\eta}$ , and hence from (9.3) and (9.4), we have  $\frac{1}{a_D} \frac{da_D}{d\eta} = \frac{1}{a_{XN}} \frac{da_{XN}}{d\eta}$ . Substituting this and the expression for  $\frac{1}{a_{XS}} \frac{da_{XS}}{d\eta}$  from (9.6) into (9.8), we obtain:

$$\frac{1}{a_D} \frac{da_D}{d\eta} = \frac{1}{a_{XN}} \frac{da_{XN}}{d\eta} = \frac{1}{\eta} \frac{E_s}{E_n} \frac{1-\rho_2}{2} \frac{\rho_S}{\varepsilon-1} > 0. \tag{9.9}$$

It follows from (9.3) and (9.4) that:  $\frac{1}{A_{ww}} \frac{dA_{ww}}{d\eta} = \frac{1}{A_{ew}} \frac{dA_{ew}}{d\eta} > 0$ . This establishes parts (ii) and (iv) of the lemma.

Finally, we turn to part (i) in the statement of Lemma 2. Log-differentiating (2.12) yields:

$$(\varepsilon-1) \frac{da_I}{a_I} = \frac{A_{ww} \left( \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{1}{\alpha} \right)^{1-\varepsilon} \right) \frac{dA_{ww}}{A_{ww}} + A_{ew} \left( \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} \right) \frac{dA_{ew}}{A_{ew}} + A_{sw} \left( \left( \frac{\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} \right) \frac{dA_{sw}}{A_{sw}}}{A_{ww} \left( \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{1}{\alpha} \right)^{1-\varepsilon} \right) + A_{ew} \left( \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} \right) + A_{sw} \left( \left( \frac{\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} \right)}.$$

We replace  $\frac{dA_{ww}}{A_{ww}}$ ,  $\frac{dA_{ew}}{A_{ew}}$  and  $\frac{dA_{sw}}{A_{sw}}$  using (9.3)-(9.5). Making use also of the expressions: (i) for  $A_{ww}$ ,  $A_{ew}$  and  $A_{sw}$  from (2.3)-(2.4); and (ii) for  $P_{ww}^{1-\varepsilon}$ ,  $P_{ew}^{1-\varepsilon}$  and  $P_{sw}^{1-\varepsilon}$  from (2.16)-(2.18); and simplifying extensively, one can show that:

$$\frac{da_I}{a_I} = \frac{\rho_1(1-\Delta_1)\frac{da_D}{a_D} + (1-\rho_1)(1-\Delta_2)\frac{da_{XN}}{a_{XN}} + \frac{1-\rho_2}{2}\frac{E_s}{E_n}(1-\Delta_3)\frac{da_{XS}}{a_{XS}}}{\rho_1(1-\Delta_1) + (1-\rho_1)(1-\Delta_2) + \frac{1-\rho_2}{2}\frac{E_s}{E_n}(1-\Delta_3)}, \quad (9.10)$$

where we define:

$$\begin{aligned} \Delta_1 &= \frac{\left(\frac{1}{\alpha}\right)^{1-\varepsilon} V_n(a_D)}{\left(\frac{1}{\alpha}\right)^{1-\varepsilon} V_n(a_D) + \left(\left(\frac{\tau\omega}{\alpha}\right)^{1-\varepsilon} - \left(\frac{1}{\alpha}\right)^{1-\varepsilon}\right) V_n(a_I)}, \\ \Delta_2 &= \frac{\left(\frac{\tau}{\alpha}\right)^{1-\varepsilon} V_n(a_{XN})}{\left(\frac{\tau}{\alpha}\right)^{1-\varepsilon} V_n(a_{XN}) + \left(\left(\frac{\tau\omega}{\alpha}\right)^{1-\varepsilon} - \left(\frac{\tau}{\alpha}\right)^{1-\varepsilon}\right) V_n(a_I)}, \quad \text{and} \\ \Delta_3 &= \frac{\left(\frac{\tau}{\alpha}\right)^{1-\varepsilon} V_n(a_{XS})}{\left(\frac{\tau}{\alpha}\right)^{1-\varepsilon} V_n(a_{XS}) + \left(\left(\frac{\omega}{\alpha}\right)^{1-\varepsilon} - \left(\frac{\tau}{\alpha}\right)^{1-\varepsilon}\right) V_n(a_I)}. \end{aligned}$$

Thus,  $\frac{da_I}{a_I}$  is a weighted average of  $\frac{da_D}{a_D}$ ,  $\frac{da_{XN}}{a_{XN}}$  and  $\frac{da_{XS}}{a_{XS}}$ . Note that  $\Delta_1, \Delta_2, \Delta_3 \in (0, 1)$ . Moreover, using the above definitions, we have:  $\text{sign}\{\Delta_1 - \Delta_2\} = \text{sign}\{(\omega^{1-\varepsilon} - 1)V_N(a_D) - ((\tau\omega)^{1-\varepsilon} - 1)V_N(a_{XN})\} > 0$ . This inequality holds as:  $V_N(a_D) > V_N(a_{XN}) > 0$  (since  $a_D > a_{XN}$ ), and  $\omega^{1-\varepsilon} - 1 > (\tau\omega)^{1-\varepsilon} - 1 > 0$ . Analogously, we have:  $\text{sign}\{\Delta_2 - \Delta_3\} = \text{sign}\{(\omega^{1-\varepsilon} - \tau^{1-\varepsilon})V_N(a_{XN}) - ((\tau\omega)^{1-\varepsilon} - \tau^{1-\varepsilon})V_N(a_{XS})\} > 0$ . This is again positive as:  $V_N(a_{XN}) > V_N(a_{XS}) > 0$  (since  $a_{XN} > a_{XS}$ ), and  $\omega^{1-\varepsilon} - \tau^{1-\varepsilon} > (\tau\omega)^{1-\varepsilon} - \tau^{1-\varepsilon} > 0$ . In sum, we have:  $1 > \Delta_1 > \Delta_2 > \Delta_3 > 0$ . We further define:  $\Delta_d = \rho_1(1 - \Delta_1) + (1 - \rho_1)(1 - \Delta_2) + \frac{1-\rho_2}{2}\frac{E_s}{E_n}(1 - \Delta_3) > 0$ , which is the denominator in (9.10). We now substitute into (9.10) the expressions for  $\frac{1}{a_{XS}}\frac{da_{XS}}{d\eta}$ ,  $\frac{1}{a_D}\frac{da_D}{d\eta}$  and  $\frac{1}{a_{XN}}\frac{da_{XN}}{d\eta}$  from (9.6) and (9.9). After simplifying, one obtains:

$$\frac{1}{a_I} \frac{da_I}{d\eta} = \frac{1}{\eta} \frac{1}{\Delta_d} \frac{E_s}{E_n} \frac{1-\rho_2}{2} \frac{\rho_S}{\varepsilon-1} [\Delta_3 - \rho_1\Delta_1 - (1-\rho_1)\Delta_2] < 0. \quad (9.11)$$

That this last expression is negative follow from the fact that  $\rho_1, \rho_2, \Delta_1, \Delta_2, \Delta_3 \in (0, 1)$ , and that  $\Delta_1 > \Delta_2 > \Delta_3$ . Moreover, (9.6) and (9.11) imply:

$$\begin{aligned} \frac{1}{a_I} \frac{da_I}{d\eta} - \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} &= \frac{1}{\eta} \frac{1}{\Delta_d} \frac{\rho_S}{\varepsilon-1} \left[ \frac{E_s}{E_n} \frac{1-\rho_2}{2} (\Delta_3 - 1) + \Delta_d \right] \\ &= \frac{1}{\eta} \frac{1}{\Delta_d} \frac{\rho_S}{\varepsilon-1} [\rho_1(1 - \Delta_1) + (1 - \rho_1)(1 - \Delta_2)] \\ &> 0. \end{aligned}$$

Thus,  $\frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} < \frac{1}{a_I} \frac{da_I}{d\eta} < 0$ , which completes the proof of the lemma. ■

**Proof of Proposition 1.** Recall the definitions of  $HOR(a)$ ,  $PLA(a)$  and  $RET(a)$  from Section 2.3.B. Lemma 2 then implies that when  $\eta$  improves,  $HOR(a)$  falls (since  $\frac{dA_{sw}}{d\eta} < 0$ ),  $PLA(a)$  increases (since  $\frac{dA_{ew}}{d\eta} > 0$ ), and  $RET(a)$  increases (since  $\frac{dA_{ww}}{d\eta} > 0$ ). This establishes part (i) of the proposition.

For part (ii), from (2.23), one can see that  $\frac{d}{d\eta} \frac{HOR(a)}{TOT(a)} < 0$ , since both  $\frac{A_{ww}}{A_{sw}}$  and  $\frac{A_{ew}}{A_{sw}}$  increase with  $\eta$ . On the other hand, from (2.24) and (2.25), we have  $\frac{d}{d\eta} \frac{PLA(a)}{TOT(a)} = \frac{d}{d\eta} \frac{RET(a)}{TOT(a)} > 0$ , since  $\frac{A_{sw}}{A_{ew}}$  is decreasing in  $\eta$  and  $\frac{A_{ww}}{A_{ew}} = 1$ .

For part (iii), we first need an expression for  $\frac{1}{N_n} \frac{dN_n}{d\eta}$ . Start by log-differentiating (2.3):

$$\frac{dA_{ww}}{A_{ww}} = -\rho_1 \frac{dP_{ww}^{1-\varepsilon}}{P_{ww}^{1-\varepsilon}} - (1-\rho_1) \frac{dP_{ew}^{1-\varepsilon}}{P_{ew}^{1-\varepsilon}}. \quad (9.12)$$

Equations (2.16) and (2.17) in turn provide us with the log-derivatives of the two price indices that appear on the right-hand side of (9.12):

$$\frac{dP_{ww}^{1-\varepsilon}}{P_{ww}^{1-\varepsilon}} = \frac{dN_n}{N_n} + (k-\varepsilon+1) \left( \Delta_1 \frac{da_D}{a_D} + (1-\Delta_1) \frac{da_I}{a_I} \right), \quad \text{and} \quad (9.13)$$

$$\frac{dP_{ew}^{1-\varepsilon}}{P_{ew}^{1-\varepsilon}} = \frac{dN_n}{N_n} + (k-\varepsilon+1) \left( \Delta_2 \frac{da_{XN}}{a_{XN}} + (1-\Delta_2) \frac{da_I}{a_I} \right). \quad (9.14)$$

We now substitute: (i) from (9.13) and (9.14) into (9.12); (ii) from (9.3) into the left-hand side of (9.12); and (iii) the expressions for  $\frac{1}{a_{XS}} \frac{da_{XS}}{d\eta}$ ,  $\frac{1}{a_D} \frac{da_D}{d\eta}$  and  $\frac{1}{a_{XN}} \frac{da_{XN}}{d\eta}$  from (9.6) and (9.9) into (9.12). After some algebra, this yields:

$$\begin{aligned} \frac{1}{N_n} \frac{dN_n}{d\eta} &= \frac{1}{\eta} \frac{1}{\Delta_d} \frac{E_s}{E_n} \frac{1-\rho_2}{2} \frac{\rho_S}{\varepsilon-1} \left[ -(\varepsilon-1)\Delta_d \right. \\ &\quad \left. - (k-\varepsilon+1) \left( \Delta_3(\rho_1(1-\Delta_1) + (1-\rho_1)(1-\Delta_2)) + \frac{E_s}{E_n} \frac{1-\rho_2}{2} (1-\Delta_3)(\rho_1\Delta_1 + (1-\rho_1)\Delta_2) \right) \right] \\ &< 0. \end{aligned}$$

Note that we make use here of the fact that  $k-\varepsilon+1 > 0$ . As  $a_I$  also decreases in response to an increase in  $\eta$ , it follows that an improvement in Southern financial development decreases both the measure of Western/Eastern firms,  $N_n$ , and the “number” of multinationals,  $N_n G_n(a_I)$ . The further effect that this has on aggregate platform sales in (2.21) can be computed from:

$$\begin{aligned} \frac{d}{d\eta} \ln PLA &= \frac{1}{N_n} \frac{dN_n}{d\eta} + (\varepsilon-1) \frac{1}{a_{XN}} \frac{da_{XN}}{d\eta} + (k-\varepsilon+1) \frac{1}{a_I} \frac{da_I}{d\eta} \\ &= \frac{1}{\eta} \frac{1}{\Delta_d} \frac{E_s}{E_n} \frac{1-\rho_2}{2} \frac{\rho_S}{\varepsilon-1} (k-\varepsilon+1) \left[ (\Delta_3 - \rho_1\Delta_1 - (1-\rho_1)\Delta_2) \right. \\ &\quad \left. - \left( \Delta_3(\rho_1(1-\Delta_1) + (1-\rho_1)(1-\Delta_2)) + \frac{E_s}{E_n} \frac{1-\rho_2}{2} (1-\Delta_3)(\rho_1\Delta_1 + (1-\rho_1)\Delta_2) \right) \right] \\ &< 0, \end{aligned}$$

where recall from equation (9.11) that  $\Delta_3 - \rho_1\Delta_1 - (1-\rho_1)\Delta_2$  is indeed negative. Looking back at the definitions in (2.20)-(2.22), and making use of parts (iii) and (iv) of Lemma 2, we then have:  $\frac{d}{d\eta} \ln PLA = \frac{d}{d\eta} \ln RET > \frac{d}{d\eta} \ln HOR$ . Hence, the aggregate sales levels  $HOR$ ,  $PLA$  and  $RET$  all decrease in response to an improvement in  $\eta$ . ■

**Proof of Lemma 3.** First, observe that the equilibrium for South’s differentiated varieties industry is still determined by (2.13) and (2.15) as in the baseline model. Thus, Lemma 1 holds and the expressions for  $\frac{da_S}{d\eta}$  and  $\frac{dA_{ss}}{d\eta}$  from (9.1) and (9.2) still apply. As for the Western industry, only two equations are affected relative to the baseline model when we differentiate the equilibrium system. The first of these is the equation obtained from log-differentiating the new FDI cutoff, (3.1):

$$\Delta_d \frac{d\tilde{a}_I}{\tilde{a}_I} = \frac{\Delta_d}{\varepsilon-1} \frac{d\eta}{\eta} + \rho_1(1-\Delta_1) \frac{da_D}{a_D} + (1-\rho_1)(1-\Delta_2) \frac{da_{XN}}{a_{XN}} + \frac{1-\rho_2}{2} \frac{E_s}{E_n} (1-\Delta_3) \frac{da_{XS}}{a_{XS}}. \quad (9.15)$$

The additional term,  $\frac{\Delta_d}{\varepsilon-1} \frac{d\eta}{\eta}$ , on the right-hand side captures the direct effect that Southern financial development has on Western firms. The second equation that is affected is the free-entry condition. In the manipulation of (9.7), we now need to bear in mind that the coefficient of the term in  $d\tilde{a}_I$  is no longer equal to 0. This is because:

$$\begin{aligned} & (1-\alpha) \left[ A_{ww} \left( \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{1}{\alpha} \right)^{1-\varepsilon} \right) + A_{ew} \left( \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} \right) + A_{sw} \left( \left( \frac{\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} \right) \right] V'_n(\tilde{a}_I) \\ & \quad - R(f_I - f_D) G'_n(\tilde{a}_I) \\ = & (1-\alpha)(1-\eta) \left[ A_{ww} \left( \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{1}{\alpha} \right)^{1-\varepsilon} \right) + A_{ew} \left( \left( \frac{\tau\omega}{\alpha} \right)^{1-\varepsilon} - \left( \frac{\tau}{\alpha} \right)^{1-\varepsilon} \right) + A_{sw} \left( \left( \frac{\omega}{\alpha} \right)^{1-\varepsilon} \right) \right] V'_n(\tilde{a}_I) \end{aligned}$$

where the last step follows from using the definition of  $\tilde{a}_I^{1-\varepsilon}$  from (3.1) to substitute out for  $R(f_I - f_D)$ , as well as from using Leibniz's rule to replace  $G'_n(\tilde{a}_I)$  with  $\tilde{a}_I^{\varepsilon-1} V'_n(\tilde{a}_I)$ . We now follow analogous algebraic steps as in the proof of Lemma 2, in particular, substituting in the definitions of the price indices (2.16)-(2.18), as well as the definitions of  $\rho_1$  and  $\Delta_d$ . This allows us to rewrite the derivative of the free-entry condition as:

$$\rho_1 \frac{da_D}{a_D} + (1-\rho_1) \frac{da_{XS}}{a_{XS}} + \frac{1-\rho_2}{2} \frac{E_s}{E_n} \frac{da_{XS}}{a_{XS}} + (1-\eta) \frac{k-\varepsilon+1}{\varepsilon-1} \Delta_d \frac{d\tilde{a}_I}{\tilde{a}_I} = 0. \quad (9.16)$$

Since the expression for  $a_{XS}^{1-\varepsilon}$  in (2.11) remains unchanged, one can quickly see from the proof of Lemma 2 that we still have  $\frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} = -\frac{1}{\eta} \frac{\rho_S}{\varepsilon-1}$  as in equation (9.6). Likewise, the same argument in the proof of Lemma 2 implies that  $\frac{1}{a_D} \frac{da_D}{d\eta} = \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta}$ . Substituting these two properties into (9.15) and (9.16), this leaves us with a system of two linear equations in the two unknowns,  $\frac{1}{a_D} \frac{da_D}{d\eta}$  and  $\frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta}$ . Solving these two equations simultaneously then yields:

$$\frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} = \frac{1}{\eta} \frac{1-\rho_T}{\varepsilon-1} \left[ 1 - \rho_S \frac{E_s}{E_n} \frac{1-\rho_2}{2} \frac{\rho_1 \Delta_1 + (1-\rho_1) \Delta_2 - \Delta_3}{\Delta_d} \right] \quad (9.17)$$

$$\frac{1}{a_D} \frac{da_D}{d\eta} = \frac{1}{\eta} \left[ -\rho_T + \frac{E_s}{E_n} \frac{1-\rho_2}{2} (1-\rho_T) \left( \rho_S - (1-\rho_S)(1-\eta) \frac{k-\varepsilon+1}{\varepsilon-1} (1-\Delta_3) \right) \right] \quad (9.18)$$

where  $\rho_T$  is defined by:  $\rho_T \equiv \frac{(1-\eta) \frac{k-\varepsilon+1}{\varepsilon-1} (\rho_1(1-\Delta_1) + (1-\rho_1)(1-\Delta_2))}{1 + (1-\eta) \frac{k-\varepsilon+1}{\varepsilon-1} (\rho_1(1-\Delta_1) + (1-\rho_1)(1-\Delta_2))} \in (0, 1)$ .

Examining (9.17), note that: (i)  $\rho_1 \Delta_1 + (1-\rho_1) \Delta_2 - \Delta_3 > 0$ , since  $\Delta_1, \Delta_2 > \Delta_3$ ; and (ii)  $\frac{E_s}{E_n} \frac{1-\rho_2}{2} (\rho_1 \Delta_1 + (1-\rho_1) \Delta_2 - \Delta_3) < \frac{E_s}{E_n} \frac{1-\rho_2}{2} (1-\Delta_3) < \Delta_d$ , since  $\Delta_1, \Delta_2 < 1$ . These two facts in turn imply that:  $\frac{E_s}{E_n} \frac{1-\rho_2}{2} \frac{\rho_1 \Delta_1 + (1-\rho_1) \Delta_2 - \Delta_3}{\Delta_d} \in (0, 1)$ . Since we also have  $\rho_S \in (0, 1)$ , it follows from (9.17) that  $\frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} > 0$ , as claimed in part (i) of Lemma 3. We have also already seen that:  $\frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} = -\frac{1}{\eta} \frac{\rho_S}{\varepsilon-1} < 0$ , which is part (ii) of the lemma.

As for (9.18), the sign of  $\frac{1}{a_D} \frac{da_D}{d\eta} = \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta}$  is in principle ambiguous: The two numerical examples in footnote 19 illustrate that this derivative can be either positive or negative. We can nevertheless evaluate the following:

$$\frac{1}{a_D} \frac{da_D}{d\eta} - \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} = \frac{1}{\eta} \left[ \rho_S - \rho_T + \frac{E_s}{E_n} \frac{1-\rho_2}{2} (1-\Delta_3) \rho_S (1-\rho_T) \Delta_3 \right]. \quad (9.19)$$

Using the definitions of  $\rho_S$  and  $\rho_T$ , we have:  $\rho_S - \rho_T = \rho_S (1-\rho_T) [1 - \rho_1(1-\Delta_1) - (1-\rho_1)(1-\Delta_2)] > 0$ , since:  $\rho_1(1-\Delta_1) + (1-\rho_1)(1-\Delta_2) < \rho_1 + (1-\rho_1) = 1$ , and  $\rho_S, \rho_T \in (0, 1)$ . Inspecting (9.19), we have

$\frac{1}{a_D} \frac{da_D}{d\eta} - \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} > 0$ , which establishes part (iii) of Lemma 3. As for parts (iv) and (v) of the lemma, these follow immediately from applying (9.3)-(9.5). ■

**Proof of Proposition 2.** As in the proof of Proposition 1,  $\frac{d}{d\eta} HOR(a)$ ,  $\frac{d}{d\eta} PLA(a)$  and  $\frac{d}{d\eta} RET(a)$  respectively inherit the signs of  $\frac{dA_{sw}}{d\eta}$ ,  $\frac{dA_{ew}}{d\eta}$  and  $\frac{dA_{ww}}{d\eta}$ . Lemma 3 then implies that  $\frac{dA_{sw}}{d\eta} > 0$ , but also that  $\frac{dA_{ew}}{d\eta}$  and  $\frac{dA_{ww}}{d\eta}$  cannot be conclusively signed. This establishes part (i) of this proposition.

Furthermore, part (v) of Lemma 3 implies that  $\frac{A_{ww}}{A_{sw}}$  and  $\frac{A_{ew}}{A_{sw}}$  are both increasing in  $\eta$ . Referring back to the definitions of the sales shares in (2.23)-(2.25), we immediately have  $\frac{d}{d\eta} \frac{HOR(a)}{TOT(a)} < 0$  and  $\frac{d}{d\eta} \frac{PLA(a)}{TOT(a)} = \frac{d}{d\eta} \frac{RET(a)}{TOT(a)} > 0$ . This pins down part (ii) of the proposition.

For part (iii), we first write down the derivatives of the aggregate variables of interest. Observe that the expressions for the log-derivatives of  $A_{ww}$ ,  $P_{ww}^{1-\varepsilon}$  and  $P_{ew}^{1-\varepsilon}$  in equations (9.12)-(9.14) remain valid in the model with host-country financing. Eliminating  $\frac{dP_{ww}^{1-\varepsilon}}{P_{ww}^{1-\varepsilon}}$  and  $\frac{dP_{ew}^{1-\varepsilon}}{P_{ew}^{1-\varepsilon}}$  from these equations and using (9.3), we have:

$$\begin{aligned} \frac{1}{N_n} \frac{dN_n}{d\eta} &= -(\varepsilon - 1) \frac{da_D}{a_D} - (k - \varepsilon + 1) \left[ \rho_1 \left( \Delta_1 \frac{1}{a_D} \frac{da_D}{d\eta} + (1 - \Delta_1) \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} \right) \right. \\ &\quad \left. + (1 - \rho_1) \left( \Delta_2 \frac{1}{a_{XN}} \frac{da_{XN}}{d\eta} + (1 - \Delta_2) \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} \right) \right]. \end{aligned} \quad (9.20)$$

In turn, how the number of multinationals,  $N_n G_n(\tilde{a}_I)$ , responds to  $\eta$  is given by:  $\frac{d}{d\eta} \log N_n G_n(\tilde{a}_I) = \frac{1}{N_n} \frac{dN_n}{d\eta} + \frac{G'_n(\tilde{a}_I) \tilde{a}_I}{G_n(\tilde{a}_I)} \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} = \frac{1}{N_n} \frac{dN_n}{d\eta} + k \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta}$ , where  $\frac{G'_n(a)a}{G_n(a)} = k$  for the Pareto distribution. Using (9.20), together with the fact that  $\frac{1}{a_D} \frac{da_D}{d\eta} = \frac{1}{a_{XN}} \frac{da_{XN}}{d\eta}$ , this yields:

$$\begin{aligned} \frac{1}{N_n} \frac{dN_n}{d\eta} + k \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} &= [-(\varepsilon - 1) - (k - \varepsilon + 1) (\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2)] \frac{1}{a_D} \frac{da_D}{d\eta} \\ &\quad + [k - (k - \varepsilon + 1) (\rho(1 - \Delta_1) + (1 - \rho_1)(1 - \Delta_2))] \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} \\ &= [(\varepsilon - 1) + (k - \varepsilon + 1) (\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2)] \left( \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} - \frac{1}{a_D} \frac{da_D}{d\eta} \right). \end{aligned} \quad (9.21)$$

Note that it is straightforward to verify that:  $(\varepsilon - 1) + (k - \varepsilon + 1) (\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2) = k - (k - \varepsilon + 1) (\rho(1 - \Delta_1) + (1 - \rho_1)(1 - \Delta_2)) > 0$ . It thus suffices to determine the sign of  $\frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} - \frac{1}{a_D} \frac{da_D}{d\eta}$ . For this, substitute in the expressions for these derivatives from (9.17) and (9.18). Some algebra leads to:

$$\frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} - \frac{1}{a_D} \frac{da_D}{d\eta} = \frac{1}{\eta} \frac{1}{\varepsilon - 1} \left[ 1 - \rho_S(1 - \rho_T) \frac{\frac{E_s}{E_n} \frac{1-\rho_2}{2} (1 - \Delta_3)}{\Delta_d} \left( \rho_1 \Delta_1 + (1 - \rho_1) \Delta_2 + \frac{E_s}{E_n} \frac{1-\rho_2}{2} \Delta_3 \right) \right]. \quad (9.22)$$

As for the effect on aggregate horizontal sales, we differentiate (2.20) with respect to  $\eta$ . Making use of (9.5), we have:

$$\begin{aligned} \frac{d}{d\eta} \ln HOR &= \frac{1}{N_n} \frac{dN_n}{d\eta} + (\varepsilon - 1) \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} + (k - \varepsilon + 1) \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} \\ &= \frac{1}{N_n} \frac{dN_n}{d\eta} + k \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} - (\varepsilon - 1) \left( \frac{1}{a_D} \frac{da_D}{d\eta} - \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} \right) - (\varepsilon - 1) \left( \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} - \frac{1}{a_D} \frac{da_D}{d\eta} \right) \\ &= \frac{1}{\eta} \left[ 1 - \rho_S(1 - \rho_T) \frac{\frac{E_s}{E_n} \frac{1-\rho_2}{2} (1 - \Delta_3)}{\Delta_d} \left( \rho_1 \Delta_1 + (1 - \rho_1) \Delta_2 + \frac{E_s}{E_n} \frac{1-\rho_2}{2} \Delta_3 \right) \right. \\ &\quad \left. - \rho_S(1 - \rho_T) \frac{\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2 + \frac{E_s}{E_n} \frac{1-\rho_2}{2} \Delta_3}{\frac{k-\varepsilon+1}{\varepsilon-1} (\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2)} \right]. \end{aligned} \quad (9.23)$$



Note that in the penultimate step, we substituted in for  $\frac{1}{N_n} \frac{dN_n}{d\eta} + k \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta}$  using (9.21), for  $\frac{1}{a_D} \frac{da_D}{d\eta} - \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta}$  using (9.19), for  $\frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} - \frac{1}{a_D} \frac{da_D}{d\eta}$  using (9.22), and then simplified extensively.

Likewise, differentiating (2.21) with respect to  $\eta$  and using (9.3), we have:

$$\begin{aligned} \frac{d}{d\eta} \ln PLA &= \frac{d}{d\eta} \ln RET = \frac{1}{N_n} \frac{dN_n}{d\eta} + (\varepsilon - 1) \frac{1}{a_D} \frac{da_D}{d\eta} + (k - \varepsilon + 1) \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} \\ &= \frac{1}{N_n} \frac{dN_n}{d\eta} + k \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} - (\varepsilon - 1) \left( \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} - \frac{1}{a_D} \frac{da_D}{d\eta} \right) \\ &= (k - \varepsilon + 1) (\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2) \left( \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} - \frac{1}{a_D} \frac{da_D}{d\eta} \right). \end{aligned} \quad (9.24)$$

Once again, we have made use of the expression for  $\frac{1}{N_n} \frac{dN_n}{d\eta} + k \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta}$  in (9.21) to arrive at (9.24). In particular, observe from (9.21) and (9.24) that the measure of multinationals, aggregate platform sales and aggregate return sales all move in the same direction when  $\eta$  changes.

It remains for us to analyze the sign of the derivatives in (9.21), (9.23) and (9.24). Recall the definition:  $\rho_S \equiv \frac{(1-\eta)^{\frac{k-\varepsilon+1}{\varepsilon-1}}}{1+(1-\eta)^{\frac{k-\varepsilon+1}{\varepsilon-1}}}$ . When  $\eta = 1$ , we thus have  $\rho_S = 0$ , in which case it quickly follows from (9.22) that  $\frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} - \frac{1}{a_D} \frac{da_D}{d\eta} > 0$ , and hence that  $\frac{d}{d\eta} \ln N_n G_n(a_I)$ ,  $\frac{d}{d\eta} \ln PLA$ ,  $\frac{d}{d\eta} \ln RET > 0$ . Moreover, inspecting (9.23), we would also have  $\frac{d}{d\eta} \ln HOR > 0$ . By continuity, it follows that  $\frac{d}{d\eta} \ln N_n G_n(a_I)$ ,  $\frac{d}{d\eta} \ln HOR$ ,  $\frac{d}{d\eta} \ln PLA$  and  $\frac{d}{d\eta} \ln RET$  must all be positive in a neighborhood of  $\eta$ , so that  $N_n G_n(a_I)$ ,  $HOR$ ,  $PLA$  and  $RET$  are increasing in host-country financial development if the initial level of  $\eta$  is sufficiently high. This establishes part (iii) of the proposition.

It is useful to point out here that some form of a sufficient condition is indeed required in the statement of part (iii) of the proposition. Examining the expression for  $\frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} - \frac{1}{a_D} \frac{da_D}{d\eta}$  in (9.22) more closely, one can see that  $\rho_S, 1 - \rho_T, \frac{E_s}{E_n} \frac{1-\rho_2}{2} (1 - \Delta_3) / \Delta_d \in (0, 1)$ , but that we cannot explicitly bound  $\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2 + \frac{E_s}{E_n} \frac{1-\rho_2}{2} \Delta_3$  between 0 and 1, even though  $\Delta_1, \Delta_2, \Delta_3 \in (0, 1)$ . That said, it is actually not easy to find parameter values for which  $N_n G_n(a_I)$ ,  $HOR$ ,  $PLA$  or  $RET$  end up decreasing in  $\eta$ , even when we set the initial level of  $\eta$  to be very small. As an example, consider the set of parameter values:  $R = 1.07$ ,  $\varepsilon = 3.8$ ,  $L_n = L_s = 1$ ,  $f_D = 0.2$ ,  $f_X = 0.15$ ,  $f_S = 0.1$ ,  $f_{En} = f_{Es} = 1$ ,  $\tau = 1.3$ ,  $\omega = 0.7$ ,  $\bar{a}_N = \bar{a}_S = 25$ ,  $k = 4$ ,  $\delta = 0.1$ ,  $\mu = 0.5$  and  $\eta = 0.01$ . While this features a low  $\eta$ , it turns out that it is also necessary to set the remaining parameter  $f_I$  to be very high to generate a counter-example to part (iii) of the proposition. In particular, when  $f_I = 1000$ , we have an equilibrium with  $a_D = 14.41$ ,  $a_{XN} = 12.28$ ,  $a_{XS} = 12.23$  and  $\tilde{a}_I = 0.20$ , in which  $\frac{d}{d\eta} HOR = -0.89 < 0$ . This value of  $f_I$  is of course exceedingly large relative to the other fixed cost parameters. But attempting to reduce the value of  $f_I$  to 100 results in an equilibrium in which the order of two of the cutoffs gets reversed, specifically  $a_{XN} = 12.18$  and  $a_{XS} = 12.23$ . ■

**Cross-industry heterogeneity.** We show that the effects of host-country financial development in our model will hold particularly for industries that have a higher financing requirement, as captured by  $f_S$ . Under the assumption that firm productivities within each industry follow a Pareto distribution, we have from (9.1) and (9.2) that  $\text{sign} \left( \frac{d^2 a_S}{d\eta df_S} \right) = \text{sign} \left( \frac{da_S}{df_S} \right)$  and  $\text{sign} \left( \frac{d^2 A_{SS}}{d\eta df_S} \right) = -\text{sign} \left( \frac{dA_{SS}}{df_S} \right)$ . To pin

down the signs of these derivatives with respect to  $f_S$ , we totally differentiate (2.13) and (2.15) to obtain:

$$\begin{aligned} (\varepsilon - 1) \frac{da_S}{a_S} &= -\frac{df_S}{f_S} + \frac{dA_{ss}}{A_{ss}}, \quad \text{and} \\ 0 &= a_S^{\varepsilon-1} V_s(a_S) \frac{dA_{ss}}{A_{ss}} + (a_S^{\varepsilon-1} V'_s(a_S) - \eta G'_s(a_S)) da_S - \eta G_s(a_S) \frac{df_S}{f_S} \\ &= a_S^{\varepsilon-1} V_s(a_S) \frac{dA_{ss}}{A_{ss}} + (1 - \eta) a_S G'_s(a_S) \frac{da_S}{a_S} - \eta G_s(a_S) \frac{df_S}{f_S}. \end{aligned}$$

Note that we have applied Leibniz's rule to the definition of  $V_s(a_S)$ , as in the proof of Lemma 1, in the last step above. Solving these two equations simultaneously yields:

$$\begin{aligned} \frac{1}{a_S} \frac{da_S}{df_S} &= -\frac{1}{f_S} \frac{a_S^{\varepsilon-1} V_s(a_S) - \eta G_s(a_S)}{(\varepsilon - 1) a_S^{\varepsilon-1} V_s(a_S) + (1 - \eta) a_S G'_s(a_S)}, \quad \text{and} \\ \frac{1}{A_{ss}} \frac{dA_{ss}}{df_S} &= \frac{1}{f_S} \left[ 1 - \frac{(\varepsilon - 1) a_S^{\varepsilon-1} V_s(a_S) - (\varepsilon - 1) \eta G_s(a_S)}{(\varepsilon - 1) a_S^{\varepsilon-1} V_s(a_S) + (1 - \eta) a_S G'_s(a_S)} \right]. \end{aligned}$$

Looking at the numerator on the right-hand side of the above expression for  $\frac{1}{a_S} \frac{da_S}{df_S}$ , observe that:  $a_S^{\varepsilon-1} V_s(a_S) = a_S^{\varepsilon-1} \int_0^{a_S} a^{1-\varepsilon} G'_s(a) da = a_S^{\varepsilon-1} [a_S^{1-\varepsilon} G_s(a_S) - \int_0^{a_S} (1 - \varepsilon) a^{-\varepsilon} G_s(a) da] > \eta G_s(a_S)$ , which implies that  $\frac{1}{a_S} \frac{da_S}{df_S} < 0$ . Next, from the equation for  $\frac{1}{A_{ss}} \frac{dA_{ss}}{df_S}$ , we have:  $0 < (\varepsilon - 1) a_S^{\varepsilon-1} V_s(a_S) - (\varepsilon - 1) \eta G_s(a_S) < (\varepsilon - 1) a_S^{\varepsilon-1} V_s(a_S) + (1 - \eta) a_S G'_s(a_S)$ , which in turn means that  $\frac{1}{A_{ss}} \frac{dA_{ss}}{df_S} > 0$ .

We can thus conclude that  $\frac{d^2 a_S}{d\eta df_S} < 0$  and  $\frac{d^2 A_{ss}}{d\eta df_S} < 0$ . In particular, the fact that  $\frac{d^2 A_{ss}}{d\eta df_S}$  inherits the same negative sign as  $\frac{dA_{ss}}{d\eta}$  is crucial, as it also means that  $\text{sign}\left(\frac{d^2 A_{sw}}{d\eta df_S}\right) = \text{sign}\left(\frac{dA_{sw}}{d\eta}\right)$ . The effects of host-country financial development on the market demand levels, and hence the respective sales shares in (2.23)-(2.25), are therefore stronger in industries with a higher  $f_S$ . ■

**The relationship between private credit and  $\eta$ .** Consider first the baseline model where MNCs do not require host-country financing. The model counterpart of our empirical measure of private credit over GDP is:  $N_s G(a_S) f_S \omega / (\omega L)$ , this being the total amount borrowed by domestic firms, divided by the total labor income in South. Since  $f_S$ ,  $\omega$ , and  $L$  are fixed, our task is to show that  $N_s G_s(a_S)$ , the “number” of successful entrants in the Southern industry, is increasing in  $\eta$ .

First, log-differentiate the ideal price index,  $P_{ss}^{1-\varepsilon}$ , given by (2.19):

$$\frac{1}{N_s} \frac{dN_s}{d\eta} = \frac{1}{P_{ss}^{1-\varepsilon}} \frac{dP_{ss}^{1-\varepsilon}}{d\eta} - (k - \varepsilon + 1) \frac{1}{a_S} \frac{da_S}{d\eta}. \quad (9.25)$$

We therefore have:  $\frac{d}{d\eta} \log N_s G_s(a_S) = \frac{1}{N_s} \frac{dN_s}{d\eta} + \frac{G'_s(a_S) a_S}{G_s(a_S)} \frac{1}{a_S} \frac{da_S}{d\eta} = \frac{1}{N_s} \frac{dN_s}{d\eta} + k \frac{1}{a_S} \frac{da_S}{d\eta} = \frac{1}{P_{ss}^{1-\varepsilon}} \frac{dP_{ss}^{1-\varepsilon}}{d\eta} + (\varepsilon - 1) \frac{1}{a_S} \frac{da_S}{d\eta}$ , where we have made use of (9.25) to obtain the last expression. We have seen from Lemma 1 that  $\frac{da_S}{d\eta} > 0$ . As  $\varepsilon > 1$ , it will thus suffice to show that  $\frac{1}{P_{ss}^{1-\varepsilon}} \frac{dP_{ss}^{1-\varepsilon}}{d\eta} > 0$ , in order to conclude that  $\frac{d}{d\eta} \log N_s G_s(a_S) > 0$ .

For this, we log-differentiate (2.4) to obtain:  $\frac{dA_{sw}}{A_{sw}} = -\rho_2 \frac{dP_{ss}^{1-\varepsilon}}{P_{ss}^{1-\varepsilon}} - (1 - \rho_2) \frac{dP_{sw}^{1-\varepsilon}}{P_{sw}^{1-\varepsilon}}$ . Substituting in the expression for  $\frac{dA_{sw}}{A_{sw}}$  from (9.5) into this last equation, and rearranging, gives:

$$\rho_2 \frac{1}{P_{ss}^{1-\varepsilon}} \frac{dP_{ss}^{1-\varepsilon}}{d\eta} = -(\varepsilon - 1) \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} - (1 - \rho_2) \frac{1}{P_{sw}^{1-\varepsilon}} \frac{dP_{sw}^{1-\varepsilon}}{d\eta}. \quad (9.26)$$

Now, log-differentiating (2.18) yields:

$$\frac{1}{P_{sw}^{1-\varepsilon}} \frac{dP_{sw}^{1-\varepsilon}}{d\eta} = \frac{1}{N_n} \frac{dN_n}{d\eta} + (k - \varepsilon + 1) \left( \Delta_3 \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} + (1 - \Delta_3) \frac{1}{a_I} \frac{da_I}{d\eta} \right). \quad (9.27)$$

Since  $\frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} < 0$  and  $\frac{1}{a_I} \frac{da_I}{d\eta} < 0$  from Lemma 2, and  $\frac{1}{N_n} \frac{dN_n}{d\eta} < 0$  from Proposition 1, it follows that:  $\frac{1}{P_{sw}^{1-\varepsilon}} \frac{dP_{sw}^{1-\varepsilon}}{d\eta} < 0$ . From (9.26), we immediately have:  $\frac{1}{P_{ss}^{1-\varepsilon}} \frac{dP_{ss}^{1-\varepsilon}}{d\eta} > 0$ , so that  $\frac{d}{d\eta} \log N_s G_s(a_S) > 0$ , and we indeed have total private credit extended in South increasing with  $\eta$  in our baseline model.

As for the extension with local borrowing by MNCs, the private credit to GDP ratio in South is now given instead by:  $[2N_n G_n(\tilde{a}_I)(f_I - f_D) + N_s G_s(a_S) f_S \omega] / (\omega L)$ , where the numerator takes into account total lending to multinational affiliates from both East and West, as well as to Southern domestic firms. Under the sufficient condition assumed for part (iii) of Proposition 3 – that the initial level of host-country financial development be sufficiently high – we have already seen that the “number” of multinational affiliates  $N_n G(\tilde{a}_I)$  will be increasing in  $\eta$ . We now show that when the initial level of  $\eta$  is sufficiently high, this increase in  $2N_n G_n(\tilde{a}_I)$  will dominate any movements in  $N_s G_s(a_S)$  in the numerator of the private credit to GDP ratio.

Log-differentiating the expression for the private credit to GDP ratio, we get:

$$\begin{aligned} & \frac{2 \left( \frac{dN_n}{d\eta} G_n(\tilde{a}_I) + N_n G'_n(\tilde{a}_I) \frac{d\tilde{a}_I}{d\eta} \right) (f_I - f_D) + \left( \frac{dN_s}{d\eta} G_s(a_S) + N_s G'_s(a_S) \frac{da_S}{d\eta} \right) f_S \omega}{2N_n G_n(\tilde{a}_I)(f_I - f_D) + N_s G_s(a_S) f_S \omega} \\ &= \frac{2N_n G_n(\tilde{a}_I)(f_I - f_D) \left( \frac{1}{N_n} \frac{dN_n}{d\eta} + k \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} \right) + N_s G_s(a_S) f_S \omega \left( \frac{1}{N_s} \frac{dN_s}{d\eta} + k \frac{1}{a_S} \frac{da_S}{d\eta} \right)}{2N_n G_n(\tilde{a}_I)(f_I - f_D) + N_s G_s(a_S) f_S \omega} \\ &\propto \left( \frac{1}{N_n} \frac{dN_n}{d\eta} + k \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} \right) + \frac{N_s G_s(a_S) f_S \omega}{2N_n G_n(\tilde{a}_I)(f_I - f_D)} \left( \frac{1}{N_s} \frac{dN_s}{d\eta} + k \frac{1}{a_S} \frac{da_S}{d\eta} \right), \end{aligned} \quad (9.28)$$

where ‘ $\propto$ ’ denotes equality up to a positive multiplicative term. We thus focus on pinning down the sign of (9.28) in the neighborhood of  $\eta = 1$ . Using (9.21) and (9.22), and setting  $\eta = 1$ , we have:  $\frac{1}{N_n} \frac{dN_n}{d\eta} + k \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} = 1 + \frac{k-\varepsilon+1}{\varepsilon-1} (\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2)$ . Next, since (2.4), (2.18) and (2.19) are unchanged in the extension with host-country financing, equations (9.25), (9.26) and (9.27) remain valid, so that:

$$\begin{aligned} \frac{1}{N_s} \frac{dN_s}{d\eta} + k \frac{1}{a_S} \frac{da_S}{d\eta} &= -\frac{\varepsilon-1}{\rho_2} \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} - \frac{1-\rho_2}{\rho_2} \frac{1}{P_{sw}^{1-\varepsilon}} \frac{dP_{sw}^{1-\varepsilon}}{d\eta} + (\varepsilon-1) \frac{1}{a_S} \frac{da_S}{d\eta} \\ &= -\frac{\varepsilon-1}{\rho_2} \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} + (\varepsilon-1) \frac{1}{a_S} \frac{da_S}{d\eta} \\ &\quad - \frac{1-\rho_2}{\rho_2} \left( \frac{1}{N_n} \frac{dN_n}{d\eta} + k \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} + (k - \varepsilon + 1) \left( \Delta_3 \frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} + (1 - \Delta_3) \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} \right) - k \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} \right). \end{aligned}$$

We now make use of the following properties: (i)  $\frac{1-\rho_2}{\rho_2} = \frac{2P_{sw}^{1-\varepsilon}}{P_{ss}^{1-\varepsilon}}$  from the definition of  $\rho_2$ ; (ii)  $\frac{1}{a_S} \frac{da_S}{d\eta} = \frac{1}{\eta} \frac{1-\rho_S}{\varepsilon-1}$  from (9.1); (iii)  $\frac{1}{a_{XS}} \frac{da_{XS}}{d\eta} = -\frac{1}{\eta} \frac{\rho_S}{\varepsilon-1}$  from the proof of Lemma 3; (iv) the expression for  $\frac{1}{N_n} \frac{dN_n}{d\eta} + k \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta}$  in (9.21); and (v) the expression for  $\frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta}$  in (9.17). Evaluating these at  $\eta = 1$  and following some algebra, one obtains:  $\frac{1}{N_s} \frac{dN_s}{d\eta} + k \frac{1}{a_S} \frac{da_S}{d\eta} = 1 - \frac{2P_{sw}^{1-\varepsilon}}{P_{ss}^{1-\varepsilon}} \frac{k-\varepsilon+1}{\varepsilon-1} (\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2 - \Delta_3)$ . We further use the expressions for the ideal price indices in (2.18) and (2.19) to simplify the following:

$$\begin{aligned}
\frac{N_s G_s(a_S) f_S \omega}{2N_n G_n(\tilde{a}_I)(f_I - f_D)} \frac{2P_{sw}^{1-\varepsilon}}{P_{ss}^{1-\varepsilon}} &= \frac{(G_s(a_S)/V_s(a_S)) f_S \omega}{(G_n(\tilde{a}_I)/V_n(\tilde{a}_I))(f_I - f_D)} \frac{1}{1 - \Delta_3} \frac{\omega^{1-\varepsilon} - \tau^{1-\varepsilon}}{\omega^{1-\varepsilon}} \\
&= \frac{f_S \omega / a_S^{1-\varepsilon}}{(f_I - f_D) / \tilde{a}_I^{1-\varepsilon}} \frac{1}{1 - \Delta_3} \frac{\omega^{1-\varepsilon} - \tau^{1-\varepsilon}}{\omega^{1-\varepsilon}} \\
&= \frac{A_{ss}(\omega^{1-\varepsilon} - \tau^{1-\varepsilon})}{A_{ww}((\tau\omega)^{1-\varepsilon} - 1) + A_{ew}((\tau\omega)^{1-\varepsilon} - \tau^{1-\varepsilon}) + A_{sw}(\omega^{1-\varepsilon} - \tau^{1-\varepsilon})} \frac{1}{1 - \Delta_3},
\end{aligned}$$

where we have substituted in the expressions for  $a_S^{1-\varepsilon}$  in (2.13) and  $\tilde{a}_I^{1-\varepsilon}$  in (3.1) for this last step. Since  $A_{ss} = A_{sw}$ , we thus have:  $\frac{N_s G_s(a_S) f_S \omega}{2N_n G_n(\tilde{a}_I)(f_I - f_D)} \frac{2P_{sw}^{1-\varepsilon}}{P_{ss}^{1-\varepsilon}} < \frac{1}{1 - \Delta_3}$ .

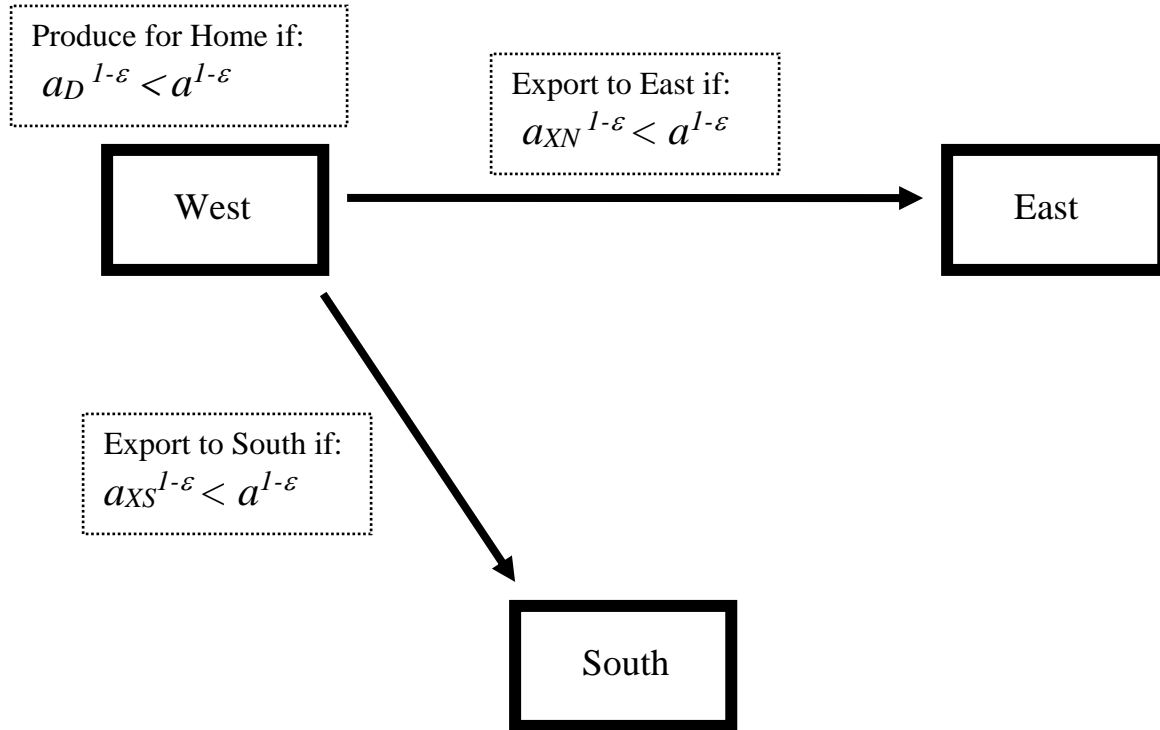
Applying the above properties to (9.28), we find that evaluated at  $\eta = 1$ :

$$\begin{aligned}
&\left( \frac{1}{N_n} \frac{dN_n}{d\eta} + k \frac{1}{\tilde{a}_I} \frac{d\tilde{a}_I}{d\eta} \right) + \frac{N_s G_s(a_S) f_S \omega}{2N_n G_n(\tilde{a}_I)(f_I - f_D)} \left( \frac{1}{N_s} \frac{dN_s}{d\eta} + k \frac{1}{a_S} \frac{da_S}{d\eta} \right) \\
&= 1 + \frac{k - \varepsilon + 1}{\varepsilon - 1} (\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2) + \frac{N_s G_s(a_S) f_S \omega}{2N_n G_n(\tilde{a}_I)(f_I - f_D)} \left( 1 - \frac{2P_{sw}^{1-\varepsilon}}{P_{ss}^{1-\varepsilon}} \frac{k - \varepsilon + 1}{\varepsilon - 1} (\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2 - \Delta_3) \right) \\
&> \frac{k - \varepsilon + 1}{\varepsilon - 1} (\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2) - \frac{1}{1 - \Delta_3} \frac{k - \varepsilon + 1}{\varepsilon - 1} (\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2 - \Delta_3) \\
&\propto (\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2) (1 - \Delta_3) - (\rho_1 \Delta_1 + (1 - \rho_1) \Delta_2 - \Delta_3) \\
&= \Delta_3 (1 - \rho_1 \Delta_1 - (1 - \rho_1) \Delta_2).
\end{aligned}$$

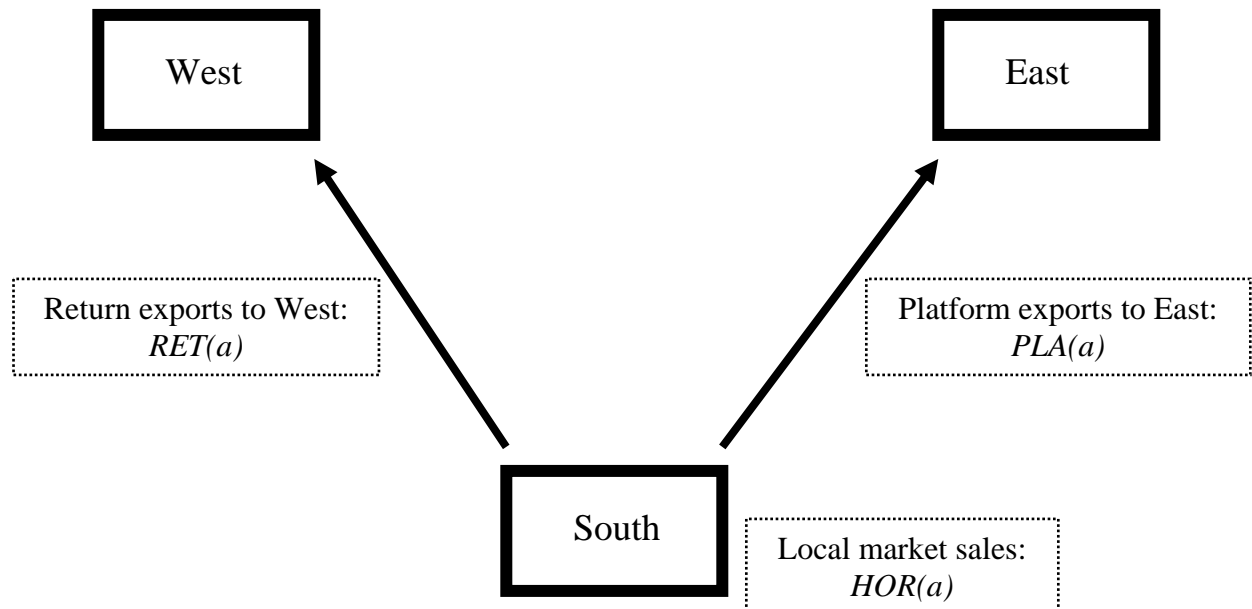
But this last expression is clearly positive, since  $\Delta_1, \Delta_2 \in (0, 1)$ . By a continuity argument, this allows us to conclude that  $[2N_n G_n(\tilde{a}_I)(f_I - f_D) + N_s G_s(a_S) f_S \omega] / (\omega L)$  is increasing in  $\eta$  when the initial level of  $\eta$  is sufficiently high. ■

**Figure 1**  
**Modes of Operation (illustrated for Western firms)**

**If  $a^{1-\varepsilon} < a_I^{1-\varepsilon}$  (No FDI):**

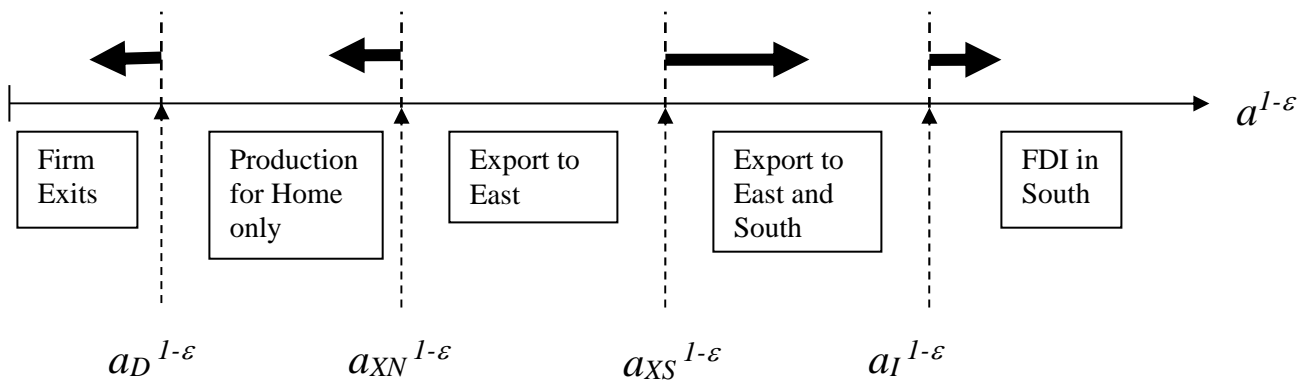


**If  $a^{1-\varepsilon} > a_I^{1-\varepsilon}$  (FDI in South):**

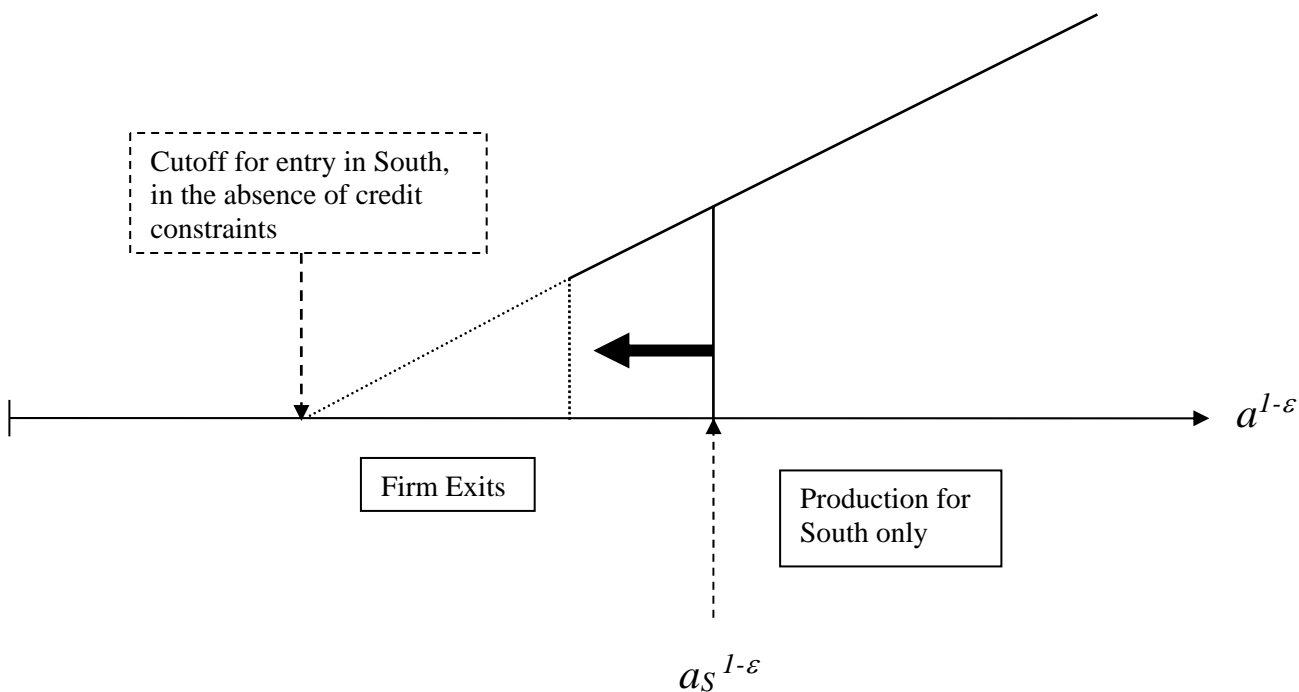


**Figure 2**  
**Response of Cutoffs to an Improvement in Southern Financial Development:**  
**Baseline Model**

**In West:**

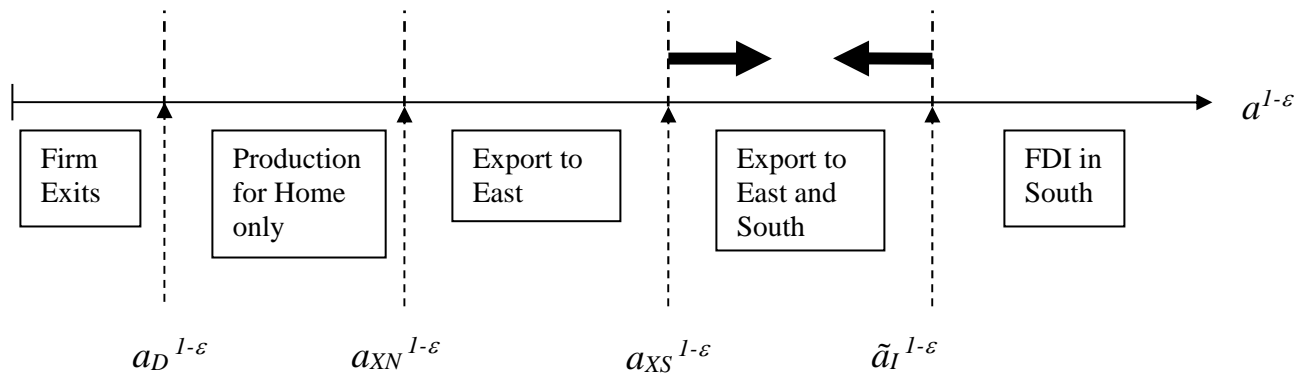


**In South:**



**Figure 3**  
**Response of Cutoffs to an Improvement in Southern Financial Development:**  
**With Host-Country Borrowing by MNCs**

**In West:**



**Table 1: Summary Statistics**

	N	Mean	Standard Deviation
<b>Country-Industry-Year Level</b>			
Total Affiliate Sales (thousand USD)	17,811	561,256	2,450,158
Local Affiliate Sales (thousand USD)	17,811	363,112	1,502,995
3rd country Affiliate Sales (thousand USD)	17,811	147,074	1,009,672
US Affiliate Sales (thousand USD)	17,811	51,070	626,707
Local / Total sales	17,811	0.78	0.32
3rd country / Total sales	17,811	0.16	0.27
US / Total sales	17,811	0.06	0.17
Number of Affiliates	17,811	4.08	6.56
<b>Affiliate-Year Level</b>			
Total Affiliate Sales (thousand USD)	227,089	192,812	845,844
Local Affiliate Sales (thousand USD)	227,089	121,663	532,596
3rd country Affiliate Sales (thousand USD)	227,089	52,490	421,167
US Affiliate Sales (thousand USD)	227,089	18,659	228,768
Local / Total sales	227,089	0.75	0.36
3rd country / Total sales	227,089	0.18	0.31
US / Total sales	227,089	0.07	0.20
<b>Industry Level</b>			
External Finance Dependence	220	0.42	2.74
<b>Country-Year Level</b>			
Private Credit / GDP	1,794	0.51	0.44
Private Credit (bank & other) / GDP	1,800	0.55	0.46
Stock Market Capitalization / GDP	1,442	0.56	0.68
Financial Reform Indicator	1,114	14.56	4.66
Log GDP	1,923	25.27	1.63
Log GDP per Capita	1,923	8.98	1.19
Log Distance	1,923	8.90	0.53
Corporate Tax Rate	1,923	0.18	0.15
Log K/L	1,855	10.73	1.25
Log H/L	1,882	0.84	0.25
<b>General</b>			
Number of Parent Companies per Year	21	1,465	304
Number of Affiliates per Parent-Year	4,724	4.18	9.78

This table summarizes multinational activity, host-country institutions, and industry characteristics across 95 countries and 220 industries in 1989-2009. External finance dependence follows the methodology of Rajan and Zingales (1998). Financial development measures are from Beck et al. (2009) and Abiad et al. (2010). GDP and GDP per capita are from the Penn World Tables, Version 7.0. Log distance between the United States and each host country is from CEPII and is time invariant. Log physical and human capital per worker (K/L and H/L) are based on the Penn World Tables and Barro and Lee (2010). All other variables are from the Bureau of Economic Analysis Survey of U.S. Direct Investment Abroad. The corporate tax rate is constructed using information on the actual tax incidence of US multinational affiliates observed in the BEA data.



**Table 2: Number of Multinational Affiliates**

Dependent variable:	Indicator N > 0	Log N	Log N, local sales	Log N, 3rd ctry sales	Log N, US sales	Indicator N > 0	Log N	Log N, local sales	Log N, 3rd ctry sales	Log N, US sales
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Fin Development	0.101 (3.11)***	0.220 (2.28)**	0.191 (2.01)**	0.130 (1.53)	0.149 (2.00)**	0.122 (3.19)***	0.223 (2.19)**	0.191 (1.90)*	0.117 (1.23)	0.129 (1.51)
Fin Development x Ext Fin Dependence						0.007 (2.62)**	0.039 (3.90)***	0.033 (2.92)***	0.036 (3.09)***	0.038 (4.23)***
Log GDP	0.073 (7.93)***	0.272 (7.37)***	0.279 (7.64)***	0.227 (6.29)***	0.214 (6.07)***	0.093 (8.93)***	0.306 (7.67)***	0.314 (7.84)***	0.260 (6.54)***	0.258 (6.55)***
Log GDP per capita	0.080 (1.69)*	0.589 (2.89)***	0.605 (2.94)***	0.599 (2.92)***	0.512 (2.30)**	0.090 (1.60)	0.620 (2.69)***	0.653 (2.82)***	0.615 (2.58)**	0.547 (2.02)**
Log Distance to US	-0.090 (-2.63)***	-0.125 (-2.33)**	-0.127 (-2.40)**	-0.024 (-0.60)	-0.153 (-3.38)***	-0.102 (-2.61)**	-0.121 (-2.14)*	-0.128 (-2.37)**	-0.043 (-1.00)	-0.186 (-3.63)***
Controls	K/L, H/L, Rule of Law, Tax Rate, RTA Dummies, Industry FE, Year FE									
# Obs	78,916	15,531	14,991	8,845	6,896	41,630	10,435	10,109	6,565	5,049
R <sup>2</sup>	0.44	0.53	0.53	0.47	0.44	0.48	0.56	0.56	0.50	0.47

\* p<0.10, \*\* p<0.05, \*\*\* p<0.01. This table reports OLS estimates of equations (4.1) and (4.2). The unit of observation is the country-sector-year triplet and the sample includes all benchmark years during 1989-2009. The dependent variable in columns 1 and 6 is a binary indicator equal to 1 if there is at least one US multinational affiliate present. The dependent variables in columns 2-5 and 7-10 are the log number of US multinational affiliates that are present, present and selling locally, present and exporting to third countries, or present and exporting to the United States. Financial Development is measured by the ratio of private credit to GDP. All regressions control for K/L, H/L, Rule of Law, corporate Tax Rate, and Regional Trade Agreement (RTA) dummies. Rule of Law is from the International Country Risk Guide. The RTA dummies are from Rose (2004) and WTO. All other variables are as described in Table 1. All regressions also include industry and year fixed effects. T-statistics based on robust standard errors clustered by country appear in parentheses.

**Table 3: Level of Multinational Affiliate Sales, Aggregate Level**

Dependent variable:	Local sales	3rd ctry sales	US sales	Total sales	Local sales	3rd ctry sales	US sales	Total sales
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Fin Development	0.233 (1.49)	0.376 (1.51)	0.756 (3.20)***	0.350 (2.30)**	0.148 (0.95)	0.403 (1.50)	0.684 (2.61)**	0.298 (1.92)*
Fin Development x Ext Fin Dependence					0.058 (2.70)***	0.103 (4.16)***	0.188 (6.47)***	0.089 (4.78)***
Log GDP	0.716 (10.33)**	0.337 (3.58)***	0.324 (3.54)***	0.601 (9.02)***	0.769 (11.18)**	0.387 (3.99)***	0.419 (4.46)***	0.646 (9.69)***
Log GDP per capita	1.120 (2.96)***	1.520 (3.16)***	1.240 (2.41)**	1.046 (2.87)***	1.275 (3.03)***	1.335 (2.57)**	1.116 (2.01)**	1.058 (2.60)**
Log Distance	-0.265 (-2.71)***	0.169 (1.22)	-0.508 (-3.34)***	-0.259 (-2.93)***	-0.278 (-2.90)***	0.152 (1.14)	-0.531 (-2.90)***	-0.233 (-2.52)**
Controls	K/L, H/L, Rule of Law, Tax Rate, RTA Dummies, Industry FE, Year FE							
# Obs	14,991	8,845	6,896	15,531	10,109	6,565	5,049	10,435
R <sup>2</sup>	0.44	0.33	0.26	0.42	0.47	0.35	0.28	0.45

\* p<0.10, \*\* p<0.05, \*\*\* p<0.01. This table reports OLS estimates of equations (4.1) and (4.2). The unit of observation is the country-sector-year triplet and the sample includes all benchmark years during 1989-2009. The dependent variables are the log of local sales, 3rd-country sales, US sales, and total sales by all US multinational affiliates. All regressions include the full set of controls described in Table 2, as well as industry and year fixed effects. T-statistics based on robust standard errors clustered by country appear in parentheses.

**Table 4: Composition of Multinational Affiliate Sales, Aggregate Level**

Dependent variable:	Local sales	3rd ctry sales	US sales	Local sales	3rd ctry sales	US sales
	Total sales	Total sales	Total sales	Total sales	Total sales	Total sales
	(1)	(2)	(3)	(4)	(5)	(6)
Fin Development	-0.057 (-2.81)***	0.033 (1.88)*	0.023 (3.53)***	-0.058 (-2.87)***	0.037 (1.99)**	0.021 (3.27)***
Fin Development x Ext Fin Dependence				-0.013 (-3.67)***	0.010 (3.02)***	0.003 (2.28)**
Log GDP	0.033 (4.50)***	-0.027 (-4.31)***	-0.007 (-2.97)***	0.035 (4.15)***	-0.030 (-4.27)***	-0.005 (-2.05)**
Log GDP per capita	-0.005 (-0.14)	0.012 (0.37)	-0.008 (-0.58)	0.028 (0.70)	-0.011 (-0.31)	-0.017 (-1.28)
Log Distance	-0.011 (-0.70)	0.020 (1.98)*	-0.009 (-0.95)	-0.017 (-1.05)	0.025 (2.10)**	-0.008 (-0.96)
Controls	K/L, H/L, Rule of Law, Tax Rate, RTA Dummies, Industry FE, Year FE					
# Obs	15,531	15,531	15,531	10,435	10,435	10,435
R <sup>2</sup>	0.22	0.23	0.13	0.24	0.24	0.15

\* p<0.10, \*\* p<0.05, \*\*\* p<0.01. This table reports OLS estimates of equations (4.1) and (4.2). The unit of observation is the country-sector-year triplet and the sample includes all benchmark years during 1989-2009. The dependent variables are the ratio of local sales, 3rd-country sales and US sales to total sales, after the numerator and the denominator have been summed across all US multinational affiliates. All regressions include the full set of controls described in Table 2, as well as industry and year fixed effects. T-statistics based on robust standard errors clustered by country appear in parentheses.

**Table 5: Level of Multinational Affiliate Sales, Affiliate Level**

Dependent variable:	Local sales	3rd ctry sales	US sales	Total sales	Local sales	3rd ctry sales	US sales	Total sales
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Fin Development	-0.153 (-2.27)**	0.237 (1.84)*	0.470 (2.95)***	-0.033 (-0.64)	-0.231 (-3.13)***	0.215 (1.58)	0.419 (2.51)**	-0.092 (-1.69)*
Fin Development x Ext Fin Dependence					-0.001 (-0.07)	0.044 (2.69)***	0.126 (4.35)***	0.014 (1.38)
Log GDP	0.301 (7.66)***	-0.088 (-1.46)	-0.080 (-1.21)	0.143 (4.96)***	0.363 (9.45)***	-0.100 (-1.67)*	-0.073 (-1.07)	0.181 (7.51)***
Log GDP per capita	0.048 (0.29)	0.520 (1.86)*	0.421 (1.41)	-0.017 (-0.11)	0.122 (0.78)	0.445 (1.56)	0.180 (0.58)	-0.014 (-0.11)
Log Distance	-0.149 (-3.73)***	0.189 (1.71)*	-0.184 (-1.56)	-0.087 (-2.35)**	-0.141 (-3.42)***	0.144 (1.21)	-0.224 (-1.63)	-0.077 (-2.65)***
Controls	K/L, H/L, Rule of Law, Tax Rate, RTA Dummies, Industry FE, Year FE							
# Obs	198,154	103,908	71,160	215,173	148,575	85,349	58,439	161,423
R <sup>2</sup>	0.12	0.18	0.16	0.11	0.13	0.18	0.16	0.11

\* p<0.10, \*\* p<0.05, \*\*\* p<0.01. This table reports OLS estimates of equations (4.1) and (4.2). The unit of observation is the affiliate-year and the sample includes all years during 1989-2009. The dependent variables are the log of local sales, 3rd-country sales, US sales, and total sales of each US multinational affiliate. All regressions include the full set of controls described in Table 2, as well as industry and year fixed effects. T-statistics based on robust standard errors clustered by country appear in parentheses.

**Table 6: Composition of Multinational Affiliate Sales, Affiliate Level**

Dependent variable:	Local sales	3rd ctry sales	US sales	Local sales	3rd ctry sales	US sales
	Total sales	Total sales	Total sales	Total sales	Total sales	Total sales
	(1)	(2)	(3)	(4)	(5)	(6)
Fin Development	-0.047 (-2.46)**	0.030 (1.86)*	0.018 (2.20)**	-0.040 (-1.90)*	0.030 (1.69)*	0.010 (1.10)
Fin Development x Ext Fin Dependence				-0.007 (-3.87)***	0.004 (2.39)**	0.003 (1.98)*
Log GDP	0.048 (5.35)***	-0.041 (-5.78)***	-0.008 (-2.52)**	0.050 (5.13)***	-0.044 (-5.68)***	-0.006 (-2.03)**
Log GDP per capita	-0.013 (-0.35)	0.001 (0.03)	0.013 (1.11)	0.007 (0.17)	-0.011 (-0.31)	0.004 (0.39)
Log Distance	-0.021 (-1.38)	0.015 (1.45)	0.006 (0.56)	-0.014 (-0.82)	0.010 (0.77)	0.004 (0.32)
Controls	K/L, H/L, Rule of Law, Tax Rate, RTA Dummies, Industry FE, Year FE					
# Obs	215,178	215,178	215,178	161,427	161,427	161,427
R <sup>2</sup>	0.14	0.16	0.08	0.15	0.17	0.10

\* p<0.10, \*\* p<0.05, \*\*\* p<0.01. This table reports OLS estimates of equations (4.1) and (4.2). The unit of observation is the affiliate-year and the sample includes all years during 1989-2009. The dependent variables are the ratio of local sales, 3rd-country sales and US sales to total sales for each US multinational affiliate. All regressions include the full set of controls described in Table 2, as well as industry and year fixed effects. T-statistics based on robust standard errors clustered by country appear in parentheses.

**Table 7: Alternative Measures of Financial Development, Aggregate Level**

Dependent variable:	Local sales	3rd ctry sales	US sales	Local sales	3rd ctry sales	US sales
	Total sales	Total sales	Total sales	Total sales	Total sales	Total sales
	(1)	(2)	(3)	(4)	(5)	(6)
<b>Panel A: Private credit by banks and other financial institutions / GDP</b>						
Fin Development	-0.056 (-2.63)***	0.036 (1.94)*	0.020 (2.80)***	-0.059 (-2.71)***	0.041 (2.09)**	0.018 (2.49)**
Fin Development x Ext Fin Dependence				-0.013 (-3.65)***	0.010 (3.01)***	0.003 (2.13)**
Controls	GDP, GDP per capita, Distance, K/L, H/L, Rule of Law, Tax Rate, RTA Dummies, Industry FE, Year FE					
# Obs	15,673	15,673	15,673	10,530	10,530	10,530
R <sup>2</sup>	0.22	0.23	0.13	0.24	0.24	0.15
<b>Panel B: Stock market capitalization / GDP</b>						
Fin Development	-0.038 (-2.64)***	0.024 (2.02)**	0.014 (3.17)***	-0.037 (-2.67)***	0.027 (2.29)**	0.011 (2.61)**
Fin Development x Ext Fin Dependence				-0.009 (-5.41)***	0.008 (4.04)***	0.002 (2.45)**
Controls	GDP, GDP per capita, Distance, K/L, H/L, Rule of Law, Tax Rate, RTA Dummies, Industry FE, Year FE					
# Obs	15,480	15,480	15,480	10,476	10,476	10,476
R <sup>2</sup>	0.22	0.24	0.13	0.24	0.25	0.16
<b>Panel C: Financial reform indicator</b>						
Fin Development	-0.006 (-2.10)**	0.006 (2.41)**	0.001 (0.42)	-0.006 (-1.95)*	0.006 (2.31)**	-0.000 (-0.11)
Fin Development x Ext Fin Dependence				-0.001 (-3.24)***	0.001 (2.02)**	0.001 (3.46)***
Controls	GDP, GDP per capita, Distance, K/L, H/L, Rule of Law, Tax Rate, RTA Dummies, Industry FE, Year FE					
# Obs	13,323	13,323	13,323	8,985	8,985	8,985
R <sup>2</sup>	0.22	0.23	0.14	0.23	0.24	0.15

\* p<0.10, \*\* p<0.05, \*\*\* p<0.01. This table replicates Table 4 using three alternative measures of financial development: the ratio of private credit by banks and other financial institutions to GDP and the ratio of stock market capitalization to GDP from Beck et al. (2009), and an indicator variable equal to 1 in all years after a country undergoes financial reform from Abiad et al. (2010). All regressions include the full set of controls described in Table 2, as well as industry and year fixed effects. T-statistics based on robust standard errors clustered by country appear in parentheses.

**Table 8: Cost of Entry, Cost of Exporting and Export Platform Potential in Host Country, Aggregate Level**

Dependent variable:	Local sales	3rd ctry sales	US sales	Local sales	3rd ctry sales	US sales
	Total sales	Total sales	Total sales	Total sales	Total sales	Total sales
	(1)	(2)	(3)	(4)	(5)	(6)
Fin Development	-0.056 (-3.50)***	0.031 (2.28)**	0.025 (3.99)***	-0.060 (-4.04)***	0.036 (2.90)***	0.024 (3.75)***
Fin Development x Ext Fin Dependence				-0.014 (-3.73)***	0.010 (3.15)***	0.003 (2.19)**
Entry Cost	0.006 (0.62)	-0.004 (-0.51)	-0.002 (-0.69)	0.010 (0.99)	-0.007 (-0.76)	-0.004 (-1.40)
Export Cost	-0.022 (-0.81)	0.031 (1.25)	-0.008 (-0.95)	-0.035 (-1.24)	0.041 (1.69)	-0.006 (-0.62)
Export Platform Potential	-0.111 (-4.16)***	0.112 (5.49)***	-0.000 (-0.02)	-0.120 (-4.47)***	0.126 (6.17)***	-0.006 (-0.59)
Controls	GDP, GDP per capita, Distance, K/L, H/L, Rule of Law, Tax Rate, RTA Dummies, Industry FE, Year FE					
# Obs	15,182	15,182	15,182	10,190	10,190	10,190
R <sup>2</sup>	0.23	0.25	0.13	0.26	0.27	0.15

\* p<0.10, \*\* p<0.05, \*\*\* p<0.01. This table replicates Table 4 adding three more controls: indices for the cost of firm entry in the host country and for the cost of exporting from the host country constructed from the World Bank Doing Business Report, as well as a measure of the host country's export-platform potential calculated using GDP and bilateral distance data from the Penn World Table and CEPII respectively. All regressions include the full set of controls described in Table 2, as well as industry and year fixed effects. T-statistics based on robust standard errors clustered by country appear in parentheses.

**Table 9: Use of Host-Country Financing, Affiliate Level**

Dependent variable:	Local sales	3rd ctry sales	US sales	Local sales	3rd ctry sales	US sales
	Total sales	Total sales	Total sales	Total sales	Total sales	Total sales
	(1)	(2)	(3)	(4)	(5)	(6)
Fin Development	-0.061 (-2.63)**	0.039 (1.82)*	0.022 (2.81)***	-0.054 (-2.13)**	0.038 (1.56)	0.017 (2.27)**
Fin Development x Ext Fin Dependence				-0.008 (-3.13)***	0.005 (2.23)**	0.002 (1.37)
Lagged Share of Local Financing	0.103 (4.42)***	-0.084 (-4.11)***	-0.019 (-2.71)***	0.084 (3.78)***	-0.073 (-3.69)***	-0.010 (-1.46)
Controls	GDP, GDP per capita, Distance, K/L, H/L, Rule of Law, Tax Rate, RTA Dummies, Industry FE, Year FE					
# observations	22,199	22,199	22,199	16,566	16,566	16,566
R-squared	0.18	0.19	0.11	0.18	0.19	0.13

\* p<0.10, \*\* p<0.05, \*\*\* p<0.01. This table replicates Table 6 adding one more control: the lagged share of affiliate financing raised in the host country from the BEA data. Only benchmark years in 1989-2009 are included. All regressions include the full set of controls described in Table 2, as well as industry and year fixed effects. T-statistics based on robust standard errors clustered by country appear in parentheses.

**Table 10: Parent-Firm Fixed Effects, Affiliate Level**

Dependent variable:	Local sales	3rd ctry sales	US sales	Local sales	3rd ctry sales	US sales
	Total sales	Total sales	Total sales	Total sales	Total sales	Total sales
	(1)	(2)	(3)	(4)	(5)	(6)
Fin Development	-0.033 (-1.94)*	0.023 (1.56)	0.010 (1.59)	-0.026 (-1.44)	0.022 (1.39)	0.004 (0.58)
Fin Development x Ext Fin Dependence				-0.009 (-5.03)***	0.006 (3.65)***	0.003 (1.99)**
Controls	GDP, GDP per capita, Distance, K/L, H/L, Rule of Law, Tax Rate, RTA Dummies, Parent Firm FE, Year FE					
# observations	215,181	215,181	215,181	161,427	161,427	161,427
R-squared	0.27	0.27	0.24	0.28	0.27	0.24

\* p<0.10, \*\* p<0.05, \*\*\* p<0.01. This table replicates Table 6 with parent firm and year fixed effects in place of industry and year fixed effects. All regressions include the full set of controls described in Table 2. T-statistics based on robust standard errors clustered by country appear in parentheses.



**Table 11: Cross Section vs. Time Series: Country Fixed Effects, Aggregate Level**

Dependent variable:	Local sales	3rd ctry sales	US sales	Local sales	3rd ctry sales	US sales	Local sales	3rd ctry sales	US sales
	Total sales	Total sales	Total sales	Total sales	Total sales	Total sales	Total sales	Total sales	Total sales
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Fin Development	0.005 (0.38)	-0.015 (-1.21)	0.010 (2.04)**	0.014 (0.94)	-0.020 (-1.45)	0.006 (1.24)			
Fin Development x Ext Fin Dependence				-0.012 (-3.46)***	0.009 (2.85)***	0.003 (2.08)**	-0.011 (-3.19)***	0.009 (2.61)***	0.003 (1.87)*
Controls	Country FE, Industry FE, Year FE			Country FE, Industry FE, Year FE			Country-Year FE, Industry FE		
	GDP, GDP per capita, Distance, K/L, H/L, Rule of Law, Tax Rate, RTA Dummies								
# Obs	15,531	15,531	15,531	10,435	10,435	10,435	11,392	11,392	11,392
R <sup>2</sup>	0.27	0.29	0.16	0.30	0.31	0.18	0.32	0.33	0.20

\* p<0.10, \*\* p<0.05, \*\*\* p<0.01. This table replicates Table 4 adding country fixed effects to the industry and year fixed effects in columns 1-6, and including country-year fixed effects and industry fixed effects in columns 7-9. All regressions include the full set of controls described in Table 2. T-statistics based on robust standard errors clustered by country appear in parentheses.

**Appendix Table 1: Host-Country Financial Development**

Country	Mean	St Dev	Country	Mean	St Dev	Country	Mean	St Dev
Algeria	0.15	0.16	Guatemala	0.21	0.08	Peru	0.17	0.08
Argentina	0.16	0.05	Guyana	0.43	0.08	Philippines	0.29	0.10
Australia	0.82	0.23	Haiti	0.13	0.02	Poland	0.25	0.09
Austria	0.99	0.10	Honduras	0.35	0.10	Portugal	1.05	0.45
Bahrain	0.41	0.07	Hong Kong	1.43	0.14	Qatar	0.29	0.04
Bangladesh	0.28	0.06	Hungary	0.38	0.14	Russia	0.19	0.12
Belgium	0.71	0.18	Iceland	0.88	0.76	Saudi Arabia	0.26	0.07
Bolivia	0.41	0.13	India	0.30	0.09	Senegal	0.20	0.04
Botswana	0.14	0.04	Indonesia	0.33	0.13	Singapore	0.92	0.12
Brazil	0.35	0.08	Iran	0.21	0.04	Slovakia	0.41	0.07
Bulgaria	0.34	0.22	Ireland	1.01	0.59	Slovenia	0.44	0.22
Cameroon	0.12	0.07	Israel	0.71	0.14	South Africa	0.63	0.10
Canada	0.96	0.24	Italy	0.71	0.18	Spain	1.05	0.42
Chile	0.55	0.12	Jamaica	0.22	0.05	Sri Lanka	0.23	0.08
Colombia	0.30	0.07	Japan	1.49	0.41	Sudan	0.04	0.02
Congo	0.06	0.05	Jordan	0.71	0.12	Sweden	0.69	0.35
Costa Rica	0.22	0.12	Kenya	0.22	0.02	Switzerland	1.61	0.07
Cote D'Ivoire	0.20	0.09	Kuwait	0.47	0.19	Syria	0.09	0.01
Croatia	0.61	0.13	Luxembourg	1.24	0.47	Tanzania	0.09	0.05
Cyprus	1.42	0.36	Malawi	0.07	0.02	Thailand	1.03	0.28
Czech Republic	0.49	0.14	Malaysia	1.09	0.22	Trinidad & Tobago	0.30	0.03
Denmark	0.97	0.70	Malta	0.97	0.15	Tunisia	0.54	0.04
Dominican Rep	0.21	0.05	Mexico	0.19	0.06	Turkey	0.17	0.07
Ecuador	0.23	0.06	Morocco	0.43	0.17	Uganda	0.05	0.02
Egypt	0.38	0.12	Netherlands	1.24	0.43	United Kingdom	1.31	0.30
El Salvador	0.35	0.09	New Zealand	1.05	0.25	Uruguay	0.32	0.15
Finland	0.69	0.14	Norway	0.64	0.09	Venezuela	0.13	0.07
France	0.91	0.09	Oman	0.34	0.04	Vietnam	0.51	0.28
Gabon	0.11	0.04	Pakistan	0.24	0.02	Yemen	0.06	0.01
Germany	1.05	0.10	Panama	0.69	0.18	Zambia	0.07	0.03
Ghana	0.08	0.04	Papua New Guinea	0.18	0.05			
Greece	0.50	0.24	Paraguay	0.22	0.05			
Panel Variation:			0.51	0.44				

This table summarizes the variation in financial development in the panel. Financial development is measured by private credit normalized by GDP. Lebanon is further included in our sample in Table 7, Panel B, where financial development is measured instead by stock market capitalization normalized by GDP.

**Appendix Table 2: Tobit, Aggregate Level**

Dependent variable:	Local sales	3rd ctry sales	US sales	Local sales	3rd ctry sales	US sales
	Total sales	Total sales	Total sales	Total sales	Total sales	Total sales
	(1)	(2)	(3)	(4)	(5)	(6)
Fin Development	-0.058 (-2.88)***	0.057 (2.15)**	0.060 (3.42)***	-0.060 (-2.92)***	0.055 (2.11)**	0.052 (3.37)***
Fin Development x Ext Fin Dependence				-0.013 (-3.71)***	0.008 (2.13)**	0.007 (2.95)***
Controls	GDP, GDP per capita, Distance, K/L, H/L, Rule of Law, Tax Rate, RTA Dummies, Industry FE, Year FE					
# observations	15,531	15,531	15,531	10,435	10,435	10,435
R-squared	0.37	0.30	0.27	0.42	0.31	0.38

\* p<0.10, \*\* p<0.05, \*\*\* p<0.01. This table replicates Table 4 but applies Tobit instead of OLS estimation. All regressions include the full set of controls described in Table 2, as well as industry and year fixed effects. T-statistics based on robust standard errors clustered by country appear in parentheses.

**Appendix Table 3: Weighted Least Squares, Affiliate Level**

Dependent variable:	Local sales	3rd ctry sales	US sales	Local sales	3rd ctry sales	US sales
	Total sales	Total sales	Total sales	Total sales	Total sales	Total sales
	(1)	(2)	(3)	(4)	(5)	(6)
Fin Development	-0.051 (-2.56)**	0.032 (1.89)*	0.019 (2.40)**	-0.046 (-2.10)**	0.034 (1.80)*	0.012 (1.34)
Fin Development x Ext Fin Dependence				-0.008 (-3.86)***	0.004 (2.39)**	0.004 (2.06)**
Controls	GDP, GDP per capita, Distance, K/L, H/L, Rule of Law, Tax Rate, RTA Dummies, Industry FE, Year FE					
# observations	210,852	210,852	210,852	159,137	159,137	159,137
R-squared	0.16	0.18	0.09	0.16	0.18	0.11

\* p<0.10, \*\* p<0.05, \*\*\* p<0.01. This table replicates Table 6 but applies Weighted Least Squares instead of OLS estimation, using log total affiliate sales as weights. All regressions include the full set of controls described in Table 2, as well as industry and year fixed effects. T-statistics based on robust standard errors clustered by country appear in parentheses.