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Three Common Misperceptions About Foreign Direct Investment

by Gerald H. Anderson

The increasing purchase of U.S. assets by foreigners in recent years has been blamed on the current-account deficit, has been attributed to the Japanese, and has caused alarm about loss of U.S. economic independence. These three common views are based on misperceptions about the causes, sources, and implications of foreign direct investment.

In the last few years, Ohioans have seen foreign investors acquire or increase their equity interest in such well-known Ohio firms as Sohio, Libby-Owens-Ford, Hanna Mining Company, White Consolidated Industries, General Motors' Terex Division, and many others. At the same time, foreign firms have established entirely new subsidiaries in Ohio, the best known of which is Honda of America Manufacturing, which produces both motorcycles and automobiles.

This increasing foreign presence in Ohio is part of a national trend of accelerating foreign investment in America. While many Americans have welcomed the infusion of foreign capital and entrepreneurship, some have worried about its implications for U.S. economic independence. Others have argued that, whether we like it or not, the increased foreign presence is an inevitable result of large U.S. current-account deficits. And some have assumed that because Japan is the nation with the largest current-account surplus, it must also be the source of most of the investment inflow into the United States.

Popular beliefs about the threat to U.S. economic independence, the association between foreign direct investment and the current-account deficit, and the importance of Japanese direct investment are all based on misperceptions. By discussing the implications, causes, and sources of foreign direct investment in America, this *Economic Commentary* attempts to dispel these three misperceptions.

Reasons for Foreign Direct Investment in the United States

Since 1982, the United States has incurred large annual deficits in its current-account balance, the inevitable counterpart of which has been large net capital inflows.[1] Although observers often suggest that the large current-account deficits make large flows of foreign, or inward, direct investment (IDI) inevitable, the annual volumes of IDI in these years have been only loosely related to the current-account balance.[2]

The net capital inflow into the United States is the sum of several inflows and outflows. It equals IDI, plus inward private portfolio investment, less outward direct investment, less outward private portfolio investment, plus or minus the inflow or outflow of government capital.[3]

In theory, the sum of these flows (the net capital inflow) should be exactly equal to the size of the current-account deficit.[4] In practice, however, the measurement errors have been quite large, and the statistical discrepancy between the two annual sums frequently has exceeded $20 billion.

Because of the measurement errors and because of the number of other capital flows in the equation, any amount of IDI can be compatible with any current-account balance.

In the last quarter century, there has been a positive amount of IDI in every year, even though the current account has been in deficit in only 10 of those years (see chart 1). Chart 1 does not suggest any obvious relationship between the size of the current-account balance and IDI. In fact, careful examination of the chart reveals that the changes in the two series have the same sign almost as often as the changes have opposite signs, thus failing to support the idea that *changes* in the size of the current-account balance cause *changes* in the size of IDI.

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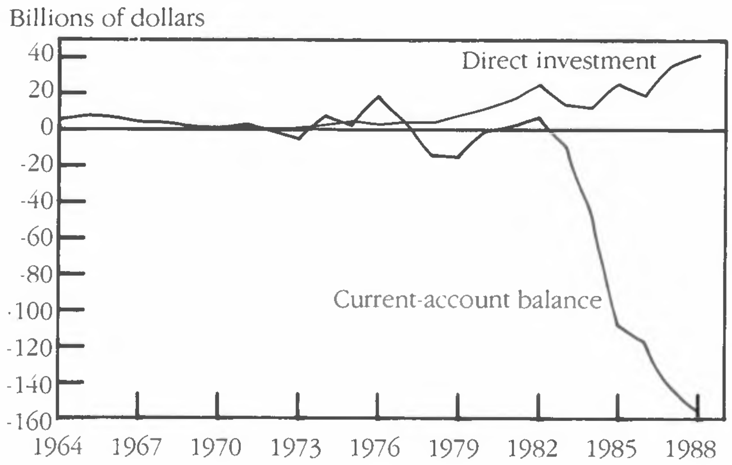
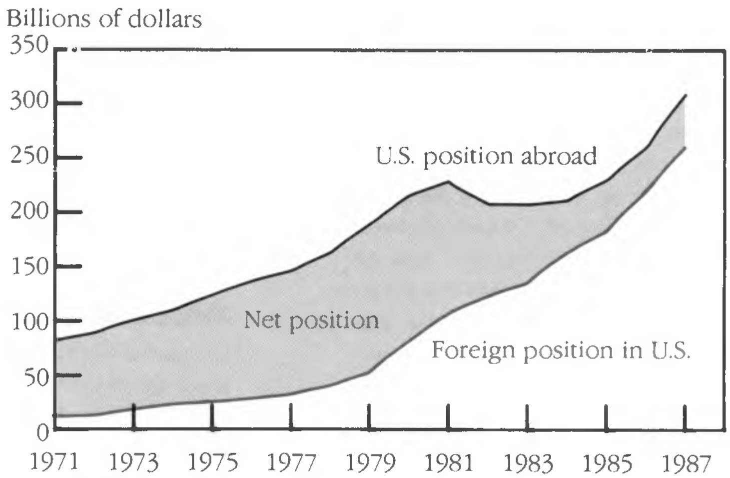
CHART 1 DIRECT INVESTMENT VS. CURRENT-ACCOUNT BALANCE



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

CHART 2 DIRECT INVESTMENT POSITIONS



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

This cursory analysis suggests that the current-account balance does *not* provide a simple and complete explanation of IDI, and shows that IDI is not an inevitable result of the large U.S. current-account deficits.

While the current-account balance provides no simple explanation for the level or the changes in the volume of IDI, several other factors help to explain the rather continuous inflow of direct investment, the tendency for IDI to grow through the years, and the swings in its volume in the last 10 years.

Several relatively permanent attributes continuously provide strong incentives for IDI. For example, the United States has a very large and growing market, a stable economy, a strong commitment to free enterprise and private property rights, military security, excellent capital markets, freedom for foreign owners to repatriate their capital and earnings, and ample supplies of skilled labor and raw materials. Investment in the United States also offers a foreign investor the advantage of geographic diversification.[5]

The tendency for the annual, current-dollar volumes of IDI to grow through time may result from the world economy's real growth, which fosters growth of the volume of annual saving available for investment, and from the decline in the purchasing power of the dollar.

Recently, some additional developments have encouraged IDI, probably contributing to its upswing in the last four years. Perhaps most important is that the dollar has depreciated greatly against other major currencies since early 1985, making it more difficult for goods produced abroad to be competitive in the U.S. market. For example, the depreciation has caused the dollar value of wage rates in some other major countries to rise relative to U.S. wage rates. Consequently, foreign firms who want to sell in the U.S. market have increased incentive to produce their goods here. Moreover, dollar depreciation has lessened the cost of purchasing U.S. production facilities when measured in the currency of the potential foreign investor.[6] The U.S. stock-market crash of October 1987 also has reduced the cost of purchasing existing U.S. firms, which probably will encourage IDI in 1988.

Another likely cause of the recent acceleration of IDI is that the persistent large U.S. trade deficits of recent years have strengthened protectionist sentiment. Some foreign firms, especially Japanese vehicle manufacturers, could have decided to produce their products in the United States to soften protectionist sentiment and to hedge against the possible loss of market share if protectionist legislation were to be enacted. The persistence of the current U.S. economic expansion probably added to the attractiveness of IDI.

The rise in IDI in the late 1970s was probably encouraged by the depreciation of the dollar and by the U.S. economic expansion in that period. Then, dollar appreciation in the first half of the 1980s, together with the recessions in the 1980-1982 period, probably contributed to the fall-off in IDI volume in 1981, 1982, and 1983.

Direct Investment Positions

At the end of 1987, foreign investors had accumulated a direct investment position in the United States totaling $262 billion. Similarly, U.S. investors had accumulated a direct investment position abroad valued at $309 billion.[7] The difference between those two positions, $47 billion, is the net direct investment position of the United States.

The net position declined from $132 billion in 1980 to $47 billion in 1984 and then leveled off, with no net change in the last three years (see chart 2). The sharp decline in the 1980-1984 period resulted as the U.S. position abroad stagnated, declining by $4 billion, while the foreign position in the U.S. doubled, rising by $82 billion. Important contributors to the stagnation of the U.S. position abroad in 1980-1984 were the appreciation of the dollar, which caused foreign-currency-denominated U.S. assets abroad to translate into fewer U.S. dollars, and borrowing by U.S. parent companies from their foreign affiliates.

European investors held two-thirds of the $262 billion foreign direct investment position in the United States at the end of last year. British investors held the largest share, 29 percent, while Dutch investors held 18 percent. Despite all of the publicity that Japanese investment in the United States has received, the Japanese share of the total was only 13 percent.

Other measures also fail to support the popular perception that Japan, with its massive surplus in trade with the United States, is the largest foreign direct investor here. For example, Japanese spending to acquire or establish U.S. enterprises was less than that of the United Kingdom and Canada in 1986, and less than that of the United Kingdom in 1987. Moreover, Japan ranks behind the United Kingdom, Canada, West Germany, and the Netherlands in the number of its U.S. employees. At the end of 1986, Japan ranked far behind Canada, the United Kingdom, and the Netherlands in the gross book value of property, plant, and equipment in America owned by firms whose ultimate owners resided in those countries.

Foreign-Owned Firms' Shares of the U.S. Economy

Recent increases in foreign direct investment in the United States have raised concerns about the degree of foreign influence in our economy. The foreign direct investment position here at the end of 1987 was 91 percent larger than just four years earlier. Foreign-owned firms' shares of U.S. employment, assets, and sales show that foreign involvement in the U.S. economy is substantial and growing.

Employment by foreign-owned nonbank firms in 1986 (latest data available) accounted for 3.5 percent of employment of all nonbank firms in the United States, up from 3.2 percent in 1981. In manufacturing, employment by foreign affiliates accounted for 7.8 percent of total U.S. manufacturing employment, up from 6.9 percent in 1981.[8]

Foreign involvement in U.S. manufacturing is even larger when judged by shares of sales and assets. Foreign affiliates held a 9.9 percent share of the sales of all U.S. businesses in manufacturing in 1986, including shares of 30 percent in chemicals and allied products, 20 percent in stone, clay, and glass products, and 19 percent in primary metal industries. The foreign share of manufacturing assets was 12.1 percent, including shares of 33 percent in chemicals and allied products, 23 percent in stone, clay, and glass products, and 21 percent in primary metal industries.[9]

Foreign investors are much more likely to acquire an existing enterprise than to start a new one. In 1987, for example, foreign investors used $25.6 billion to acquire existing enterprises and only $4.9 billion to establish new enterprises. In the same year, newly acquired enterprises had 331,000 employees, while newly established enterprises had only 15,000 employees.

Implications of Foreign Direct Investment

Cries of alarm have accompanied the increases in the volume of U.S. physical assets owned by foreigners. Usually, the alleged dangers are not stated very specifically, but they seem to center on the idea that the United States somehow could lose control of important industries and thereby lose control of its economic destiny. The concern about IDI has led to proposals for legislation that would require closer monitoring, or even restriction, of investment.

Despite the alarm being expressed in some quarters, there are several defenses for and benefits of IDI. First, the U.S. direct investment position abroad is larger than the foreign position in the United States (see chart 2). Moreover, even though the gap between the two positions narrowed substantially in the early 1980s, it has not narrowed since 1984, because the flow of outward direct investment has roughly matched the enlarged inward investment flow.

Second, foreign acquisition of existing U.S. enterprises sometimes brings an infusion of new capital, improved technology, and better management. When IDI creates a new enterprise, the new facility provides new jobs, increasing total employment or at least displacing a less-efficient competitor.

Third, foreign owners are subject to the same laws protecting labor, investors, the environment, and so forth as are domestic owners. They also have the same economic incentive to use their U.S. holdings efficiently and profitably, that is, in ways that are beneficial to the United States. Moreover, because most foreign ownership of U.S. assets is lodged in major industrialized democracies that are friendly to America, the possibility is very remote that foreign governments would prevail upon foreign owners to use their U.S. holdings in a way that is detrimental to us. The possibility is even more remote that U.S. legislation could not successfully counteract any such hostile efforts.

Conclusions

Contrary to popular belief, foreign, or inward, direct investment is not an inevitable result of the recent large

U.S. current-account deficits, and there is apparently no simple relationship between the current-account balance and the volume of IDI. Instead; the dollar's foreign exchange rate, the stage of the business cycle, expectations of protectionist actions, direct investment opportunities abroad, income opportunities from portfolio investment, and a host of other considerations moderate the fact that, other things equal, an increase in the current-account deficit should be accompanied by an increase in IDI.

Also contrary to popular perception is the fact that Japan is not the largest source of IDI, even though it has the largest current-account surplus. The Japanese direct investment position in the United States is far exceeded by those of some other nations, and even in recent years, the inflows from Japan have been exceeded by those from the United Kingdom, a nation that does *not* have a large current-account surplus.

In addition, although many observers view the direct investment inflow with alarm, their concern may be unwarranted. First, IDI and the resulting foreign investment position in America are not larger than the U.S. direct investment outflow and position abroad. Second, the inflow can provide an infusion of new management, new technology, and new employment. Finally, it seems unlikely that foreign owners of assets in the United States are likely to want to, or be able to, use those assets in detrimental ways.

Footnotes

1. Although there is some debate among economists about the direction of causality, the assumption here is that a current-account deficit causes a net capital inflow.

2. Foreign, or inward, direct investment (IDI) in America is the flow of foreign lending to, or equity investment in, a U.S. firm or property that the foreign investor controls. Foreign portfolio investment in the United States is foreign purchase of U.S. securities that does not result in control of a U.S. firm. The cumulative total of all past IDI is the foreign direct investment *position* in the United States.

U.S. investors can make direct investments abroad, or outward direct investment. The cumulative total of these investments is the U.S. direct investment *position* abroad.

3. Different sets of incentives guide IDI and inward private portfolio investment. Direct investors are often foreign manufacturers or retailers acquiring manufacturing or distribution facilities in the United States. Portfolio investors are often banks, insurance companies, and portfolio managers acquiring stocks and bonds or lending in America. Because the direct investor acquires assets that are much less liquid than those acquired by a portfolio investor, he typically would take a longer-run view of the prospects for his investment. Moreover, a direct investor would be interested in the outlook for a particular industry, while a portfolio investor purchasing bonds would be interested in the outlook for interest rates. Thus, there need not be any similarity between trends in IDI and inward private portfolio investment.

4. Similarly, a current-account *surplus* should be accompanied by a net capital *outflow* of equal size.

5. Some other countries also have some of these attributes. In addition, some have low-cost labor or raw materials or tropical growing conditions that are not as readily available in America. Consequently, U.S. investors make direct investments in other countries. Geographic diversification is also a reason for outward direct investment. Until 1980, U.S. outward direct investment in a year usually exceeded inward direct investment.

6. On the other hand, dollar depreciation also discourages inward direct investment because it causes a foreign investor's U.S. dollar profits to translate into fewer units of the investor's home currency.

7. Both positions may be understated because they are measured on a historical cost basis.

8. Ned G. Howenstine, "U.S. Affiliates of Foreign Companies: Operations in 1986," *Survey of Current Business,* U.S. Department of Commerce, Bureau of Economic Analysis, vol. 68, no. 5 (May 1988), pp. 59-75.

9. Ibid.

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