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1. Multiplier effect
2. Life cycle of direct investment
3. Moral hazard
1) Multiplier effect

In economics, the **multiplier effect** refers to the idea that an **initial spending rise** can lead to an **even greater increase in national income**.

For example, let us think in a tourist arriving from the UK at the Girona’s airport.

The multiplier effect depends on the **marginal propensity to consume**. The **basic formula** for the economic multiplier is the change in equilibrium GDP divided by the change in consumption (i.e. the initial increase in spending).

\[
\frac{\Delta Y}{\Delta C}
\]

The multiplier effect is a tool used by governments to **re-stimulate aggregate demand**. This can be done in a period of recession or economic uncertainty. The money invested by a government creates more jobs, which in turn will mean more spending and so on.
2) Life cycle of foreign direct investment

Vernon’s analysis of the life cycle of foreign direct investment has to do with the product’s life cycle theory.

The different stages in a product life cycle are:

1) Market introduction stage
   - High costs of production
   - Sales volume low (new and still unknown product). Demand has to be created
   - No/little competition (only few companies producing the good)
   - Prices are very high
   - It is produced only in the most developed countries (USA, Germany, Japan). Very high technological levels, products are created
2) Life cycle of foreign direct investment

2) Growth stage

– Costs are falling due to economies of scale (increasing production)
– Prices are falling
– Sales volume increases significantly
– Competition begins to rise with new players
– It is produced both in developed and richest developing countries (South Korea, Taiwan, Hungary, Brazil); the second group of countries fabricate the most simple variants of the product. There is still some technological progress.
2) Life cycle of foreign direct investment

3) Mature stage

– Costs are very low (economies of scale)
– Prices tend to drop
– Sales volume peaks
– Increase in competition
– It is produced both in richest developing countries as well as in poor developing countries (Philippines, Vietnam, El Salvador); the second group of countries fabricate the most simple variants of the product. No technological progress
2) Life cycle of foreign direct investment

In other words, we have a concrete type of country as the main producer for each stage.

Hence, trade and foreign investment move as far as the product is growing older.

For example, in the first stage developed countries are going to be the exporters of the product; in the second stage, we are going to see developed countries firms investing in richest developing countries.
3) Moral hazard

Moral hazard is the prospect that a party insulated from risk may behave differently from the way it would behave if it was fully exposed to the risk.

Moral hazard arises because an individual or institution does not bear the full consequences of its actions.

Example: an individual with insurance against automobile theft

A relevant field for moral hazard is the financial sector.
3) Moral hazard

**Financial bail-outs** of lending institutions by governments, central banks or other institutions can encourage risky lending in the future, if those that take the risks come to believe that they will not have to carry the full burden of losses.

A moral hazard arises if lending institutions believe:
- that they can make risky loans that will pay handsomely if the investment turns out well but
- they will not have to fully pay for losses if the investment turns out badly.