Part VII

FOREIGN-OWNED FIRMS, TRADE AND ECONOMIC INTEGRATION

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Introduction

Research completed last year for the Tokyo Club documented the rapid growth of foreign direct investment(FDI) among the G-5 countries, particularly since 1983.[1] The build-up of overseas production bases was especially significant by Japan, although the United States and Britain still have much larger total holdings of FDI. Germany, the world's largest merchandise exporter, has been sensitive to the appreciation of its currency and to the need to establish a presence in important markets. French firms have become more outward-looking at the same time as French attitudes towards inward investment have grown more relaxed. Several hypotheses were advanced to explain FDI growth, and it was founded to be closely correlated with the growth of GNP, though roughly four times as volatile. Projections were made showing continued strong growth in FDI at least until the mid -1990s when Japan's current account surplus is expected to have shrunk to the sustainable range of 1-2% of GNP.

Such increased FDI is a desirable component both of the *economic* adjustment process associated with current account imbalances and of the international *political* adjustment needed to accommodate the decline in US hegemony and the growing importance of Japan. But there are signs, particularly in the US, that as the increased FDI is more widely noticed, it will be viewed not as part of a necessary global adjustment but from a short-term mercantilist perspective. This could lead to a reversal of the current liberalizing climate for long-term investment flows. Protectionist pressures could be diverted from trade to investment.

Part of the problem is that most previous research on FDI has focused either on its microeconomic rationale[2] or on its political implications.[3] Perhaps because of data difficulties, there have been few attempts to view FDI as a macroeconomic phenomenon or to put it into a multi-country context.

The first objective of this research is to measure the macroeconomic importance of foreign-owned firms(FOFs)[4] in advanced economies. To do this, it is necessary to look beyond FDI flows. They are only a partial measure, representing the investment flows between the parent and its foreign affiliates. Many multinational enterprises (MNEs) buy local firms or build factories with capital raised in the host country or in third countries. Often, expansion abroad is carried out almost entirely through foreign-owned firms already established in the host country. To capture these inter-

national economic linkages, the perspective must be shifted from the initial investment flow to the continuing role of the FOF in its host country. Thus, this paper examines such measures as the share of FOFs in the total assets, sales, exports, value added, investment and employment of each G-5 country.

A second objective of the research is to explore the linkage between FDI and trade. Our work suggests that there is a strong complementarity between the two and that, at least among the G-5 countries, investment trends of the 1980s have resulted in FDI becoming the dominant vehicle for serving foreign markets. A large and growing share of trade flows is pulled along in its wake. For example, this FDI-related trade accounted for 58% of US exports and 57% of Japan's imports in a recent year.

The importance of FOFs in national economics

Foreign-owned firms constitute an important subset of the productive structure in most advanced economies. They are, in many respects, indistinguishable from domestically-owned firms. Their employees are nearly all nationals of the host country, they buy most inputs locally, they import some from other countries, most of their sales are to the local market, some are exported. On average, they have a higher proportion of both imported inputs and exported output than domestically-owned firms. As discussed in the following section, this results in their having a disproportionate influence on host country trade figures. In the G-5, roughly four million industrial workers are employed by FOFs, representing 8% of total manufacturing employment.

Table 1 summarizes measures of FOF involvement in the G-5.[5] The most striking feature is the contrast in FOF importance across countries. In the three European countries, FOFs account for a surprisingly large proportion of sales(19-27%), employment(8-20%) and exports (24-32%). These proportions are roughly double those in the United States for all measures except exports. Japan lies far at the other end of the spectrum with an almost insignificant participation by FOFs in its economy. While there is no a priori reason to expect the same proportion of FOF involvement to obtain in each country,[6] the FOF share in Japan is negligible by any measure other than as a percentage of Japanese imports. Furthermore, as discussed below, the proportions have actually decreased over the past decade. this may now be starting to reverse, with a more positive official attitude toward inward investment and growing interest by foreign firms in reaching the affluent Japanese market, but the gap between Japan's burgeoning outwar-

Table 1. Indices of FOF Involvement in the G-5 (percent of FOFs in total)

	US	Germany	UK	Japan	France
Sales	10	19	20	1	27
Value added			19		24
Employment	4	8	14	0.4	20
Assets	9	17	14	1	
Investment	8		13		19
Exports	23	24	30	2	32
Imports	34			15	
memo item: * Sales/imports	150	139	60	42	74

*Gross sales of goods by FOFs as a percent of merchandise imports.
Sources and notes:see Appendix I.

d flows of FDI and foreign investment into Japan will continue to widen for the forseeable future.

It is interesting that, despite all the attention given to globalization of industry, only the US has registered a significant increase in recent years in the role that FOFs play in its economy. Since 1977 FOFs have roughly doubled their share of the various US economic aggregates. In the European countries, FOFs provide roughly one fifth of economic activity(excluding services for the French and much of the UK data), virtually unchanged since 1977, or even 1972 in the case of France. comparisons over time and across countries are brought out in greater detail below.

Sales/Value added

The sales figures show the market share of FOFs in each economy. The ratio of gross sales of goods to merchandise imports(in Table 1) shows that foreign investment is the preferred way of serving the US and German markets. For the other three countries total merchandise imports still exceed sales by FOFs. In Japan FOF sales are only 42% of total imports although, as is discussed later, these FOFs serve as an important conduit for imports into Japan.

Table 2 shows how the FOF share of total sales has changed since 1977. For the three EC countries, the changes have been less than three percentage points, with the UK being the only country to witness a declining share. One reason for the stable market share of FOFs in the European countries is the prominent position of the US in each country, and the fact that the period of most rapid growth in US investment overseas was in the 1950s and 1960s. To the extent that the 1992 drive to complete the European

Table 2. FOF Shares in Sales (percent of national total)

	1977	1986 or latest year
France	24	27
UK	22	20
Germany	17	18
US	5	10
Japan	2	1

Sources and notes:see Appendix I.

market stimulates intra-European mergers and new investment, and that Japanese investment in manufacturing in these three countries continues to grow, the proportion of sales contributed by FOFs should again start to rise.

In the US, foreign participation in manufacturing, retail and wholesale trade has doubled since 1977. This rapid increase in foreign penetration explains a good deal of the public reaction against inward FDI. Most of the increase in manufacturing took place before 1982, during the first surge in outward FDI among the G- 5. In recent years the service sector and real estate have seen major increases.

Employment

The employment share of FOFs is less than the share of sales for each country, indicating a tendency for FOFs to invest in more capital intensive industries. In all five countries, the chemical industry has among the highest ratios of foreign participation. Another sector which figures prominently is the high technology industry of office machinery and data processing equipment.

The same ranking of countries applies for employment and sales, as shown in Table 3. FOF employment in Europe has hardly changed, falling one percentage point in the UK and in Germany while increasing slightly in France. In spite of this decline, there have been important increases in some sectors, notably distribution and miscellaneous services in Germany. In the US the share of the labour force employed by FOFs has doubled. Once again, most of the manufacturing increase took place before the deep US recession in 1982. Employment by FOFs in Japan is still insignificant.

The FOF shares in employment in manufacturing are included in Table 3 for the US and Germany, thus allowing a better comparison with the French and British figures which only cover manufacturing(and petroleum in the case of France). The share of FOFs in each economy is generally higher in the manufacturing than in the economy as a whole, since much of the FDI before 1980 was in either manufacturing or petroleum industries. In the 1980s, however, the

Table 3. FOF Shares in Employment (percent of national total)

	1977	1986 or latest year
Manufacturing		
France	18	21
UK	15	14
Germany	14	13
US	3	7
Japan	2	1
Total		
France:oil & manuf.	18	20
Germany:total	9	8
US:total excl. banks	2	4
Japan	1	0.4

Sources and notes:see Appendix I.

impetus for increased FDI has come from service industries. It is therefore reasonable to expect the lower shares for all sectors in Germany and the US to reach at least the level in manufacturing, to the extent that FDI is permitted in the service sector. Since many services are labour intensive, increased service sector FDI could lead to even higher shares for FOFs in each economy at an aggregate level.

Assets/Investment

Asset and investment figures provide a more accurate picture of the total value of foreign investments in a country than do the data on the stock of inward FDI or on capital inflows. The former are more closely related to market values than are the latter(which are often recorded at book value), and assets and independently of the parent firm.

Table 1 showed that almost one fifth of French and British industrial investment is undertaken by FOFs. Similarly, 17% of German nonfinancial assets and 14% of UK assets are held by foreign firms. Over time, the FOF shares in Europe have changed little, indicating that most US investment in European manufacturing (or all nonfinancial sectors for Germany) took place before 1977 and has grown along with—but not faster than—the European market. Japanese investment in Europe is increasing, but the amounts are still too small to affect the FOF share in European assets.

Table 4 tells much the same story. The participation of FOFs in the US has increased by three percentage points(five points for manufacturing) while Japan's share remains tiny. The only noticeable difference between the assets and investment shares and the other measures is that in manufacturing the UK has the highest portion of FOF involvement rather than France.

Table 4. Share of FOFs in Assets and Investment (percent of national total)

	1977	1986 or latest year
Assets		
Germany	17	17
UK:total		14
US:total	5	9
Japan	2	1
UK:manufacturing		20
US:manufacturing	4	9
Japan:manufacturing	5	2
Investment		
UK:total		13
US:total	4	8
UK:manufacturing	21	22
France:manufacturing & oil	19	19
US:manufacturing	3	7

Sources and notes:see Appendix I.

Trade

In all of the G-5 countries, the importance of FOFs is greatest in the trade figures. In European countries and the US alike, FOFs account for at least a quarter of total exports. In France it is nearly a third. However only 2% of Japan's exports are from FOFs located there, in striking contrast to the 15% of Japan's imports that are purchased by FOFs. It is abundantly clear that the subsidiaries that MNEs have set up in Japan are there to serve the domestic market rather than being fully integrated into a global production and sales strategy.

It may appear from the US and Japanese data in Table 5 that FOFs

Table 5. FOF Shares in Trade (percent of total merchandise trade)

	1977	1986 or latest year
Exports		
France	28 (1980)	32
UK	30	
Germany		25
US	21	23
Japan	5	2
Imports		
US	29	34
Japan	20	15

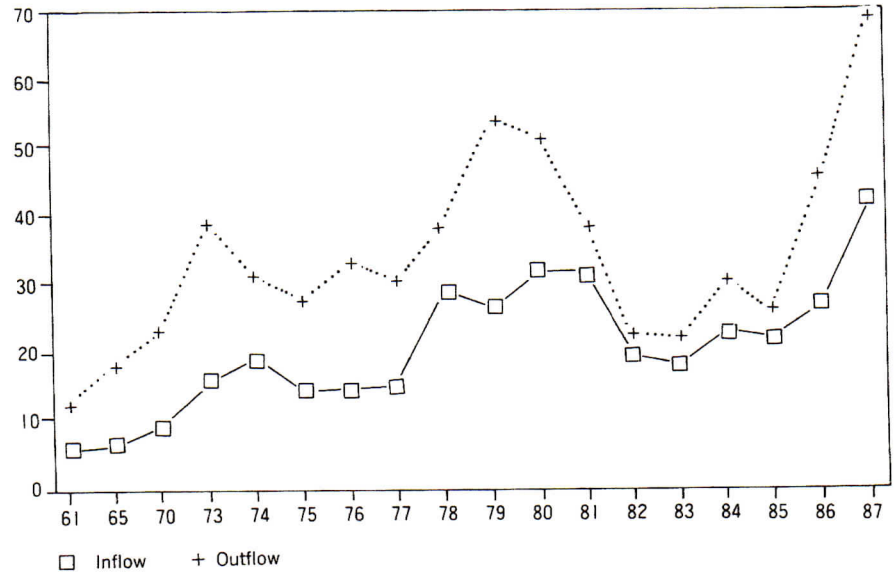
worsen the trade balance since they account for a greater share of imports than exports. However, the aggregate figure is heavily influenced by investment in distribution networks in the host country. Excluding distribution from the US, the US trade deficit drops from $74 billion to $15 billion, or one tenth of the total merchandise trade deficit in 1986. In section IV we look more closely at the links between trade and FOFs in the US and Japan, where data are available.

The country situations

This section explores the role of FOFs and inward FDI in each of the G-5 countries, building on earlier work on outward FDI by the same countries.[7] At an aggregate level, outflows and inflows for the G-5 countries are closely related. Just as with trade, FDI flows circulate mainly among the G-5. Inflows into the G-5 countries since 1961 have equaled over one half of total G-5 outflows over the same period. In the 1980s, the ratio of average inflows to outflows has been 75%. Figure 1 illustrates this link between inflows and outflows.

Not only are the G-5 prominent in both outflows and inflows of FDI, but a relatively large portion of these flows circulates among the G-5 economies themselves. With few exceptions, the five countries are the largest investors in each others' economies. Within this network,

Figure 1. Aggregate Outflows/Inflows of FDI by the G-5
(billions of US dollars)



however, there has been a major reversal in the direction of flows since the 1960s. Between 1960 and 1975, only the US exported a significant amount of FDI on a net basis(outflows - inflows), reaching 79% of G-5 outflows in 1966. Britain and Japan were also net exporters but in amounts which paled in comparison with the US. France and Germany were net importers of direct investment capital.

Starting with the dramatic jump in commodity prices in 1973, all G-5 countries except France became net exporters of FDI as the need to acquire raw materials in developing countries led to greater MNE investments abroad. In addition, the advent of floating exchange rates in 1973 may have induced manufacturing companies to produce more in local markets to minimise exchange rate risk.

In 1981, a reversal occurred in net flows. The US for the first time in decades experienced a net inflow of FDI and has received net inflows every year since. These net inflows have persisted in spite of the fact that the US has also been the largest exporter of FDI of any G-5 country for each of the last three years. At the same time as the US became a net recipient of FDI, France reversed its previous position as an importer of FDI and has sent out net outflows of FDI in six of the last seven years. In the last three years, Japan has become the most prolific net investor, followed by the UK and Germany. Japan's rapid rise to this prominent position is a combination of massive outflows and negligible inflows. For this reason, there have been and, will continue to be, calls for investment reciprocity with Japan just as there have been in the sphere of trade.

Because of the strong link between inflows and outflows, it is useful to summarize the results of the previous study on outflows as a point of departure before looking at inflows. Tables 6 and 7 are updated versions of data collected in the earlier study. Table 6 depicts the geographic distribution of FDI flows. Among the most interesting conclusions are the importance of Europe to US firms(almost one half of US FDI is in Europe) and the keen interest of other G-5 members in investing in the US market(on average, one third of each country's FDI is in US). In contrast, investments in Japan represent a very small part of total FDI by the other economies, between 1% and 4%. Among the European countries, Germany and France have invested much more within Europe relative to the rest of the world than has the UK. Only one fourth of UK FDI is in Europe, while the comparable figures for Germany and France are, respectively, 48% and 38%.

Table 7 summarizes the sectoral distribution of FDI. Manufacturing is still the most important sector for outward FDI for all countries except the UK(whose oil companies bulk exceptionally large). In the 1970s, much of the overseas investment by US, UK and French firms was by oil companies. In the 1980s, services

Table 6. Geographic Distribution of Outward FDI (percent of total stock) [a]

Home Country	Host Country			
	US	Europe	Japan	Other
United States	—	46	4	50
United Kingdom	35	25	1	39
Japan	33	14	—	53
Germany	28	48	2	22
France	38	38	1	23

Note:a. US:position, 1987.
UK:position, 1984.
Japan:cumulative outflows, FY1951—86.
Germany:position, 1986.
France:cumulative outflows, 1976—86.

Table 7. Distribution of Outward FDI by Sector [a] (percent of total stock)

	Manufacturing	Oil & mining	Finance & insurance	Real estate	Other
United States	39	24	23	0	14
United Kingdom	25	29	14	4	28
Japan	27	12	17	6	38
Germany [b]	44	3	15	5	33
France	33	23	20	2	22

Note:a. US:position, 1986(excludes the Netherlands Antilles).
UK:position, 1984.
Japan:cumulative outflows, FY1951—86.
Germany:position, 1986.
France:cumulative outflows, 1972—86.

b. The German data are by industry of affiliate. If one were to look at the industry of the German parent then manufacturing accounts for 61% of outward German FDI. The difference results from the fact that German manufacturing firms sometimes invest overseas to distribute their goods, without producing in the host country. In this case the investment would be considered as retail trade if one were to look at the industry of the affiliate.

have led the resurgence in FDI. It was argued that the increased service sector FDI is a natural reflection of the growing importance of services in domestic economies, stimulated by the spreading deregulation of services such as banking and telecommunications.

With these trends in mind, it is easier to discuss the somewhat impressionistic statistics that are provided by each country and to discern the effects of the tide of FDI flows on the domestic economies of the five countries. Using aggregate data limits the amount that can be said about how FOFs affect the competitiveness of domestic firms in the host country. For that question, industry studies are most appropriate.[8] Nevertheless, where the aggregate data do bring out divergences between FOFs and national firms, they are pointed out.

United States[9]

The US has been the world's largest overseas direct investor for decades, accounting for as much as two thirds of total G-5 outward FDI in 1966. However, until recently it has not attracted much inward investment—especially in relation to the size of its market — despite a relatively open policy stance toward foreign investors. For example, in 1977 the stock of foreign owned investment in the US was smaller than in Canada, and only slightly larger than in the UK or Germany.

The 1980s saw a major surge of FDI flows into the US, during years of dollar strength and dollar weakness alike. By 1985, the stock of foreign owned investment in the US was over twice as large as in Canada, and three to four times as large as in the UK or Germany. Table 8 shows FDI inflows to the US in nominal and real terms. Average real inflows in the 1980s have been 2.5 times larger than those of the late 1970s. This has naturally produced a change in the net position of US FDI. Whereas in 1980 the stock of US FDI overseas was over three times as large as foreign FDI in the US, by 1987 it was only 18% larger.[10]

Table 8. FDI Inflows into the US ($ millions)

	nominal	1980 prices
1970	1,464	2,988
1975	2,603	3,762
1976	4,347	5,906
1977	3,728	4,749
1978	7,897	9,368
1979	11,877	12,952
1980	16,918	16,918
1981	25,195	22,988
1982	13,792	11,818
1983	11,946	9,856
1984	25,359	20,142
1985	19,022	14,576
1986	34,091	25,613
1987	41,977	30,618

Source: US Commerce Department; author's calculations.

This surge of inward investment has aroused public concern, much as US investment did in Europe in the 1960s. A recent bestseller illustrates the extreme nature of some of the criticism:

> "There is little recognition that some of these foreign businessmen have hidden

> agendas, including the destruction of American competitors and the acquisition of American technology. Many of these foreign investors have been motivated by a desire to avoid protective tariffs and view foreign investment as part of their nation's export strategy, to increase their market share."[11]

Fortunately, the only concrete manifestation of such views so far has been the Bryant amendment to the original US trade bill. It called for stiffer reporting requirements on foreign firms in the US. Objections to that amendment were based on the potential disclosure of commercially sensitive information — an ironic byproduct of the "open files" policy of the US government which already publishes more complete information on the domestic operations of FOFs than any other country of our sample.

The countries most responsible for the flood of FDI into the US in the 1980s are Japan and the UK. The value of their FDI in the US has grown *each year* 30% and 34% respectively since 1980, rising from 6% to 13% of the stock of FDI in the US for Japan and from 18% to 28% for the UK. In contrast, the importance of Canadian MNEs in the US has dwindled from 15% of inward US FDI in 1977 to 8% in 1987, although in absolute terms, Canadian FDI in the US has grown by $12 billion($6 billion in 1980 prices). As can be seen from Table 9, the other major countries have maintained a fairly constant part of the total.

Although the country ranking is similar on most of the measures in Table 9, it is significant that Japan has the highest proportion of FOF sales and the lowest proportion of FOF employment. This is an indication of the early stage of Japanese investment in the US, much of which has gone into sales networks to market imported Japanese products. Such networks typically have high sales/assets ratios. By any measure, the top seven countries represent between 71% and 84% of total FOF activity in the US.[12] UK and Japanese firms represented 55% of total outlays in 1987 and UK firms were responsible for four of the six acquisitions of over $1 billion in 1987. Roughly one half of the $10.7 billion in Japanese outlays in 1987-87 has been in real estate while British firms have shown a strong preference for the manufacturing sector.

By sector of investment, the change over the last decade has not been great. Services remain the largest sector, accounting for 52% of the stock of inward FDI by the end of 1987, though by industry of the parent MNE, the share of services is probably less significant because of FDI in distribution networks in the US by foreign MNEs. The share represented by petroleum has fallen from 19% to 14% while manufacturing has dropped from 40% to 35% in spite of a $19 billion increase in 1987 alone. Only real estate has risen

Table 9. FOFs in the US, by Country of Investor (percentage of all nonbank FOFs)

	FDI	outlays[a]	assets	sales	employment
UK	29	28	16	17	21
Canada	8	14	16	12	20
Japan	13	10	12	25	7
Netherlands	18	5	8	7	9
Germany	7	7	6	9	10
Switzerland	5	5	10	5	6
France	4	5	4	6	7

Note: 1. FDI: position in 1987, including banks.
Outlays: investment outlays, 1981—1987.
Assets, sales, employment: 1986.
2. a. Investment outlays include all US business enterprises in which foreigners acquired at least a 10% minimum stake and all new US businesses established by foreign investors or their US affiliates. This differs from FDI data in that it includes acquisitions of US enterprises that are made by the affiliate independently of the parent, but excludes acquisitions of additional equity or voting interests in existing US affiliates. In this respect the outlay data resemble most closely Japanese FDI data. Outlay and FDI statistics are to some extent complementary. Total recorded investments should therefore be greater than either number but less than the sum of the two.

Source: US Commerce Department.

significantly from 2% of the total in 1977 to 9% in 1987. Two sectors with above average increases in FOF activity have been motor vehicles and equipment, where the FDI position has doubled since over the last five years, and business services, where the FDI position has tripled.

Given the rapid growth in FDI into the US, it is not surprising that FOFs are playing an increasingly important role in the US economy. The FOF share of manufacturing sales doubled between 1977 and 1986, from 5% to 9.9%, while the share of total assets owned by FOFs grew from 6.3% to 12.1%. Those industries with the greatest foreign participation include chemicals and allied products, stone, clay and glass products, and primary metals. The least penetrated industries are textiles, rubber and plastic products, and transportation equipment. As can be expected after the recent investment by Japanese automobile companies in the US, the shares of FOFs in total assets and sales in that sector has grown 5 and 17 times respectively since 1977, but from a small base. By 1987 FOFs still controlled less than 5% of assets in the motor vehicle industry.

The US data on FOF are sufficiently rich to provide a glimpse of the discrepancies that arise by considering international direct investment only as a cross-border(i.e. balance of payments) flow. Three out of every four dollars used to purchase US firms over the last two years were supplied by FOFs in the

US rather than by the foreign MNE directly. Since the local borrowings of FOFs are not part of FDI(because they do not cross borders), it is likely that FDI data capture only about one-third of the value of new acquisitions and establishments by FOFs in the US. The fact that so much FDI is done through affiliates rather than through the foreign MNE lends support to the idea slowly creeping into economic theory that FDI is not so much an international movement of capital as it is a change of ownership between a foreign and a domestic firm.[13] In the US, foreign acquisitions of an existing firm are 20% more numerous than greenfield investments; and in dollar terms, acquisitions are five times larger than establishments.

United Kingdom[14]

The UK has had an important network of foreign investments since the days of the British empire, but it has also expanded its overseas investment strongly during the 1980s. Annual outflows are second in size to those of the US, and have averaged 10% larger than Japan's during the 1980s. As a percentage of GNP, UK outflows are the highest of any G-5 country. Investment income from FDI is about 10% as large as total UK merchandise exports.

In terms of inward FDI, the UK also figures prominently as the second most favored location for FDI after the US. Table 10 records inflows into the UK. The pattern follows that of the US, with a peak in real inflows in 1980 followed by a trough in 1983. In the second half of the 1970s, real inflows averaged £1.7 billion compared with £2.7 billion in the 1980s.

Table 10. FDI Inflows into the UK (£ millions)

	nominal	1980 prices
1970	363	1,339
1975	1,518	1,223
1976	1,653	1,387
1977	2,546	2,021
1978	1,962	1,730
1979	3,030	2,084
1980	4,355	4,355
1981	2,932	2,630
1982	3,027	2,520
1983	3,386	2,683
1984	−181	−138
1985	4,213	2,999
1986	4,225	2,885
1987	5,715	3,733

Source: Department of Trade and Industry; author's calculations.

US and Japanese firms prefer the UK over Any other EC country for both manufacturing and service investment, although the UK may rank second after Luxembourg in banking and financial services. For US MNEs, 35% of their FDI and 31% of the employment they create in the EC is in the UK while for Japan the comparable figures are 34% of all FDI and 23% of manufacturing employment. since 1980, according to JETRO, Japanese manufacturers have set up more operations in the UK than in any other EC country. US firms have done the same: their nonbank assets in the UK increased from 27% of the US total in Europe in 1977 to 35% in 1982. At the same time, employment by US firms in the UK has fallen as

a percentage of the total for US firms in Europe from 39% in 1966 to 31% in 1985. This indicates that US firms' investment in other European countries, although growing slower than that in the UK, has been in more labour-intensive industries. it is difficult to predict whether the 1992 drive to unify the European market will stimulate US and Japanese firms to diversify their European presence away from the UK, or whether they will instead concentrate their European strategy on using existing UK sites to serve the more integrated European market. Presumably much will depend on the position Brussels takes with respect to acquisitions and investment by non-EC firms.

The growth of inward investment in the UK during the 1980s has been accompanied by a considerable revival of domestic industry. Thus it is interesting to note that FOFs in manufacturing are slightly less important now than they were in 1977(accounting for 20% of total sales, compared to 22% then). Their share of total employment has also fallen marginally from 15% to 14%. It may be that, with relatively open policies toward FDI, foreign ownership in the UK economy has reached something of an equilibrium at the macroeconomic level, in contrast to the US case where it is still much lower an growing rapidly.

The shifts by sector in FOF employment in the UK have paralleled those of the overall economy. For example, between 1977 and 1985, manufacturing employment fell by 30% for all UK industries, while FOF manufacturing employment fell by 33%. Over the same period, US data show an 11% increase in employment in US-owned service firms in the UK, while total UK employment in services grew by 12%.

Japanese investment in Britain has received much media attention, both positive and negative.[15] British jobs in Japanese-owned manufacturing firms grew almost six times in the eight years to 1985. Nevertheless, the absolute increase was only 5,200 jobs which meant that the 6,300 Britons in Japanese-owned manufacturing firms in 1985 still represented less than one percent of total employment by manufacturing FOFs in the UK. By the latest JETRO estimate, the employment figure has now increased to over 14,000.Even if Japanese manufacturing firms continue to increase their employment of British workers at the 31% annual rate registered in the British data from 1983 to 1985, it will still take 17 years before Japanese firms employ as many British manufacturing workers as are currently employed by US firms in the UK. In the short term, Professor Dunning of the University of Reading estimates that, based on a survey of Japanese firms in the UK, Japanese firms will employ 22,000 in the UK by the end of the 1980s with over £1 billion in sales(at current prices).[16]

It is possible to make certain cautious generalisations about the competitiveness of FOFs in the UK based on cross-industry averages.

Workers employed by FOFs appear to be more productive and to receive a higher compensation than their counterparts in domestic industries. Foreign MNEs employed 13% of the operatives in UK manufacturing but paid wages and salaries to those workers worth 16% of the total of all UK firms in 1985. Similarly, FOFs hired 16% of all other manufacturing employees but paid 19% of total compensation received by all workers in that category.

In terms of the gross value added per employee, FOFs were on average more productive than UK enterprises. The Italian - owned manufacturing firms were the most productive at £ 35,312 per employee or 2.3 times the national average and 1.7 times the average of all FOFs in the UK. Italian-owned firms were followed by firms from Denmark, Australia, and the US while Japan lagged far behind, being only slightly more than two thirds as productive as other FOFs and less productive than all manufacturing firms in the UK.[17]

Japan[18]

Japanese firms have been investing overseas at a record pace in the 1980s. This has been driven partly by the threat of protectionism in major export markets, partly by yen appreciation, and partly by an official MITI-supported strategy to "internationalize" Japanese business and recycle part of the current account surplus into long-term investment. Japan could become the world's largest overseas investor by the year 2000.

The increase in capital outflows has brought calls for greater reciprocity for FOFs in Japan. In the past, FDI in Japan was only welcomed if it provided greater access to either raw materials or to foreign technology. Faced with foreign pressure, the Japanese Ministry of International Trade and Industry(MITI) created in 1984 the Office for the Promotion of Foreign Investment in Japan. Such efforts on the part of the Japanese government, along with privatisation and financial liberalisation within Japan, will doubtless bear fruit in the form of increased FDI in Japan in the future. Nevertheless, it starts from an extremely low base and it will be difficult to change corporate attitudes toward less-than-friendly takeovers.

The FDI data in Table 11 confirm that foreign firms are increasing

Table 11. FDI Inflows into Japan (millions of yen)

	nominal	1980 prices
1970	33,652	70,108
1975	67,075	85,228
1976	33,510	39,751
1977	5,639	6,321
1978	1,684	1,801
1979	52,374	54,387
1980	63,034	63,034
1981	41,682	40,390
1982	109,346	104,040
1983	98,804	93,299
1984	−2,375	−2,216
1985	153,143	140,627
1986	38,086	34,250
1987	168,506	152,218

Source: Bank of Japan; author's calculations.

their investments in Japan. Average real inflows in the 1980s of 78 billion yen were 40% greater than the average during the 1970s of 56 billion yen. The 1980s have seen a 160% increase in the stock of inward FDI in Japan. But compared to the other G-5 countries, foreign investment in Japan is still negligible. Although the Japanese economy is roughly half as large as the US economy, the stock of inward FDI in the US is between roughly 40 and 60 times as large as inward FDI in Japan depending on which Japanese data are used.

Other measures of FOF participation reveal the same low share of foreign firms in Japan. Indeed, although FDI inflows have been increasing, the role of FOFs in Japan has actually fallen. Sales by FOFs in Japan as a percentage of total domestic sales fell from a peak of 2.2% in 1980 to only 1.4% in 1984. Similarly, the asset and employment percentages for FOFs were halved to 1.1% and 0.4% respectively from their peaks in the late 1970s. The same results hold if one looks only at manufacturing FOFs though the percentages are higher, twice as high in the case of employment.

By industry, most FOF participation is still in the energy- and resource-intensive sectors: oil, rubber, chemicals and nonferrous metals. In the oil and coal industries, over one third of total sales in Japan are by FOFs.

By country, the US dominates inward investments in Japan, just as it does in all other G-5 countries. Although only 4% of US outward FDI goes to Japan, US companies in Japan represent almost one half of the cumulative inward investment in that country. Almost two thirds of the US investment is in manufacturing, with another 23% in the distributive trade. European investment in Japan is fairly evenly divided between the two sectors.

Garmany[19]

Germany, like Japan, has had to rebuild its stock of outward FDI since the second world war. It now stands in third place after the US and the UK in terms of its stock of outward FDI(its average outflows are fourth largest after Japan). Much of this investment has been within the EC although the US and Brazil rank first and third, respectively, as locations for German FDI.

In contrast to the other four countries of our sample, inward FDI in Germany has been lower in the 1980s, in real terms, than in the latter half of the 1970s(see Table 12).[20] This is probably a reflection of the structural and labour market rigidities which still persist in Germany, as well as the relatively high growth rates in recent years of alternative investment locations in Europe, notably Italy, the UK and Spain. However, it should also be noted that FOFs already have a significant presence in the German economy, accounting for 19% of gross sales, 17% of total assets and 13% of manufacturing employment.

By country of investor, the Ger-

Table 12. FDI Inflows into Germany (DM millions)

	nominal	1980 prices
1970	2,176	3,651
1975	1,690	2,066
1976	3,378	3,983
1977	2,249	2,556
1978	3,270	3,566
1979	3,194	3,348
1980	771	771
1981	770	740
1982	2,001	1,843
1983	4,584	4,089
1984	2,105	1,842
1985	2,145	1,836
1986	2,221	1,845
1987	3,456	2,812

Source: Bundesbank.

man pattern is similar to that of the UK. The FDI position has increased most rapidly for Japan, growing 330% between 1976 and 1986. In absolute terms, however, Japan still ranks only fifth, well behind the 37% share of total inward FDI coming from the US. US FDI still exceeds investment by all EC countries in Germany though the gap is narrowing.

By industry, the investment position has risen most rapidly in services. In wholesale and retail trade, finance and insurance primary FDI[21] has roughly doubled since 1976 while in other services it has tripled. In mining and manufacturing, the stock of primary FDI has fallen since 1976 in many industries such as mining, iron and steel, machinery, and transportation equipment. These declines have been partly offset by increases in secondary FDI in almost all sectors. Nevertheless, in real terms the data show that inward FDI in both mining and manufacturing have probably declined over the last decade. This is corroborated by the data on assets and sales of these enterprises.

In terms of assets and turnover, the financial sector has recorded the greatest increases, but in manufacturing foreign MNEs have expanded their assets and sales by 32% and 56% respectively, predominantly in office machinery and data processing equipment. As shown in Table 13, against the background of overall growth in German manufacturing, foreign penetration in the German manufacturing sector has fallen slightly as a percent of total assets and risen as a percent of sales. Foreign penetration has declined most impressively in iron and steel production and in road vehicle manufacturing by either measure. Thus although foreign assets in the road vehicle industry have grown 66% since 1976, they have not kept pace with the growth of the domestic industry. In mineral oil processing, FOFs now control almost the whole industry, reaching 97% of total sales by the end of 1985. In construction the foreign share has been halved over the last decade while in the distributive trades, the foreign share has increased.

France[22]

Of all the members of the G-5, France is both the least active overseas investor and the country with the largest involvement of foreign firms in its domestic economy. Out-

Table 13. Foreign Participation in German Industry (as a percent of each industry total)

	Assets		Sales	
	1976	1985	1976	1985
Manufacturing	22	20	22	22
Chemicals	26	26	28	30
Mineral oil processing	89	97	87	91
Iron and steel production	31	22	27	17
Mechanical engineering	17	15	19	17
Road vehicle manufacture	26	17	26	19
Electrical engineering, office machinery and data processing equipment	26	25	25	27
Construction	2	1	3	1
Distributive trades	12	14	13	17

Source: Bundesbank.

flows, though increasing, are still far lower than those of the other four countries. Much of French FDI in the 1970s was in the oil sector in order to secure strategic supplies for the home market. In the 1980s, there has been a more even distribution of outflows across sectors. Three fourths of French FDI is now divided evenly between the US and Europe.

While French MNEs have been reluctant to expand overseas, foreign firms have been very active in France. Table 14 shows all inflows excluding FDI by banks. The high shares of FOFs in France shown in Table 1 have materialized despite a level of inward FDI that is less than half the UK or German level and ahead of only Japan within the G-5. In part this may reflect deficiencies in the French statistics on FDI, which do not include retained earnings; but it may also be that in those industries for which FDI is important(petroleum, chemicals, automobiles, etc.), French firms are in a weak position vis a vis MNEs from the other G-5 countries. Within the G-5, the oil industry is dominated by US and UK MNEs. In the chemical sector, firms are

Table 14. FDI Inflows into France
(millions of French francs)

	nominal	1980 prices
1970	3,461	8,567
1975	6,247	10,141
1976	5,022	7,429
1977	8,670	11,716
1978	11,031	13,535
1979	11,579	12,894
1980	14,061	14,061
1981	13,184	11,835
1982	10,275	8,260
1983	12,433	9,102
1984	19,212	13,096
1985	19,858	12,795
1986	19,039	11,702
1987	26,255	15,683

Source: Banque de France; author's calculations.

predominantly US and German, and for automobiles the largest MNEs are US, Japanese, and German.

The French economy is more closely linked with the rest of the EC than is that of the UK. Whereas roughly two thirds of all FOFs in the UK are American, the comparable figure for France is only one third. These ties with the EC help to explain why France, although not the preferred European location for investment by either US or Japanese firms, still has the highest penetration ratios in its industrial sector of any G-5 country.

The US is the largest single investor in French manufacturing, while Germany, the UK and Switzerland compete for second place depending upon which statistic is chosen. Japanese firms employed less than one percent of all industrial workers in France in 1985. Table 15 shows the importance of each of the major countries by various measures, and how it has changed over the period 1972-85. It is striking how stable the pattern has been. In fact, the overall share of FOFs in the French economy has not changed much since 1972 when the ratios were 18% of employment, 26% of sales and 24% of investment. The only significant trend shown in Table 15 is a decline in the share of employment represented by US MNEs and a concomitant increase in the share of German firms.

The industries with the highest degree of foreign participation are capital intensive and technologically sophisticated; including office machinery, chemicals and pharmaceuticals. In the computer and data processing sector, fully 69% of the sales and 84% of the exports were by FOFs in 1985. The industries with the lowest foreign participation were the traditional consumer goods

Table 15. FOFs in France, by Country of Investor (percent)

	FDI	Employment			Sales		
		1972	1980	1985	1972	1980	1985
EC	52	44	46	43	45	51	43
Belg.—Lux.	6	10	9	7	9	9	7
Germany	14	9	16	17	7	11	16
UK	16	8	11	9	8	13	8
USA	22	37	33	32	42	36	38
Switzerland	15	na	12	13	na	7	9
Japan	3	—	—	1	—	—	1

Note: FDI: Inflows 1981—1985(excluding banking).
Employment, sales: Industrial only.
Source: Banque de France; Ministere de l'Industrie et de la Recherche.

industries such as leather, clothing, furniture and wood manufacturing, and in those industries that are either monopolies or are provided government shelter such as aeronautics and, to a lesser extent, automobiles.

The role of FOFs in trade[23]

The original economic theories of international trade were developed on the assumption of factor immobility; i.e. that land, labour, capital and entrepreneurship stayed within national boundaries while the outputs they combined to produce were traded across borders for mutual gain. In such a world, trade statistics had a well-defined meaning and were a good measure of economic interdependence among countries. Such a paradigm no longer provides an adequate conceptual framework. Movements of capital and entrepreneurship—in the form of FDI and the production, sales and trade by foreign-owned firms from their host countries—have created a more complex web of international linkages and, at the same time, have undermined the traditional interpretation of trade figures and external imbalances.

In this section we use the data on FOFs' activities in their host countries to disaggregate trade flows into two components: FDI-related trade and exogenous trade. After exploring the concept of FDI-related trade and measuring its significance for the US and Japan(where data are available), we discuss the relationship between local sales by FOFs and exports from the home country—the two ways to reach a foreign market.

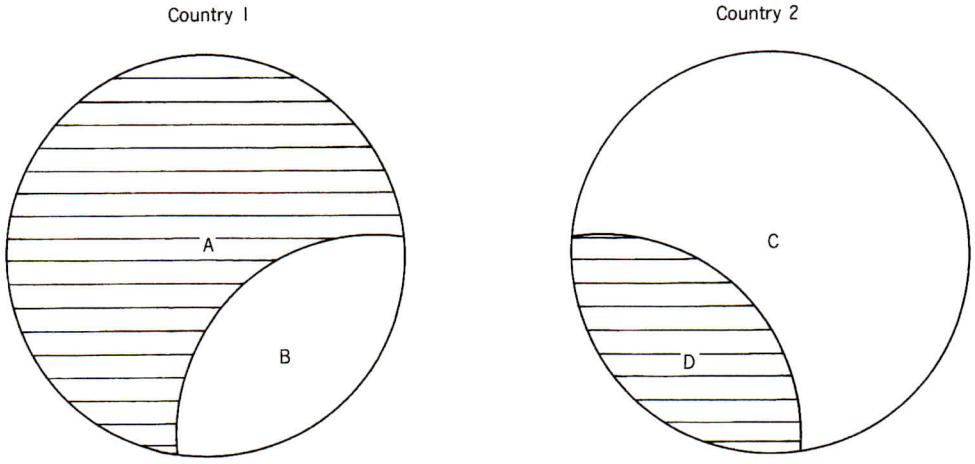
FDI-related trade

As noted in Section 2, foreign-owned firms are particularly important in their share of host country imports and exports. From a trade perspective it is useful to distinguish between those flows which are between unrelated parties ("exogenous") and those which are between FOFs and their home countries, which we call FDI-related trade.[24] It can best be explained in terms of a two-country world as illustrated in Figure 2.

Country 1 and Country 2 each contain purely domestic firms, represented by areas A and C, and foreign-owned firms, represented by areas B and D. The firms in B belong to parent firms in C, while A owns D. we define AB to mean sales by A to B. Thus FDI-related trade consists of(AD+DA)+(BC+CB)+(BD+DB).

The extent to which a country's trade is FDI- related will depend on the size and propensity to trade of its own MNEs abroad and of FOFs in its economy. For only two countries in our sample, the US and Japan, do sufficient data exist to provide an estimate of the share of

Figure 2. Two-country world with intra-firm trade



Key : A = Unaffiliated firms and consumers in Country 1
B = Foreign-owned firms in Country 1
C = Unaffiliated firms and consumers in Country 2
D = Foreign-owned firms in Country 2

total trade represented by FDI-related trade. The results from these countries are provided in Table 16, using the notation from Figure 2 where the US and Japan are each Country 1 in turn, and where Country 2 represents the rest of the world.

Total FDI-related trade represents 53% of US merchandise trade and 48% of Japanese trade respectively. Within those totals, however, there are wide variations in how trade is conducted by US and Japanese MNEs and by FOFs in those two countries. In the US, FOFs are responsible for one fourth of US exports and one third of US imports. In Japan, FOFs play a much smaller role as a conduit for Japanese trade, but are nevertheless much more important in terms of Japanese imports than they are for Japanese exports. Conversely, Japanese MNEs send both more exports to, and receive more imports from, their affiliates abroad than do US MNEs as a percentage of total exports and imports.

Such a measures are sensitive to the scope of FOF activities in each country and to the importance of the affiliate network for each country's MNEs. They give little indication of the propensity of FOFs or affiliates to trade. A better measure would be to compare exports and imports as a percentage of total FOF sales.[25] While FOFs in Japan and in the US export 8% and 7% of their total sales respectively, FOFs in Japan import an amount equal to 39% of their local sales, compared with only 20% for FOFs in the US. Thus, while Japan has been accused of setting up tariff-jumping assembly plants abroad, Japanese firms in the US import only marginally more as a

Table 16. FDI-related Trade[a] (percent of total merchandise exports or imports)

	US	Japan
Exports:		
to affiliates abroad (AD + BD)[b]	32	38
by FOFs (BC + BD)	23	3
Total FDI-related exports	55	41
Imports:		
from affiliates abroad (DA + DB)	18	40
to FOFs (CB + DB)	34	17
Total FDI-related imports	52	57

Note: a. US figures are for 1986 and Japanese data for 1983.
b. Both BD and DB are likely to be close to zero. Such trade would result from, for example, an IBM subsidiary in Japan buying from a Hitachi subsidiary producing in the US. To the extent that such trade exists, it will result in double counting when the two components of FDI-related exports (or imports) are added.
Source: MITI, US Commerce Department; authors' calculations.

percent of local sales than do US firms in Japan, 45% against 40% respectively.

A window on the importance of FDI-related trade for other countries can be gleaned from the US data. Table 17 shows the percentages of US imports that are from US-owned companies in each of the countries or regions listed.

If one removes imports from US MNEs in Canada from the total of US merchandise imports from Canada, the $13 billion US trade deficit with Canada in 1986 turns into a $17 billion trade surplus. This does not imply that outward FDI by US MNEs leads to a deterioration of the US trade balance. While US companies imported $30 billion from their Canadian affiliates in 1986, they also exported $32 billion worth of goods to those same affiliates. The high 43% share of Canadian imports to the US represented by US-owned firms stems in part from the

Table 17. US Imports from US-owned firms abroad, 1986 (as a percentage of total US imports from each region)

Canada	43%
Japan	9
Europe	11
Australia, New Zealand and South Africa	14
Latin America	19
Other Africa (incl. Middle East)	22
Other Asia and Pacific	12

Source: US Commerce Department.

US-Canadian Automotive Agreement which allows US automobile companies to produce on both sides of the border. This percentage is likely to increase further when the US-Canada free trade agreement is implemented.

In most other regions or countries, exports by US-owned firms back to the US are a smaller share of total US imports than that found for Canada. However, for some developing countries the share is even higher. To take two of the most extreme examples, 59% of US imports from Singapore and 58% from Malaysia are from US affiliates in those countries, producing mostly electronic equipment.[26] In addition, five of Taiwan's leading electronics exporters are US-owned firms.[27] In countries such as these with skilled workforces and low wages relative to industrial countries, one would naturally expect high levels of vertically integrated FDI by foreign MNEs, particularly in industries with high value added and low transportation costs. What is surprising is the degree to which exports by those countries to industrial markets are dominated by FDI-related trade.

The impact of global sourcing policies on US trade and measures of competitiveness is illustrated in a recent study by Lipsey and Kravis.[28] They found that while the US share in world exports fell from 17.5% in 1966 to 14% in 1984, the share of world exports represented by US MNEs(US parents and their majority-owned affiliates abroad) rose from 17.7% in 1966 to 18.1% in 1984. This illustrates the importance of foreign production bases. An even broader measure of competitiveness is to look at the wordlwide sales of firms classified by headquarters location. This is explored below.

Local production rather than exporting

Referring again to Figure 2, it is possible to define the two ways in which Country 1's firms sell to the firms and consumers of Country 2. The first is exogenous exports, represented by AC, and, to the extent that it is different from zero, DB. The second is local sales by FOFs from Country 1 located in Country 2, represented by DC. The benefits to MNEs from this second route are partly political and partly financial.

On the political side, foreign production allows an MNE to enjoy the status of a local company in each of its principal markets. This has the advantage of removing the threat of trade restrictions. The Japanese have openly claimed that the threat of US trade restrictions against Japanese exports has been one of the most important catalysts for their manufacturing FDI in the US.

Such a form of corporate strategy has its limitations. Few FOFs achieve fully comparable political status to that of local companies. Witness the British Government's rejection of Ford's recent attempt to acquire British Leyland even though Ford has been in the UK since 1913. In addition, FOFs run the risk of being accused

of "screwdriver operations" designed to avoid tariffs by importing components for final assembly in the host country. Even when local content ratios satisfy local or regional requirements, there is no guarantee that exports by that FOF will be allowed into other markets in the region. The current row over Nissan's exports to France from its UK plant is an example of the shortcomings of this strategy.

On the economic side, local production has become a viable alternative to exporting for a number of reasons. First, labour costs have diminished as a share of total costs to the point where MNE investments in foreign production facilities need no longer be confined to the lowest cost producer in a country or region.[29] Another important determinant of investment location, productivity, may also be less important in the investment decision because of the recent success of Japanese firms in recreating Japanese productivity levels in American and European factories.[30] The declining relevance of wage costs along with the greater transferability of worker productivity levels has meant that MNEs now have greater flexibility when deciding where to invest. Exchange rate considerations also operate in favor of local production over exports. During the 1980s the wide swings in bilateral exchange rates have been far more significant than differential labor costs in international competitive positioning.

Table 18 shows the dominant importance of local sales by FOFs compared to exports(including both exogenous and FDI-related) for the

Table 18. Local Sales versus Trade (billions of US dollars, 1985)

Local sales of goods by US-owned FOFs in the country	Country	US merchandise exports to the country
76,922	Canada	45,333
48,079	Germany	10,561
21,589	Italy	4,838
8,889	Spain	2,615
7,848	Netherlands	11,600
66,320	UK	11,418
2,977	Switzerland	5,233
25,846	Japan	26,882
17,963	Australia	5,551
19,112	Brazil	3,885
5,916	Mexico	12,392

US and its main trading partners.[31] In all cases except Mexico and Japan, local sales by US firms abroad are larger than US exports to those regions.[32] Similarly, local sales by FOFs in the US are equal to US imports for Canada and, at the other extreme, are eight times as large for the grouping Australia, New Zealand, and South Africa. In fact, for a sample of 12 of the richest OECD countries, only Italy exported more to the US than its firms sold locally in the US in 1985.

The implications for trade policy of this shift in the way that sales are made into foreign markets may be very important. Consider an extreme, though not impossible, example. A US MNE may decide, because of a strong dollar or low US productivity, to supply the US market from a production base in Taiwan. At the same time, a foreign MNE may decide to invest in the US to supply the US market through local production, perhaps because of anticipated protectionist legislation in the US against that country's exports. If the US Congress then enacts legislation to penalize imports from Taiwan, it would actually be helping the foreign firm producing in the US at the expense of the US MNE. Tax benefits or subsidies granted to firms in the US would have a similar net effect on competitiveness in this industry. It is perhaps for such reasons that US MNEs played such an active role in lobbying against the most protectionist clauses in the 1988 Omnibus Trade Bill.

SUMMARY, PROSPECTS AND POLICY ISSUES

The first wave of FDI in the postwar period was by American firms, primarily into Europe in the 1960s. In the 1970s FDI mostly reflected the ownership pattern of the major international oil companies, with US firms still dominant. In the 1980s British and Japanese firms expanded strongly overseas, mostly into the United States. German and French firms have been less active but more diversified in their targets, moving both into the US and into other European countries.

The impact of FDI is slower to be felt than trade flows, but also longer lasting. Thus, the levels of participation by FOFs in the domestic economies of the G-5 has followed the FDI waves with a lag. In the European countries it reached the 15-20% range(as a proportion of domestic sales and investment) in the mid-1970s and has remained there. In the US on most measures of FOF involvement, the ratios have doubled to about 10% during the 1980s. With continued strong inward investment, this can be expected to grow to around 15% before leveling off in the latter years of the 1990s. Inward investment has yet to take

Table 19. Inward FDI in the G-5
(billion US $, annual average)

	1985–87
United States	28.2
United Kingdom	7.0
France	3.1
Germany	1.2
Japan	0.7

off in Japan.

Table 19 summarizes the relative positions of the G-5 countries as recipients of FDI in recent years. It highlights the large share that has gone into the US, the very small amount into Japan and the unusual ranking of the three European economies, with the smallest(Britain) attracting more than five times as much inward FDI as the largest(Germany).

Over the next five years we expect to see a slower rate of FDI growth into the US and a higher growth of FDI into Europe. The European countries are still under-represented as recipients of each other's FDI and of Japan's. With the drive to unify the European market by 1992, there is already increased interest in trans-European mergers and in rationalizing existing European production and distribution networks. In addition, Japan is showing greater interest in Europe as part of a general broadening and rebalancing of its international interests away from heavy reliance on the US.[33] A natural extension of this in the commercial field will be increased European investment.[34]

Trade policy in the EC

A major expansion of Japanese investment in Europe would pose significant policy issues for the EC and for individual member governments. At present, Japanese investment in Europe is almost insignificant compared to US investment. For example, in early 1988 Japanese-owned manufacturing firms employed about 60,000 Europeans compared to the more than 2 million employed by American firms. As Japanese firms establish manufacturing bases in the EC to supply the entire European market, some of the more restrictive EC members will confront the problem of imports of Japanese goods produced in other EC countries whose direct import from Japan had been restricted.

The British government has already found itself defending the interests of Japanese-owned firms in the UK against another EC member. In the case of exports from the UK-based Nissan plant to France, the European Commission has sided with the UK in claiming that with local content levels between 60% and 65% for the Nissan factory the exports can be considered as British goods. France was calling for a local content level in excess of 80%.[35] However, with the European Commission's permission, France managed to block imports of Japanese televisions produced in the EC. The Commission has also ruled that when dumping duties are applied on an import, firms from the foreign country may not supply the

market through local manufacture unless the local content level reaches at least 40%. Japan has protested to GATT against this ruling.[36]

Local content will be a major feature of any policies that are enacted within the EC towards Japanese investment. The latest JETRO survey of Japanese manufacturing firms in Europe found that for the 137 firms interviewed, the local content ratio of components and materials supplied by European firms was 56% in 1987. The content provided by Japanese suppliers was 39% with the rest coming from other non-EC countries. The operations were on average 6.8 years old and the initial local content levels were only 44%.[37] Such a pattern of increasing local content over time is to be expected as Japanese firms establish contacts with European suppliers and as Japanese suppliers in turn set up their own operations in Europe.

Reciprocity of market access may become the policy equivalent of local content for the service industries. The Commission has threatened, but not yet implemented, a policy of denying the right of establishment to non-EC banks and other service firms whose home government has restricted entry to any EC member firm in that sector. It is also trying to redefine reciprocity in terms of "equivalence of benefits" rather than in terms of legal obligations. This is a dubious economic concept and may also fall foul of the Community's GATT obligations to provide national treatment to established firms of whatever nationality. However, it is an example of the type of issue which will generate serious internal bargaining in the run-up to 1992.

Competition policy in the EC

In addition to trade policy conflicts within the EC, it is likely that competition, or antitrust policy will become an increasingly contentious area. Indeed, it may well supplant trade policy as a public issue, just as FDI and local sales have supplanted exports as the most important vehicle for serving foreign markets.

In many countries, the government has wide powers to block any merger it deems to be in conflict with the national interest. Institutional barriers are in part a manifestation of cultural barriers. The practice of the predatory bid, common in the UK and the US, is anathema to many continental European countries just as it is in Japan. In those countries, employees have a greater say in management, and the rights of the shareholder are not held in as high regard. Other hindrances to cross-border takeovers in preparation for 1992 include the absence of a European junk bond market and the fact that many large European companies are not listed on their own stock exchanges.

An important element in future takeover regulation will be the role of the European Commission. The Commission is keenly interested in expanding its role, ultimately including the right to prescreen any large merger or takeover activity involv-

ing two companies with a combined turnover of ECU 1 billion, provided that 75% of this total is in one member state. Currently only the UK opposes such a transfer of power to Brussels.[38] EC ministers have also sought to prevent hostile takeovers by requiring disclosure for investors holding a 10% stake in a company after 1990.

The role of the UK in the internal debate over EC competition policy is symptomatic of the key position that Britain occupies in Europe as a haven for FDI. Partly this is historical, partly it is the natural reflection of the UK's own large overseas holdings of FDI and partly it has been reinforced by the Thatcher government's liberal attitude toward inward investment. However, Britain's own clear vested interest in the issue of EC competition policy creates a delicate balancing act for UK officials in Brussels. A liberal outcome is likely to mean disproportionate gains for the UK; a more restrictive policy will fall especially heavily on Britain.

The reason for this is that both Japanese and US MNEs have shown a preference for the UK over other European countries. Table 20 depicts the relative share of US and Japanese FDI in each of the major European countries as a percentage of their total FDI in Europe. The share of each country in the total employment of US- and Japanese-owned firms in Europe is added for comparison.

Any change in the relative importance of the UK as a location for non-EC investors is likely to appear only slowly because of the enormous amount of capital already invested in Europe by American firms. The actual change in the UK share depends on which measure is used to represent the presence of US firms in Europe. Using US statistics on the stock of outward US FDI, the importance of the UK has declined only slightly, from 30% of the European total in 1980 to 28% in 1986. Using employment figures of US-owned firms in Europe(excluding banking), the share of the UK has

Table 20. Distribution of Japanese and US Firms in the EC[a] (percentage shares of total in EC)

	United States		Japan	
	FDI	Employment	FDI	Employment
UK	28	31	34	23
Germany	16	21	10	17
Netherlands	9	5	16	4
Luxembourg	—	—	21	8[b]
France	8	20	7	19
Italy	6	9	—	—
Spain	2	6	5	18

Note:a. US FDI:Position, 1986.
US Employment:Nonbank affiliates, 1985.
Japanese FDI:Cumulative total, March 31, 1988.
Japanese Employment:Manufacturing, 1987.
b. Belgium and Luxembourg.
Source:US Commerce Department;Ministry of Finance;JETRO.

dropped steadily over the last two decades from 39% in 1966 to 31% in 1985. Looking at the total assets of US-owned firms, the UK has increased its share from 27% in 1977 to 35% in 1982.[39]

The following table shows the pattern of establishments of Japanese manufacturing firms within the EC over time. Whereas Germany was the favored location for Japanese firms manufacturing in Europe in the 1970s, the scale has tipped heavily in favor of the UK with 50 new establishments since 1980, twice the number of France and Germany. Spain has also become an important location for labor-intensive production by Japanese companies since it has joined the EC.

The preference of US and Japanese investors for one EC member over another cannot be ascribed to any one cause. There is a complex mix of economic, political, cultural, and legal factors influencing investment decisions. Table 22 shows the divergence of existing legislation in major European countries regarding foreign investment. If all of these national regulations were superceded by a "one-stop" EC clearing house, it is probable that inward investment would still be influenced by historical and cultural receptivity as much as by economic factors. However, the existing pattern of non-EC FDI would change radically if Brussels decided to implement a "market sharing" approach to inward investment and mergers.

Longer term issues

For the reasons discussed above, during the next five years we expect the major international economic policy focus to be on Europe. Negotiations will intensify, both among the European countries and between them and the US and Japan. The outcome of that process will largely determine the eventual economic success of the 1992 exercise.

Beyond that horizon, Japan's policies toward investment—both inward and outward—will come under increased scrutiny. By 1995 Japan's portfolio of international direct investment will be second only to that of the US. The East Asian region will probably represent the fastest growing market of affluent

Table 21. Japanese Manufacturing Investment in Europe (number of establishments per time period)

Country	Before 1971	1972–79	1980–87	1987–
UK	4	14	50	13
France	7	5	26	1
Germany	7	19	26	6
Spain	5	9	18	4
Total Europe	36	80	162	33

Source: "Current Management Situation of Japanese Manufacturing Enterprises in Europe" JETRO 1988.

Table 22. Regulation of Inward Investment within the EC

Policy	Germany	France	Italy	Spain	Netherlands	UK
Regulatory preview period	no	5-day	20-day	5-day	no	no
National anti-trust laws	yes	no	no	no[b]	yes	yes
Investment controls	no	yes	no	yes	no	no
Public share registers	no	no	no[a]	no	no	yes
Accepted takeover code	no	no	no	no	no	no
Non-voting share structure	yes	yes	yes	yes	yes	yes
Bearer shares	yes	no	no	yes	yes	no
Ability to reach 100%	no	no	no	no	yes	yes
30% bid-triggering stake	yes[c]	no	no	no	no	yes
Practice of aggressive bids	no	yes	yes	no	no	yes

Note:a. pending.
b. only for shareholders.
c. a variation.
Source:David Brierley, "Bidders Guide to Europe", *The Sunday Times*, 22 May 1988, p. D3.

consumers in the world. It will have passed through the stage of being mainly a producer for the US and Europe, to becoming a fully integrated producer/consumer of globally-organized goods and services. Japan's receptivity toward inward investment from outside the region and her ability to open the Japanese market and distribution channels fully to production from abroad and FOFs in Japan will be the central determinant of the extent to which the Asian region is brought into the network of two-way trade and investment flows that increasingly link the other G-4 countries.

APPENDIX I:Explanation of Table 1

UNITED STATE(1986)
Sales: manufacturing, wholesale, and retail
Employment: nonagricultural, nongovernment
Assets: nonfinancial corporate business
Investment: expenditure for new plant andequipment
Exports, Imports: merchandise
Source:*Survey of Current Business*, US Commerce Department

GERMAN(1986)
Sales, assets: nonfinancial corporate business
Employment: all except government(1985)
Source: Bundesbank
Exports: based on a sample of the largest 16 industrial FOFs in 1983 in Germany with an es timate for all manufacturing

FOFs assuming a constant ratio of merchandise exports to employment for al FOFs.
Source: Forschungsstelle Sozialoekonomik der Arbeit database, Free University of Berlin.

UNITED KINGDOM1985)
Sales, value added, employment: manufacturing 1985
Source: PA1002, *Summary of the Census of Production*
Assets: total net assets of all large companies 1983
Investment: expenditure on tangible fixed asset, all large companies 1983
Source: MA3, *Corporate Finance*
Exports: a survey covering 80% of the manufacturing industry
Source: J. M. stopford, "Employment Effects of Multinational Enterprises in the United Kingdom", International Labor Office, Working Paper # 5, 1979, p. 24.

JAPAN (FY1984)
All industries
Source: MITI Annual Survey of Foreign Capital Affiliated Companies in Japan

FRANCE(1985)
Manufacturing and Petroleum Sectors
Source: *L'implantation etrangere en France*, various issues, SESSI

Foot Notes

1. DeAnne Julius and Stephen Thomsen, "Capital Flows and International Economic Relations: The Explosion of Foreign Direct Investment among the G-5," *Tokyo Club Papers*, No. 1, 1988. The G-5 countries include the United States, Japan, West Germany, France and the United Kingdom.
2. See, for example, Michael Porter(ed.), *Competition in Global Industries*, Boston, Harvard Business School Press, 1986. In addition, there have been economic studies of the determinants of FDI such as those reported by John Dunning, *International Production and the Multinational Enterprise*, Chichester, John Wiley, 1981. For an example of the case study approach see L. Turner, *Industrial Collaboration* with Japan, Chatham House Paper, Routledge, 1987.
3. Much of the work on multinationals was done in the 1970s. See, for example, Raymond Vernon, *Storm over the Multinationals*, Macmillan 1977.
4. This paper uses the term "foreign-owned firms" rather than the usual terms such as "foreign affiliate of a US parent" for reasons of brevity. Foreign-owned firms are those firms in which foreign shareholders have a lasting interest and exercise some form of managerial control. The degree of foreign ownership necessary for such control is assumed(by the OECD and most of the countries surveyed) to be at least 10% of the voting stock. Where other assumptions are used in country data, it will be indicated. In fact, most FOFs are wholly-owned subsidiaries of their foreign parent.
5. The sample universe for each country is different and therefore the results are not completely comparable. As a rule, the wider the sample, the less important are FOFs. One would therefore expect both the French and the UK samples which include almost exclusively the industrial sectors to be overstated relative to the other countries. Nevertheless, the differences are so great among the countries that the same ranking would probably apply if the same sectors were included for each country.
6. The US economy, for example, is so much larger than the European economies that at the current rate of expansion of FOF assets in the US

and of total US corporate assets, it would take until 1996 before the share of FOFs in US nonfinancial corporate assets matched the asset shares of FOFs in Europe.

7. Julius and Thomsen, op. cit. p. 31
8. See chapters 4 and 5, *Inward Investment: Policy Options for the United Kingdom,* Michael Beach and Margaret Sharp, Chatham House Papers 21, Royal Institute of International Affairs, Routledge & Kegan Paul, London, 1984.
9. All US data come from the Commerce Department, thus creating a more cohesive body of information than found in the scattered and inconsistent statistics of other countries. The only industry which is absent from the US data on FOF involvement is banking. The foreign MNE must hold 10% of the voting stock of the local firm for it to be considered as FDI.
10. The outward stock is understated relative to the inward stock because both are recorded at book value and outward FDI is generally older and therefore valued in less inflated dollars. In addition the outward stock is reduced by $15 billion owing to intercompany loans from finance affiliates in the Netherlands Antilles. Though recorded as FDI, investment in those affiliates is for the purposes of raising capital in the Euromarkets and is thus excluded from our figures.
11. Martin and Susan Tolchin, Buying into America, Times Books, New York, 1988, p. 15.
12. The importance of looking at inward and outward flows together is illustrated by the fact that the seven largest direct investors in the US are also the seven largest recipients of US FDI outflows.
13. See for example Alan Deardorff, "Comparative Advantage and International Trade and Investment in Services," Discussion Paper # 5, Fishman- Davidson Center for the Study of the Service Sector, University of Pennsylvania, March 1985.
14. FDI data are gathered by the Department of Trade and Industry. Oil companies are excluded from the total in the 1970s and from the disaggregated data before 1983. The percentages of FOF participation in the UK relate only to manufacturing(divisions 2-4) and therefore exclude the important sectors of oil and services. If these two were included they would probably show a lower level but faster growth in FOF involvement in the UK. The UK applies a 20% minimum ownership for FDI.
15. For a review of recent experience see L.Turner, *Industrial Collaboration with Japan,* Chatham House Paper No. 34, Routledge & Kegan Paul, 1987.
16. John H. Dunning, *Japanese Participation in British Industry*, Croom Helm, London, 1986, p. 192 17. Because FOFs are not dispersed evenly across industries, such comparisons should not be taken too seriously. Japanese-owned firms may simply be in industries which require more labor-intensive technology. To be able to make the most useful generalizations, FOFs should be compared with their domestic UK competitors in each industry.
18. Total figures for FDI come from the Bank of J apan and are on a calendar year basis. Disaggr egated data by country or by sector provided by the Ministry of Finance(MOF) were formerl y based on approvals by the MOF but now depend only upon notification by the investor. MOF data are by fiscal years. Japan applies a 10% minimum for FDI, down from 25% prior to 1981. The data exclude retained earnings which are an important method of increasing the stock of F DI for many countries. The FOF shares are based o n company surveys which generally have a resp onse rate greater than 50% and which involve 75% of the total FDI capital in Japan.
19. German data comes from the Bundesbank. Inflows come from the balance of payments accounts using a 25% minimum ownership while figures for FOF involvement are derived from annual surveys of FOFs in Germany.

20. A different picture is presented by data from the Free University of Berlin which conducts an annual survey of FOFs in Germany. Their figures for fixed investment by 44 foreign enterprises were over three times higher than comparable government figures for manufacturing between 1980 and 1982. For a discussion of this, see "Company Data — preliminary results of a 1983 survey," Dr. Werner Olle, *CTC Reporter*, No. 20(Autumn 1985) pp. 56-59.
21. Primary FDI data record all investments by the foreign MNE directly. Secondary or indirect FDI includes investment by FOFs(including holding companies) rather than by the foreign parent. Primary and secondary FDI may not be consolidated because of the considerable double counting that would result.
22. French FDI data come from the Banque de France on a flow basis only and exclude retained earnings. A 20% minimum ownership is applied. The FOF percentages come from an annual survey of FOFs in France which includes only manufacturing and petroleum.
23. Throughout this section, the data on FOF activities are on a fiscal year basis for both the US and Japan while trade figures are on a calendar year basis. No adjustment was made to make the two comparable because the calculations in this section are only intended to convey orders of magnitude.
24. FDI-related trade differs from the more common concept of intra-firm trade in that it includes all trade between the FOF and the home country and not just trade between the FOF and the parent firm.
25. While the proper comparison would be between merchandise trade and sales of goods, the data are not sufficiently detailed to distinguish between goods sales and sales of services. For the US, goods sales are given for outward FDI data, but for sales by FOFs in the US, an estimate had to be based on sales by goods-producing industries. For Japan, no such adjustment was made so the sales figures will include both goods and services. This will have the effect of exaggerating total sales by Japanese-owned firms abroad relative to Japanese exports.
26. Using FY1982 figures.
27. William Finan, "Globalization is skewing the trade statistics," *The International Economy*, January/February 1988.
28. Robert Lipsey and Irving Kravis, "The Competitiveness and Comparative Advantage of US Multinationals 1957 - 1984" Banca Nazionale del Lavoro *Quarterly Review* No. 161, June 1987.
29. Peter Drucker, "Low wages no longer give competitive edge," *The Newsletter*, International Center for Economic Growth, April 1988.
30. MIT study quoted in *The Economist*.
31. The two measures are not strictly comparable because the sales figure for US affiliates abroad includes all sales by FOFs except exports back to the US. It therefore may include some sales in third countries.
32. Local sales include services so the ratios will be overstated somewhat.
33. For a discussion of the reasons behind this move see Ryohei Murata, "Political Relations between the United States and Western Europe: Their Implications for Japan", *International Affairs*, Winter 1987/8.
34. Only 14% of cumulative Japanese FDI is in Europe compared to 35% in the US.
35. *Financial Times*, 19.7.88
36. *Financial Times*, 20.7.88
37. "Current Management Situation of Japanese Manufacturing Enterprises in Europe" JETRO, March 1988.
38. *Financial Times*, 2.8.88
39. All three measures have their shortcomings. The FDI figure represents only transactions between the parent in the US and the affiliate in Europe, excluding anything that the affiliate does independently of the parent. The

FDI position is also recorded at book value so older investments, such as those by US firms in the UK, are likely to be understated. Employment statistics avoid the problems of exchange rate changes and of varying rates of inflation across countries, but in turn overemphasize manufacturing. The total assets figures are at least a closer estimate of the market value of a country's assets abroad, but they in turn suffer from a possible upward bias introduced when a takeover inflates the share prices of a firm. The stock of total assets, like FDI, is also influenced by changes in exchange rates and by inflation.

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