

FRBSF WEEKLY LETTER

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Foreign Direct Investment: Gift Horse or Trojan Horse?

The last decade and a half witnessed a rapid increase in foreign direct investment (FDI) in the U.S. Some view this trend with concern, if not alarm. Foreign acquisitions of landmark U.S. corporate assets such as Columbia Pictures, Rockefeller Center, and MCA, are bemoaned as a wholesale sellout of America—worse yet, at bargain prices. To some, FDI seems tantamount to wheeling a Trojan horse inside the gates of the U.S. economy.

Other take a more benign view, ringing a variation on the equine theme: Don't look a gift horse in the mouth. Foreign investment, after all, is a vote of confidence in the U.S. economy, with ultimate benefits including new jobs and improved efficiency.

Which view makes more sense? This *Letter* reviews the recent trends in FDI in the U.S. and examines both the arguments and evidence pro and con. It concludes that FDI, like other forms of economic exchange, should be mutually beneficial to the parties involved. And indeed, the evidence suggests that any economic costs that may accompany FDI are amply outweighed by its benefits.

Background

While FDI conjures up an image of capital flowing across national borders to purchase new assets, it actually needs to involve neither capital flow nor investment in new capacity. What FDI measures is the extent to which foreign firms or individuals gain *control* over U.S. production. This element of control distinguishes direct investment from portfolio investment—for example when a foreign firm buys U.S. corporate bonds—which establishes a claim on domestic assets with the limited purpose of realizing a return.

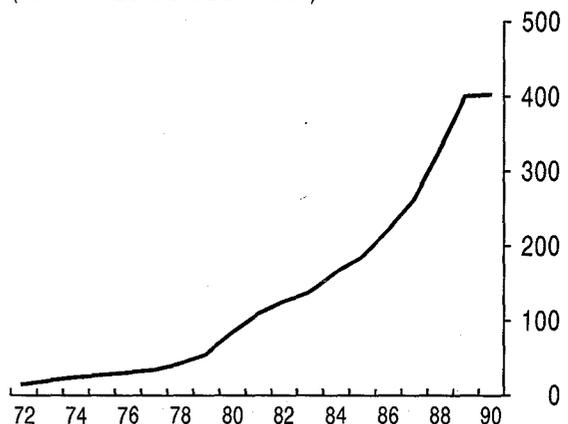
To provide a concrete example of FDI, when Bridgestone, a Japanese tire manufacturer, took over the U.S. firm Firestone in 1988, financing was provided largely by U.S. domestic lenders. Although no new investment expenditure nor any substantial capital flow took place between

Japan and the U.S., FDI occurred since the deal resulted in an international transfer in the control of corporate assets. Honda's opening of a new car factory in Maryville, Ohio is an example. This type of FDI is sometimes referred to as a "greenfield" investment to distinguish it from an acquisition or takeover that involves no new investment expenditure.

According to the Department of Commerce's definition, FDI occurs when a *single* foreign resident (usually a firm) acquires 10 percent or more of the equity in a U.S. firm. The idea is that a 10 percent stake is a large enough block of shares to provide the investor an effective say in the operation of the firm. It turns out that on average, foreign parent firms hold equity stakes of nearly 80 percent in U.S. affiliates; that is, FDI in the U.S. typically involves majority rather than fractional ownership by the foreign investor.

Figure 1 shows the growth in FDI stock in the U.S. from 1972 to 1990, computed from the balance of payments statistics. On average, FDI stock grew by 20.6 percent per year since 1972, reaching \$404 billion in 1990. Two periods of accelerated growth are discernible: one from about 1977 to 1981 and another from 1987 to

Figure 1:
Stock of Foreign Direct Investment in the U.S.
(Billions of Dollars in Book Value)



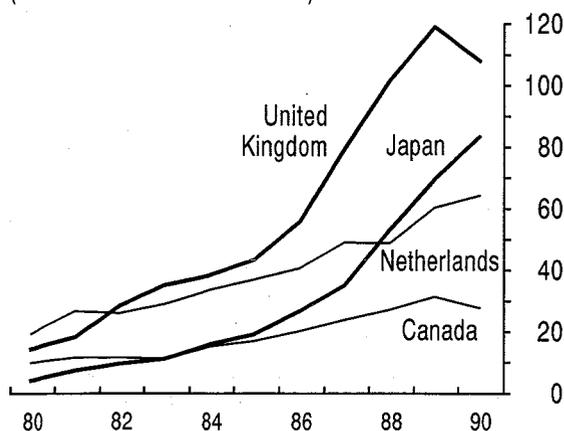
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1989. The FDI growth rate appears to have tapered off since then, but it is still too soon to predict future trends. Although not shown in the figure, a similar pattern is revealed in FDI stock as a percentage of the total net worth of all non-financial U.S. corporations. This ratio increased fivefold from 2.1 percent in 1977 to 10.5 percent in 1990.

FDI therefore is qualitatively more important in the U.S. economy today compared to fifteen years ago. Graham and Krugman (1991) estimate that, depending on the measure used, foreign-owned firms attained control (that is, held 10 percent or more of equity) of between 10 and 17 percent of the manufacturing sector by the end of 1989, and some 14 to 21 percent of the U.S. banking industry by 1990. These numbers each represent about a 150 percent increase from their respective levels in the mid-1970s. It is worth emphasizing, however, that despite these rapid increases, the role of FDI in the U.S. is still relatively small by international standards. According to the latest available data, as of 1986 major European nations had twice the share of foreign-owned firms (in sales and assets) compared to the U.S.

Figure 2 shows that in book value terms, the United Kingdom has been by far the largest direct investor in the U.S., accounting for more than a quarter of the total. Japan's FDI increased considerably in recent years in relative terms, overtaking the Netherlands in 1987 as the second largest investor in the U.S. It is clear from the figure, however, that Japan has not singlehandedly caused the recent surge in FDI as is sometimes presumed. Japan is but one of the major direct

Figure 2:
Major Foreign Direct Investors in the U.S.
(Billions of Dollars in Book Value)



investors, holding about one-fifth of the total stock of all FDI in the U.S.

Concerns

One concern about FDI is that foreign-controlled firms may have a greater tendency to procure production inputs from abroad than do domestic firms. The lower demand for inputs supplied by domestic firms therefore will result in reduced employment and a worsened trade balance in the U.S.

A second set of concerns stems from the so-called "headquarters effect." When a foreign firm acquires or displaces a U.S. firm in the U.S. market, it allegedly prefers to locate production involving higher skills and higher value-added, as well as research and development (R&D), near its headquarters. The reduction in R&D is seen as particularly problematic since these activities can generate significant spillovers from one firm to another—"positive externalities" in economists' jargon. The agglomeration of high tech firms in Silicon Valley is an example where innovative firms have mutually benefited from such positive externalities, and where the combined impact of such spillover effects has proved to be very substantial in contributing to economic growth.

Benefits

The potential costs of FDI must be weighed against possible benefits, and these may be divided into two categories. The first set of benefits is closely related to the gains from international trade. Trade permits nations to specialize in producing goods and services where they have a comparative advantage, and thereby they achieve efficiency gains. A similar principle underlies FDI. A foreign firm acquires an existing U.S. firm or builds a new factory in the U.S. because, given its comparative advantage, it expects to generate higher returns than would a U.S.-owned firm. The foreign firm's comparative advantage may be knowledge or assets that translate into superior production and management skills compared to domestic firms. (The success of Japanese automobile and electronic manufacturers in the U.S. comes immediately to mind.) Alternatively, a foreign multinational may have technological knowledge generated from its R&D activities elsewhere that can be deployed to its advantage in the U.S. market through production by its subsidiary. In either case, FDI increases international integration and thereby fosters specialization according to comparative advantage, which should be to the mutual benefit of the source as well as the recipient country. The notable difference with international trade is that FDI achieves this efficiency gain through international transfer of corporate control rather than through movements in goods and services.

The second set of benefits amounts to turning an earlier argument on its head: FDI may generate beneficial technology spillovers in the domestic economy. Foreign-owned firms can bring foreign technology, know-how, and management methods that can be emulated by domestic firms. Foreign firms also train local workers who may subsequently transfer their skills elsewhere. FDI may therefore add to the U.S. economy's real output more than the foreign direct investor directly accrues.

Evidence

Whether the benefits of FDI outweigh its costs (or vice versa) is ultimately an empirical question. Unfortunately, the benefits—gains from integration and spillovers—are inherently difficult to measure. What about the costs? Lipsey (1991), among others, finds evidence suggesting that, indeed, foreign-owned firms, and Japanese firms in particular, have on average a greater tendency to import production inputs compared to their domestic counterparts. Foreign-owned firms also tend to be less export-oriented with respect to their output, thus exacerbating the trade balance problem. But do these findings provide sufficient grounds to reject FDI?

There are at least two reasons to think that they do not. First, any cost engendered by foreign firms' greater tendency to import appears relatively small. Graham and Krugman (1991) estimate that as of 1988, this greater tendency to import worsened the U.S. current account balance by about \$10 billion. Under reasonable assumptions, this implies a reduction in the equilibrium value of the dollar of about 2 percent. Stated differently, as a result of FDI, a given amount of U.S. exports purchased about 2 percent less of foreign imports. This deterioration in the terms of trade seems rather small a cost compared to the benefits conferred by FDI.

Second, the higher propensity of foreign firms to import may reflect the fact that a large proportion of FDI in the U.S. is relatively recent. Past history indicates that although FDI in manufacturing typically begins with assembly operation with low local content, local sourcing by foreign affiliates increases over time. This pattern holds for U.S. multinationals that were established in Europe during the 1950s and 1960s, and there is no reason to expect anything different from their foreign counterparts operating in the U.S. Indeed, data collected by the Department of Commerce indicate that the local content of products made

by foreign multinationals has been rising. Any deleterious impact of FDI on trade balance and domestic employment should therefore decline further in the future.

What about the headquarters effects? Graham and Krugman find that when foreign-owned firms are compared to U.S. firms as a whole, both compensation and value added per worker are actually *higher* in foreign affiliates than in the average U.S. firm. When the comparison is restricted to manufacturing firms, no systematic difference could be detected in compensation or value-added between foreign and domestic firms. In other words, available evidence does not support the view that FDI depletes the U.S. of higher skill production or higher value-added production.

The authors reach a similar conclusion with respect to R&D. For industries, as well as for the subset of manufacturing, R&D expenditures per employee were again *higher* for foreign-owned firms than for U.S. firms. Thus, the possibility that foreign-owned firms favor undertaking R&D activities in their home countries is not supported by the data.

Conclusions

On economic grounds at least, FDI is not a Trojan horse as some fear. Rather, the increasing importance of FDI in the U.S. should be seen as a part of a larger trend toward globalization and increased international economic integration. To the extent that the process entails reorganization and reallocation of resources within the U.S. economy, some adjustment costs will be inevitable. If past experiences with increased international trade in goods and services are any indication, however, such costs should be amply offset by increased efficiency to the benefit of all countries concerned.

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