Part V

CAPITAL FLOWS AND INTERNATIONAL ECONOMIC RELATIONS:

The Explosion of Foreign Direct Investment among the G-5

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■Summary

Despite widespread media attention to trade balances, international capital movements now dwarf trade flows. They receive less attention partly because they are more difficult to understand and partly because they are widely assumed to represent nothing more tangible than pools of funds shifted across the world's computer screens by bankers and securities dealers. Indeed, the enormous figures that are quoted for capital flows - 20 times greater than trade flows on a daily basis - are mostly trading in the financial markets rather than transactions linked to the "real" side of the economy.

However, a portion of those capital flows represents foreign direct investment (FDI) - indisputably a "real" economic transaction, and one that is growing in importance for a number of reasons. In an era of increased trade restrictions, FDI can be an alternative to exports. For example, the Japanese Ministry of International Trade and Industry (MITI) has traced the interest by Japanese automobile makers in opening factories in the United States to the 1981 imposition by the US of voluntary export restraints (ie, import barriers) on autos. MITI projects that by 1990 Japanese auto production in america will be equivalent to 60% of its auto exports there in 1985. This is a straightforward case of FDI as an export substitute.

Outside the manufacturing sector, FDI is less a substitute for trade and more the medium of trade itself. DIn many of the service industries —banking, hotels, retail trade, telecommunication— transactions are "invisible" at the customs posts because they involve the movement across borders of money, people and electronic signals rather than goods. Often, once the investment has been made, transactions take place only in the host country where the market is. As the company grow, its increase value represents additional FDI, even if none of it crosses the border back to its home country.

Since the service sector is growing more rapidly than manufacturing in nearly all advanced countries, it would not be surprising if FDI were to grow faster than world trade over the years ahead. Indeed, if the shift away from manufacturing and towards information-based, service-oriented economies continues, one might expect FDI flows among countries eventually to dominate trade. Even now, it is clearly inappropriate to focus only on the trade balance when discussing international economic relations among countries.

What has happened to FDI over

the 1980s? Is there evidence that investment flows among the large countries are increasing? Who are the big players in FDI? Where are the surpluses and deficits? Are "trade frictions" emerging with FDI? Is the political climate toward FDI growing more or less protectionist? Could FDI become the international "engine of growth" in the 1990s as expanding world trade was during the 1950s and 1960s?

These are the kinds of questions that this research set out to answer. Our sample is the G-5 countries: the United States, Japan, West Germany, France and the UK, which together account for more than three-quarters of the total stock of foreign assets held by the OECD countries. We focus mostly on the period since 1980, although our data base goes back to 1970.

Definitions and Data Problems

Aggregated data on foreign direct investment are misleading, not only because of differing definitions of FDI across countries, but also because the net figures conceal vast differences among economies. For these reasons, it is more useful to look at gross amounts of investment by the major actors individually, making adjustments to the data where necessary and discussing the source and direction of biases.

All of the countries in our survey have adopted the following IMF definition of foreign direct investment.

> Direct investment refers to investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise.

Each country was left free to determine what constituted "a lasting interest" and as a result there was no consistent interpretation of FDI. To correct this deficiency, in 1982 the OECD suggested that 10% ownership of the voting stock of an enterprise should be considered "a lasting interest."[1] The United States and Japan both use a 10% minimum, while the UK and France adhere to a 20% rule.[2] Germany is the most conservative, with a 25% level. Thus data from the UK, France and Germany are understated relative to the other two countries. To form a judgement on the size of this understatement, it is possible to compare the 1984 US data on the UK investment position[3] in the United States ($38.4 billion) with that reported by the UK ($35.2 billion). This implies an understatement of around 10%. Similarly using 1986 stock figures for German investment in the US, the US data showed a stock 4% larger than the German data.

A bigger data problem affecting cross-country comparisons is in the treatment of retained earnings; ie, the increase in the value of an overseas subsidiary which is left in the subsidiary rather than repatriated back to the parent. The United States, Britain and Germany — but not Japan or France — adhere to the OECD suggestion that retained earnings be included in FDI. This means, for example, that both capital outflows of Japanese FDI and Japanese earnings on its overseas investments are understated. To give an idea of the degree of understatement, one can examine US data on Japanese FDI in the US during the 1980s. These show that in most years retained earnings represented between one-fourth and one-third of total Japanese FDI flows to the US. Since Japan is the fastest growing overseas investor, this definitional quirk will begin to undermine international comparisons unless corrected soon.

The French data suffers from many of the same shortcomings as that of Japan, particularly by excluding retained earnings. Neither France nor Japan publish stock figures. Given the variability of yearly bilateral FDI flows and the incompleteness of cumulative flows (because they exclude retained earnings), the stock position is the only reliable indicator of the importance of a particular economy as a source or as a recipient of FDI. The lack of stock figures and the exclusion of retained earnings by France and Japan are the largest empirical obstacles to developing a clear picture of global FDI flows.

There are various other problems that affect all countries' data: inflation and exchange rate movements over time, loans and repayments between parent companies and overseas subsidiaries, the treatment of investment in the US by the Dutch affiliate of a UK parent, etc. In these days of global companies with access to multiple capital markets, it is no wonder that detailed breakdowns of data on FDI often appear erratic and are therefore difficult to interpret. Beyond identifying the obvious differences and making adjustments where possible, we have tried to minimize this problem by using mostly aggregated figures. In addition, the next stage of our research will focus on broader measures of international investment activities — rather than just cross-border flows — which will provide a more complete perspective for FDI figures.

An Overview of FDI in the 1980s

The most striking feature about FDI flows—as compared to trade—is the dominance of the United States. Although its share of the total is beginning to decrease, foreign investment by US companies still accounts for nearly half of all OECD flows. By contrast, US exports are only about 10% of total world exports (17% of the OECD's exports).

This points up an obvious, but important, difference between trade flows and FDI. The former are transitory and heavily influenced by market and foreign exchange risks. FDI implies a longer term commitment and is often undertaken precisely in order to reduce trade risks by moving into the market (to facilitate quicker response) and enabling most costs to be in the same currency as revenues. The US trade position deteriorated rapidly during the 1980s, while its overseas assets grew roughly in line with inflation, despite little new investment until 1986. Having been a capital exporter for most of this century, the enormous stock of assets built up overseas continues to produce and earn large returns, long after the competitive position of the exporter has deteriorated.

This is demonstrated even more clearly by the UK experience. Its long period of capital surplus prior to the second world war, and its much briefer recent spurt caused by North Sea oil, have made it second only to the US in the size of its foreign holdings.[4] In per capita terms, or as a proportion of GNP, it is by far the largest. Earnings from those overseas assets contributed more than half as much to the UK current account as total oil exports at their peak.[5] Moreover, the foreign earnings are growing rapidly, while oil production has already started to decline. The implications of the UK and US experiences for Japan are discussed in the final section of this paper.

Historical trends

The pattern of FDI in the 1980s is one of strong recovery after a fall in the early part of the decade due to worldwide recession and the aftermath of the second oil shock, as shown in Figure 1. During the 1970s, the driving force for FDI growth came from the oil companies. After the oil price increases of both 1973 and 1979 FDI spurted, only to fall back again in 1975-76 and the early 1980s. Thus growth rates over the decade of the 1980s are somewhat overstated in that they measure from a trough in the cycle.

In real terms,[6] FDI in 1986 was $6 billion above the previous peak of 1979. The 1983 nadir was the lowest aggregate outflow since 1967. This decline in investment in the early 1980s has been reported by both the United Nations and the OECD.[7]

Table 1 also shows the trend towards a more even distribution of FDI outflows among the G-5. Throughout the 1970s US FDI represented over half of the G-5 total; by 1986 the US share had fallen to one-third. As Japanese, German and French multinationals continue to mature as international investors, this trend is likely to be reinforced. Nonetheless, in terms of its stock of FDI assets, the US is still far ahead of the other four countries, as shown in Table 1.

The very rapid growth of FDI in the 1980s is also shown in Table 1. Only France failed to increase its real rate of foreign investment. The United States and Britain — the world's largest investors — recorded increases in real terms of 6-7% a year. Japan and Germany, starting from much lower bases, increased their FDI at more than twice that rate.[8]

When real FDI growth is compared with the real growth of GNP, a clear relationship emerges. Both GNP and FDI growth peaked in 1973 and 1979-80, plummeting thereafter during the oil shock to reach nadirs in 1974 and 1982-83. Regressing the real growth of FDI on the real growth of GNP from 1962 to 1986 yields the following equation for the aggregated data[9]:

$$\text{FDI} = -0.7 + 4.2\,(\text{GNP})$$
$$(-1.5) \quad (5.7)$$

$$DW = 1.88 \quad R^2 = 0.59$$

The equation suggests that a one percent increase (decrease) in real GNP has coincided with a 4.2% increase (decrease) in real FDI. In other words, FDI growth mirrors GNP growth but has been roughly four times as volatile as GNP since the early 1960s. When the same regression is run only for the period of greatest volatility since 1973, real GNP growth explains an even greater portion of the movement of FDI growth ($R^2 = 0.68$).

Using aggregated data from the five countries produced a better result than running individual equations for each country. The aggregation diminishes the effect of a random occurrence in an individual country in a given year. [10] For example, the US FDI data may be strongly affected in one year by the expropriation of an affiliate of a US oil company. In addition, the use of aggregated GNP as the exogenous variable highlights the importance of both the home and the host economy in the investment decision. While slow growth in the host country erodes investment opportunities, the same slow growth at home impairs business optimism and the ability of parent companies to raise money for FDI. The relative importance of each country's economic growth is difficult to assess owing to the global nature of recent past recessions. [11]

The link between FDI and economic growth can also be found with trade; indeed the three are intertwined. An economy expanding at a faster rate than its trading partners will have a higher rate of import growth. As the faster growth continues, that economy will also attract more inward FDI in order to supply the increase in demand more efficiently and with less exchange

Table I. Average annual rate of increase in FDI, 1981-86
(percent per year, valued in domestic currency)

	Nominal (%)	Real (%)	1986 Position[a] ($ bill)
United States	10	6	276
United Kingdom	12	7	140 (est)
West Germany	16	13	70 (est)
Japan	18	16	60 (est)
France	7	0	42 (est)

Note: a. For Japan and France,this is represented bycumulative flows for the period 1961-86.

risk. If the faster relative growth causes the trade balance to worsen, protectionist pressure may lead to even greater inward FDI to circumvent anticipated trade barriers. All of these trends have been evident in the US since 1983.

Geographic distribution of FDI

For all countries in this study except Japan, FDI has been directed mostly to the industrialised countries. As shown in Table 2, almost half of US assets are in Europe, with another 19% in Canada. Whether for economic, political or historical reasons, only 4% of the US' massive overseas investments are in Japan. UK companies have 60% of their foreign holdings in the US and the other European countries, with only 1% in Japan. Germany's FDI is focussed on Europe but almost one third is still comprised of US assets. For France, its FDI is evenly divided between the United States and Europe.

A striking feature in Table 2 is the importance of the United States as a recipient of FDI. On average for the four other countries, one third of their investments are in the US. If one considers only the period of the 1980s, the percentages in the United States range from 35% for Japan to 54% for France. The predominance of the US as a host country for direct investment is in sharp contrast to the negligible role played by Japan in hosting FDI. Just as the rapidly growing US drew in FDI despite the high dollar during the period of 1980-85, so FDI into Japan should show a marked increase during the latter half of this decade as foreign companies seek to establish themselves in its rich and growing market.

Sectorial distribution of FDI

As might be expected, there are major differences among the countries in their sectoral patterns of FDI, as shown in Table 3. The US

Table 2. Geographic Distribution of FDI
(percent of total position)

Home Country	Host Country			
	US	Europe	Japan	Other
United States	—	47	4	49
United Kingdom	35	25	1	39
Japan	30	13	—	57
West Germany	30	43	2	25
France	38	38	1	23

Note: US : 1986 Position
UK : 1984 Position
Japan : Cumulative outflows, FY51-85
West Germany : 1985 Position
France : Cumulative outflows, 1976-86

companies are surprisingly concentrated in the manufacturing sector, compared with those of the UK or Japan. This may represent diversification attempts by US multinationals when they began to lose world market share in manufactured exports. They may have moved production from their US bases to overseas ones. The high percentage of German FDI in manufacturing reflects the importance of the chemical and automotive sectors in the German economy. It is surprising that only 27% of Japanese FDI is in manufacturing, despite examples such as the auto industry cited above. The explanation is likely to be a time lag. The Japan External Trade Organisation estimates that only 4% of Japanese companies' production is carried on outside Japan, compared with almost 20% for American and German firms.The rise of the yen since 1985 is bound to spur Japan toward levels similar to those of its main trading partners.

In the 1970s, the driving force for FDI growth was the oil sector, particularly by the US, the UK and France. Nearly all French overseas investment during the period was made by its oil companies. In the 1980s the impetus to FDI has come increasingly from the service sector. The figures for finance and insurance indicate the strong international position of all five countries in these rapidly growing sectors. We argue below that the spreading deregulation in other service sectors - telecommunication, air transport - will spark similar bursts of international investment by previously constrained national monopolies.

In summary, the past 5 years have brought a rapid growth in international investment by the major countries, while trade flows have grown only slowly. The US and the UK remain the largest investors, but Japan and Germany are rapidly growing newcomers. French companies have not yet been bitten by the bug of overseas expansion. In addition to the growing importance of Japan and Germany, experience in the recently liberalised financial service sector portends a possible burst of FDI as other service indus-

Table 3. Distribution of FDI Position by Sector (percent)

	Manufacturing	Oil & Mining	Finance & Insurance	Real Estate	Other
United States	38	23	23	0	16
United Kingdom	25	29	14	4	28
Japan	27	13	17	6	37
West Germany	43	4	15	5	33
France	33	23	20	2	22

Note : US :Position,1985
UK :Position,1984
Japan :Cumulative outflows ,FY51-86
Germany :Position,1985
France :Cumulative outflows ,1972-86

tries are deregulated. The following section considers the recent trends and policy environment affecting FDI in each of the five countries.

The Country Situations

The United States

The United States is both the largest overseas investor and the host country with the most inward investment. During the 1980s the rate of US investment abroad slowed, compared to the previous decade when its current account had been healthier and its oil companies had expanded rapidly. US FDI took a major dip in 1982 83 partly because, with very high domestic interest rates, US companies drained cash from their foreign subsidiaries to finance investment at home. This was another manifestation of the domestic capital shortage caused by the huge government deficit and a low national savings rate. By 1985 FDI had recovered and it continued to grow strongly in 1986. Annual increases in the US FDI position are shown in Table 4.

Over the same period there was a major increase in FDI into the United States, especially from the UK and Japan. From 1980 to 1986, inward investment grew at 16.5% annually and the total position of UK and Japanese companies in the US increased by $56 billion. France and Germany lag far behind the other two countries in their investment in the US, contributing only $10 billion over the last five years.

By the end of 1986 the UK was the largest foreign investor in the US with 25% of the total, while Japan's holdings were third largest (behind the Netherlands) representing 11% of the total. By 1986 the foreign FDI position in the US was about three-fourths as large as the total US holdings abroad, compared to 38% at the beginning of the decade.[12]

On the policy front, the US is a strong promoter of outward investment. It has devoted considerable diplomatic effort to win greater rights for US service companies both bilaterally (eg, the pressures on Japanese banking) and multilaterally through its successful push to include trade-related investment measures (TRIMs) in the forthcoming Uruguay round of the GATT.

Regarding inward investment, the picture is mixed. In general, both the federal authorities and individual states have been keen to attract FDI. However, national security concerns and a rise in anti-Japanese sentiment have, on occasion, tempered that enthusiasm. Thus the NUMMI joint venture between Toyota and General Motors was only given anti-trust exemption for a limited number of years. The Federal Reserve ruled that Sumitomo Bank's $500 million acquisition of 10% in Goldman Sachs must remain a passive investment, because of US laws dividing banking from securities. Despite Japanese disappointment, both of these decisions had firm US precedents and would likely have been the same if only American companies had been involved.

There was, however, a surprisingly negative response to Fujitsu's proposed acquisition of Fairchild from the French company Schlumberger in 1986. Given that Fairchild had been in French, not American, hands, the spate of objections to Japanese control are of considerable interest in determining the limits to the US welcome of inward investment. The Pentagon voiced worries about its growing dependence on foreign chip suppliers. There were technical anti-trust concerns that the combined companies would dominate the world gate array (semi-custom chips) market. On the trade front, the US semiconductor industry claimed that Fujitsu was trying to circumvent the purpose of the US-Japan semiconductor pact, which was designed to give the American industry a breathing space from Japanese competition. This mixture of objections, which included national security, anti-trust and wider industrial policy considerations, suggest some of the ways that the acceptance of inward FDI can still be challenged, even in as traditionally tolerant a country as the US.[13]

In addition to specific FDI disputes, there was a surge of interest among the states in 1982-84 in the principle of unitary taxation, whereby companies (both domestic and foreign) would be taxed according to a formula such as dividing the company's total profits by its turnover or assets in the state concerned, rather than simply taxing the profits declared within the state. This would have hit foreign multinationals especially hard and it triggered a diplomatic row, led by the British and the Japanese. Finally

Table 4. Total US Foreign Direct Investment
(million $)

	Change in Position
1970	7,387
1971	7,280
1972	7,118
1973	11,435
1974	8,765
1975	13,972
1976	12,759
1977	14,254
1978	16,911
1979	26,406
1980	29,655
1981	15,932
1982	5,823
1983	2,662
1984	7,531
1985	12,403
1986	25,348
1987 QI-III	16,228

Note : The date have been adjusted for the Netherlands Antilles finance affiliates and for the 1977 and 1982 revisions based on the benchmark surveys.

Source : Survey of Current Business, August issues.

the Administration was persuaded to take an activist role against the Californian position[14] on the grounds that it was creating foreign policy problems of a national dimension. California capitulated in late 1986 with a bill allowing foreign companies to be exempted from unitary taxation by paying a small annual fee. This was the most notable demonstration of federal government support for the interests of foreign multinationals operating in the US.

Probably the most important impact that the US has had on the general FDI environment in the 1980s has been not through legislation or diplomatic initiative, but through the impact of its deregulation policies. These have been focused on service activities such as banking, insurance, telecommunications, airlines and trucking. Wall Street's Big Bang in 1975 started a financial revolution that forced other major world centres to rethink their regulations, especially those regarding foreign competition in securities broking which almost universally had been preserved for nationals. The emergence of major financial conglomerates in the US, such as American Express and Merrill Lynch, put pressure on the international competition which brought a wave of liberalization that is still spreading.

In many ways of even greater significance than banking, was the anti-trust case of 1984 which led to the dismemberment of AT&T. This has had two major impacts. First, it has served as a model for countries such as the UK and Japan which have also wanted to stimulate a sector which has traditionally been a public monopoly. Second, the rump AT&T company has been galvanized into becoming a global player by building strategic alliances with competitors around the globe. This has meant that even the most illiberal telecommunications monopolies elsewhere in the world have been confronted with the new fact of global competition. They too are having to devise international strategies to come to terms with the underlying forces now driving the industry.

Looking to future, America's strength in the service sectors and head start with deregulation portend further increases in FDI. However, the experience of the early 1980s demonstrates the limits that macroeconomic constraints can place on companies' global strategies. Over the medium term an increase in the US savings rate will be necessary to underpin a sustained resurgence of FDI. In the meantime, the growing flow of inward investment from Europe and Japan represents a much more stable and productive means of financing the current account deficit than the purchase of government bonds by foreigners. The US would do well to keep its doors open to FDI.

The United Kingdom

The UK is a mature and diversified foreign investor. Many British companies have a long history of overseas operation. In the financial sector, many of today's firms can trace their origins to the development of trade finance and ocean marine insurance in the late seventeenth century. In recent years there has been an almost unbroken growth in FDI with especially large spurts in the mid-1970s following Britain's entry into the Common Market and in the 1980s with the advent of North Sea oil. We estimate that the real value of Britain's outward FDI position increased by £37 billion between 1980 and 1986.

By the end of 1984, 35% of UK FDI was located in the US, while another 20% went to Australia, Canada and South Africa. All four countries have strong historical links to the UK. Only one-fourth of UK FDI is located in the other countries of Western Europe.

Investment into the UK has also increased. From 1980 to 1986, inward FDI totaled £19 billion at 1980 prices. The United States represented over one half of all FDI in the UK in 1984, while the EC accounted for 30 percent. Japanese FDI in the UK was still less than two percent of the total stock in 1984.

As an active host and parent economy for FDI, the United Kingdom has extended its basically liberal policies in recent years. Exchange controls were abolished in 1979. Within the European Community (EC), the UK has been in the lead in opposing the Vredeling Initiative which would impose heavy reporting and consultative requirements on foreign companies and would make a company's largest subsidiary in the EC ultimately responsible should the global headquarters refuse to come to terms with the EC authorities. The British have also taken a high profile stance toward Japan to widen access for UK firms to its financial market. The reciprocity provisions of the Financial Services Act of 1986 were specifically inserted to give British diplomats a chance to put pressure on countries which did not offer UK financial interests the same freedom as their nationals find in the City of London.

Despite the official UK policy of welcoming inward FDI, there are still sensitive areas where formal policies may get swept aside. There were two such cases in 1986. In the Westland affair, a major political

Table 5. Total UK Foreign Direct Investment
(millions £)

	Total Outflows
1970	546
1971	676
1972	737
1973	1,621
1974	1,576
1975	1,308
1976	2,359
1977	2,346
1978	3,531
1979	5,893
1980	4,957
1981	6,093
1982	4,109
1983	5,402
1984	6,092
1985	8,828
1986	10,895
1987 QI-III	12,411

Note: Outflows of oil companies are excluded before 1975.
Source: British Business, various issues.

controversy ensued which ultimately led to two ministers resigning over whether the financially troubled helicopter company should be sold to European or American interests. The government sided with Westland's board on the American solution but was widely criticized for not seeking an alliance with other European companies. In a separate case, the British authorities considered dismembering the automobile company, Rover, by accepting a bid from General Motors for two of its divisions. When the news broke of these talks, there was much public criticism and the government backed away from the deal. Meanwhile, the public has not been concerned about the deepening links between Rover and Honda, so it would be wrong to interpret these cases as evidence of a general xenophobia. However, they do show that even in a country as relaxed about inward investment as the UK, there are unpredictable political responses when national champions seem likely to fall under foreign control.

On the liberalization and privatization fronts, there have been major developments since the early 1980s. Large government owned companies such as British Telecom, British Aerospace, Cable and Wireless, British Gas, Jaguar and Rolls Royce have been privatized, with British Petroleum, the Central Electricity Generating Board and others to come. Most of this has occurred for domestic political reasons, but the British authorities have ensured that several of these equity flotations have had a strong international element, often through equity placings in New York and Tokyo. Sometimes a limit was placed on foreign holdings (10% for British Telecom, 15% for British Gas and British Aerospace), but these privatizations have been partially designed to spur the companies into developing a global business outlook. Attracting some foreign investment to them is part of that design.

In parallel with privatization, there has been wider liberalization in sectors such as telecommunications, aviation and, particularly, financial services. The "Big Bang" of 1986 which swept away fixed commissions and several other historic practices in the London Stock Exchange proved to be the catalyst for a revolution throughout the entire financial services sector in the UK. In particular, foreign financial institutions, originally limited to carrying out "offshore" Eurocurrency transactions, have been allowed to penetrate domestically-oriented sectors. Foreign members have been allowed into the London Stock Exchange since 1986. American banks have been allowed into the life assurance market and Japanese security traders, such as Nomura, have won banking licenses.

Probably the single most important sign of the opening of British financial markets was the 1986 creation of The Securities Association from a merger of the Stock Exchange—a 200 year old bastion of the British commercial establishment — and the International Securities Regulatory Organization (ISRO) — created in 1985 to bring together the foreign financial institutions in London trading in international equities. The Securities Association will be the largest of the self-regulating organizations set up after the Big Bang. It is now developing the rule book to cover the full range of investor protection needs from the local stockbroker to the international financial supermarket operating from a London base. Fifteen of the 31 members of the initial Council were nominated by ISRO, hence the interests of the international financial community (especially the American and Japanese companies in London) will be well represented. The Chairman is an American. Given that this is the world's most ambitious attempt to regulate the new world of financial services, the international spread of The Securities Association's membership is a symbol of how purely national approaches to regulation are now almost certainly doomed to failure.

The UK has been well served by its open approach to FDI. Remittances of overseas interest, profits and dividends have quadrupled since 1980 and now more than cover the deficit Britain incurs on visible trade. The UK's traditional strength in invisible trade (service) should be enhanced by the opening of its own market to foreign competition and by the lead role it is thus able to play in shaping the international regulatory environment of the future.

Japan

Japan has become a major direct investor in other industrial countries in the 1980s. From 1970 to the end of 1980 real yen-denominated FDI increased at an annual rate of 7%, while from 1981 through 1986 it grew at an annual rate of 16%, as shown in Table 6. [15]

As late as 1981 Indonesia was the major recipient of Japanese FDI, mostly for oil extraction and liquified natural gas export back to Japan. However, by 1986 nearly 50% of Japanese FDI went to the United States, and Japan had become the third largest investor in that country. This is a natural extension of Japan's export success, and follows the British and US experience of earlier decades. [16]

The close link between Japan's exports and its FDI is illustrated by US data on the proportion of Japan's exports to the US that go to Japanese companies. In 1985 Japanese companies in the US imported $58 billion from Japan—an amazing 88% of all Japanese exports to the US. By contrast, US companies in Japan (in 1984) imported $3 billion from the US, or 12% of US exports to Japan. Figures like these are open to differing interpretations. On the one hand, some claim that Japanese FDI is merely a trojan horse designed to get around export controls by setting up "screwdriver operations" in the target markets. In that case, a strict vetting procedure and requirements for a minimum local content of production may be appropriate. On the other hand, this may be a natural phase that a new investor passes through while local supply channels are being developed. As Japanese companies abroad grow more familiar with local suppliers (and as the effects of yen appreciation are felt from their traditional suppliers) their reliance on imported inputs from Japan will fall. Time will tell which explanation is correct; certainly such figures are being closely monitored by US and European trade officials, and the speed with which they fall may well be the key determinant of further liberalization of—or restrictions on—foreign direct investment.

Within Japan policies toward FDI have been in a state of flux. The strengthening of the yen has probably been the major reason for the upsurge of interest by Japanese companies in overseas investment and has undoubtedly stifled investment by some foreign companies in Japan. Since 1980 the government has relaxed exchange controls and MITI has increased its exhortations for more foreign investment both as a means of recycling the trade surplus and to defuse trade tensions.

Regarding inward investment, the picture is less clear. At the official level, the mission of JETRO has been changed from export promotion to the attraction of foreign industries into Japan. In 1984 MITI created an Office for the Promotion of Foreign Investment in Japan, and the Japan Development Bank established a financing system for foreign investors. Despite these signals, some methods of entry into the Japanese economy — particularly

Table 6. Total Japanese Foreign Direct Investment
(billion of yen)

	Total Outflows
1970	127
1971	125
1972	219
1973	517
1974	846
1975	523
1976	590
1977	442
1978	499
1979	635
1980	541
1981	1,080
1982	1,131
1983	858
1984	1,417
1985	1,540
1986	2,440
1987 QI-III	1,929

Note : The date are from the bank of Japan and are on a calendar year basis. Since Japan reports its data in US dollars, the Japanese figures have been reconverted back into yen at the period average exchange rate, one similar to that used by the Japanese authorities.

through mergers or acquisitions–still seem to be positively discouraged. Acquisitions of Japanese companies by foreign companies are not impossible, as demonstrated by BOC's purchase of a controlling stake in Osaka Gas and Merck's of a majority share in Banyu. The Ministry of Finance has to approve foreign bids, but there is no law against hostile takeovers. Nonetheless, there is undeniably a business culture that discourages the contested acquisition which, in other parts of the world, is one of the fastest way of entering a new market.

Meanwhile, the liberalization of the Japanese economy is picking up speed, though foreign investors are still not always fully accepted. The partial privatization of NTT was part of a wider package of liberalization within telecommunications which provided opportunities for foreign companies to enter this sensitive market. This legislation goes further than that of most of Japan's competitors, with the exception of the United States. The trouble has arisen over the first attempt of foreign companies to actually join the new type of consortia, in which they would have had a 20% share. The foreign application provoked pressure by the Ministry of Posts and Telecommunications to dilute the foreign companies' share on national security grounds. In addition it was argued that there was not enough business to go round the two consortia applying for licenses. Both the British and American governments protested strongly at the prospect that their companies would be squeezed into subsidiary roles. At the time of writing (March 1988), the dispute is still pending.

The other important area of liberalization in Japan has been the financial services sector. Development have been rapid following the 1984 recommendations of a high level Japan–US working group for a substantial liberalization of Japan's highly regulated financial markets. [17] Since then interest rates have been partially deregulated, a few foreign companies have been allowed to join the Tokyo Stock Exchange, controls on yen-denominated foreign lending have been largely abolished, a huge Euroyen market has been allowed to develop, and special arrangements were even worked out to allow foreign banks to deal in securities which is not permitted under Japanese legislation for its own banks. There are still pressures for a faster pace of reform—understandable given the rapid restructuring of the industry worldwide—but substantial progress has been made in three years, and there is little doubt that this will continue.

Even with the high yen, foreign interest in serving the large and increasingly wealthy Japanese market portends an increase in inward investment—especially from its current low level. Japanese companies have begun their rush overseas, and this too is likely to intensify as their patterns of production mature into levels(of overseas relative to domestic production, of local inputs relative to imports, etc) similar to those of their competitors. Yet the volume and rate of increase of Japanese FDI are already stirring echoes of "le defi americain" that worried European countries in the 1960s.

West Germany

Formerly a net recipient of FDI, Germany has been a net exporter of direct investment capital every year since 1975. In fact from 1980 to 1986, Germany exported over five times as much FDI as it received from abroad. Table 7 depicts outflows of German FDI.

Table 7. German FDI Flows, 1970-1986
(DM million)

	Outflows
1970	3,194
1971	3,656
1972	4,988
1973	4,417
1974	4,959
1975	4,940
1976	6,179
1977	5,122
1978	7,242
1979	8,235
1980	7,597
1981	9,257
1982	6,752
1983	8,095
1984	12,526
1985	14,173
1986	19,547
1987 QI-III	11,813

Source : Bundesbank

The most important recipient of German FDI is the US, with an equal amount going to the EC as a whole. The third highest recipient is Brazil with almost 6% of total German FDI, most of which is in the automotive sector. In other countries, German FDI is mostly in either chemicals or in the distributive trades. In total, almost 30% of German FDI is in the chemical and road vehicle manufacturing industries. In that respect, it represents the state of Germany industry which has been slower than that of other countries in shifting to the service sector. Increases in non-manufacturing FDI by German companies will depend upon the policy environment of the government in Bonn.

German regulation of FDI is shared by the central government and by the lander (states). Inward FDI has been kept to negligible amounts by both restrictive government policies and by the strength of the Deutschmark. The Federal Cartel Office makes it especially difficult for non-European companies to acquire majority ownership in a German company.

Government policies on inward FDI are not the only barrier to entry by foreign firms. Labour costs and corporate tax rates are high, regulation of industry is generally stricter in Germany than in the rest of G-5 and environmental protection laws are tightly enforced. Furthermore, the German practice of mitbestimmung (codetermination) whereby workers have input at the board level has not encouraged FDI in Germany in spite of the quality and productivity of the workforce.

In the area of privatization, Germany lags behind France and the UK within the EC. While some firms such as the oil company Veba have been partially sold off, attempts to lower the government's involvement in Lufthansa were blocked by domestic opposition. There is also little sign that the Bundespost will follow the example of British Telecom in being privatised. The Bundespost may be split into its separate components, but it is unlikely that the telecommunications market will be opened up to foreigners as it was in the US.

In the financial markets, there has been some progress and occasional relapses. German liberalization in financial services has been prompted by the fear of losing business to such financial centers as London and Luxemburg. The withholding tax on income paid to foreign residents was repealed in 1984 after a similar move by the US government, but at the beginning of 1988 the tax was reinstated. The Federal bond issuing consortium has been expanded to allow for greater participation by foreigners. Foreign banks are now permitted to lead-manage Deutschmark Eurobond issues. Additional moves can be expected as part of the drive to unify the European market by 1992.

France

France presents a contrast to the other four countries in that it is still relatively underdeveloped as an international investor. French FDI has historically been dominated by the oil sector, where the motivation was to secure strategic supplies for the home market, rather than to develop a fully competitive international oil industry.

Throughout most of the 1970s, France had a net inflow of FDI. It managed a substantial net outflow in 1981, 1982 and 1986, in part because US investment in France declined so precipitously in the early 1980s. As shown in Table 8, 1986 also represented a peak for outflows in nominal terms. In real terms, 1986 flows were both surpassed in the early 1980s.

By region, French FDI is evenly divided between Europe and the US, with the remaining one-fourth in the developing countries and in other

Table 8. French FDI Outflows, 1970-1986
(millions of French francs)

	Outflows
1970	2,079
1971	2,196
1972	2,995
1973	4,163
1974	3,754
1975	6,122
1976	8,184
1977	5,885
1978	8,095
1979	8,395
1980	13,260
1981	25,079
1982	20,133
1983	14,029
1984	18,580
1985	20,000
1986	36,227

Source : Balance des Paiements entre la France et l' Exterieur, Banque de France

OECD member countries. The importance of the US as a target for French FDI has increased. Since 1981 fully 54% of French FDI has gone to the US, a higher proportion than that of any other G-5 country. From 1981 to 1984, 43% of French investment in the US was in the energy sector, echoing the importance of Elf-Aquitaine and Total in the French economy, just as German chemical FDI in the US reflected the importance of that sector in the Germany economy. Within the EC, most French FDI goes to Germany and the UK.

The French have never welcomed inward investment, whether under the conservative government of former president Giscard d'Estaing or under the various incarnations of the Mitterand presidency. Thus it is surprising that France has the highest level of foreign participation in its industry of any country in this study. Foreign firms operating in France were responsible for 26% of total French sales in 1985.

Beginning in 1985, with the arrival of Prime Minister Chirac, the French government sought to attract more inward FDI, but since many industries were still in public hands, the main channel for FDI could only be greenfield investments. Under the privatization policies of Chirac, foreign interest in acquiring French companies has increased, but the French government has been careful to maintain control of newly or partially privatised companies such as Elf-Aquitaine, Saint-Gobain and Paribas. A limit of 20% foreign ownership has been established for these companies, with the government retaining a veto of any unwanted bids. In the financial sector France is lagging behind liberalization moves in the major financial markets of London and New York. As of mid-1987, only Morgan Guaranty had been permitted to become one of the 13 primary dealers in Paris. As with Germany, the 1992 drive for a unified European market is likely to bring further liberalization.

Prospects and Threats

The development of FDI over the 1980s stands in sharp contrast to developments in international trade. In trade, we have seen sluggish overall growth (less than 3% a year in real terms) with major imbalances emerging among the large economies and an increase in protectionist legislation. In the case of foreign direct investment, the major countries have liberalized their policies, and we estimate that since 1981 real FDI has increased at an average annual rate of about 7%. This period included a severe through in foreign investment in the early 1980s during the world recession. Since 1983 the G-5 have increased their real FDI at the amazing annual rates of 105% for the US, 40% for Japan, 31% for Germany, 29% for France and 21% for the UK.

While a portion of these recent increases can be explained as a recovery from the cyclical low of 1982, we believe that a substantial part reflects fundamental changes in the world economy and policy environment that are unlikely to be reversed. The shift from manufacturing toward service industries is mirrored in FDI where services are the fastest growing component. The privatization or deregulation of national monopolies in some countries creates a new dynamic of competitive pressure for similar liberalization in other countries. This has already happened in telecommunications and financial services; it may next come to the energy and transport sectors.

In addition to these international trends, the drive in the European Community to create a single market by 1992 and the emrgence of Japan as a global investor will have a large and lasting positive impact on the total FDI position. As was true of Britain and the United States in earlier decades, Japan's current account surplus can provide the basis for a gradual buildup of international assets that not only assists in recycling its surplus in the short term, but also eases the longer term transition of the Japanese economy into its next phase of development.

If these three trends – the liberalization and growth of service industries, the unification of the European market and the recycling of an increasing portion of Japan's trade surplus into FDI – are allowed to run their course, we foresee the period between now and 1995 as a continuation of the boom in FDI that began in 83–84.

The latest available figures for 1987 in the five countries show that the total G-5 FDI has probably surpassed the 1986 peak. In the UK and Japan, outflows in the first three quarters of 1987 equalled or exceeded the 1986 levels. For the US, the first half of 1987 recorded an FDI figure that was already more than one half the 1986 level. Inward FDI in the US also showed a slight increase over the 1986 level for the first half of 1987 at an annual rate ($25 billion in 1986 compared with $15 billion from January to June 1987). Only for Germany do partial year figures show a drop in outflows on a yearly basis.

Over the period through 1995, we expect total real FDI to grow at 13% a year, with an upsurge in intra-European investment and Japan's FDI increasing at about 20% per year. Britain is expected to continue its overseas expansion – at the slightly lower rate of 15% a year – based on the current strength of the UK economy, while outflows from the US and rest of the world are projected to grow by an average 10% a year. This would mean that by 1990 the US and Japan would be spending $37 billion and $30 billion respectively in overseas direct investment, with the UK a close third at $29 billion. Aggregate FDI from all industrial countries would be about $135 billion (in 1986 prices) compared to an estimated $85 billion in 1986.[18]

FDI flows of this magnitude would make a major contribution to easing the adjustment of the world economy be ameliorating the savings/investment imbalance that lies at the root of the US/Japan trade tensions. They would also expand and strengthen the web of business and personal links across countries–links that ultimately can be the most effective way of promoting a liberal trade and investment climate in democratic countries.

There are two major threats to this expansion scenario. The first is that the current boom in FDI is brought to an abrupt end by a growth failure in one of the major countries that quickly transmits itself to the rest of the world. The second threat is the possibility of protectionist pressure spreading from trade into the area of FDI as inward investment becomes larger and more visible in the US and Europe. As noted above, the dominant trend of the 1980s thus far has been toward liberalization of investment flows, with major advances in service sectors such as finance and telecommunications. Competitive forces are such that movements by the major countries in these sectors can exert considerable pressure for others to follow. This route, in parallel with the more cumbersome GATT negotiations, is likely to prove fruitful in promoting trade and investment in the service sectors. But to be successful at drawing others into the wake of the leaders' liberalization, those leaders must move together and at a rapid enough pace for the cascading pressures of competition to be felt by the slower and smaller actors.

Continued liberalization by the leaders– both inside and outside the European Community –will require reciprocal bargaining and concessions. A danger of negotiation outside the GATT is that selective discrimination against partners who fail to reciprocate is a real possibility. The rapid growth of Japanese FDI and the current low level of foreign investment in Japan–even if largely due to historical and geographic factors –will put it in the spotlight as this bargaining proceeds. The Japanese government's response to individual disputes (eg, the Cable and Wireless affairs, the Kansai Airport contracts) will be taken as key indicators of its openness to significant inward investment. Attempted acquisitions of Japanese companies by foreigners will be closely watched. It may be necessary for Japan to adapt its domestic commercial practices much more rapidly than would otherwise be economically or politically desirable in order to preserve and extend an open environment for foreign investment. In this respect, the major policy adjustment burden for FDI is likely to fall on Japan – the country which also has the most to gain from further liberalization by others.

Foot Notes

1. "Detailed Benchmark Definition of Foreign Direct Investment," OECD, 1982.
2. Prior to December 1980 Japan required 25% ownership to qualify as FDI. Thus there is a discontinuity in the Japanese data between 1980 and 1981. In this paper we use the period 1981-86 when discussing trends or growth rates "over the 1980s" for Japan.
3. The word "position" is used in this paper instead of "stock" to reflect the total presence of a country's multinational enterprises overseas. The distinction becomes relevant when a foreign affiliate increases its assets by issuing debt locally. The parent company would be entitled to claim a share of those increased assets. However, because it is not a balance of payments transaction, local borrowing by the affiliate does not show up i the FDI data. In addition, FDI is carried at its book value rather than revalued in line with inflation and capital gains. In these respects, the FDI position is an understatement of the total stock of foreign assets held by one country in another.
4. By contrast, UK exports represent only 5% of total world exports. It is fourth in the league table of exporting countries.
5. For an analysis of the role of overseas assets in Britain's current account see D Julius, "Britain's changing international interests: economic influences on foreign policy priorities," International Affairs, summer 1987.
6. All real values in this paper are based on 1980 prices.
7. "Salient Features and Trends in Foreign Direct Investment," UN Centre on Transnational Corporations, New York, 1983; and "Recent Trends in International Direct Investment," OECD, 1987.
8. By comparison, over the same period the volume of world trade grew by only about 3% a year.
9. T statistics are shown in parentheses.
10. This is because the aggregated data will have a lower variance, the higher the covariance across countries according to the following formula: Variance(A+B)=varianceA+varianceB−2 covariance (A,B)
11. In 1981 and 1982, 17 of the 24 OECD economies had at least one year of negative growth of real GDP (19 countries if 1983 is included).
12. All outward US FDI data have been adjusted for the Netherlands Antilles finance affiliates. Both the inward and outward FDI position are recorded at book value. Since US outward flows are generally older than inward flows, the outward FDI position is understated compared to the inward. This can be seen by the fact that although the two figures are similar in size, repatriated income into the US by its overseas companies ($37 billion) was six times larger than income repatriated out of the US by foreign companies ($6 billion) in 1986.
13. However, the deal was eventually dropped by Fujitsu and Schlumberger themselves; it was not formally vetoed by any part of the US system.
14. California was the first and largest state to adopt unitary taxation. It was involved in a Supreme Court case in 1983 that upheld its right to impose such taxes.
15. Aggregate figures on Japanese FDI are taken from the Bank of Japan which records overseas investment on a balance of payments, calendar year basis that is compatible with data collection methods in other countries. However, it does not produce geographic or sectoral breakdowns of FDI. For those the only source is Ministry of Finance data which is based on reporting of expected overseas investment by Japanese com-

panies. On an aggregate basis, these figures overstate FDI by about 50%.

16. FDI has tended to follow in the footsteps of exports. Thus Britain's former colonies (including the United States) today account for over 60% of its FDI position. The US has twice as much FDI in Britain as in Germany and four times as much as in France, despite the smaller size of the UK market.
17. Japanese sources argue that these changes would have come anyway, but many outside observers feel that it needed a major diplomatic initiative by an economic partner as strong as the US to speed the process.
18. This projection is considerably more optimistic than the latest OECD report on FDI. However, that report was based on data only up to 1983 when the major economies were still recovering from the 1981-82 recession and the liberalization of service industries was just beginning.