Foreign Direct Investment: The Neglected Twin of Trade

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Group of Thirty, Washington, DC

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Introduction

Foreign direct investment (FDI) is an increasingly important and widely misunderstood phenomenon.* In many ways, FDI was a key part of the successes of the international economic system in the 1980s. Now, because of nationalist political pressures, its future is in jeopardy. Just as the trade expansion of the 1950s and 1960s was nurtured by multilateral trade liberalization, so the expansion of FDI in the 1990s and through the beginning of the next century needs active multilateral support if its full potential is to be realized.

The political debate on FDI is fed by misinterpretations. Like the proverbial elephant described by the blind men, each of whom touches a different part, FDI is variously and inconsistently portrayed as:

- An insidious way for foreigners to buy into a country's productive assets;
- A welcome new source of jobs for depressed regions;
- A balance of payments flow that finances half of the United States current account deficit and recycles most of Japan's surplus;

*The IMF defines direct investment as "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." Most countries (but not the United Kingdom, France or Germany) use 10% ownership as the practical minimum for having an "effective voice" in management, with smaller purchases of equity considered as portfolio investment. Profits retained in the foreign subsidiary should also be counted as FDI, but Japan and France do not follow this convention. There are other cross-country differences in definitions and in the scope of data coverage; let this footnote be a general health warning for all figures cited in the paper.

- A tool of global companies to gain strategic advantage by shifting low-paid jobs abroad while keeping high value-added research at home; and
- A vehicle for technology transfer and an alternative to debt finance for developing countries.

Much of the political debate resembles the blind men's argument over whether the elephant is in truth a snake (its tail), or a bird's wing (its ears) or a tree trunk (its legs). While there is evidence for each view, the real shape and size of the beast goes unnoticed in the heat of the argument.

So, the first task at hand is to develop a view of FDI that is more comprehensive than those prevalent in the newspapers or, indeed, in most of the economic literature.

FDI is of two kinds: the creation of productive assets by foreigners who build something new from scratch — greenfield investment, as it is called; or the purchase of assets by foreigners — presumably because they think they can use the assets more productively than the sellers. FDI of the first kind can provide new jobs or, in an economy near full employment, raise real wages. FDI of the second kind may have a similar direct effect if the assets in question have been underutilized in the past, or indirectly if the inflow of funds — the proceeds to the seller — are reinvested domestically, and thereby lower the cost of capital at the margin. But these are both longer-term, economy-wide effects. In the short term, greenfield investment can be especially attractive to the region in which it occurs, since the secondary effects of new job creation or real wage increases tend to be greatest locally. But FDI in its second form — takeovers — may result in local job losses in the first instance as the new owners restructure the business. It may, therefore, be much less welcome in the local community.

FDI is also a cross-border financial flow recorded on the balance of payments, but neither its size nor its net sign correlates across countries with the sign on the current account balances. For example, in recent years the United Kingdom was a major net exporter of FDI while running a current account deficit in excess of 4% of gross domestic product (GDP). FDI can help finance a chronic deficit or be a conduit for a chronic surplus, but it does not *have* to, and so it is difficult to link convincingly to the balance of payments condition of the originating and recipient countries, wherever capital markets are well developed.

From the company perspective, FDI can serve one or many of several strategic purposes: to penetrate foreign markets — market-based FDI; to provide access to raw materials, technology or cheap labor — factor-based FDI; to facilitate exports; or to substitute for them.

From a country perspective, FDI is desirable as a vehicle for technology and skills transfer — certainly this is increasingly recognized by developing countries as a plus — and as a form of capital inflow that carries no debt-servicing obligation. But it is more of a complement to external debt than a substitute for it. Both lenders and investors come to countries with sound economic policies, while problem debtors attract little FDI.

To develop a complete picture of the FDI animal and how it interacts with its economic and political habitat, I begin by briefly reviewing the trends in FDI flows and the reasons for their massive increase during the 1980s. Next I consider the politics of FDI as it has evolved in the United States, the European Community (EC), Japan and in developing countries since the early 1980s. I conclude that fundamentally different perceptions about the role of FDI — both among developed countries and between them and the developing world — are resulting in unnecessary economic frictions that spill over from trade into FDI with the potential to depress FDI growth and to constrain its competitive benefits. The subsequent section explores the links between FDI and trade. As a vehicle for economic integration, I suggest viewing FDI as the twin of trade, with the same potential for creating gains in efficiency and growth in the 1990s as trade had in the 1950s and 1960s. The last section considers the policy implications of such a view for the member countries of the Organization for Economic Cooperation and Development (OECD), for East Europe and for the developing world.

FDI in the 1980s

The surge in FDI during the past decade is unprecedented both in size and in diversity of source. During the 1980s, companies from the big five countries spent over $650 billion on direct investment in other countries, three-quarters of which stayed within that Group of Five (Figure 1).* By the end of 1989, multinational companies from the G-5 owned nearly $1 trillion of direct investment assets abroad. Seventy percent of that total stock was acquired during the 1980s.

Trends in FDI flows over time are clearly cyclical, yet beginning in 1984 or 1985 (depending on the country) FDI began to climb rapidly, achieving real annual growth rates of 15% to nearly 40% over the period through 1989 (Figure 2). In part, this surge represented a recovery from the fall in FDI in the early part of the decade due to widespread recession and the aftermath of the second oil price shock. But by the end of the decade FDI outflows from the Group of Five were some 60% higher in real terms than their previous peak of 1979.

What accounts for this acceleration in FDI flows? A large part of it mirrors and contributes to the healthy rate of economic growth in the OECD between 1982-83 and 1989. A simple regression analysis relating real FDI growth over the past 25 years to real GNP growth in the G-5 yields a GNP coefficient of 3.44 (t-statistic = 5.23; $R^2 = 0.53$). Like domestic

*All data in this section are from D. Julius (1990), updated to include 1989 figures. Original data sources are national publications from the United States, the United Kingdom, Japan, Germany and France. This Group of Five (G-5) accounts for more than 75% of the world's FDI. Country-specific growth rates are calculated in domestic currency; cross-country aggregations use average period exchange rates. Real figures are in 1985 prices.

Figure 1
Summary of G-5 Foreign Direct Investment

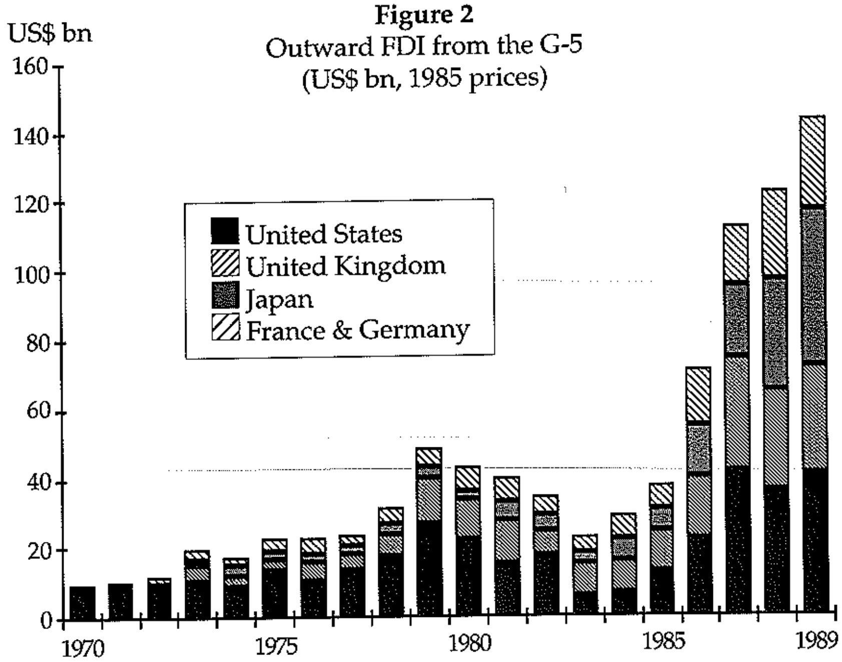
	Outward			Inward
	stock (1989)	real growth in flows (1983-89)	total flows (1980-89)	total flows (1980-89)
	$ bn	% pa	$ bn	$ bn
United States	385	33	218	324
United Kingdom	226	17	175	99
Japan	158	37	140	2
Germany	91	18	66	15
France	69	26	55	32
Total	**929**		**654**	**472**

investment, FDI is more volatile than GNP, growing faster than income during good times and falling more sharply during recessions. So, with GNP growth in the G-5 averaging 3.6% annually from 1983-89, one could have expected an average real FDI growth of somewhat above 12% per annum, whereas in fact it was 27% per annum — over twice as high.

To explain this unexpected performance, various political or structural factors have been suggested, ranging from trade barrier jumping (screwdriver plants) to anticipatory investment in Europe prior to 1992 and to the stimulus to corporate restructuring given by the junk bond boom in the United States. While each of these may have motivated individual FDI decisions, in previous work I found two other structural changes to be more significant (Julius 1990). The first is the liberalization of service industries (especially banking, insurance and telecommunications) in most OECD countries. Deregulation and privatization — beginning in the mid-1970s in the United States, the early 1980s in the United Kingdom, and the mid-1980s elsewhere in Europe and in Japan — are opening large, previously protected industries to international competition. Given the nature of most services — exchange of which often requires direct contact between the buyer and the seller — it is not surprising that international competition often takes the form of FDI rather than of trade: a retailer or hotelier, for example, can only diversify internationally through FDI.

The stock of total service sector FDI nearly tripled between 1980 and

Figure 2
Outward FDI from the G-5
(US$ bn, 1985 prices)



1988 (Figure 3). For the G-5 countries together, it grew from 34% of the total FDI stock in 1980 to 42% in 1988. The service sector has been to FDI growth in the 1980s what oil was in the 1970s. But whereas the oil industry was already internationally diversified and globally competitive at the beginning of the 1970s, that process is just starting for many of the service industries. And whereas oil consumption accounts for less than 10% of expenditure in advanced economies, services account for more than 60%. The trend of increasing FDI in services has plenty of headroom.

The second structural change that has been important for the growth of FDI in the 1980s has been the emergence of Japan as a major investor, alongside the United States and Britain. This emergence has no single explanation. It is not simply the counterpart of Japan's current account surplus. Germany has run equally large surpluses as a share of GDP, yet its outward FDI in those periods has been far smaller. By 1989 Japan's stock of outward FDI was 70% larger than that of Germany, whereas in 1980 Germany's stock was 40% larger than Japan's. The proportion of Japan's current account surplus "recycled" through direct rather than through portfolio investment rose steadily to reach 80% in the fiscal year that ended in March 1990 (Figure 4). It would not be surprising if Japan's

Figure 3
Stock of Service Sector FDI by Outward Investor
($ bn)

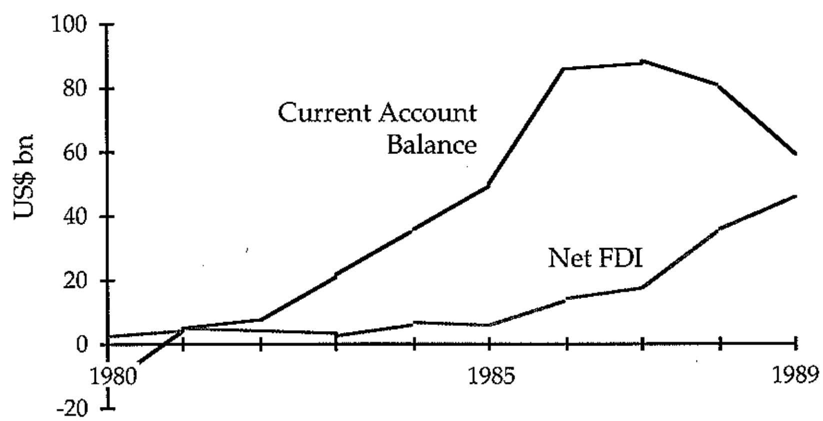
	1980	1988
United States	62.5	132.8
United Kingdom	23.7	71.8
Japan	5.1	66.1
Germany	9.2	24.2
France	7.4	22.8
Total	**107.9**	**317.7**

net FDI outflows exceed its current account surplus in 1991.

Although the link between Japan's FDI and its current account surplus is not a direct one, there are important indirect links. The rather sudden emergence of Japan's surplus in the early 1980s set off a chain of economic and political developments that created a strong push for Japanese companies to shift operations overseas. The 40% rise in the yen during 1985-87 was a major incentive for Japan's export-oriented industries to establish overseas production bases, both in the country of the final market and in third country "export platforms" where production costs were suddenly much lower than at home.

The political impetus came from the Japanese government, as it

Figure 4
Japan's Current Account Balance and Net FDI



moved to adopt economic policies that would defuse the trade tensions arising out of the current account surplus. Seemingly overnight — in the view of many Japanese as well as Americans and Europeans — Japan had become an economic superpower and was held to international standards of behavior that were much stricter than those applied to a Korea or a Switzerland. Japan was perceived as the free rider in the world trading system, taking advantage of other countries' open markets while keeping its own closed. By the mid-1980s it was clear to many in the Japanese government that, in the interest of harmonious international economic relations, the country would have to find an alternative economic ethos to the export-led growth that had served it so well. Prime Minister Nakasone asked former central bank governor Haruo Maekawa to chair an independent commission whose brief was to chart new directions for the 1990s. The resulting "Maekawa Report" recommended a fundamental reorientation of the economy towards domestic-led demand. Both macroeconomic and microeconomic measures were put forward to achieve this, and official encouragement was given to the restructuring of Japanese industry through moving production offshore.

The net result of these economic and political pressures on Japanese industry was an unprecedented acceleration of FDI outflows. Since 1983 these flows have doubled every two years (measured in yen), promoting Japan from seventh place in the league of international direct investors in 1980 to first place for 1989.* Yet only an estimated 6% of Japanese companies' production is carried on outside Japan (it was 4% in 1986), compared with 20% for German firms and 17% for American firms. The "Japan factor" as a structural influence on the FDI surge of the 1980s — like the liberalization of services — has generated a process that is far from complete.

*In terms of total stocks of outward FDI, Japan is still third after the United States and the United Kingdom. The projections described in Julius (1990) imply that Japan would overtake the United Kingdom in 1994.

The Politics of FDI

Will the trends of the 1980s continue in the 1990s? That depends on the politics of FDI. In the United States, critics of FDI are increasingly vocal. Across Europe national moods vary, but the European Community's new merger regulation, which came into operation in September 1990, allows for "reciprocity of access" to be considered in regulating inward investment by non-EC firms. Japanese attitudes toward inward investment are under challenge due to the extreme lopsidedness of its inward and outward flows (Figure 1).

In developing countries meanwhile, attitudes towards FDI seem to be moving in the other direction. Many now claim to welcome such flows, and some, such as Korea and India, have eased restrictions on foreign ownership in some sectors. Yet total FDI into developing countries as a group was lower, in real terms, during the 1980s than in the 1970s. Clearly the professed change in government attitudes has not been sufficient to attract higher investment inflows, even during a period of rapid global growth in outflows. At least part of the gap between expectation and reality derives from a "blind man's" perspective of what drives FDI.

It is worth examining the rationale and assumptions of the political issues in each region.

United States

Two features of the global FDI trends of the 1980s account for the American phobia: (a) flows into the United States accelerated much more rapidly than for any other country, and (b) inward flows from Japan grew most rapidly of all. In the broader international context, neither of these features is particularly surprising or threatening. Inward investment in the United States grew from a very small base in 1980. Even by the end of the decade, the role of foreign-owned firms (FOFs) in the US economy was much smaller than that of FOFs in the United Kingdom, France or Germany (Figure 5). In addition, the total stock of US FDI abroad was roughly equal to the stock of foreign FDI in the United States. Yet over the decade, the United States saw a much larger increase in foreign ownership than for any other country and than at any time in its recent past. This was bound to raise the political profile of FDI.

The fact that so much FDI belonged to Japanese companies undoubtedly aggravated American sensitivities. The large bilateral trade deficit

Figure 5
Indices of Foreign-Owned Firm Involvement (% of FOFs in total)

	US (1986)	Germany (1986)	UK (1985)	Japan (1984)	France (1985)
Sales	10[e]	19[b]	19[d]	1[a]	27[f]
Value added	na	na	17[d]	na	24[f]
Employment	4[g]	8[g]	13[d]	0.4[a]	20[f]
Assets	9[b]	17[b]	14[c]	1[a]	na
Investment	8[b]	na	13[c]	na	19[f]
Exports	23	24	30[d]	2	32
Imports	34	na	na	15	na

Notes: (a) *all industries*
(b) *all nonfinancial sectors*
(c) *all large companies*
(d) *manufacturing*
(e) *manufacturing, wholesale, retail*
(f) *manufacturing, petroleum*
(g) *all except government*

of the United States with Japan had become a symbol both of declining industrial competitiveness and of "unfair" barriers to American exports in Japan.

The US-Japan talks on "structural impediments" were based on the idea that trade barriers might include deeply rooted business customs as well as explicit government policies. This is dangerous terrain. It is almost inevitable that attempts to harmonize business practices will fail in some measure and it is quite likely that such failures will reinforce the populist case of protectionist lobbies.

Against this backdrop it is not surprising that inward investment by Japanese companies was regarded as another unfair means of invasion of US markets. By the summer of 1990, congressional sentiment in favor of regulating foreign investment was at its highest point in years.* Bills were deliberated, calling for the Defense Department to compile lists of critical US technologies that could only be procured from domestic firms; for involvement of the Federal Bureau of Investigation (FBI) and the Central Intelligence Agency (CIA) in investigations of "industrial espionage" activities by foreign-owned firms; and, for giving the Departments of Commerce and Defense effective veto power over the recommenda-

* "Progress Report on US Legislation to Regulate Foreign Investment," *The International Business Issues Monitor*, Bulletin #90-51, August 16, 1990.

tions of CFIUS, the interagency Committee on Foreign Investment in the United States, which carried out the Exon-Florio law requirement for presidential review of mergers or foreign acquisitions that might affect US national security. There were also proposals to increase access to commercially sensitive information on FOFs.

Congressional attention was diverted by the Gulf war, and to date there has been little follow-through on these threats. However, legislation extending the Exon-Florio procedures was allowed to lapse before the Christmas recess and there is growing unease among foreign-owned firms in the United States about the resulting policy void. An increasingly vocal group of politicians on both sides of the aisle believes that a crackdown on foreign-owned firms is justified on the grounds of competitiveness* and national security. Their rationale is a straightforward extension of protectionist thinking from the trade field, and their clout in policy circles grew stronger when the prospects for the Uruguay Round of negotiations under the General Agreement on Trade and Tariffs (GATT) were set back in December 1990.

Europe

American political rhetoric of the 1980s carries strong echoes of Europe in the 1960s. During that heyday of American multinational expansion, European resentment ran high. Like the Japanese companies investing today in the United States, nearly all US FDI into Europe in the 1960s was in the form of new ("greenfield") plant. Whether for the strategic reasons of US companies or because of the, then, relatively primitive nature of most European stock exchanges, foreign takeovers of European domestic firms were so rare as not to be a source of political concern.

Today in Europe, greenfield investment is a prize, which European governments seek to attract by championing their technically skilled workforce and competitive infrastructure. The politics of FDI is all about takeovers and mergers.

*The competitiveness issue cuts both ways. Graham and Krugman (1989) suggest that one of the reasons for the increase in FDI into the United States is the narrowing of the vast technological lead that US firms had after the Second World War. European and Japanese firms are increasingly able to compete in the US market. This increase in European competitiveness coincided with large flows of US FDI into Europe in the 1960s and 1970s, transferring US technology and managerial practices. If the US is worried about its competitiveness now, it should welcome inward FDI from the more advanced Japanese and European firms.

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The European Community's new merger control regulation, which became effective in September 1990, is arguably the most sweeping piece of legislation included in the 1992 Single Market program. It represents a major extension of Community power to regulate private business activity. While European business generally welcomes the "one stop shop" that the regulation provides for most large European acquisitions — which avoids having to deal with both national and EC competition authorities — there are many uncertainties in its application that will only become clear with experience.

Particularly worrisome is the extent of extraterritorial power that the European Commission may try to wield. The merger control regulation allows for review of mergers/acquisitions of non-EC companies if the parties each have EC-wide sales greater than 250 million ecu (about US$ 210 million). Given the degree of market interpenetration by multinational companies across the OECD, this jurisdictional definition could scoop into the European Community's regulatory net most large mergers and acquisitions worldwide.

However, the matter does not end there. The EC approach to competition policy is quite different from that of the US Justice Department. In the United States, the government must prove that a proposed merger would be anti-competitive before it may prevent it. In Europe, under the new Commission rules, the burden will rest with the company to provide the information to prove that its plans would *not* restrict competition. Unless the Commission is particularly circumspect in exercising its extraterritorial reach, the EC merger control regulation may provide a field day to lawyers and a headache to companies and policymakers on both sides of the Atlantic.

A second internationally contentious issue is that of level playing fields for corporate control. This issue has been raised most forcefully by the British. The depth of the UK stock market, the importance of equity finance to British companies and the concentration of shares in the hands of disinterested institutional fund managers — all have undoubtedly made it easier to mount a takeover bid in London than in Frankfurt. Heeding this concern, the European Commission has started to tackle some of the most blatant legal ploys by companies to remain bid-proof. French companies were recently told that, as of July 1, 1991, shares in the parent company held by its own subsidiaries would cease to carry voting rights. The Commission has let it be known to several of the countries of the European Free Trade Area (EFTA), including Sweden and Switzerland, that full access to the EC market after 1992 will depend in part on their providing nondiscriminatory access to EC companies wishing to acquire or merge with their firms. This will mean changing dual shareholder systems where national shareholders have sole or greatly magnified voting rights compared to foreign shareholders.

The EC's new merger regulation also provides for retaliatory action if such negotiations fail. If the European Commission finds that a non-EC country "does not extend to EC undertakings (companies) treatment comparable to that offered by the Community to undertakings of that non-EC country," it may request a negotiating mandate from the European Council of Ministers. If negotiations fail, the Commission may draw up further legislation to restrict the access to the Community of companies in the offending country. Because the ease of corporate takeovers is a function of a set of legal, financial, social, and even cultural structures in a society, such reciprocity tests for FDI would be powerful machinery should the political forces for a Fortress Europe gain the ascendancy.

Japan

If FDI erupts into a full-scale international shouting match, Japan has two strikes against it: the numbers and its penchant for planning. The first issue relates to inward investment in Japan. Although the Japanese economy today is nearly half the size of the US economy, the stock of inward FDI in the United States is between 40 and 60 times (depending on which measure is used) as large as the stock of foreign investment in Japan. Japan is conspicuous among the G-5 for the extremely low levels of foreign-owned firm participation in its economy (Figure 5). Despite official attempts since 1980 to encourage inward investment, such participation ratios actually declined between 1977 and 1986. For example, the share of FOFs in gross sales fell from 2% to 1% and in manufacturing assets dropped from 5% to 2%. With no real tradition or prospect of business takeovers — domestic* or foreign — such ratios will change only very slowly even with government encouragement.

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*W. Carl Kester, of Harvard Business School, has argued that the buildup of *keiretsu*, the Japanese conglomerate groupings, has served many of the functions that corporate takeovers serve in other countries. However, their patterns of cross-shareholdings and nonmarket internal transfer pricing between different members of a group could not easily accommodate foreign company participation. Indeed, the strength of *keiretsu* in the primary industrial and financial sectors in Japan is one of the main structural barriers to acquisition of the smaller group members by foreign companies.

Japan's second area of political vulnerability on FDI concerns its alleged "targeting" of outward flows. What appears from inside Japan to be perfectly legitimate government coordination to facilitate private sector investment (in support of the Maekawa Report's recommendations, which were widely welcomed internationally) often appears from outside to be a sinister plan by the Ministry of International Trade and Industry (MITI) to target aid and investment for the strategic global advantage of Japanese companies. The rapid buildup of Japanese investment in Asia is a good example. Japanese government aid to the region is focused on building the roads and ports that private sector investors would need to produce and market their output. The location of these infrastructure supports takes into account the investment plans of Japanese industry. Industry, in turn, is guided by reports prepared by MITI that take a view of economic development based on regional division of labor. Thus Indonesia reportedly is to concentrate on textiles, forest products and plastics. Thailand will build furniture, toys and die-cast molds. Malaysia will export sneakers, photocopiers and television picture tubes. A mid-level official in the Japanese Foreign Affairs Ministry is quoted as saying "Laissez-faire can't be recommended. Careful utilization of market forces is always ideal."* This preference of at least some Japanese bureaucrats to limit competition between countries and to build complementary patterns of development based partly on Japanese companies' investment plans, if successfully implemented, would tilt the playing field against investors from other countries and, even more seriously, distort international competition in third markets for those industries' products.

Developing Countries

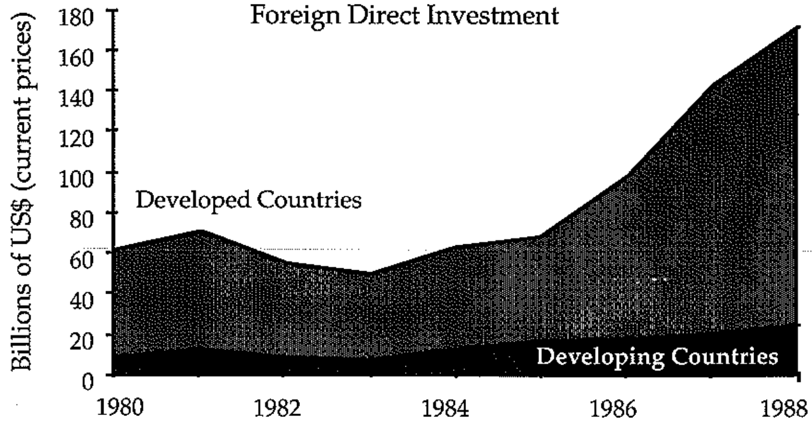
The most striking feature about FDI in the developing world is that there was so little of it during the boom years of its growth in the OECD countries (Figure 6). Yet among development economists and many public officials in the less-developed countries (LDC), interest in foreign direct investment has staged a revival. Disillusionment with other forms of capital inflow, the lack of commercial long-term debt finance since the early 1980s (Figure 7), changing fashions in official development assistance and the new rhetoric of aid agencies have all played a part.

Nonetheless, the commitment to FDI remains halfhearted. Many

**The Wall Street Journal*, European edition, August 21, 1990.

Figure 6

Foreign Direct Investment



LDC political leaders want it for technology transfer, export promotion and access to foreign exchange but seem ambivalent about a basic reliance on market mechanisms. For potential foreign investors, this inevitably creates doubts about the return they can expect from FDI — rules can change quickly where commitment is lacking — which may explain why the LDCs have not succeeded in attracting a proportionate share of the FDI flows of the 1980s.

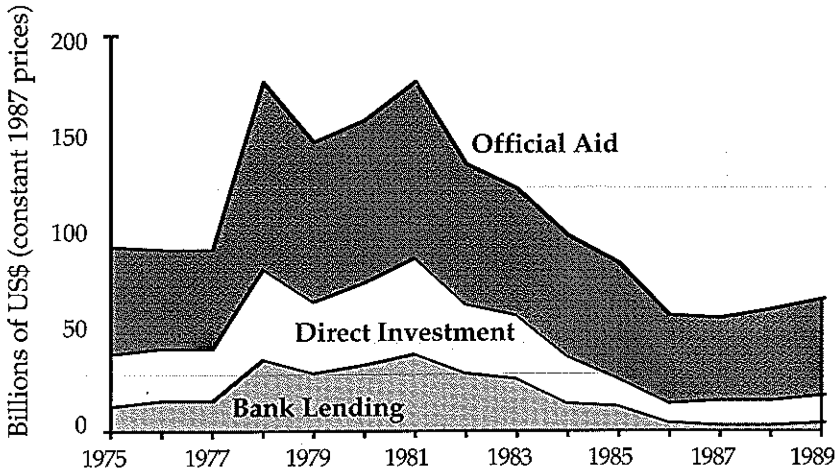
There are exceptions to this dismal picture. The most long-standing is Singapore. Reflecting on its 25th national anniversary in 1990, the Singapore Economic Development Board noted:

> Indeed we would not have done as well without the strong partnerships with leading international companies incorporating Singapore into their global strategic plans. It has been these partnerships that plugged us into the world economic grid, enabling us to apply ourselves to advance our well-being. The partnerships too have served international companies well. In the years ahead, as we further enhance our capabilities through technology exploitation and regional collaboration, there will be even more scope for broader and closer partnerships.

Such a view, that characterizes FDI as a two-way partnership, stands in sharp contrast to many other LDCs, whose leaders would welcome the benefits of FDI but still distrust foreign investors. This is evident when they impose such measures as limiting expatriate work permits or controlling imported inputs for foreign firms. They are not yet prepared to treat foreign investors on the same basis as domestic investors.

So, in general, the politics of FDI are a cause for concern worldwide.

Figure 7
Net External Financing for Less-Developed Countries



While attitudes in developing countries may have begun to shift in favor of FDI, there is a long way for most of them to go. And, in the industrial countries, the seeds of conflict are clearly present, in large part because of fundamentally different national and regional views.

- Many of Japan's policymakers see FDI as mainly factor-based and as a vehicle for the transfer of technology. From their perspective, there is nothing odd about Japan attracting so little inward investment because Japanese land and labor are expensive and its technology is advanced.
- By contrast, most American policymakers acknowledge the rationale for market-based as well as factor-based FDI: the size and wealth of the US market, rather than the low cost of US labor or raw materials, explained the flood of inward investment during the 1980s.* Still, the inflow has been so strong and sudden that it has raised concerns about national sovereignty and economic competitiveness, especially vis-á-vis Japan.
- The view from Europe is probably the most nuanced. The Euro-

*A quirky exception is Robert Reich, who has argued in the *Harvard Business Review* for an activist US industrial policy to improve the attractiveness of US workers and infrastructure to FOFs and to bargain aggressively over the terms of their patronage. Such a policy is directly counter to the recommendations made in this paper.

> pean Commission sees FDI as a central element in firms' competitive strategies and thus as something that must be facilitated through the 1992 process if Europe as a whole is to become more competitive. This entails giving high priority to issues of market access through mergers and acquisitions both within and, perhaps on a reciprocal basis, outside the European Community. There is, at the same time, a worry that large firms may abuse dominant market positions. To address this issue, competition policy has been strengthened. But the approach developed within the EC may well collide with established US antitrust norms.

The case for fostering FDI in the 1990s has to be made. To do so convincingly, we must review what it was that powered FDI among the OECD countries during the 1980s and explore the nature of the benefits it conferred.

FDI and Trade

Why do companies invest abroad? What causes FDI? Depending on the precise question — why abroad rather than at home, why in country A rather than in country B, why now rather than five years ago — academics and business consultants have produced a variety of circumstantial explanations for FDI.*

Many of the more powerful explanations connect FDI to trade in some way that goes beyond the factor-based explanation. I review the issue from three directions:

- By a taxonomic perspective — which influenced the approach adopted in multilateral trade negotiations for a while;
- By means of a case study; and
- By reviewing in synopsis the historical development of FDI and trade.

The taxonomic approach asks the question, what types of linkages are possible between trade and investment? For example, in an article about the GATT negotiations on trade-related investment measures (TRIM), Mohamed Ariff (1989) has suggested four subdivisions of trade-related FDI:

(a) Trade substituting (where foreign investment goes into import-substitution activities aimed at the domestic market);
(b) Trade promoting (where foreign investment takes the form of offshore operations producing for the international market);
(c) Trade complementing (where foreign investment is directed at providing backup and intra-industry support facilities in the export markets); and
(d) Trade diverting (where foreign investment moves in to take advan-

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*Literature reviews usually begin with Dunning in the United Kingdom (1958) and Kindleberger (1969) and his student Hymer (1976) in the United States. Essentially, they asked how a foreign firm can compete successfully with local firms. They found that the foreign firm often had advantages of a monopolistic or monopsonistic type, often deriving from superior technology or management skills. Some of these advantages stemmed from market failures (especially in the licensing of technology) or from high transaction costs in moving goods or factors between countries. Work on internalizing markets through vertical (McManus 1972) and horizontal (Horst 1971) integration provided additional explanations for FDI by firms from small economies. For a good survey, see chapter 1 of Casson 1987.

tage of unfilled quotas under preferential arrangements such as the Generalized System of Preferences).

He concludes that "it is this complexity of the investment-trade relationship that renders the task of the negotiators in the TRIMs group extremely difficult." Indeed, the GATT negotiations on services nearly ran aground on a similar reef when trying to draw lines between trade in services and goods, and between trade in nonfactor services and trade in factor services that are closely related to FDI. But, as the negotiations proceeded, it became clear that trade in many service industries could not take place without factor movement — either labor (such as construction engineers or medical professionals), or capital (FDI) or both.

This led to the more productive negotiating route of looking for similarities between goods and services. The negotiators then began to discuss how the accepted GATT principles for trade in goods might be applied to trade in services (Feketekuty 1988). And their approach acknowledged the importance of FDI to trade, especially in services.

Second, consider a brief example: the recent case of an investment in the United States by the British Technology Group (BTG), a medium-sized British company ($50 mn revenues) in the business of patenting and licensing technology. It is typical of US inward investment in that it is a service business rather than manufacturing, it involves FDI from the United Kingdom into the United States, and it is a greenfield investment rather than the takeover of an existing company. Its staff of 200 has been entirely based in the United Kingdom, although the company licenses technology worldwide and 70% of revenues come from abroad, including 40% from the United States.

In 1990 BTG opened its first overseas office in the United States, its largest source of foreign earnings. This is typical of the pattern of FDI following trade. It might seem a case where trade replaces FDI, but in fact most of the existing US licenses will continue to be handled by the British executives in London who are familiar with their clients' needs. The main reason for a US presence is to enable BTG to develop its US business beyond a few large companies into the much larger market of medium and small US companies and universities. This could not be done in a cost effective way from London.

In addition, BTG hopes to develop a new line of business — helping US companies protect and license their technology abroad. Currently many US firms and universities fail to patent their technology internationally so they receive no royalty or license income from its foreign use. BTG thinks the expertise it has developed in patenting and licensing technology into the United States, Europe and Japan will prove attractive to US firms. This expertise and its own technology portfolio should enable it to compete effectively against homegrown firms. BTG offers services that are not widely available in the United States outside large corporations.

There are three things to note about this brief example of FDI in services. First, even for this straightforward case of an initial investment by a company in its core business, the motivation for the investment and the links between FDI and trade look complex in terms of some of the established taxonomic systems. From the company's point of view, the decision to invest abroad represents a deepening of links it had already developed between the two markets through trade. Yet the FDI is likely to be trade expanding rather than trade substituting. In the classification of Thomsen and Nicolaides (1991), this investment has elements of both market-driven and factor-driven FDI. Its primary rationale is to reach more of the US market. However, by offering its knowledge of European markets to US firms, its success would translate directly into greater US export revenues — a result more usually associated with factor-based FDI.

Second, the FDI flow itself is almost incidental to understanding the economic impact of the investment decision. This depends on the level and character of BTG's sales and purchases once it is established in the United States. It is these sales and purchases that are similar to imports and exports — not the initial FDI — in their impact on US efficiency and growth.*

The third salient feature of the BTG example is the way that FDI extends the boundaries of international competition beyond what would happen with trade alone. This is, perhaps, obvious for a service industry where conventional forms of trade may be difficult, but it is also true in the manufacturing sector. For instance, a Japanese automobile company setting up production in Britain seems at first to shift competition — from imported Japanese cars to locally produced ones — rather than to extend it. However, case studies have shown that the presence of local Japanese-owned firms has stimulated the productivity of British competitors and

*The common focus on the FDI itself stems from a preoccupation with its balance of payments impact. Local sales and purchases of FOFs do not appear in the balance of payments because they are not in foreign exchange. For an advanced economy whose capital markets are internationally integrated, this way of delineation is somewhat arbitrary since foreign exchange is a commodity like any other. If it is not a binding constraint on an economy then it is inappropriate to accord any special status. See Julius (1990) for an elaboration of this point.

suppliers, as Japanese working practices and management techniques have been copied (Dunning 1985). In the language of development economics, these are transfers of technology — the "technology" of management — and constructive backward linkages. FDI often exposes parts of the host country, including its labor force and its service suppliers, to international competitive forces more directly than trade, in effect expanding the tradable sector and shrinking the nontradable sector of the economy. Thereby, FDI can generate gains in efficiency similar in kind to those of trade, and often greater in extent.

It is also possible to view the linkages between FDI and trade from a historic perspective on structural shifts in economic development. As economies develop, their center of gravity tends to move from agriculture to manufacturing to services. Along the way, international links are forged within the predominant sectors that lead to specialization and trade.

- In the 18th century, when Adam Smith was writing, most international trade consisted of raw materials and agricultural products. These were also the sectors of the domestic economy that employed most of the labor force. Thus it was natural to think of land and labor as the key elements of comparative advantage.
- By the 19th century in much of Europe, manufacturing had become the predominant sector and international trade began to take the form of manufactured goods flowing outward from Europe with agricultural products and raw materials coming in from the Americas and other developing regions. Much of this trade had its origin in direct investment especially by British companies in the then and former colonies.
- When the GATT was established in the mid-20th century, manufacturing was still the dominant sector in advanced economies and the fastest growing part of trade was in manufactured goods. The creators of GATT tried to design an international framework to facilitate the growth of such trade. This focused on negotiated tariff reductions, extended multilaterally through the principle of "most-favored-nation" — namely, what is granted to one shall be granted to all.
- Today the service sectors have become both the largest and fastest growing part of advanced economies. It is natural that international competition is developing in those industries, and for many of them direct investment is a more effective route to foreign markets than trade.

This review of FDI and trade from three different perspectives serves to underline the conceptual similarity of FDI to trade, both in underlying motivation and in economic effects. As mechanisms for integrating international markets, trade and FDI are twins. Both enable firms in one country to reach markets — for inputs or outputs — in another. At different times or in different countries, a company may choose one route over the other. In many cases, trade will lead to investment that (if successful) will lead to more trade, which will stimulate further investment and so on. This is why both trade and FDI grow faster than GNP during times of economic expansion. It is also why increased FDI, like increased trade, provides an impetus to further growth through extending the bounds of competition within economies.

On this view, during the 1980s the OECD countries entered a period of FDI expansion closely analogous to the trade expansion of the 1950s. The tariff reductions that spurred trade in goods during that period are paralleled by the liberalization of service industries now underway in the OECD. Trade expansion was helped in the 1950s by the shift to convertible currencies. The global linkage of money and capital markets acted as the corresponding financial market impetus to FDI in the 1980s. The greater linkage permitted a smoother transfer of global savings among countries — aided by flexible exchange rates — and a wider array of options for companies to raise finance for investment wherever they chose.

Just as trade liberalization in the 1950s stimulated growth through improved efficiency in sectors facing import competition, so FDI played a largely unacknowledged role in provoking the efficiency gains in the service industries in the latter half of the 1980s. The high growth that resulted was curtailed in 1990 by the Gulf-war induced jolt to confidence that turned a cyclical slowdown into recession in the United States and several other countries. But, post-recovery, the potential remains for a supply-side stimulus to growth through increased FDI — provided no roadblocks are put in the way of increased FDI in the years ahead.

The varying success of developing countries in the 1980s also lends support to the idea of a strong two-way linkage between FDI and growth. For them, the foreign exchange constraint to growth provides an additional dimension to the parallel role of FDI and trade in "leading" growth. The starkest comparison can be made between 10 major Latin American countries, which grew at an average annual rate of 2.5% between 1984-89 and received FDI of 0.7% of GDP, and five Asian

Figure 8
FDI in Selected Developing Countries
(1984–89)

	10 Latin American LDCs[1]	5 Asian LDCs[2]
FDI/GDP (%)	0.7	1.5
FDI/net external borrowing (%)	59	106
GDP growth rate (% pa)	2.5	4.7

(1) Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Peru, Uruguay, Venezuela

(2) Indonesia, Malaysia, Philippines, Singapore, Thailand

Source: Institute of International Finance, Inc., 1990

countries, which grew by 4.7% per year over the same period and attracted FDI equivalent to 1.5% of their GDP (Figure 8).

Obviously there were many factors besides direct investment that contributed to the success of the Asian countries, and to the problems of the Latin American ones. Development economists have long lauded the importance of trade linkages and an "export-oriented development strategy" (World Bank 1987). But the role of FDI in establishing those trade flows has not been widely recognized. In 1982, when Singapore's export success in the US market was at its zenith, 47% of those exports were by US-owned firms in Singapore. In the same year, 52% of Malaysian exports to the United States were from US affiliates. Taiwan's five leading electronics exporters are US-owned firms. These Asian countries are about to enjoy another wave of export success, but this time on the back of the heavy Japanese FDI they have been receiving. A developing country that can harness its economy to the twin engines of FDI and trade can multiply its prospects for growth.

If FDI is the twin of trade, it is, from a policy perspective, the neglected twin. Trade, not FDI, has been the focus of post-World War II international negotiations, perhaps because FDI flows seem so much smaller. If one compares total FDI flows with total trade flows, this neglect would seem to be confirmed. Even after the substantial growth of the 1980s, global FDI is roughly one-tenth the size of world trade and this may explain why it has received so little attention.

But that is not a fair comparison. FDI itself is only the initial vehicle

Figure 9
US Exports and Local Sales by US Affiliates Abroad
($ bn, 1987)

	US exports to:	Local sales of US firms in:	Ratio
Canada	59.8	100.0	1.67
Japan	28.3	36.7	1.30
Mexico	14.6	7.0	0.48
United Kingdom	14.1	88.1	6.24
Germany	11.7	61.4	5.27
Netherlands	8.2	15.2	1.85
Korea	8.1	0.7	0.08
France	7.9	42.3	5.32
Taiwan	7.4	1.7	0.23
Benelux	6.2	10.8	1.75
All countries	**254.5**	**537.9**	**2.11**

through which firms establish themselves in their target market. It is the local purchases from suppliers and sales to customers in their host markets that are analogous to imports and exports. Not only are these much larger than the initial FDI flow, but they generally continue and grow for many years after the investment takes place. BTG's case served to illustrate that point. Subsequent sales may not appear on the balance of payments, but they are the raison d'étre for the FDI and the relevant measure, along with trade, of economic impact and integration.

How large are these local sales and purchases of FOFs? The data are limited but it appears that they are already a more important way of reaching foreign markets than are imports and exports for many firms and thus, in aggregate, for many countries. For the United States, this is borne out by comparing US exports with local sales by US-owned firms abroad (Figure 9). In 7 of its 10 biggest export markets, US subsidiaries in those countries sell more locally than the US exports to them. Total 1987 sales by US-owned firms abroad were more than double US exports.

Even this result understates the importance of FOFs in reaching foreign markets because about 30% of US exports go to US affiliates abroad. This explains two of the three exceptions in the top 10 of Figure 9: as popular offshore production bases for US firms, neither Korea nor Taiwan would make the list if it were not for the exports of US parents to their subsidiaries in those countries.

Figure 10
US Trade Balance versus Net Foreign Sales, 1986

Foreign sales		*US $ bn*
Exports of goods and services		304.0
less:	exports to US-owned firms abroad	71.3
	exports by FOFs in US to home countries	50.7
plus:	local sales to FOFs in US	400.4
	local sales by US-owned firms abroad	865.2
	Total foreign sales	**1,447.6**
Foreign purchases		
Imports of goods and services		439.4
less:	imports from US-owned firms abroad	65.6
	imports by FOFs in US from home countries	124.5
plus:	local purchases from FOFs in US	616.5
	local purchases by US-owned firms abroad	558.5
	Total foreign purchases	**1,424.3**
	Net exports:	**-135.4**
	Net foreign sales:	**+23.3**

Similar figures are not available for other countries, but there is corroboratory evidence of another sort from the United Kingdom. An analysis carried out by a London brokerage firm using data from companies listed on the Stock Exchange showed that the average proportion of their profits earned through exports was 5% in 1987, while 39% came from overseas sales by their subsidiaries (Phillips and Drew 1988).

Such figures show how misleading it can be to use trade statistics alone in assessing a country's international economic standing or in setting its policy priorities. For example, there was much concern in the mid-1980s that the large US trade deficit signaled a fundamental loss of competitiveness by US companies. But the issue of competitiveness must surely include both ways of dealing in foreign markets — through trade and through the local sales and purchases of overseas subsidiaries.

Using data from the Department of Commerce and a bit of extrapolation* about the local-purchasing behavior of US-owned companies

*See Julius 1990 for details. The data in Figure 10 are updated and revised from those in the 1990 source, but the method is the same as described there. I am grateful to Guy Stevens of the US Federal Reserve Board for pointing out some problems with the original data.

abroad and about foreign-owned companies in the US, it is possible to construct an alternative, ownership-based "trade" measure that encompasses both competitive routes (Figure 10). Traditional import and export figures are converted into measures of "foreign purchases" and "foreign sales" that assign transactions according to country of ownership rather than residence.

This is done by making two adjustments. First, to avoid double counting, the trade that takes place between foreign-owned firms abroad and their home market is subtracted. For example, if IBM Japan imports parts from the US, assembles them and sells them in Japan, then those parts are included both in US exports to Japan and in the local sales of US-owned firms in Japan. The second adjustment is to add the local sales and purchases of foreign-owned firms in their host countries.

Using this more comprehensive measure transforms the 1986 US trade balance from a deficit of $135 bn, based on the location of companies, to a surplus of $23 bn, based on their ownership. While these figures are imprecise, they highlight the importance of including FDI-related flows in analyses and policy discussions about international economic issues.

To sum up, the reasons for FDI are many and complex, but the case for encouraging FDI is relatively simple. When barriers to investment and trade are lowered, both flows tend to increase and they complement each other. Countries that have effectively encouraged FDI seem to have prospered, much as have those that have encouraged trade. Although FDI flows themselves are small in relation to trade flows, the new international competition they create is already larger than that provided via trade, at least for the United States and Britain. The effects reach deeply into national economies, extending the gains in efficiency and growth that come from competition. This is particularly so in the service sectors and, as they increasingly dominate the domestic economies of OECD and developing countries alike, the gains from FDI — which is the vehicle for international competition in many services — are likely to increase in importance too.

If governments are to overcome the negative politics of FDI and to promote open as well as "fair" international competition, FDI deserves a prominent place alongside trade on the international policy agenda.

Implications for Policy

I have argued that the importance of FDI is not yet widely understood. Protectionist sentiment is still widespread, increasing uncertainty and inhibiting investment. Moreover, in areas such as competition, different national and regional policies are likely to skew investment and to depress its growth.

The case for promoting FDI, as the twin of trade, is a compelling one. Is there anything that can be done to strengthen international economic relations and to counter these tendencies? Can international rules be devised and agreed that, in the future, will make it difficult for a nations' policymakers to give in to nationalistic sentiment against FDI?

Jan Tumlir, the former GATT chief economist has linked the importance of investment to the rationale for a rule-based framework for trade:

> International trade as a large-scale activity requires careful planning and substantial investments, which can be recouped only over long periods of time. All long-term investments are highly sensitive to uncertainty, and foreign-trade related investments doubly so for their outcomes may be affected by policy changes in several countries. The trade part of the international economic order can thus be understood as a set of policy commitment exchanges between and among countries in order to minimize policy-generated uncertainty and so to maximize the gains from trade. (Tumlir 1986)

It is a short logical extension of Tumlir's point to argue for an international rule-based framework for foreign investment. While this may be too ambitious as a short-term goal, it is still worth considering what principles and institutional framework would be needed to achieve it as a long-term objective. Then it makes sense to consider what short-term agenda might move us in the right direction.

The Long-Term Objective: Principles

A sound set of principles, multilaterally agreed and enforced, to reduce restraints on FDI and to inhibit governments from creating new ones might well be the best way to defuse the worries about fairness that have generated so much political heat over FDI. The principles should be simple but powerful, designed to promote open international competition. At a minimum they should include:

(a) ***Trade-investment neutrality.*** Government policies should be neutral between trade and investment as alternative methods of access to a market. Voluntary export restraints are an example of a policy that falls foul of this principle. Skewing business decisions towards (or away from) investment rather than trade results in inefficient resource allocation and distortions to competition.

(b) *National treatment.* This is the familiar principle that foreign and domestic firms should be treated equally in the host country. They must obey the same laws and they should be accorded the same rights. Nowadays, this principle is frequently violated by local-content restrictions and reporting requirements that apply only to foreign firms.

(c) *Market access.* Foreign firms should be allowed to establish themselves in the host country in order to undertake any activity that is legally permissible for domestic firms.

The third principle is the farthest from current reality, and it is likely that under any new regime exceptions would have to be allowed. To avoid undermining the power of the general principle, governments could be asked to define at the outset those sectors in which they wish to forbid or restrict foreign ownership. For most governments these would be related to military security, but some might want to include parts of the media or financial services.

Such lists could be negotiated multilaterally, but the incentive then would be for each government to start with a long list. The negotiating incentives could be altered positively by allowing a limited form of sectoral reciprocity in this initial bargaining phase — that is, if France wished to restrict the holdings or operations of foreign media concerns, then other signatory countries would have the right to restrict selectively and comparably the activities of French media enterprises in their markets.

Such a departure from the GATT "most-favored-nation" principle would risk the proliferation of selective restrictions. But it might be a risk worth taking, if it were contained by appropriate international review and enforcement, since it might deter businesses and governments tempted to protect their home markets from FDI.

Why? Because more and more businesses find themselves facing the same competitors in markets around the world. They would be loath to lobby for home market protection if they risked exclusion from foreign markets as a result. In fact, many firms — especially the large and rapidly growing ones — would find it in their interest to take a more active stance in favor of liberal trade and investment policies in their home countries.

Such a stance could reverse the worrisome trend in the United States of weakening support among the business community for liberal trade, except in the "new issue" areas of services and intellectual property (Ostry 1990). In Europe and Japan, it could encourage business to pay more attention to public policy issues and to overcome the traditional reluctance to take a higher public profile.

Whatever the negotiating strategy, the three principles of trade-investment neutrality, national treatment and market access could form the basis of a multilateral system of rules for foreign investment.

The Long-Term Objective: Institutional Options

An effective dispute settlement and enforcement procedure would be critical for any rule-based framework for FDI.* Rules command no credibility if they cannot be enforced. This would be especially important if the use of a tool as powerful as sectoral reciprocity were allowed in the initial negotiations.

The central importance of enforcement limits the institutional options. In many respects the OECD would be an attractive organizational base for an international regime to liberalize FDI. It has long been active in this field and its national treatment instrument (adopted in 1976) and codes of liberalization have been important in eliminating discrimination against foreign-owned firms in member countries. Currently, OECD is trying to reach agreement to strengthen the national treatment instrument by building in techniques, such as standstill and rollback, to prevent countries from backsliding on the progressive liberalization already achieved.

However, the OECD has two major drawbacks for this role. Its membership is limited to the developed countries (currently 24 of them), and it contains no enforcement mechanisms, other than peer review and criticism. As a testing laboratory for different policy principles and approaches, the OECD is invaluable. But it cannot be expected to provide the basis for a strong international agreement on FDI.

The IMF, the World Bank and GATT are main alternative candidates. These three institutions were conceived at the same post-war conference to provide a comprehensive international framework to handle policy

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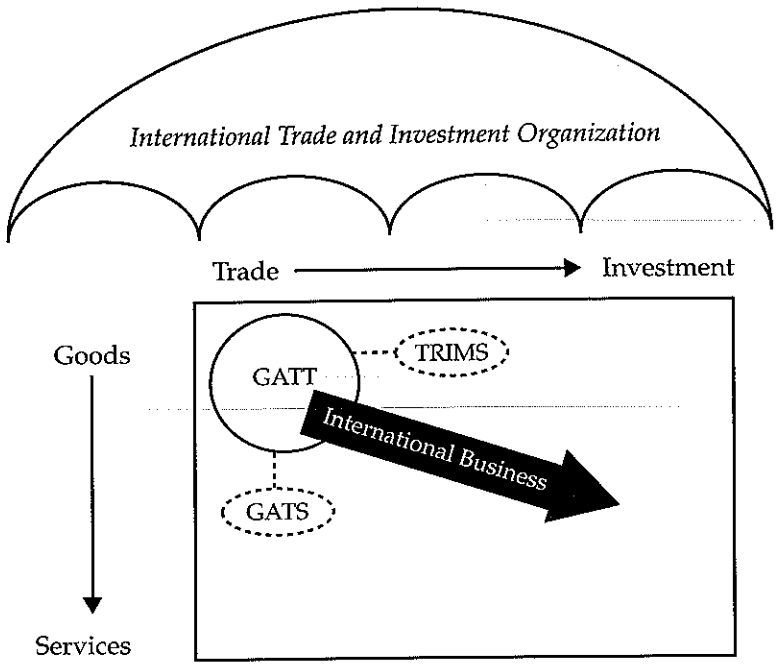
*This section on institutional options benefited from discussions at a Ditchley Park Conference in October 1990 and from the rapporteur's report prepared by Clive Crook.

Figure 11



conflicts and promote economic growth and integration. They have broad membership and provision for sanctions when agreements are not observed.

Policies towards foreign direct investment are important both for economic development (the purview of the World Bank) and for the balance of payments (the concern of the IMF). However, FDI is not central for either institution. In addition, the sanctions available to the IMF and World Bank are in the form of withholding disbursements on loans or refusing to commit to new lending. Since developed country members no longer borrow from the World Bank, and only rarely borrow from the IMF, these institutions would have little relevance to the part of the world where most FDI takes place.

We are left with GATT. Its many shortcomings as an institution are well known,* its dispute settlement procedure is used only sporadically and findings are sometimes ignored, and of late its effective survival has

*See Wolf (1990) for an entertaining account of these.

been called into question by the failure of the dominant countries to conclude the Uruguay Round of negotiations within the agreed four-year timetable. Yet it provides the best model, or starting point, for an international regime to liberalize FDI.

The limitations of the current GATT approach to tackling "new issues" such as FDI by focusing on their trade-related aspects have been noted. These limitations could be overcome by fundamentally broadening the scope of GATT or by creating a parallel institution for foreign investment (proposed in Bergsten 1990). Although the latter has some attractions, I favor the former for two reasons.

First, the intertwining of trade and investment in commercial activities would lead to overlaps and jurisdictional disputes between any new institution and GATT. Some countries might be members of one but not the other. Where would issues such as intellectual property protection and rights of establishment for service industries belong?

Second, on pragmatic grounds, there is limited political capital available for tackling international institutional problems. GATT itself is in urgent need of reform. Rather than compete for attention with this important task by proposing a new institution, it might be possible to add to its political appeal by coupling international investment to trade in a general call for a strengthened GATT.

The constitutional model put forward by Professor John Jackson (1990) is well suited to this vision of a unified approach to trade and investment (although he did not include that aspect). Jackson's proposal for strengthening GATT is to build around it a legal umbrella whose charter would be "focused on the institutional and procedural issues, largely leaving substantive rules and obligations to other treaty instruments such as GATT, which would be served and 'sheltered' by the broader organization." This would provide the legal framework that GATT currently lacks. It would also establish centralized procedures for dispute settlement to be used by GATT and by all its side agreements. And it could provide for follow-up negotiations without having to launch a new "round."

Figure 11 shows how GATT's current domain maps onto the business environment. The fastest growing area for international competition — via direct investment in industries with a high service element — is still well outside GATT with only short, tentative steps leading towards it. Linking foreign investment with the often-cited benefits from free trade could increase support for both among the business community and the general public.

An Action Menu for the Short Term

To change public perceptions and to build political constituencies for the reform of GATT will take time. The continuing saga of negotiating difficulties in the Uruguay Round suggests that this is not the moment to attempt the bold multilateral initiatives outlined above. However, there are a number of other avenues that can be pursued unilaterally, bilaterally and regionally to liberalize the investment climate and, perhaps, to lay the conceptual and political groundwork for broader action in the mid-1990s.

The basic theme of these suggestions is that governments should reorient their trade negotiating objectives and agenda to highlight policies affecting FDI. FDI should be brought out of the shadows as the neglected twin of trade. Trade policy should become trade and investment (T&I) policy.

OECD Countries. In addition to the Uruguay Round, the next two years will involve a number of major bilateral and regional trade negotiations. The United States and Canada are negotiating with Mexico to conclude a North American Free Trade Agreement. The European Community is discussing forms of economic association with several of the East European countries. Japan will have regular bilateral discussions with its East Asian trade partners. In each of these discussions, foreign investment should be accorded equal billing with trade.

Thus the United States, Canada and Mexico should aim for a North American free trade and investment area. This should not be unduly difficult because the United States and Canada have already agreed on most of the contentious investment issues (banking, for example), and Mexico claims to welcome inward investment and has reduced restrictions in many sectors. The current negotiations should urge the process to go further and faster, while making it easier for Mexican firms in labor-intensive sectors to obtain work permits for contracts in the United States and Canada.

The EC should encourage East European countries to liberalize their foreign trade and investment regimes together. At present these regimes are proceeding along different tracks, with different sequencing often handled by different ministries. The implications of joint T&I liberalization are far-reaching and differ across the region. For some countries, it would require unifying the exchange rate regime for current and capital account transactions. For others it would mean a shift in the privatization priorities and the limits placed on foreign ownership.

In the negotiations between the EC and EFTA over access to the post-1992 single market, barriers to foreign ownership and discrimination against foreign shareholders in countries such as Sweden and Norway are already receiving attention. The EC should stand firm on the principle of achieving a single market in corporate governance throughout the European Economic Area as part of the package that allows EFTA countries open access to the EC market.

Developing Countries. Although some LDC-based companies are foreign investors in their own right — Taiwanese and Korean firms are prominent — most LDCs are net recipients of FDI. Those that wish to increase inward flows should focus first on creating a stable, low-inflation environment where foreign exchange regulations permit profit and capital remittance as well as import/export transactions. Without this, domestic as well as foreign investment will be deterred, and capital flight will become a problem.

Aside from the macroeconomic environment, the biggest obstacle to inward FDI in developing countries is the simple fact that many still prohibit it in numerous sectors. Typically these range from minerals to electricity to banking. Often these sectors are controlled by inefficient public sector monopolies. Allowing foreign competition, with or without privatization of the domestic producer, can bring substantial gains in the efficiency of capital used in the sector, as well as the obvious financial benefits of FDI.

East Europe. The key obstacle here to inward FDI is no longer entrenched political opposition but the practical, legal (and sometimes social) problem of determining who owns the land and existing firms and thus who should receive the benefits of any sales. Each country will have to find its own answer to this question, but progress so far has been disappointingly slow. Governments should not be distracted from this task by thinking that, in any case, the establishment of a fair price will have to wait until the market economy is fully functional. As long as potential buyers are allowed to compete openly and on equal legal footing, then a price will be found that reflects the value of the assets, given the future uncertainties. These countries can ill afford to delay the dynamic gains that foreign firms bring through their managerial expertise and links to external markets.

A Bilateral T&I Initiative. Sometimes international policy initiatives begin with a bilateral trial. The US-Israel agreement to liberalize service trade between the two countries provided a negotiating model for the inclusion of services in the Uruguay Round. A similar opportunity should be sought for a T&I agreement. Again the initiative probably would have to come from the United States. Its negotiations with Mexico provide one avenue for such an initiative, as discussed above; but, these negotiations will have special features due to the proximity of the two countries and the sensitivity of the illegal immigration issue.

For a number of reasons, Poland would be an attractive candidate for a bilateral initiative. It has reduced inflation and stabilized its exchange rate. It has implemented far-reaching economic reforms yet attracted little foreign investment, partly because privatization is going slowly. Its export performance has been encouraging but the restrictive policies of its European neighbors towards its agriculture and textile products have been a handicap. With a population the size of Spain, Poland has a larger domestic market than any other East European country, which should be attractive to US firms. There are many Polish-Americans and much residual goodwill between the two nations, which could help to overcome commercial objections in some US quarters to providing preferential access to Polish products. A US-Poland free trade and investment agreement would be a dramatic illustration of commitment on both sides to growth through markets that are open to trade and inward investment. It would also be a tangible step away from regional trade blocs.

There are other ongoing negotiations that relate to FDI, including those of the Uruguay Round of GATT. Like the OECD work described above, they are valuable and necessary steps towards creating a more open and transparent environment for foreign investment. But they are unlikely to engage the interest or change the perspective of the body politic.

Without a broader understanding of the economic gains conferred by FDI, it is likely that misguided political opposition will hold those gains far below their potential. New initiatives that can capture the public imagination are needed. In the near term, it is important to link trade and investment negotiations, whatever the context, to underline their complementary nature. For the longer term, the proposed reform of GATT may provide an opportunity to create an appropriate multilateral umbrella to promote FDI. The surge in FDI in the 1980s was a remarkable phenomenon inextricably linked to economic growth in the decade. The challenge is to ensure FDI continues to grow — and to spur world growth and development — in the 1990s and beyond.

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