

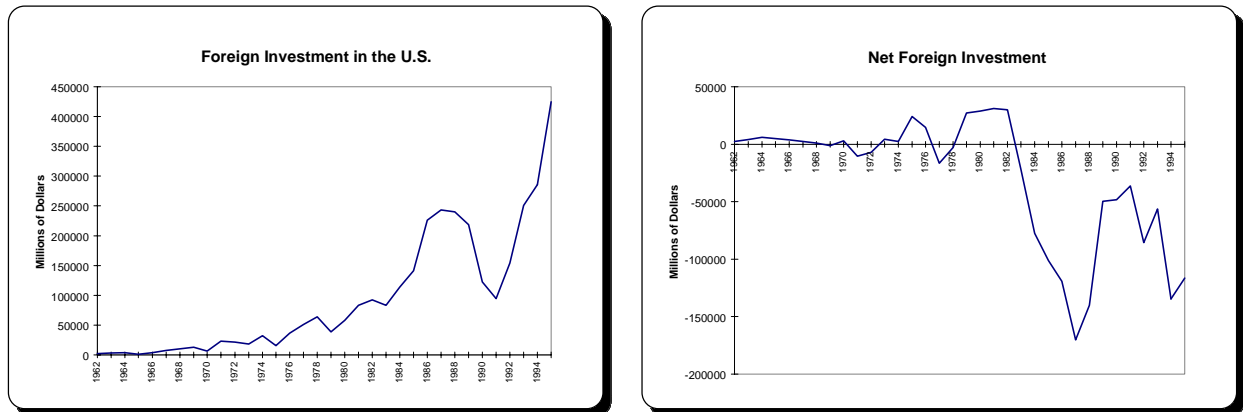
Foreign Investment in the United States

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What Is Foreign Investment?

Foreign investment is essentially the total purchases of domestic assets or claims by foreigners. Since the mid 1980s, foreign investment has become more and more important to the U.S. economy. Foreign investment helps to finance the large U.S. federal government deficit, as well as provide much needed capital for investment in new plant and equipment. Foreign investment was growing so fast in the late 1980s that economic journalists were able to raise the spectre of foreign ownership and control of the U.S. economy. In the early 1990s, the growth in foreign investment slowed, and the alarm died down somewhat. Recently, however, the level of foreign investment has risen again to an all time high.

Figure 1. Foreign Investment and Net Foreign Investment



The graph on the left in figure 1 shows the total amount of foreign investment per year from 1962 to 1995. This investment climbed quickly in the 1980s, to reach a peak in 1987, then fell during the slow growth years of 1989 to 1991, only to catapult upward after 1991. The chart on the right shows net foreign investment, defined as U.S. foreign investment abroad minus inward foreign investment to the U.S. This number reached its absolute peak in 1987, since after 1991 the U.S. also stepped up its investments abroad.

The position of foreign investment in the economy is easily grasped by studying the balance of payments accounts. This is shown for the United States in table 1, in billions of dollars. As the mercantilists taught, by exporting more than it imports, a country can accumulate gold. In the

Table 1. The U.S. Balance of Payments Accounts for 1995

	Credits	Debits
<i>Current Account</i>		
Exports of goods, services and income	969.2	
Merchandise, adjusted, excluding military	575.9	
Services	210.6	
Income receipts on U.S. assets abroad	182.7	
Imports of goods, services and income		-1082.3
Merchandise, adjusted, excluding military		-749.4
Services		-142.2
Income payments on foreign assets		-190.7
Unilateral transfers, net		-35.1
Current Account Balance (credits - debits)	-148.2	
<i>Capital Account</i>		
Change in U.S. assets abroad, net		-307.9
Change in foreign assets in the U.S., net	424.5	
Allocations of special drawing rights	0.0	
Statistical discrepancy	31.5	
Capital Account Balance	148.2	

modern world, countries that export more than they import accumulate assets on their capital account. In total, of course, the current account and the capital account must balance.

Exports and imports can be logically divided into three parts: merchandise trade, services trade and income earnings on foreign assets. In 1995, the U.S. ran a merchandise trade deficit of \$173.5 billion. In contrast, the country ran a surplus in trade of services, of \$68.4 billion. The balance of income payments and receipts was about -\$8 billion in 1995.¹ One other item in the current account is called net unilateral transfers. These are defined as international payments not made for goods or services, such as pension payments to retired citizens abroad, foreign aid and reparation payments. Adding together the credits and debits in the current account yields the current account balance of -\$148.2 billion for 1995.

Just as the current account balance represents the difference between receipts and payments of current income from goods, services and assets, the capital account balance represents the difference between sales and purchases of assets. The bulk of the capital account is comprised of the net change in U.S. assets abroad, and the net change of foreign assets in the U.S. In 1995, the U.S. net increase in holdings of foreign assets was \$307.9 billion, whereas the increase of foreign-held assets in the U.S. was \$425.5 billion. The balance of these two flows is \$116.6, which is not exactly the negative of the current account balance. The difference between this number and \$148.2 is due to

¹ 1994 and 1995 are the only two years for which this balance has been negative since at least 1929, when our NIPA (National Income and Product Accounts) data begins!

Table 2. Composition of Foreign Investment in the U.S. for 1995

Change in foreign assets in the U.S., net	424.5
Foreign official assets	109.8
U.S. government securities	72.5
Other	37.2
Other foreign assets	314.7
Direct investment in the U.S.	60.2
U.S. Treasury securities	99.3
Other U.S. securities	95.3
U.S. liabilities to foreigners by nonbanks	34.6
U.S. liabilities reported by U.S. banks	25.3

mismeasurement of the current account items, the capital account items, or both. Therefore, a statistical discrepancy of \$31.5 billion brings the two accounts into consistency.²

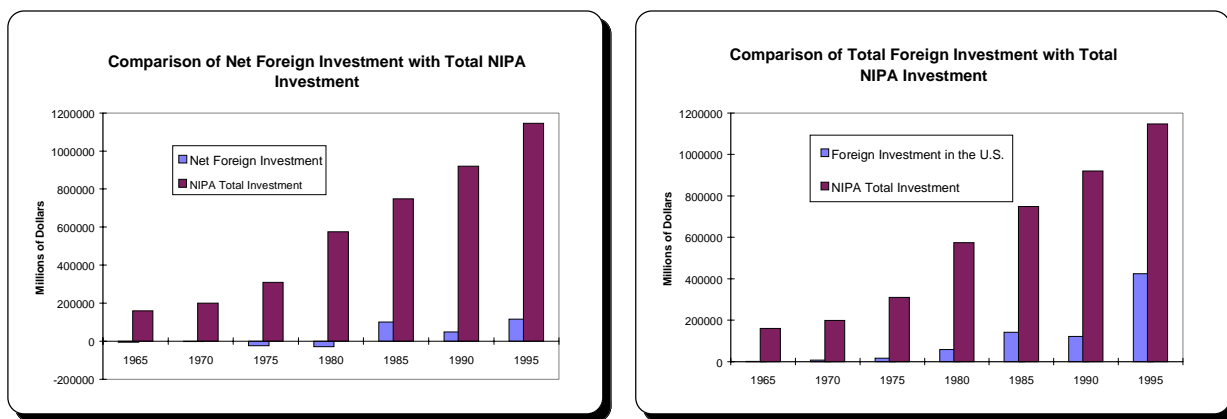
Foreign investment is simply the change in foreign assets in the U.S. Let's now take a look at the composition of this foreign investment. Of the total of \$424.5 billion inward foreign investment, \$109.8 billion was in foreign official assets, and \$314.7 in other foreign assets. Foreign official assets are U.S. assets held by foreign governments, often for purchases of exchange intervention. Of the \$109.8 billion in foreign official assets, \$72.5 billion consisted in purchases of U.S. Treasury securities and other securities. The other component, amounting to \$37.2 billion in 1995, consists mostly of U.S. liabilities reported by U.S. banks, which consists of borrowing or repayments from foreign banks. Other foreign assets consist of foreign direct investment (FDI) of \$60.2 billion, private purchases of U.S. Treasury securities of \$99.3 billion, purchases of other U.S. securities of \$95.3 billion, increases in non-bank liabilities of \$34.6 billion, and increases of bank liabilities of \$25.3 billion.

² The figure for the balance, \$148.2 billion, is conceptually similar to that of net foreign investment in the NIPA (National Income and Product Accounts). A few minor adjustments are necessary, however, for the treatment of holdings of gold, different treatment of U.S. possessions and Puerto Rico, and services furnished without payment by pension plans. The NIPA value of net foreign investment for 1995 was \$141.1 billion.

How Important Is Foreign Investment to the U.S. Economy?

Perhaps a good measure of the importance of foreign investment to the economy is the ratio of foreign investment to total investment. But which measure should we use, net foreign investment or total foreign investment? To determine how much the U.S. relies on foreign savings to finance its current expenditures, net investment is the appropriate measure. However, to get a perspective on how big foreign investment is in relation to total investment spending, we should look at total foreign investment.

Figure 2. Relation of Foreign Investment to Total Investment

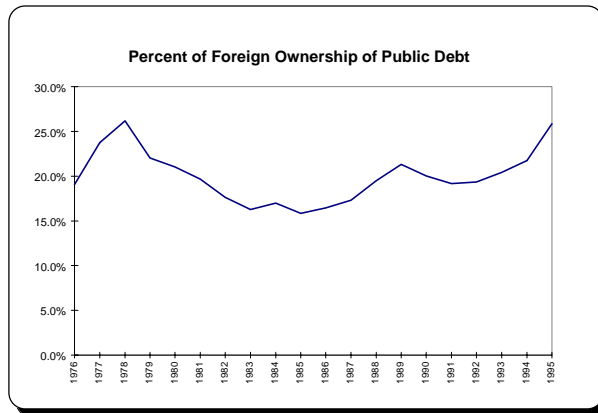


The graph on the left in figure 2 compares *net* foreign investment with total U.S. investment from the NIPA, for selected years. Before 1983, the U.S. outward investment was usually higher than foreign inward investment. Since 1983, the position has been reversed, reflecting the fact that the U.S. is borrowing from abroad to finance its current account deficit. In 1985, net foreign investment was about 13.5% of total NIPA investment; by 1990 it had fallen to 5.2%; but by 1995, had climbed to 10.2%. In terms of total foreign investment, of course, the shares are even larger. In 1985, total foreign investment was 18.9% of total NIPA investment; falling to 13.3% in 1990; but rising to 37.0% by 1995! On the one hand, this means that quite a large percentage of foreign money may be said to be financing current investment and other borrowing in the U.S. However this observation should be tempered by the fact that U.S. savings are also financing quite a lot of investment and other borrowing overseas.

Perhaps the largest single borrower in the U.S. economy is the federal government, which has consistently run large deficits since the early years of the Reagan presidency. figure 3 shows the percentage of total public debt (including state and local governments) held by foreign individuals or governments. Although this percentage shows no long-run upward trend, it seems to have made a

gentle U-turn around 1983, the same year that inward foreign investment started to exceed outward investment. At any rate, the total amount of debt held by foreigners is large -- \$848 billion out of a total of \$3279 billion in 1995.

Figure 3



No one seems to be complaining that foreigners are helping to finance the U.S. government budget deficits. What seems to generate more alarm is the growing scale of foreign direct investment, to which we now turn.

Foreign Direct Investment in the U.S.

Total foreign investment in a country is generally divided into *portfolio investment*, where the investor is a passive holder of stock or debt, and *direct investment*, where the investor maintains some degree of active control over the company in which the investment takes place³. Many of the difficulties in discussing foreign investment stem from different conceptions about how it should be measured. Two common measures presented in the U.S. statistics are the balance of payments (BOP) measure, and the BEA foreign direct investment in the U.S. (FDIUS) series. The BOP measure represents the flows of funds from abroad used to set up new establishments ("greenfield"), acquire existing establishments, or purchase further equity in existing establishments. The FDIUS measure represents the total outlays by foreign direct investors to acquire or establish businesses in the U.S., whether financed by foreign or U.S. funds. For example, if a German company buys a U.S. pharmaceutical company, and borrows some of the money from a U.S. bank, the entire value of the purchase will be counted in the FDIUS data, but only the amount actually invested by the German

³ Under the International Investment and Trade in Services Survey Act, which authorizes the collection of the direct investment data by the Bureau of Economic Analysis (BEA), foreign direct investment is defined as the ownership or control of 10% or more of the voting securities of an enterprise.

firm will be counted in the BOP data. Another example would be if a Japanese firm increased its equity in a U.S. firm in which it already had a substantial ownership position. That investment would not be counted in FDIUS, but would be counted in the BOP measure. Figure 4 below shows a comparison of the two series from 1980 to 1995. Table 3 shows the same data.

Although the two series show the same broad movements, it is important to make the distinction between them. The BOP measure is the more accurate measure of foreign capital flows, whereas the FDIUS measure may be a better measure of foreign control of the economy.

The FDIUS measure is also of great interest to us because the Bureau of Economic Analysis has collected data on this basis since the late 1970s, both with respect to the main industry of the

Figure 4

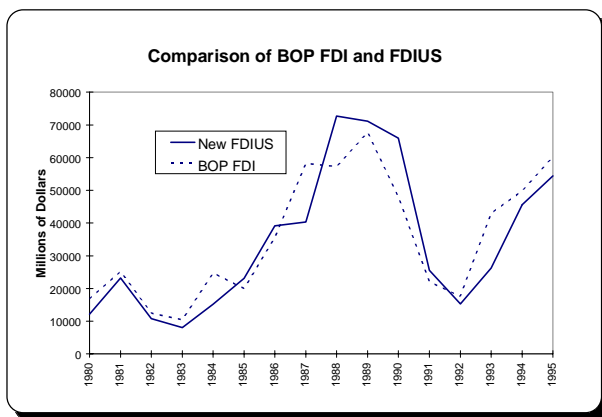


Table 3

	<u>New FDIUS</u>	<u>BOP FDI</u>
1980	12172	16918
1981	23219	25195
1982	10817	12464
1983	8091	10457
1984	15197	24748
1985	23106	20010
1986	39177	35623
1987	40310	58219
1988	72692	57278
1989	71163	67736
1990	65932	47915
1991	25538	22004
1992	15333	17600
1993	26229	43022
1994	45626	49760
1995	54368	60236

acquired U.S. business enterprise, as well as the country of the ultimate beneficial owner (UBO).⁴ Examining this data can give insight into the sources and destinations of foreign investment in the U.S. Table A-1 in the appendix shows new outlays for foreign investment classified by country of UBO, from 1980 to 1995. Table A-2 shows the same total investment outlays classified by industry of the U.S. business enterprise. Foreign investment in the U.S. is dominated by very large investments, of a billion dollars or more. Therefore, investments from any given country or in a given industry are lumpy, displaying volatile swings from year to year.

⁴ BEA defines the UBO as the person (or company) in the ownership chain, beginning with the foreign parent, that is not owned more than 50 percent by another person (or company). It is indeed possible for the UBO to be the same country in which the foreign investment is taking place.

Foreign Direct Investment by Country of Origin

One convenient way to summarize this data is to aggregate across a number of years. In the charts in Figure 5, the data by UBO from table A-1 is summarized. The top-left chart aggregates 6 years of data, from 1980 to 1985, the top right shows the sum of 1986 to 1990, and the bottom left shows the sum of investment from 1991 to 1995. Finally, the bottom right chart shows the sum of investment over the entire period.

The first observation to draw from these charts is that despite all the attention it gets in the press, Japan is *not* the largest foreign investor in the U.S. Over the period shown in these charts, and indeed well before this, the U.K. has been the largest investor by far. This is even more exceptional when we remember that Japan has a considerably larger GDP than the U.K. However, it is significant that starting out from a relatively small investment position in the 1980s, Japan is now the second largest source of foreign investment into the U.S., followed by Canada and Germany. It is enlightening to look at a year by year comparison of investment by these four countries, as is shown in Figure 6. One can see from this graph that quite a large share of the foreign investment boom from 1986 to 1990 was from the U.K and Japan combined. Since 1992, however, the Japanese investment has remained small, with the U.K., Germany and Canada providing much of the stimulus for new

Figure 5. Foreign Direct Investment by Country

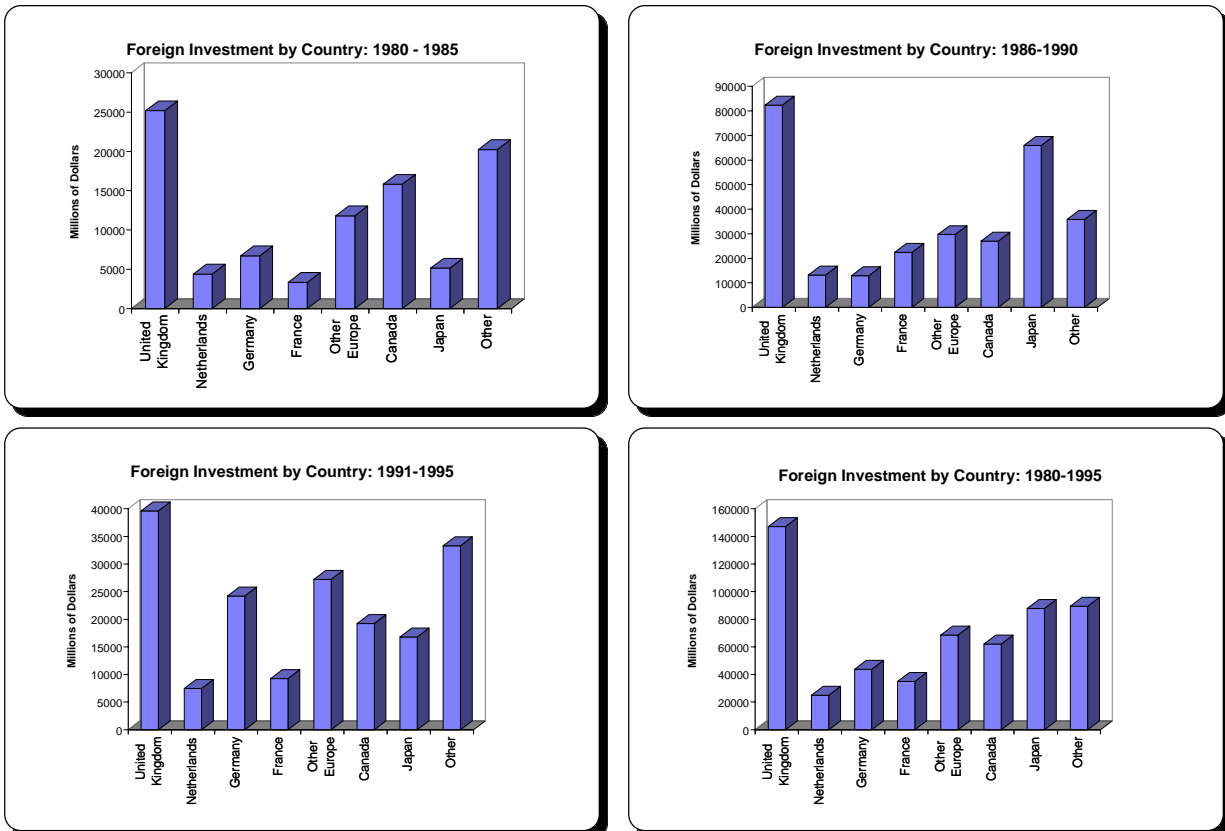
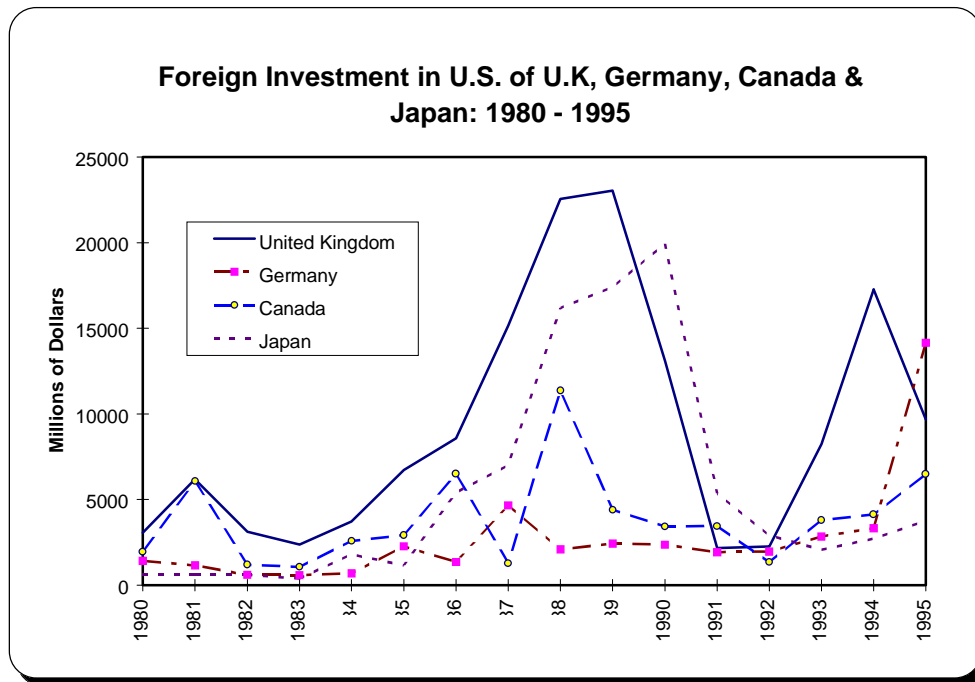


Figure 6



foreign investment. It will be interesting to see how fast Japanese foreign investment in the U.S. increases when the Japanese economy returns to a period of more healthy growth.

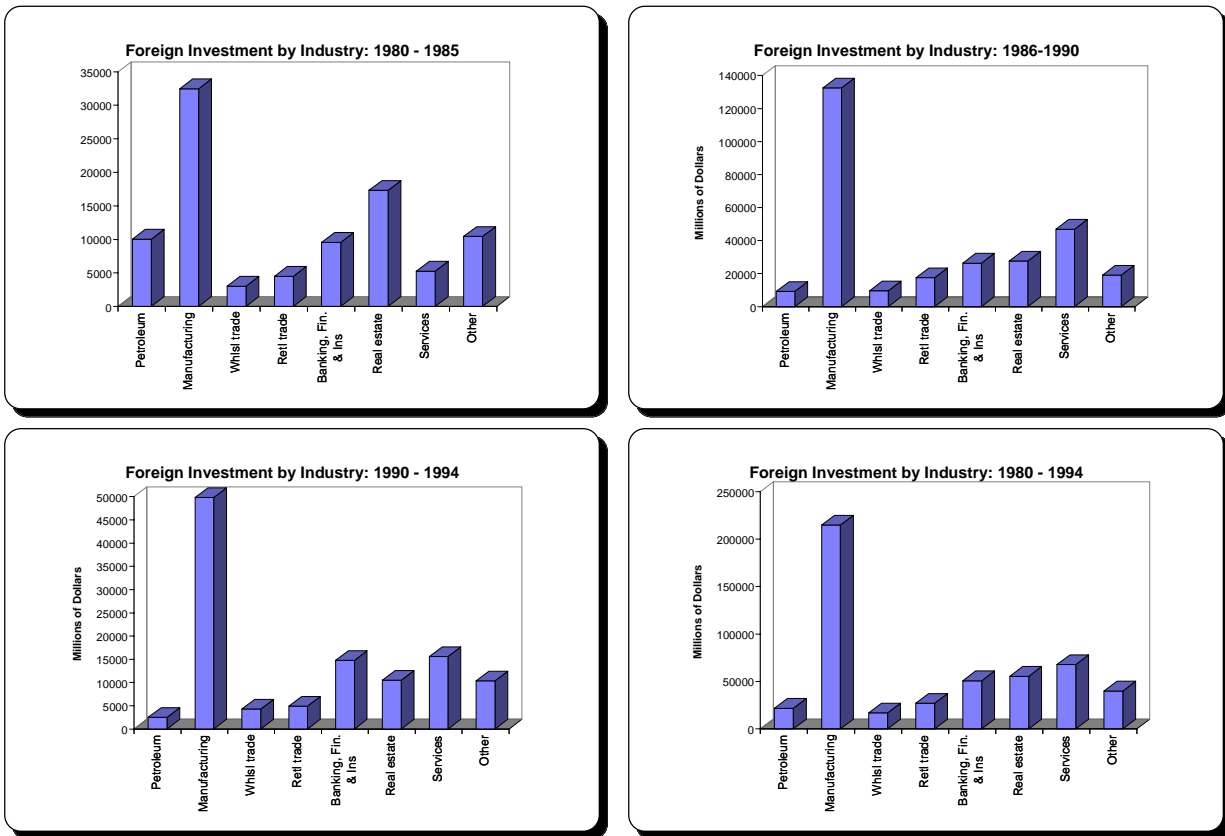
One of the main themes of our conference is the INFORUM model of bilateral trade flows. One may indeed wonder what is the relationship of bilateral foreign investment flows to bilateral trade. The answer is that of course the total foreign investment, or capital account of each pair of countries is a mirror image of the current account, by definition. However, the share of FDI of the total capital account may be different for each country. Therefore, even though the U.S. doesn't have a large trade deficit with the U.K., it still receives quite a large amount of FDI. Also, it is the *net* FDI that figures into the total capital account. So if the U.S. also invests a lot of FDI in the U.K., the net amount may be small.

Foreign Direct Investment by Industry

Table A-2 in the appendix shows the detail on foreign investment in acquiring or establishing U.S. enterprises, classified by the main industry of the U.S. business enterprise. As we have done with the country data, it is useful to summarize this data by aggregating over time periods. For certain industries, we will also look at the relationship between foreign investment in the industry and total investment in plant and equipment.

Figure 7 below contains four graphs, aggregating the industry data for different periods. The graph on the top left summarizes investment from 1980 to 1985, the graph on the top right summarizes the data from 1986 to 1990, and the one on the bottom left is a summary from 1991 to 1994.⁵ Clearly the bulk of foreign direct investment capital is drawn to manufacturing industries. Within manufacturing, investment is concentrated in the food, metals, chemicals and machinery industries. In the period of the early 1980s, there was also a lot of investment in the petroleum and real estate sectors, and much of this was from Kuwait and Saudi Arabia. In the late 1980s, foreign investment

Figure 7. Foreign Direct Investment by Industry



⁵ Data for 1995 is available for all but Wholesale trade and Insurance, for which data were not released due to disclosure constraints.

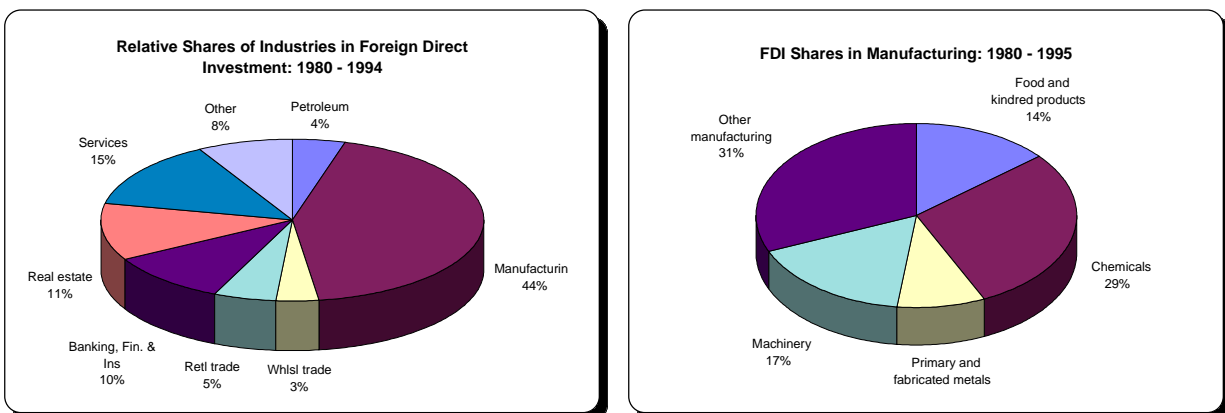
in services industries was on the rise, which included purchases of some large entertainment companies, such as CBS and MCA. During this period, the Japanese were also investing heavily in the U.S. banking and finance sectors.

Over the entire period however, manufacturing took by far the largest share (44%), as shown by the left hand chart in Figure 8 below. The chart on the right in Figure 8 shows the shares of FDI within manufacturing, showing the shares of some of the largest industries. The largest single industry was Chemicals, with a share of 29%, followed by Machinery (17%), and then Food and kindred products (14%). Another large industry for FDI is Transportation equipment, which has received quite a lot of publicity. However, a continuous time series for Transportation equipment is not available, due to constraints of disclosure, so it is grouped with Other manufacturing.

An obvious question arises when examining this data: Why is FDI so heavily concentrated in certain industries? For example, why is almost half of FDI in manufacturing, which accounts for only about 20% of U.S. GDP? Within manufacturing, why is such a large proportion in the chemicals and machinery industries? The answer may lie in what are called "industrial organization" theories of FDI. According to these theories, FDI is conducted by large oligopolistic firms that produce differentiated products. Even though production abroad suffers from additional costs and risks, firms may possess certain advantages in a host country, allowing them to obtain larger profits than domestic firms. The most often cited advantages are economies of scale and technological and managerial advantages. Therefore, FDI is most likely to be in industries which have large capital requirements leading to economies of scale and in which technological improvements are very important -- in the so-called "high-tech" industries.

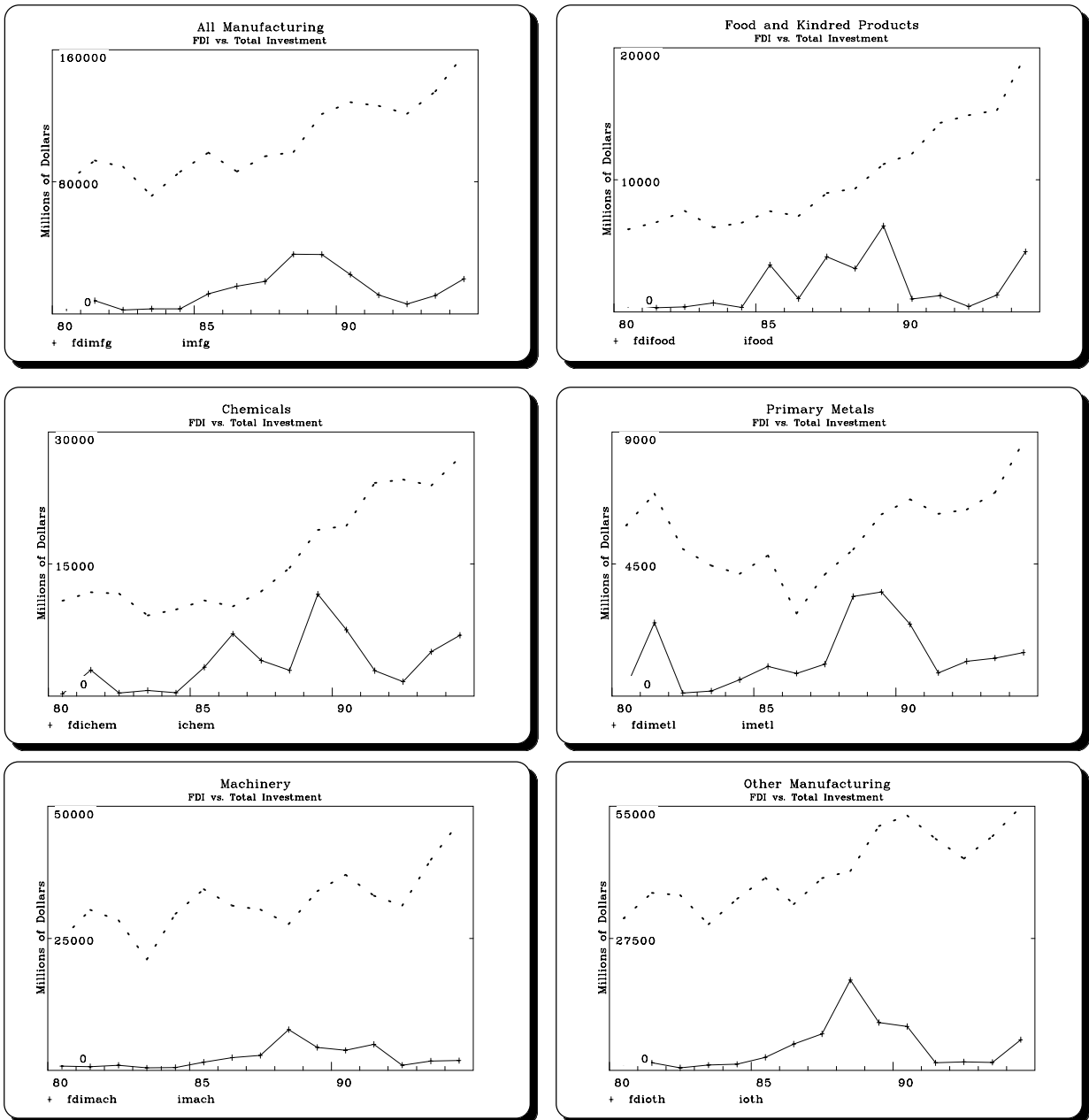
When looking at FDI by industry, it is also interesting to compare FDI with total investment in plant and equipment for those industries. The graphs in Figure 9 compare FDI from the dataset we have been examining with total plant and equipment investment from the BEA Capital Stock Study.

Figure 8. Shares of FDI by Industry



These graphs are only meant to provide a benchmark with which to compare the overall size of foreign direct investment. However, it should be remembered that when a foreign firm buys a domestic firm, the value of that firm may be more or less than the total value of plant and equipment that it owns. Other assets, such as land, goodwill, patents, marketing and operational techniques are also part of this total value.

**Figure 9. FDI Compared to Total Plant and Equipment Investment
Selected Manufacturing Industries**



Factors Explaining Direct Foreign Investment

The factors underlying these direct investment patterns are many, but here are some reasons that have been advanced for why firms from one country would want to do foreign investment in another country:

1. *Closer access to the market* of the host country, especially in the face of protective tariffs or other restraints.
2. *Low wages* in the host country relative to the source country.
3. *High return on investment* in the host country relative to the source country.
4. *High liquidity* in the source country.

The timing of foreign investment can be affected by the following factors:

1. Exchange rate movements -- if the currency of the host country is perceived to be temporarily below its equilibrium level, then firms may perceive it is a good time to invest in that country.
2. Tax policy changes -- an imminent change in tax policy may make foreign investment more urgent.
3. Business cycle effects -- foreign investment tends to be correlated positively with the growth of GDP. One reason is that this signifies that the host market is strong, and the outlook for profits in that market is good. Another reason is that mergers and acquisitions tend to be more prevalent in periods of strong economic growth, and many of these mergers and acquisitions are financed by foreign capital.

The period from 1986 to 1990 was a period of a relatively low value of the dollar, especially when comparing it with its high value at 1985. The periods 1984 to 1990 and 1993 to 1995 were also periods of relatively strong economic growth in the U.S. One explanation for the low Japanese investment during the latter period is that this was the "post bubble age" in Japan, when money was tight, and the Japanese economy relatively weak. Also, Japan was busy during this period investing in countries with low labor cost, such as Indonesia and Malaysia, due to the high value of the yen.

Foreign investment also tends to be correlated with the current account deficit. However, the causal relationship between foreign investment and the current account deficit is not clear. Does foreign investment occur because a country is running a current account deficit, or is the current account deficit due in part to foreign direct investment? A current account deficit implies, by the balance of payments accounting logic, that there must be an equal and opposite capital inflow, but this capital inflow may be either in the form of portfolio investment or direct investment. Trade can be explained by relative prices and exchange rates, among other factors, but the exchange rates themselves are determined by demands for currency assets. Demands for currency, in turn depend partly upon demands to hold assets denominated in a certain currency.

It seems that foreign direct investment is one of the more primary causal components of the balance of payments accounts. When foreign firms decide to undertake direct foreign investment in the U.S., this creates a demand for dollars, which tends to put upward pressure on the dollar. This tends to stimulate imports and reduce exports. Since foreign lending in this case is supplying much of the capital for investment, real investment needs tend to put less upward pressure on interest rates, which tends to reduce foreign portfolio investment.

Foreign direct investment can also have more direct impacts on imports and exports. Newly built plants, such as the auto plants built by Toyota or Honda, tend to import more of their intermediate requirements.⁶ Whether U.S. plants acquired by foreign owners change their suppliers to foreigners seems less likely. On the other hand, foreign-built plants may enhance the export capacity of the U.S. For example, since Japanese competition brought about the demise of the last U.S. color television manufacturers in the late 1970s, the Japanese have since invested heavily in production of color televisions in the U.S.. Now the U.S. is again exporting color televisions, although produced by Japanese companies. A directly opposite case is that of the personal computer industry, where U.S. firms still dominate the world market, but the U.S. runs a trade deficit in PCs, because of these companies' global outsourcing policies. The U.S. firms have invested heavily in countries such as Taiwan, Singapore and South Korea, and many of the components used in U.S. brand PCs are actually produced in countries such as these.

Since 1985, FDI of the G-7 countries has grown at four times the rate of growth of output, and much faster than the rate of growth of exports of goods and services. As such, it will increasingly become a driving factor in the determination of the direction of trade flows. For this reason, it is important that we be able to predict and understand the effects of foreign direct investment.

⁶ Multinational corporations (MNCs) whether foreign-owned or U.S. companies, play a significant role in the imports of the U.S. It is estimated that over 50% of U.S. imports are internal purchases by a U.S. establishment of the MNC from a foreign establishment of the MNC.

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