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INVESTMENT PATTERNS IN A LONGER-TERM PERSPECTIVE

Introduction

Reports on trends in international direct investment tend to focus on recent developments.[1] While such information is clearly of most relevance for policymakers and others interested in the pace and scale of globalisation, it fails to provide any perspective on the nature of globalisation itself. By their nature, recent developments give more weight to the cyclical element in global investment flows. A country's performance in terms of annual inflows is often taken as a measure of the appropriateness of its policies and, by extension, of its relative attractiveness as a location for investment. Such important issues can only be assessed over a long time period and relying on more sources of information than simply flows of foreign direct investment (FDI). This study focuses on such long-term trends and includes, where appropriate, other estimates of multinational activity.

By focusing on long-term patterns, this paper demonstrates how FDI has evolved from an activity largely undertaken by large multinational enterprises (MNEs) located in a handful of countries into a global phenomenon. These large firms still dominate global flows in value terms, but they are increasingly only one part of an expanding universe of firms investing abroad. Many of these newer MNEs are small or medium-sized companies originating from countries which were formerly predominantly hosts to foreign investors, including some non-OECD countries.

The rapid and uninterrupted expansion of international direct investment over the past five years is part of a long-term trend towards increasing economic integration of the world economy. More firms from more countries in more industries are investing abroad than ever before. Multinationality is no longer the preserve of the world's largest firms. Although they still dominate global flows in value terms, the number of firms investing abroad is continuously expanding. The nature of multinationality is also changing, as the activities of foreign affiliates have become more integrated with the parent and with other affiliates.

In many ways, FDI is a means by which the world economy becomes more integrated. Through their international presence, multinational enterprises lower the transactions costs involved in international business and help to channel goods, services, capital, labour and technology worldwide. When appropriate trade and active competition policies are in place, FDI can also stimulate competition in the local economy. The ultimate outcome is improved growth prospects for the countries involved and greater integration with the global economy. The full effect of international investment can only be discerned by examining the details. Why are firms investing abroad in record numbers? Which industries are most involved? Where are they investing? These questions are addressed below.

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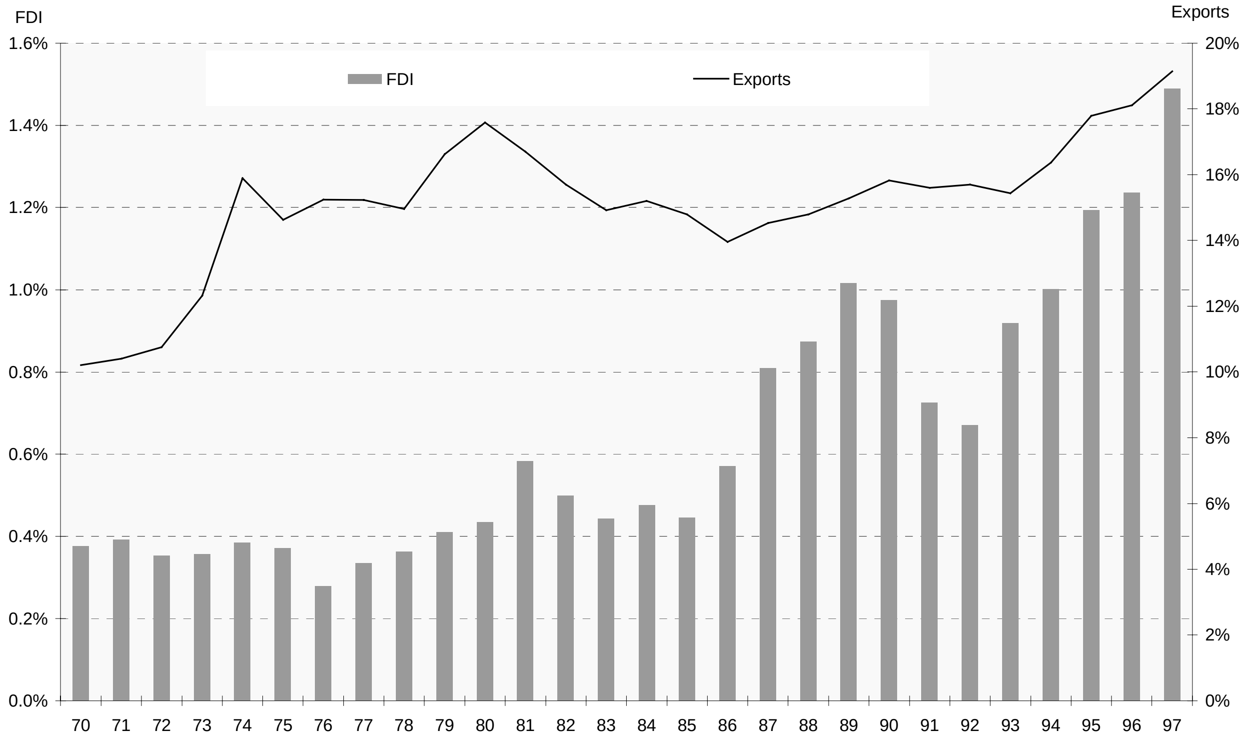
1. See, for example, "Recent Trends in Foreign Direct Investment", *Financial Market Trends,* June or July issues, OECD, or the *World Investment Report*, UNCTAD.

I. Global trends in FDI flows

Both trade and investment have grown rapidly in the past five years relative to economic growth more broadly. There have been periods of rapid FDI growth before, such as at the beginning and end of the 1980s, which were subsequently interrupted by economic recessions in major economies. But there is nevertheless a secular upward trend which goes beyond the economic cycle. Figure 1 shows trends in global trade and FDI over three decades. In both cases, the upward trend over time is immediately apparent.

Figure 1. **Global exports and FDI flows as percentage of GDP, 1970-97**

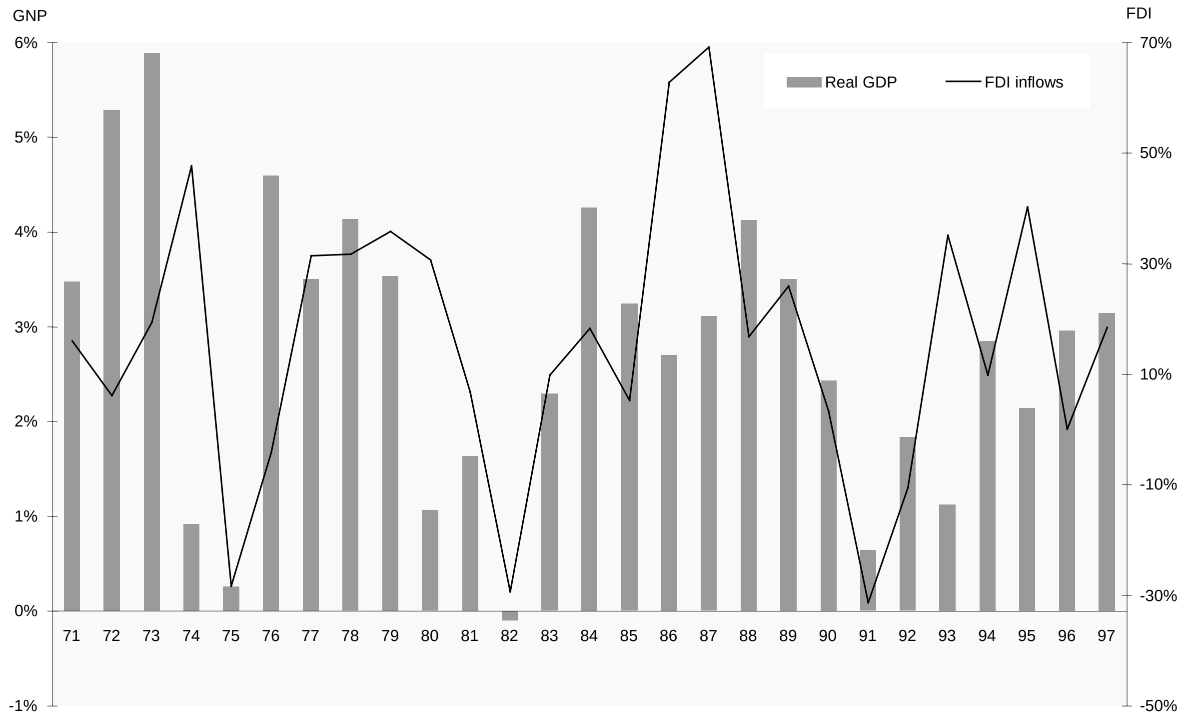


Source: OECD, IMF, UNCTAD

The steady expansion of FDI flows has been driven by several inter-related factors: rapid technological change, trade and investment liberalisation at a national, regional and global level, privatisation, deregulation, demonopolisation and the switch in emphasis by firms away from product diversification towards a more balanced geographical distribution of production and sales. Growing equity markets have also facilitated the sale of domestic companies to foreign investors. These factors interact at various levels, as policy reform and technological change bring greater competition at a global level which in turn drives firms to expand abroad and to invest in newer technologies. Governments respond by trying to increase their attractiveness to foreign direct investors by further liberalisation and reform. While this process is mutually-reinforcing, it is not necessarily self-perpetuating. It relies on the continued willingness of national governments to pursue open and non-discriminatory policies.

The upward trend in FDI flows can also be interrupted temporarily by a decline in global growth. Like any form of investment, FDI is affected by the business cycle. Slower growth in home countries reduces investor profits at home which could have been used for acquisitions abroad. Figure 2 compares growth in OECD inflows with real growth in OECD countries since 1971. The three periods of sharp declines in growth in FDI inflows — in the mid-1970s and early 1980s and 1990s — have all coincided with a slowdown in economic growth in OECD countries.

Figure 2. **Growth in real GDP and FDI inflows in OECD countries, 1971-97**



Source: OECD

Economic growth influences both the "supply" and "demand" for FDI. Slower growth in the home country reduces both earnings and equity prices and hence limits the pool of capital available for expansion abroad. Similarly, recession in host countries lowers the short-term profitability of a potential investment. Because of the long-term nature of FDI, the host country impact on the "demand" for FDI may be less than the supply-side response to slower growth in the home country. Experience suggests that outward investment is more constrained by the available resources which can be devoted to those activities than by the short-term macroeconomic environment in the host economy. This might explain why the financial crisis has not dampened global investment flows. Indeed, outward investments have continued to soar, as the prolonged economic expansion under way in major home countries such as the United States has provided profits which can be invested abroad. These investors can also take advantage of relatively low interest rates and high equity prices at home to raise capital for FDI.

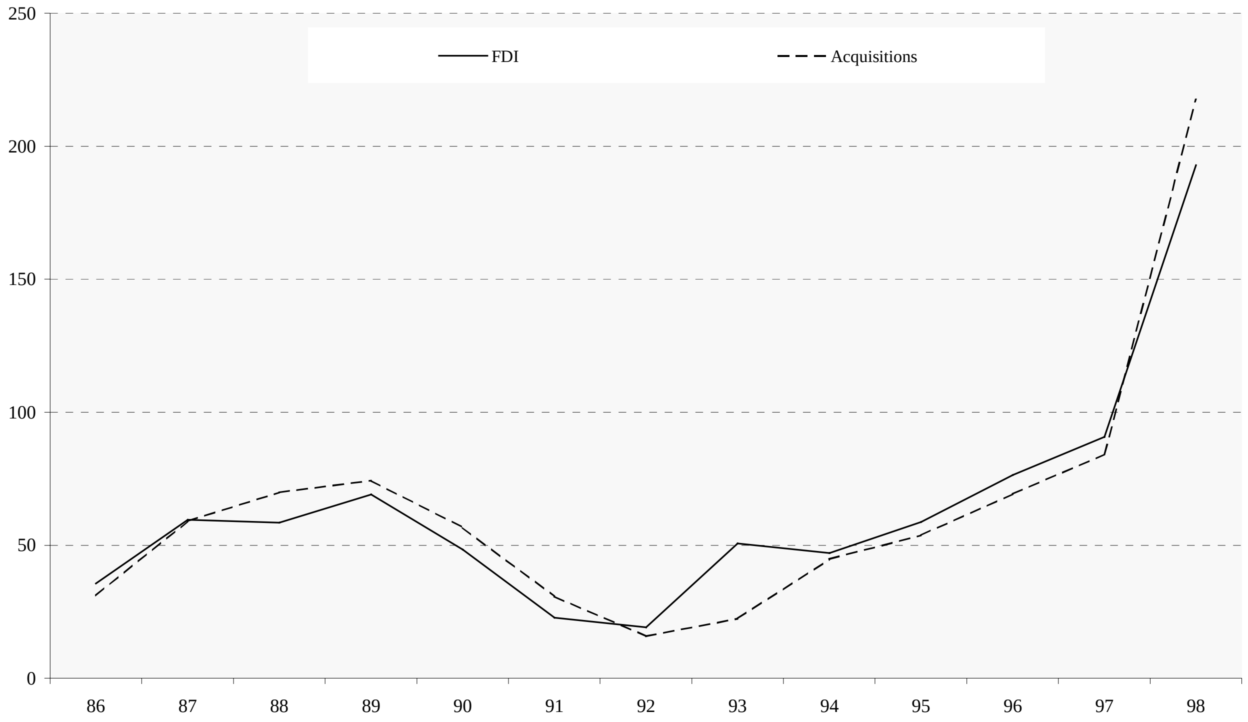
If home country conditions are the main driver of global flows, then the current surge in FDI flows worldwide could reverse itself should conditions change in source countries. Any such downturn could significantly depress global outflows, but the experience of three decades of secular increases in FDI flows suggests that the long-term trend would not be affected — unless liberalisation of trade and investment is halted.

Cross-border mergers and acquisitions

A significant share of FDI among OECD countries represents acquisitions of local firms by foreign investors. Investors in many sectors commonly prefer to invest abroad through acquisitions rather than greenfield sites because the local firm provides a distribution network, an established brand and market share, as well as intimate knowledge of local customs and regulations. Excess capacity in a given sector in the host country also favours acquisitions.

Cross-border mergers and acquisitions (M&As) are estimated to account for no less than 60 per cent of the total value of global investments, or 80 per cent of FDI in the United States and 85 per cent in Australia. A higher proportion of FDI in developing countries is likely to come from greenfield investment, although privatisation programmes have no doubt pushed up the share of acquisitions in these countries as well. Intra-OECD flows are closely associated with cross-border acquisitions. Figure 3 compares total acquisitions of US companies by foreign investors over time with total recorded FDI in the United States. The close, almost perfect, correlation between the two trends is immediately apparent.

Figure 3. **Foreign investment in the United States, 1986-98** ($ billion)



Source: OECD, Securities Data Corporation

Not all investments are made through acquisitions, however. In some industries and in some countries, particularly developing ones, investments are more likely to be greenfield sites where the investor establishes a presence and builds it up slowly over time. FDI figures tend to underplay the former in total flows and hence provide little idea of the extent to which FDI flows represent actual shifts in production. To estimate the magnitude of this process of structural reallocation of activities through FDI requires recourse to other types of measures.

The potential benefits from FDI do not depend on the mode of entry. Irrespective of how the investor enters the market, FDI facilitates the international transfer of capital, technology, and goods and services because such transfers are presumably easier between the parent and its affiliates than they are among unconnected companies. Thus what rising FDI flows imply for the world economy is the enhanced potential for greater global integration through trade, technology and capital flows. FDI through M&As can also bring about efficiency gains through economies of scale and scope. Whether these potential benefits are ever realised depends partly on the alertness of the MNE to new profit opportunities but also much more importantly on the policy environment in the host country, particularly with respect to trade and competition policies. Technology transfers tend to be greater when the foreign affiliate faces stiff competition in the local market.[2]

II. Trends in OECD flows

As the largest home and hosts to FDI, total OECD flows closely mirror global trends. OECD inflows and outflows are dominated by firms from the United States and the United Kingdom, accounting for 45 per cent of OECD inflows and 38 per cent of outflows in the 1990s, but many other countries have witnessed spectacular growth in inflows and outflows in the past five years. For many of these countries, recent inflows are not simply higher than before, they represent a different order of magnitude. For ten OECD Members in 1998, inflows were roughly twice the level of 1997.

In Finland, inflows in 1998 exceeded in nominal terms total cumulative inflows in the previous thirty years. For OECD countries as a whole, inflows in the past five years have exceeded total nominal inflows between 1981 and 1993. Among the only OECD countries for which the 1990s has not represented a watershed are Spain and Portugal. Investments in these countries grew rapidly in the late 1980s following their accession to the European Community. Inflows since then have remained significant, but they have not exceeded the peak reached in 1990. After aggressive expansion by Spanish banks and utilities in Latin America, Spain has become a net outward investor in recent years (on a flow basis).

Table 1 compares cumulative FDI flows from and to OECD countries in the 1990s. OECD countries are divided evenly into net recipients and net outward investors. Eight of the top OECD recipients of FDI are also among the top ten investors. All eight are nevertheless substantial net outward investors, principally Germany, Japan and the United Kingdom. The correlation between outflows and inflows points to the fact that FDI, like trade, flows among the same group of predominantly rich countries, with two-way flows within the same industry a common occurrence.

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2. See the discussion on this issue in *Foreign Direct Investment and Economic Development: Lessons from Six Emerging Economies*, OECD, Paris, 1998.

Table 1. **FDI inflows and outflows involving OECD countries, 1990-98**

	Inflows	Outflows	Net outflows (+)
US	625 776	657 672	31 896
UK	237 507	365 120	127 613
France	177 620	257 437	79 817
Netherlands	114 515	175 802	61 287
Belg.-Lux.	104 493	79 540	-24 953
Spain	80 486	48 636	-31 850
Canada	74 918	93 118	18 200
Mexico	69 088	na	-69 088
Sweden	66 767	79 820	13 053
Australia	60 473	26 205	-34 268
Germany	60 246	320 012	259 766
Italy	32 924	71 634	38 710
Switzerland	25 870	100 690	74 820
Denmark	24 460	24 669	209
Poland	24 078	356	-23 722
Norway	19 710	23 165	3 455
Austria	18 853	15 516	-3 337
Finland	18 564	41 045	22 481
New Zealand	18 461	4 014	-14 447
Hungary	16 880	1 012	-15 868
Korea	16 180	24 931	8 751
Portugal	16 117	7 995	-8 122
Japan	13 509	219 953	206 444
Czech Republic	10 797	479	-10 317
Greece	8 337	na	-8 337
Turkey	7 443	1 238	-6 205
Ireland	7 230	na	-7 230
Iceland	389	na	- 389
OECD	1 951 690	2 640 058	688 368

Source: International Direct Investment Statistics Yearbook, OECD

OECD investors typically invest in the largest and richest markets, which are found for the most part within the OECD area itself. Since 1982, 75 per cent of OECD outflows have gone to other OECD countries. The share of OECD investment remaining within the OECD area has fluctuated within a band between 70 and 80 per cent, with no long-term structural decline in the OECD share. Over one quarter of OECD outflows between 1982 and 1998 went to the United States, twice as much as to the second favourite destination: the United Kingdom. The top nine destinations for OECD investment during this period are all OECD countries. The countries of the European Union collectively received 42 per cent of total OECD outflows, part of which originated within the EU itself.

Within the OECD area, inflows have tended to concentrate in the large regional markets of Europe and North America. Europe has received the largest share of inflows since 1990, but both regions have seen a quickly rising inflows over time. Total regional inflows include both intra- and inter-regional flows and hence are likely to be greatest in OECD Europe which represents 22 separate economies. The four OECD countries in Asia which represent a much smaller and less integrated market so have tended to receive much less investment as a share of the total. With the rapid increase in cross-border mergers in Japan and Korea, however, inflows into OECD Asia are likely to grow in the future.

Among non-member country destinations, Brazil comes first for OECD investors. Recent flows to Brazil have been encouraged by the massive privatisation programme under way, but the relatively large Brazilian economy has attracted OECD investors for decades, particularly in the automotive industry. The other countries in the top ten among non-members are all large or relatively wealthy developing countries. The remaining non-OECD countries represent a mere seven per cent of total OECD outflows.

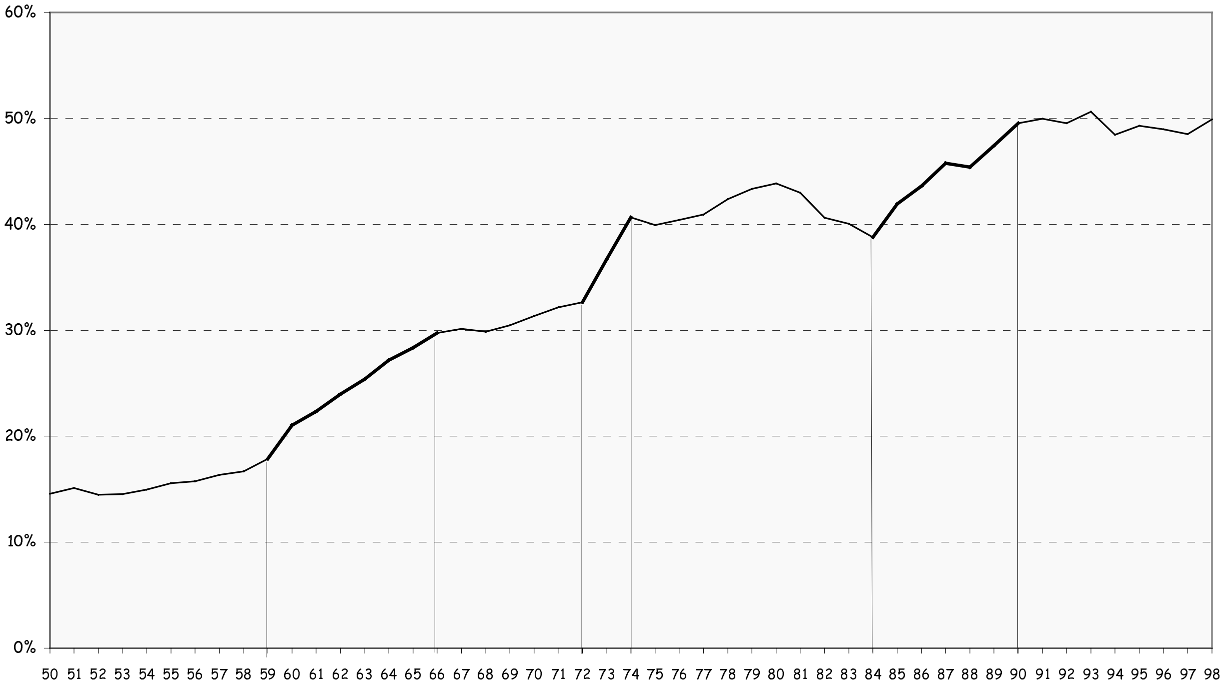
This comparison of shares should not disguise the fact that investment has tended to increase in most countries over time. But it does put fears of a massive relocation of production to the lowest wage countries as a result of globalisation in perspective. This can better be seen by looking at the pattern of sales of MNE affiliates abroad which is discussed later. Multinational enterprises invest abroad for market access, not in the narrow sense of avoiding tariff barriers, but rather in order to limit the distance between buyer and seller in a world where there are important information costs which increase with distance. As long as OECD markets remain the most important for OECD based MNEs, the largest share of OECD flows will remain within the OECD area.

European integration and FDI in Europe

The introduction of the euro at the beginning of 1999 has focused attention on the impact of ever-greater European economic integration on patterns and levels of FDI in Europe. European integration over four decades has played an important role in FDI trends in Europe, encouraging investment by firms from outside of the region, promoting consolidation of European industry and helping to shape the geographical pattern of production by both European and non-European firms in Europe. At the same time, however, global factors have also been at play which should not be overlooked.

FDI in Europe has often been greatest during periods of rapid integration. The longest record of direct investment in Europe is by US firms, beginning in the nineteenth century but growing most quickly over the past four decades. Figure 4 shows the share of US direct investment abroad which has gone to Europe since 1950. The three periods of rapid growth in the European share of total US direct investment coincide with the three phases of most intensive integration among European economies: 1960-66 after the signing of the Treaty of Rome and subsequent tariff reductions among Common Market members; 1973-80 when the United Kingdom, Ireland and Denmark all joined the Community; and 1985-90 following the launch of the Single Market Programme in the mid-1980s.

Figure 4. **European share of the stock of US direct investment abroad, 1950-98** (per cent)

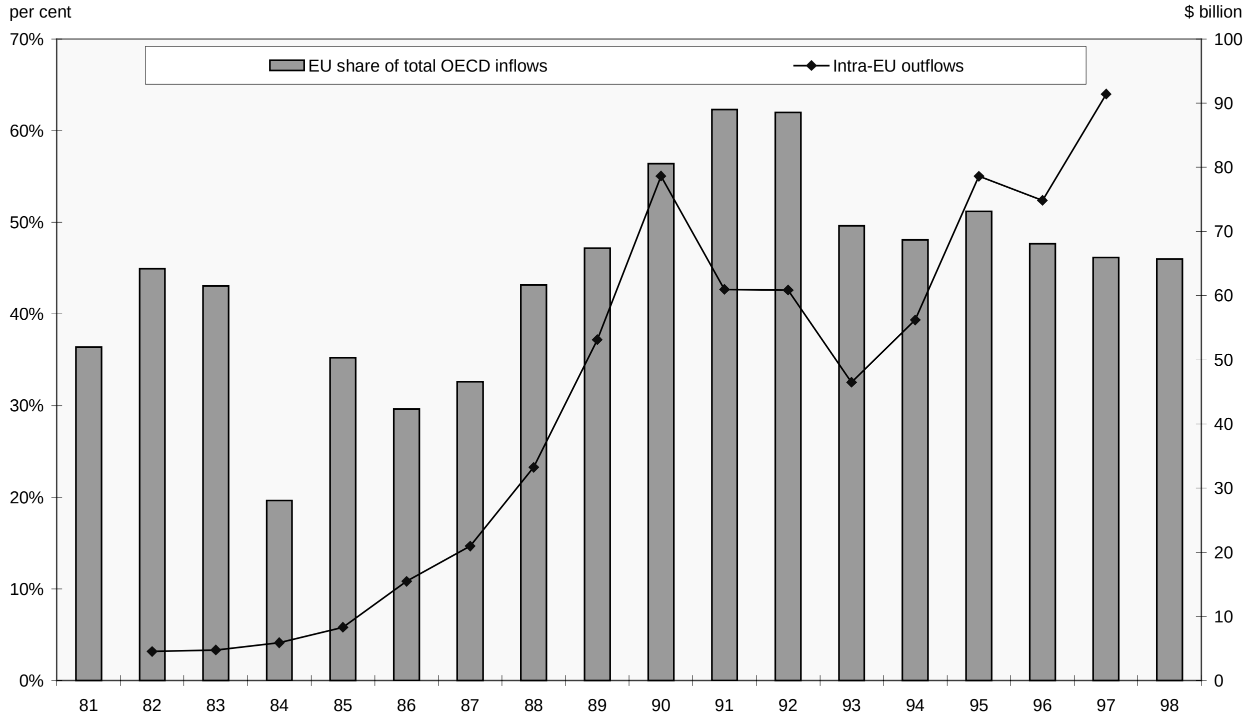


Source: US Department of Commerce

The Single Market encouraged Japanese investors in a similar fashion, both through the opportunities offered in a large, integrated market and through the perceived threat of a Fortress Europe. The European share of total Japanese manufacturing investment overseas grew rapidly in the late 1980s and peaked at almost 30 per cent in 1991. Even with the prospect of a Single Market, however, Japanese manufacturing investment in Europe still ranks only third after similar Japanese investments in the United States and Asia. Global factors are likely to have been at least as important a driving force behind Japanese investment in Europe, such as the appreciation of the yen and the pressure for Japanese firms to increase overseas production in all major markets.

The greatest impact of continuing European integration since the mid-1980s has been on investments within Europe, by both European firms and established foreign enterprises. In the early years of the Common Market, the most visible investor response was by US MNEs rather than European ones. Figure 5 shows both intra-EU inflows and the share of total OECD inflows going to EU countries. By both measures, the late 1980s and early 1990s represents a period of unprecedented cross-border investment activity within Europe, as EU firms responded to the opportunities and challenges of the approaching Single Market.

Figure 5. **Direct investment in Europe, 1981-98** (per cent; $ billion)



Source: OECD

European integration has helped to focus the minds of European investors about the need to achieve scale and establish a presence throughout the region, but it is neither the only objective of European firms nor only restricted to those firms. Figures on mergers and acquisitions involving European firms provide a useful reminder of the global nature of most investors' strategies. In particular, they tell the following story:

- Although the share of national mergers in total Community mergers is falling steadily over time, it still accounts for one half of the total number of mergers in and by European firms;

- Cross-border mergers among EU firms remain less important in numerical and value terms than international mergers involving one EU firm and a bidder or target outside of the European Union;

- US firms represent the single most important source of bids as well as targets for European firms;

- Intra-EU mergers rose rapidly in the late 1980s and again in the second half of the 1990s, but this latter trend must be seen in the context of a dramatic rise in M&As worldwide during this period;

- Total mergers in Europe doubled in value to reach $1,200 billion in 1999, but they remain well below those in the United States ($1,700 billion).[3]

Seen from a longer term perspective, the introduction of the euro is just another step in this ongoing process of European integration. It remains to be seen whether it will have a similar catalytic effect on intra-EU direct investment. While intra-EU M&As have tripled since 1996 in value terms, they still remain below cross-border purchases of US firms (principally by EU investors). This, together with the concomitant rise in national M&As, suggests that recent intra-EU mergers have been driven as much by global industrial logic as by regional considerations. The advent of the euro will nevertheless facilitate cross-border fusions in Europe by helping to create a unified capital market in Europe and eliminating currency risk, both of which will make it easier for European investors to raise equity capital outside of their own national market.

Integration has probably increased significantly levels of FDI in Europe, both by European firms and by those outside. It cannot easily be claimed, however, that moves towards integration have promoted cross-border flows within Europe more than flows between Europe and other regions. In terms of investment flows, European integration does not appear to have occurred at the expense of integration with the rest of the world.

European integration and the location of economic activity

Even more important than the issue of whether integration in Europe has encouraged direct investment into and within Europe is the question of how integration has affected patterns of direct investment in Europe and what light this sheds on the emerging division of labour within Europe as national economies become ever more closely intertwined. Because FDI flows are only an imperfect proxy for shifts in production between countries, this section will focus specifically on where US MNEs choose to locate their production for export within Europe. US firms are among the oldest direct investors within Europe and perhaps the first to respond to the opportunities offered by an integrating market. For this reason, their location decisions should best reflect the comparative advantage of each EU member state.

Exports by US manufacturers in Europe appear to be highly skewed in favour of the two largest markets for American products: Germany and the United Kingdom. In part, this reflects the fact that US automobile producers have, partly for historical reasons, major operations in these two countries. But at the same time, it reflects a proclivity for firms to export from those countries where demand is greatest for their products. These two countries are the most important export platforms for US firms in almost all major manufacturing industries.

3. “M&A records on both sides of the Atlantic”, *Financial Times*, 1 January 2000.

Table 2. **Non-US exports by US manufacturing affiliates in Europe*** ($ million; per cent)

	77	96	change
Europe	**36 943**	**205 513**	
Belgium	13.4%	8.0%	-5.4%
France	13.5%	11.2%	-2.3%
Germany	25.7%	22.6%	-3.1%
Ireland	2.1%	6.7%	4.6%
Italy	4.6%	5.5%	0.8%
Netherlands	11.9%	10.5%	-1.4%
Spain	2.0%	5.6%	3.6%
Sweden	1.3%	1.2%	-0.1%
Switzerland	1.5%	2.2%	0.6%
United Kingdom	21.0%	21.5%	0.5%
Others	2.9%	5.1%	2.2%

*non-US exports

Source: US Commerce Department, BEA.

A second tier of export locations is comprised of France and the Benelux countries. Together, these countries represent almost three quarters of all exports (excluding to the United States) of US manufacturing firms in Europe. Of the remaining countries, Ireland is notable for the large volume of MNE exports relative to the size of its economy and given that it is generally considered to be on the periphery of the European market. Ireland’s role grew quickly in the years following its accession to the European Community and has continued to do so to this day.

In terms of changes over time, the countries at the core of the European market (the original six members of the Common Market and the United Kingdom) have seen their share of total US MNE exports fall from 90 per cent in 1977 to 80 per cent in 1996. Much of this decline has been offset by rising shares from Spain and Ireland. The stock of US manufacturing investment in Ireland trebled in the five years following its accession to the European Community and Ireland now attracts over six per cent of US manufacturing investment in the European Union while representing less than one per cent of EU GDP. Similarly, US manufacturing investment in Spain doubled in the year following accession and trebled within four years – although unlike in Ireland, a significant part of this investment was driven by the new access to the market provided by EC membership

The tentative conclusion that one might draw from these casual observations is that the core of the European market retains a strong appeal for investors, even when they are looking for export platforms to supply the whole European market, but that the more peripheral countries with lower unit labour costs are seeing their shares rise slowly over time. Given that Table 2 spans two decades of continuing and sometimes intensive integration, any reaction to changing locational advantages on the part of US MNEs must be seen as evolutionary rather than revolutionary.

III. Developing countries[4]

Direct investment in developing countries has expanded rapidly in the 1990s (Figure 6), particularly in Asia and Latin America. Several developing countries are now among the most important hosts to inward investment worldwide. The reasons for this growth are not hard to find. Among the most significant has been the liberalisation of investment regimes in many developing countries and particularly in major markets such as China, Mexico, Argentina and Brazil. Such liberalisation has not been confined to these countries, however. UNCTAD estimates that between 1991 and 1997, there were 750 changes in legislation relating to FDI worldwide, over 700 of which represented a liberalisation.

Liberalisation of investment regimes has often been combined with privatisation, and sales of State assets to foreigners and has constituted a main vehicle for market access by foreign investors in the 1990s. Privatisation receipts in Brazil between 1996 and 1998 resulted in at least $14 billion in FDI inflows.[5] The combination of economic reforms spurred rapid economic growth in many countries before the crisis, and this too encouraged many MNEs to expand their presence within these dynamic regions. Global competition and the resulting cost pressures have also prompted firms to seek a broader international division of labour encompassing developing countries. This division of labour has been facilitated by multilateral trade liberalisation and technological advances in communications and transport.

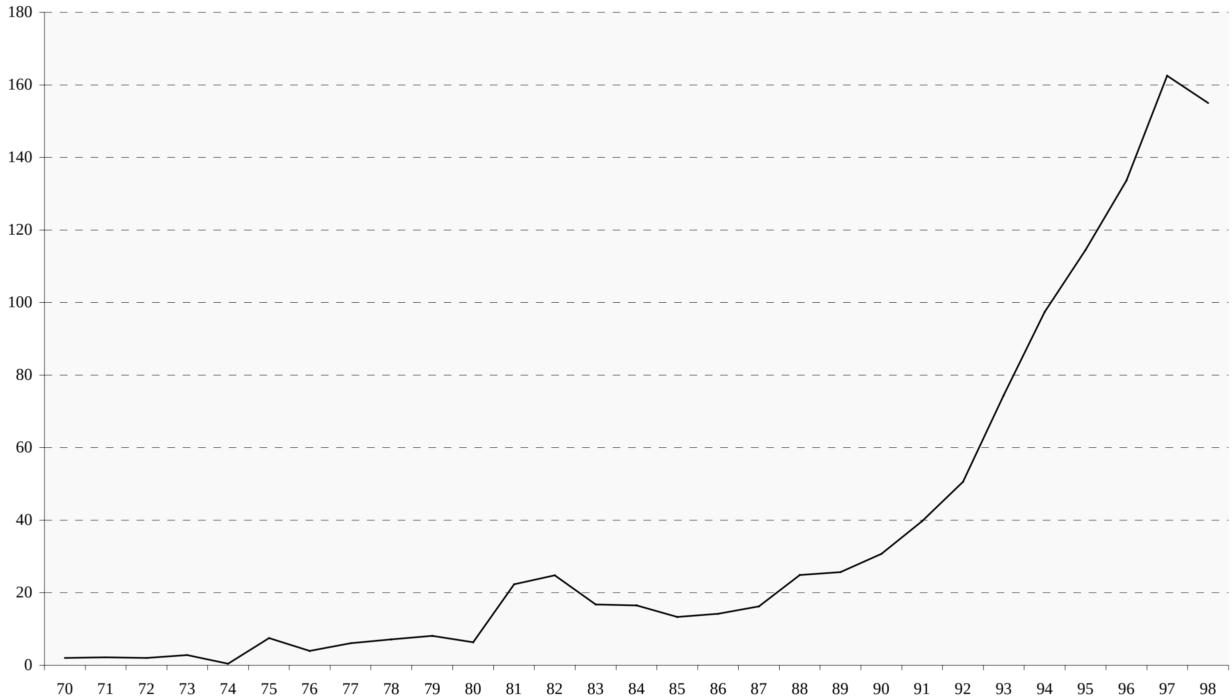
Another factor behind the rise of developing country investment has been the increase in flows among developing countries, some of whom are now net outward investors. The largest investor in China is Hong Kong, China, followed by Chinese Taipei. Latin American firms have also begun to expand within their own region, as has South Africa.

Judged in isolation and at an aggregate level, developing countries have been spectacularly successful at attracting inward investment in the 1990s. And yet their share of global inflows is still below what it was in the early 1980s before the debt crisis. Furthermore, much of this investment has gone to only a handful of large or relatively rich developing countries. These points are considered below.

4. This section adopts the IMF/World Bank classification of developing countries and hence includes Mexico and Korea even though they are Members of the OECD. In some figures, Central and Eastern European countries are also included.

5. UN ECLAC.

Figure 6. **FDI flows to developing and transition economies, 1971-98*** ($ billion)



Source: OECD

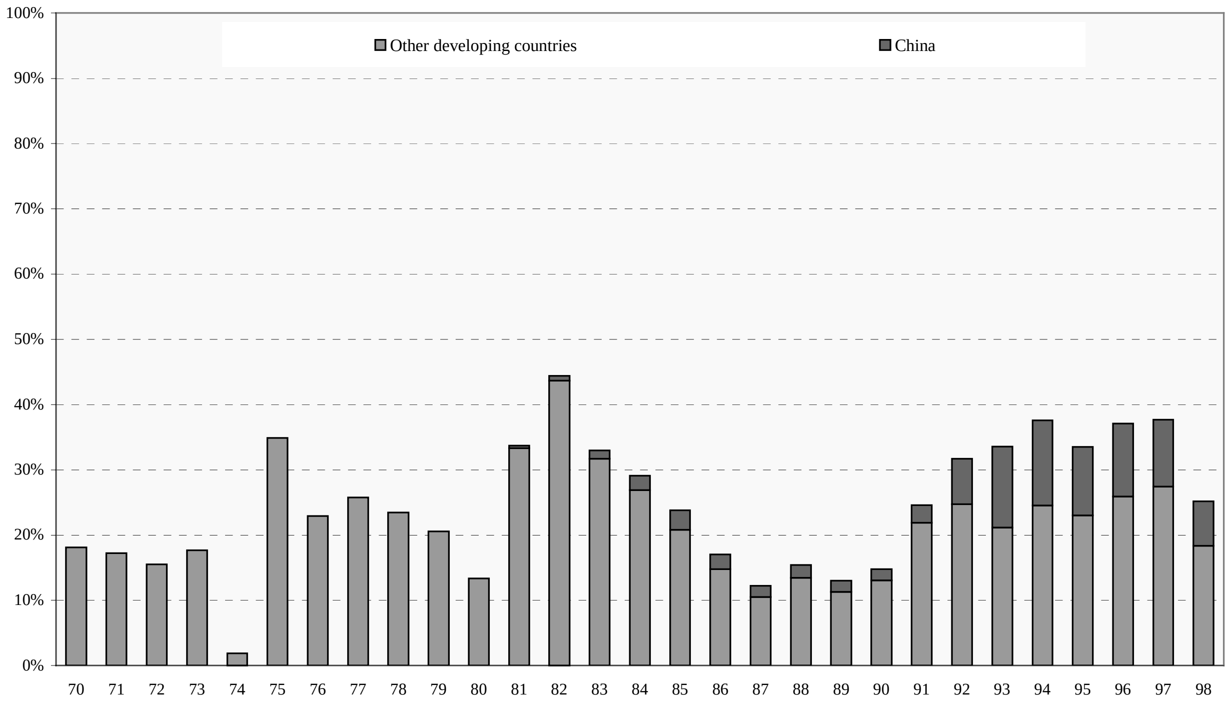
*refers to all countries except the first 24 members of the OECD

Share of global inflows

Figure 7 shows the developing country share of inflows over three decades. The steady rise in the share for these countries in the 1990s can be seen from a longer term perspective to be less of a watershed than a return to levels of foreign investment which prevailed before the debt crisis. The shifts in developing country fortunes with respect to FDI can be explained partly with reference to major events which had an impact on FDI flows to these countries. The sharp drop in the developing country share in the early 1970s is associated with expropriation of foreign investor assets at the time in many countries, particularly in raw materials sectors. Large net outflows were recorded at that time in Saudi Arabia, Venezuela and Chile.

Foreign investor interest in developing countries soon returned in other sectors, partly in response to the import substitution policies followed at the time in many of these countries. The developing country share reached a peak in 1982 which has never since been matched. Almost two thirds of this investment in 1981-82 went to three countries: Saudi Arabia, Brazil and Mexico. The steep drop in the share of developing countries after 1982 relates to the debt crisis which hit major host countries, particularly in Latin America. Slow growth and policy uncertainty arising from debt servicing problems over this period made large developing country markets less appealing to foreign investors.

Figure 7. **The developing country share of global FDI flows***



Source: OECD, IMF

*refers to all countries except the first 24 members of the OECD

The gradual recovery in the developing country share in the late 1980s stemmed partly from the wave of investment from Japan and certain newly-industrialising economies into Southeast Asia in the face of rising costs and appreciating currencies at home. Much of the foreign investment in Malaysia, for example, dates from this period. These inflows peaked at the beginning of the 1990s, and subsequent growth in inflows into the non-OECD area has been driven by China. Indeed, without China, there would have been very little change in the developing country share of global inflows between 1990 and 1998.

The estimated decline in the share in 1998 is more likely to result from a slowdown in privatisation projects in major host countries than it is by the financial turmoil. Of the most affected economies, only Indonesia has seen sharp falls in foreign investment in its economy. Investment in China fell by five per cent. Contracted investment in China peaked in 1993, while realised projects have continued to grow, but at an ever-decreasing rate. The gold rush into China appears to be waning.

The trend in relative shares in Figure 7 necessarily depends on events in both developed and developing countries. The description above looks only at the latter. The prolonged growth in cross-border mergers and acquisitions (M&As) involving firms in OECD countries, and the high value of such mergers, has meant that intra-OECD FDI flows continue to dominate global flows in value terms. Independently of any events in developing countries, their share of global inflows might increase significantly once the current wave of cross-border M&As slows down.

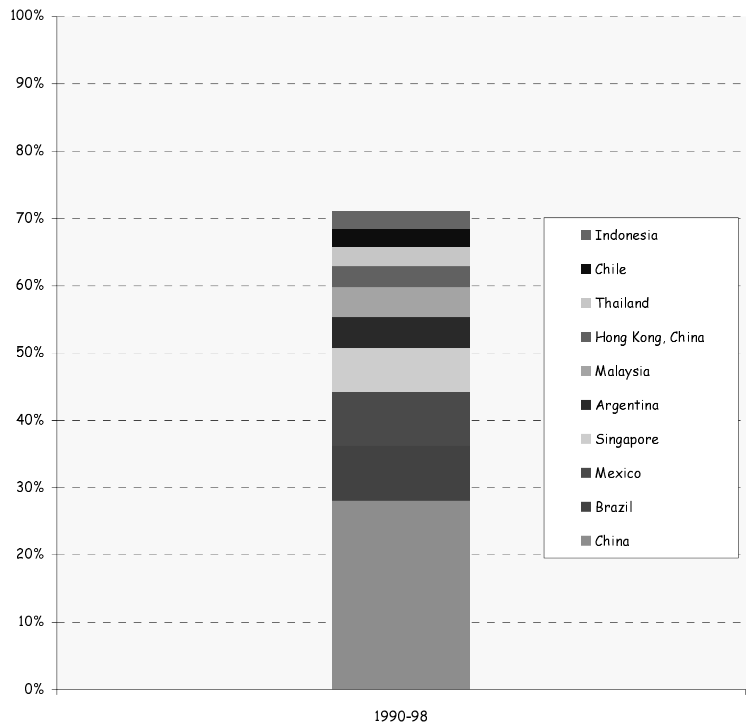
The share of global investment going to developing countries can be expected to grow over time. Firms are driven to invest abroad primarily for market proximity, and the rising share of developing countries in the world economy will imply a growing interest of OECD investors in locating within these dynamic regions. In addition, the relatively greater scope for liberalisation in these economies compared to among OECD countries will mean that such liberalisation could have a major impact on global flows.

Changing distribution of FDI flows outside of the OECD area

The same ten developing countries have tended to be the most important destinations for foreign investors for the past three decades, with the exception of China which only appeared as a host to FDI in the early 1980s. These countries are Argentina, Brazil, Mexico, Saudi Arabia, China, Indonesia, Malaysia, Singapore, Thailand and Hong Kong, China. They have taken in over two thirds of inflows into the developing world since 1970, or never less than 58 per cent in any single year since the mid-1970s, with no general tendency for this share to diminish over time. Nor is this pattern driven by the behaviour of relatively few source countries. For the five largest home countries for FDI (the US, the UK, Germany, Japan and France), three of these host countries are always among the top ten non-OECD destinations (Brazil, Singapore and Hong Kong, China) and five countries are among the top ten in four out of five cases (Malaysia, Thailand, Indonesia, Argentina and China). The role of these few host countries is both pervasive and persistent.

Figure 8 calculates the cumulative importance of the top destinations in total developing country inflows in the 1990s. China along accounts for one third of total inflows and, together with Mexico and Singapore, represents almost one half of total flows. In spite of this concentration, many other developing countries are receiving increasing amounts of FDI, often as a result of privatisation and other structural reforms. Flows to these other developing countries almost tripled in 1996. Even the 48 least developed countries experienced an increase in inflows of 56 per cent in 1996, to $1.6 billion.

Figure 8. **Cumulative shares of major host developing countries**
(share of total developing country inflows, 1990-98)



Source: OECD, IMF, UNCTAD

What matters for host developing countries is how much investment they receive relative to the size of their economies. Market size is the primary determinant of the global distribution of FDI flows, so it is not surprising that these countries receive such a small share of global direct investment. Nevertheless, relative to the size of their economies and compared with past performance, several developing countries which are not among the leading hosts to FDI have been doing well in the past few years. Table 3 shows the performance of selected developing countries from different regions over time in terms of FDI inflows as a share of their GDP. While some smaller developing countries have not seen any increase in investment in the 1990s, these countries clearly have – in spite of lacking a large domestic market size or other attributes typically of interest to potential investors.

Table 3. **FDI inflows as a percentage of GDP for selected developing countries, 1988-97**

	1988	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**
Ghana	0.1%	0.3%	0.3%	0.3%	0.4%	2.8%	5.0%	4.7%	4.2%	2.9%
Lesotho	0.9%	0.4%	0.4%	1.3%	0.5%	2.2%	2.5%	2.7%	3.5%	2.1%
Mozambique	0.4%	0.3%	0.7%	2.1%	2.4%	3.1%	2.2%	2.7%	4.5%	2.1%
Tanzania	na	na	na	0.1%	0.3%	0.6%	1.1%	2.7%	3.0%	2.1%
Uganda	na	na	na	0.0%	0.1%	1.5%	1.6%	2.0%	2.1%	2.7%
Bolivia	-0.7%	-1.0%	0.2%	1.9%	2.3%	2.3%	2.1%	5.7%	6.7%	7.5%
Colombia	0.6%	1.7%	1.4%	1.2%	1.8%	2.0%	2.4%	3.4%	3.4%	6.9%
Nicaragua	0.0%	0.0%	0.0%	0.1%	0.8%	2.2%	2.3%	3.9%	4.6%	8.6%
Paraguay	0.1%	0.3%	1.5%	1.4%	2.3%	1.7%	2.3%	2.1%	2.4%	2.0%
Peru	0.3%	0.3%	0.3%	0.0%	0.4%	1.8%	5.7%	3.3%	6.2%	3.1%
Laos	0.4%	0.7%	0.7%	0.7%	0.7%	2.3%	3.8%	5.8%	8.6%	5.1%
OECD average	1.0%	1.4%	1.4%	1.4%	1.1%	1.5%	1.6%	2.2%	1.7%	2.0%

Source: OECD, IMF, UNCTAD

The countries in Table 3 were not selected at random and a different selection might reveal a static or even downward trend in inflows. Table 3 is nevertheless useful because it demonstrates that the small markets and remote locations do not condemn these countries forever to remain outside of the global economy. Host country policies matter too, and countries which strive to create a dynamic private sector in their economies will doubtless find that some of those private investors are foreign MNEs. Increasingly, these MNEs are originating in other developing countries, often in close geographical proximity to the host country.

The role of developing countries in outward direct investment

If rising FDI flows were simply a reflection of greater overseas activities of MNEs from major home countries, there would be little new in trends in the 1990s. Indeed, the concept of globalisation would itself be a misnomer. Instead, what marks the 1990s compared to previous periods is the greater role played by firms from a growing number of countries which were formerly mostly hosts to FDI. Although the same five countries tend to dominate global outflows (the US, the UK, Germany, France and Japan), firms from a rising number of other countries have begun to invest abroad and in some cases to turn their own country into a net outward investor.

Between 1990 and 1997, 27 countries invested more than $5 billion abroad and usually significantly more than that. These countries include not only prominent OECD investors but also Hong Kong China, Chinese Taipei, Singapore, China, Malaysia, Kuwait, Chile and Brazil.[6] As a result of this activity, net outward investments flows are no longer the preserve of a handful of countries. Table 4 provides a list of the largest MNEs based in developing countries. These firms tend to be small compared to the largest MNEs, but within their sector they are sometimes major players.

Table 4. **Country of origin of 50 largest MNEs in developing countries, 1996**

Argentina	1
Brazil	5
Chile	3
Colombia	1
Mexico*	4
Venezuela	1
China	4
Chinese Taipei	2
Hong Kong, China**	10
India	1
Korea	6
Malaysia	3
Philippines	1
Singapore	3
South Africa	4

*includes one joint Mexican/Panamanian company.
**includes one Hong Kong Chinese firm now incorporated in Bermuda.

Source: UNCTAD

FDI versus other forms of capital flows to developing countries during crises

Multinational enterprises are increasingly courted by developing countries for their contribution to technology transfer and export-led growth. The financial crisis which erupted in Asia in 1997 has served as a reminder that FDI is also an important source of capital inflows and hence of balance of payments financing. Recent experience with capital inflows during economic crises in developing countries suggests that FDI flows are less volatile than other forms of capital. Figures 9 and 10 consider the examples of Thailand and Mexico during their respective crises. Although the depth of each crisis and the type of inflows most affected differ in each case, the stability of FDI flows is striking.

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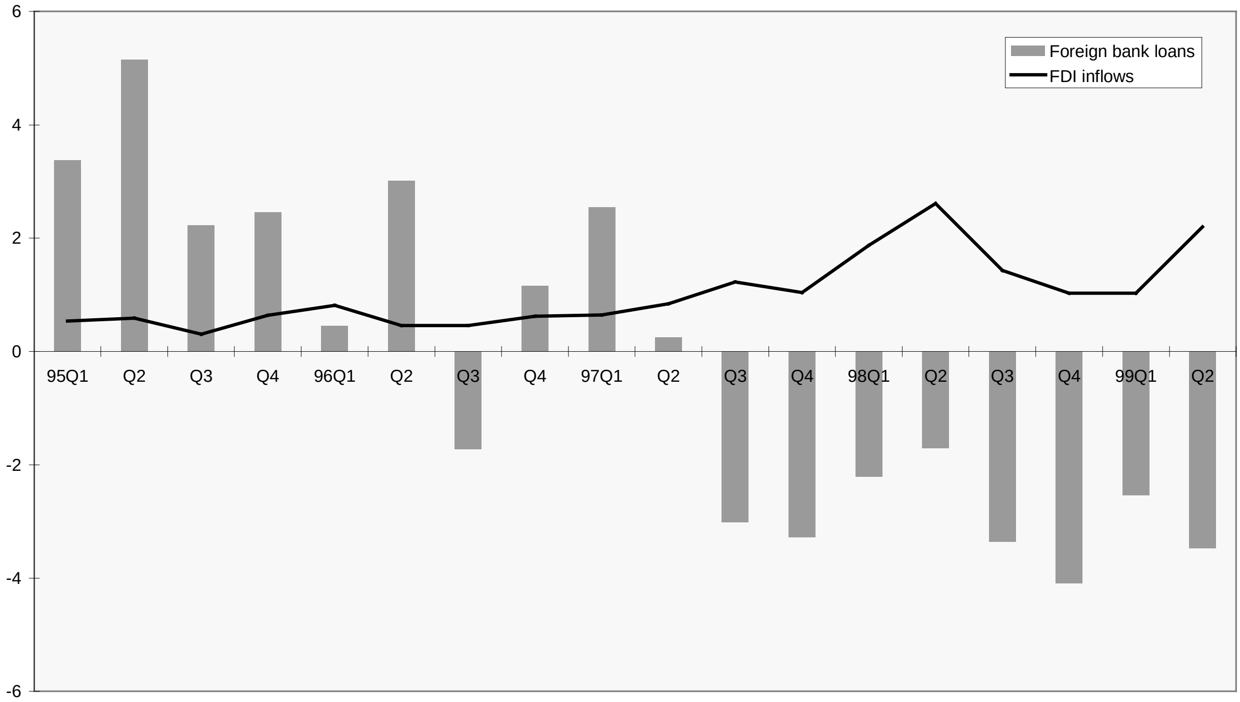
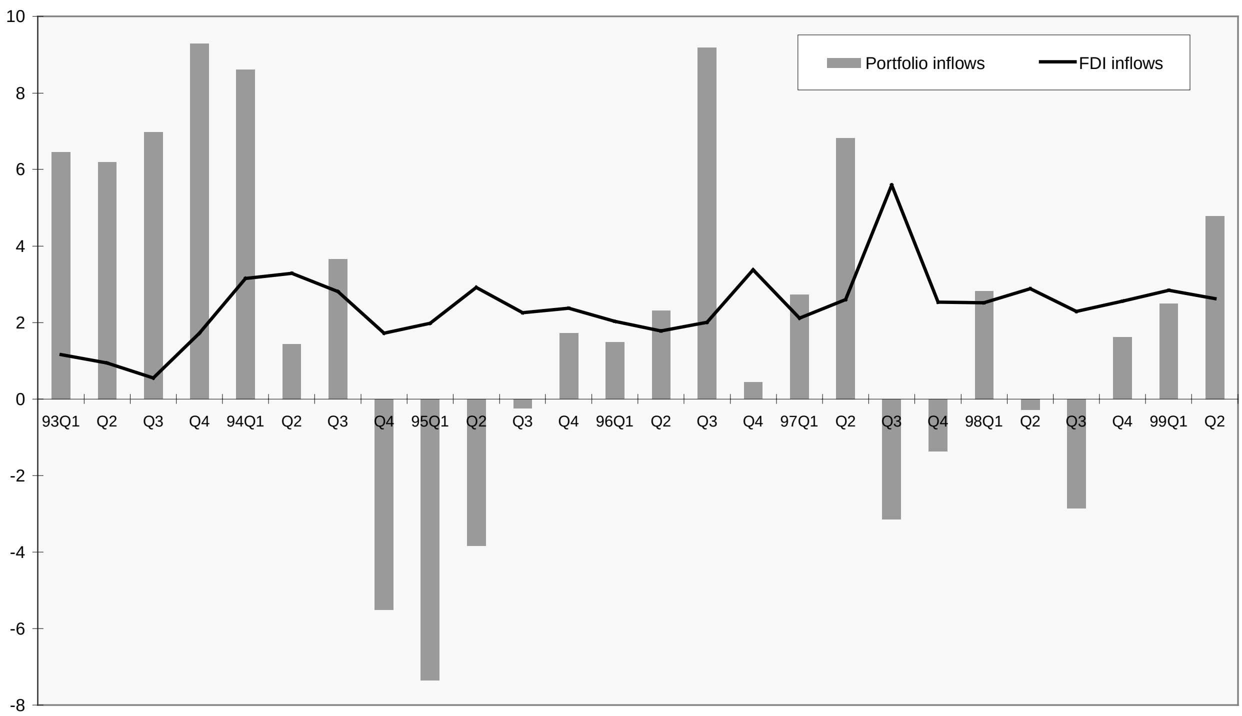
6. Not all countries report outward direct investment. Some, such as Mexico and Argentina, would probably appear on the list of outflows exceeding $5 billion in the 1990s.

Figure 9. **Thailand: Quarterly foreign capital inflows, 1995/Q1-1999/Q2** ($ billion)



Source: IMF

Figure 10. **Mexico: Quarterly foreign capital inflows, 1993-99/Q2** ($ billion)



Source: OECD, IMF

In Thailand, foreign bank lending fell from $2.5 billion in the first quarter of 1997 to a net outflow of $3 billion in the following quarter. Portfolio flows were maintained at first but fell subsequently. Net outflows by banks remain a drag on the economy. In contrast, net FDI inflows have remained both positive and significant. Indeed, they have since reached record levels. It remains to be seen whether FDI flows into Thailand will continue at such levels in the future or whether direct investors simply lag behind other investors in their response to crises. At the very least, massive FDI inflows attenuated the collapse in other forms of inflows during the worst of the crisis.

The example of FDI in Mexico during its own crisis beginning in December 1994 provides some support for the notion that direct investors are concerned with long-term growth prospects and hence much less dissuaded by short-term macroeconomic problems. In the Mexican case, FDI flows actually grew in the two quarters following the outbreak of the crisis. Since then, they have fluctuated within a range of $1.8 – $3.4 billion each quarter, making Mexico one of the most popular destinations for FDI in the developing world. Foreign investors in Mexico responded to the crisis by expanding their presence in the domestic market and by increasing their exports. NAFTA, which was signed just before the crisis, may have played a stabilising role in terms of MNE perceptions by adding greater credibility and certainty to Mexican policies.

Recent experience therefore suggests that FDI flows have been more stable than either portfolio flows or international bank lending during financial crises. This finding is confirmed in numerous studies.[7] Foreign investors remained in Mexico and Thailand because they were able to switch from local sales to exports in the face of a collapse in local demand and because, in the long run, the host country was still expected to grow more quickly than their home country. Furthermore, in response to the crisis, the Thai government created – if not always an open door – then at least a window of opportunity for foreign investors to acquire control of local companies. Not all countries offer favourable export opportunities or even impressive long-term growth prospects, and not all countries respond to crises by accelerating the process of liberalisation. In cases where firms have invested to share in the economic rents accruing from a protected market and where policies are not otherwise open, the response could potentially be very different.

Given that FDI often represents physical assets which are, by their nature, less footloose than financial assets, it seems likely that direct investors will always be slower to respond to both threats and opportunities than other investors. Some of the assets of foreign affiliates are nevertheless likely to be relatively liquid and hence can quickly be transferred out of the country during a crisis. If the affiliate sustains losses, retained earnings will be negative and hence constitute an outflow of capital in the balance of payments. Similarly, the affiliate could increase dividend payments to the parent or even lend money to the parent or other affiliates elsewhere, both of which would serve to deplete the stock of investment capital in the host economy. It would not take a crisis for this to occur. Inflows into Germany, for example, went from $4.7 billion in 1991 to a net outflow of $2.1 billion in 1992.

Net outflows in any given year do not necessarily imply a withdrawal from the host country. If foreign MNEs were to pull out, this would further exacerbate the balance of payments situation. Some large automotive producers, for example, pulled out of both Argentina and the Philippines in earlier decades owing to low profitability unrelated to any short-term crisis. These investors have since returned to both markets.

Crises are only likely to lead to a withdrawal of investors to the extent that they influence perceptions about the long-term growth prospects. To the extent that these perceptions do not change, those firms with

7. See World Bank (1999) *Global Development Finance*, p. 55 for a summary of these studies.

the financial resources to sustain their operations during periods of low profitability will doubtless remain in the host country. In this way, foreign-controlled companies are no different from domestic ones.

IV. FDI and Globalisation

Figures on international direct investment flows provide a useful, easily comparable and relatively up-to-date set on indicators on evolving economic integration brought on by MNEs. They suggest that MNEs invested record amounts abroad in the 1990s, but they shed little light on the nature of globalisation, including on the motives for investing abroad and the likely impact on home and host economies. They also say little about whether rising FDI flows are the result of large MNEs becoming even larger or of an ever-expanding universe of firms with foreign affiliates. Because MNEs are intimately associated in the public consciousness – for better or for worse – with the process known as globalisation, it is instructive to look more closely at the activities of foreign enterprises, as indicated by a variety of statistical sources. Because the most complete data source on the activities of MNEs comes from the US Department of Commerce and because US MNEs have a long history of investing abroad, this section will focus predominantly on US firms. Where such activities are not likely to be representative of global trends, other possibilities will be suggested.

Foreign direct investment is a balance of payments concept designed to capture cross-border flows of capital in which the investor acquires an ownership stake for the purpose of having an effective voice in the management of the foreign enterprise. It is not investment in the sense of contributing to gross fixed capital formation, although the foreign investor will presumably undertake such investment as part of the ongoing operations of the affiliate. Rather, FDI simply records one type of capital flow and one way in which foreign investors acquire interests in, or establish, a local enterprise. When a foreign investor acquires a local company through local borrowing or through an affiliate already operating in the local economy, there is no recorded FDI in the first instance. In addition, part of total FDI involves reinvested earnings of existing affiliates which originate in the host country itself.[8]

International direct investment statistics provide evidence that investments by MNEs are increasing, but they fail to distinguish whether this represents a rise in investments abroad by existing firms in either established operations or in new activities and markets or an increase in the number of firms becoming MNEs. Table 5 describes the degree of multinationalisation of US MNEs in the 1980s and 1990s. Very little multinationalisation occurred in the 1980s, as the number of US parents increased by only 71 and foreign assets and sales grew in line with those of the parent itself. Employment in foreign affiliates actually fell slightly. In contrast in the first half of the 1990s, foreign assets grew twice as fast as domestic assets and foreign employment increased by one million while domestic employment by US MNEs remained unchanged. On average, foreign assets, sales and employment now represent just under one third of the global totals for US MNEs.

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[8]. These earnings are considered for balance of payments purposes to have been repatriated in full (through the current account) and then invested from abroad (through the capital account).

Table 5. **The international growth of US MNEs since 1982**

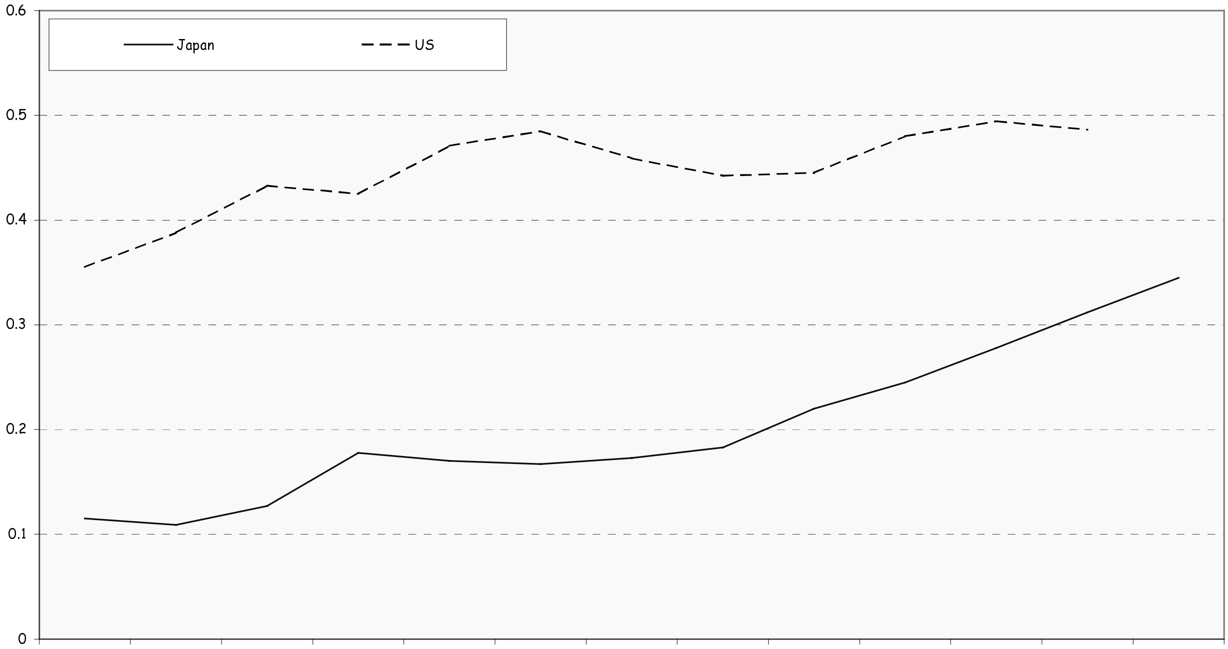
	1982		***1989***		***1996***	
	Affiliates	*Parents*	*Affiliates*	*Parents*	*Affiliates*	*Parents*
Number	17 213	2 110	17 822	2 181	21 901	2 613
Assets ($ m.)	751 486	2 741 619	1 330 028	4 852 373	3 075 516	7 805 133
Sales ($ m.)	935 780	2 348 388	1 284 894	3 136 837	2 227 014	4 497 607
Employees	6 640 200	18 704 600	6 622 100	18 765 400	7 616 500	18 775 100
Affiliates/parent	8.2		8.2		8.4	
Assets/affiliate ($ m.)	44		75		140	
Sales/affiliate ($ m.)	54		72		102	
Employees/affiliate	386		372		348	

Source: US Department of Commerce

US MNE activities abroad are most likely to capture the behaviour of relatively mature foreign investors since, in many cases, these US firms established themselves abroad several decades ago. Many large European investors might also fit this profile. Foreign investment by these firms appears to have marked time in the 1980s and then expanded faster than domestic activities in the 1990s. The timing may well differ for more recent investors such as from Japan and other Asian home countries who began to expand abroad in earnest in the late 1980s following major currency realignments. They have nevertheless continued to expand in the 1990s, along with older MNEs.

Figure 11 shows the overseas production ratio for Japanese and American since 1986. American MNEs are still far more international in scope compared to Japanese firms, but the gap is narrowing. Since the trends in Figure 11 are based on sales, they are affected by relative growth at home and abroad in any given year. Thus, the relative performance of the US and Japanese economies might help to explain why the Japanese curve is rising faster than the one for US MNEs. Nevertheless, for both US and Japanese direct investors, the importance of sales by foreign affiliates within total group sales is growing as foreign markets become more important relative to the home economy. At the same time, however, affiliate sales are still only one half of the level of parent sales. Investors from smaller countries such as Sweden or Switzerland are likely to have a far higher overseas production ratio given the small size of the domestic economy.

Figure 11. **Overseas production ratios*, 1985-98**



* sales of foreign affiliates/sales of parent companies

Source: Japanese MITI, US Bureau of Economic Analysis

Why do firms invest abroad?

Firms invest abroad for many reasons, but in general they are prompted to do so by market saturation at home and by faster growth prospects abroad. For some firms, faster growing foreign markets could be supplied through exports. But in many cases, this is not the preferred option. A local presence is seen as a way of enhancing the investor's share of the local market. It allows for closer interaction between buyers and sellers, promotes greater brand recognition and overcomes many of the obstacles associated with foreignness. These benefits may not be important for bulk commodities, but most MNEs produce differentiated goods. Furthermore, the exporting option does not exist in many cases, such as services or where transport costs or trade barriers are high. As a result, sales abroad by MNEs vastly exceed exports by those same firms.

The benefits of proximity between producers and consumers or even among producers themselves are part of the broader issue of agglomeration in the world economy which is as much a characteristic of national economies as of the global one. The net effect of this process -- of which FDI is just one manifestation -- is a continual shifting of production towards those regions where growth is most promising. In other words, production follows demand. This could partly explain the rapid growth of FDI in East Asia in the decade leading to the crisis, as MNEs sought to participate in the growing demand for consumer goods in Southeast Asia and China. Since this investment is aimed at future growth abroad, it does not usually displace production at home, but it might limit the possible expansion of home production to supply foreign markets through exports.

This description of MNE motives is not the only possible version, but it does have the advantage of explaining why the market size of the host country remains the single most important determinant of FDI patterns worldwide. Nevertheless, there are clearly other motives which cannot be ignored, especially as they tend to receive the most attention and generate the greatest concerns about the process of globalisation. Firms invest abroad not only in search of new markets but also sometimes to seek out more efficient locations in which to produce a given good or service. In some cases, the output might be intended for the parent company in its own downstream production, but it is commonly assumed that the affiliate will supply the global market. In this way, FDI is seen to promote a more efficient distribution of economic activities worldwide to the benefit of all.

Intra-firm trade represents a large and growing share of world trade, hence the possibility of an international division of labour orchestrated by MNEs is very real, but its importance within total FDI flows is much exaggerated. For most investors, exports tend to be less important than sales to the local market. When exports do arise, they usually remain within the region of the affiliate. To the extent that there is a division of labour, it tends to be a regional one. The evidence for these assertions and their implications for our understanding of the process of globalisation will be presented later.

Related to the efficiency seeking investment motive is the strategy of acquiring a rival foreign firm through FDI in order to enhance economies of scale for the combined firm at a global level. In many cases, this strategy relies on national mergers, but the national merger wave of the late 1990s has seen a lesser, though still impressive, rise in cross-border M&As. The value of a single acquisition might dwarf any potential new foreign investments in most countries. Mergers are also used frequently as a means of rapid access to a foreign market and hence fit equally well into the first category of motive described above. The net impact on the location of production from these mergers is difficult to assess a priori.

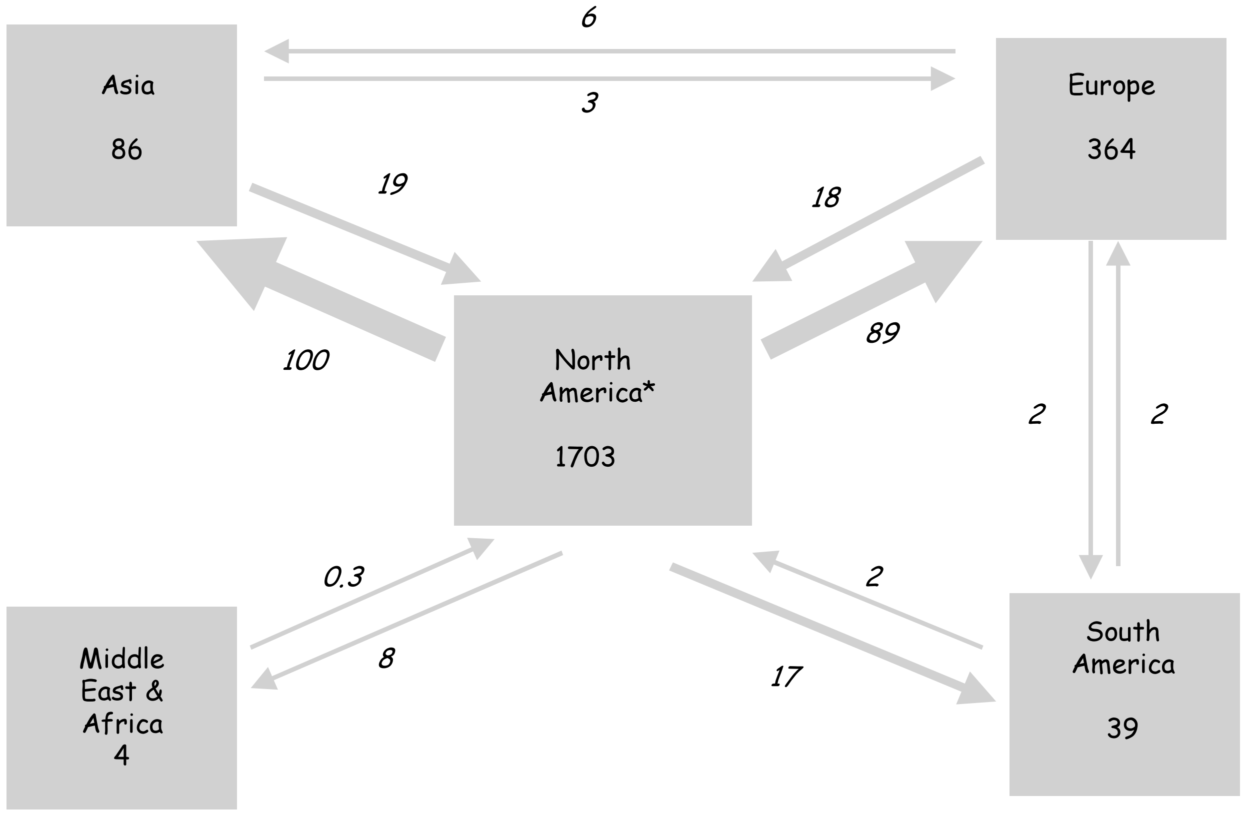
The relative importance of these different motives for FDI has implications for our understanding of the process of globalisation. The motive which is expected by economists to have the greatest positive benefit to the world economy but which paradoxically raises the most public fears about globalisation is that of efficiency-seeking investment. In a global economy, it is feared that investors will seek out not only those locations with the lowest unit labour costs, but also those where environmental or social regulations are most lax or where fiscal policies are least burdensome. In this world, FDI and globalisation more generally will lead to a race to the bottom with governments lowering standards in order to attract FDI. The empirical analysis in this study cannot refute the possibility of such internecine regulatory competition, but it does suggest that its impact is most likely to be at the margin.

The easiest way to assess the relative importance of different motives for international direct investment is to look at sales patterns of foreign affiliates. If they are primarily market seeking, then most of their sales will be to the local or regional market. If they are efficiency seeking, then sales are more likely to be destined for either the home or global market. The figures on sales patterns provided below for US and Japanese-owned affiliates strongly suggest that the parent firm has invested abroad to supply the regional market in which the affiliate is located.

Sales patterns of US and Japanese MNEs

Figure 12 shows sales figures by region of US MNEs engaged in manufacturing, including both the parent company and all majority-owned foreign affiliates. US manufacturing MNEs had total sales worldwide of $2.5 trillion in 1994, of which one quarter represented exports by either the parent or affiliates. The pattern of sales suggests strongly that US MNEs operate on a regional basis in each of the regions in which they locate. Over one half of exports remained within the region where the production was located, and almost all of the remaining exports were either to or from the parent. Other than trade with the parent firm, there is virtually no interaction among affiliates in different regions. Inter-regional trade among affiliates in different regions amounted to less than one per cent of total sales by US MNEs. Total trade between affiliates in Europe and South America, for example, amounted to only $4 billion in 1994.

Figure 12. **Sales of US manufacturing MNEs (parents and affiliates) worldwide, 1994** ($ billion)



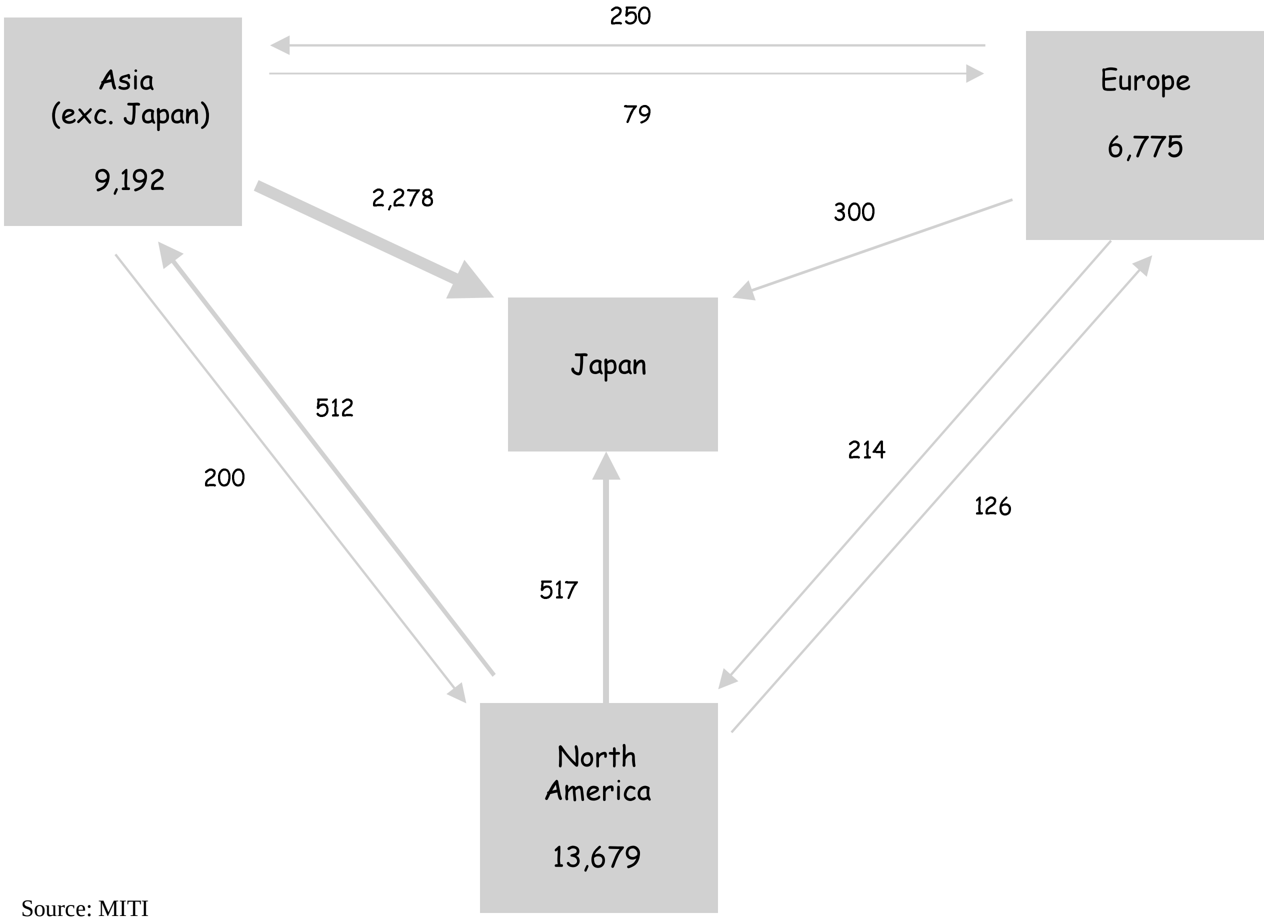
*includes Central America

Source: US Bureau of Economic Analysis

To the extent that there is a division of labour, it appears to be regional rather than international. Majority-owned foreign affiliates of US companies exported $96 billion back to the United States in 1994. Of this, almost 60 per cent came from Canada and Mexico, and another 20 per cent came from other OECD countries. The only other developing country to export significant amounts to the United States from its US-owned affiliates was Singapore. Affiliate exports to the United States from the rest of the world amounted to less than $10 billion in 1994.

Few other major investor countries provide this same degree of detail on the operations of their MNEs, but an analysis of Japanese data suggest an even stronger regional bias in sales patterns. Over 90 per cent of sales in Europe and North America remain within the region of the affiliate. In Asia, the comparable figure is 75 per cent, owing to a relatively high proportion of sales which are back to Japan. In no other case, do exports to other regions or to Japan represent more than five per cent of total sales.

Figure 13. **Sales of affiliates of Japanese MNEs worldwide, 1995** (yen, million)



Source: MITI

This regional bias in MNE exports is not confined to intra-firm trade. Geography exerts a powerful influence on all exporters, perhaps more so on national enterprises with no foreign affiliates. Most countries trade more with their neighbours than with other, more distant locations (except when those destinations are large markets). Figures 12 and 13 demonstrate that MNEs are not immune to the effects of distance. This implies that, although many MNEs may be present in all major markets, they do not necessarily source on a global basis. This, in turn, suggests that environmental or social policies in distant locations are unlikely to entice MNEs to invest in export platforms. To the extent that regulatory competition does arise, it is likely to do so on a regional basis.

Conclusion

Evidence on long-term trends suggests that the 1990s represented not so much a watershed as an acceleration of trends already underway. What changed most was official attitudes towards foreign investors as more and more countries pinned their hopes for growth and sustainable development on foreign MNEs. The process is not necessarily irreversible, but it achieved considerable momentum in the 1990s. Not all countries participated equally, but the notion of developing countries as passive partners in the process of globalisation is largely a myth. Many firms from developing countries are now important foreign investors in their own right. And host country governments can influence their share of global inflows through judicious policy reforms. Lacking large markets or geographical proximity to OECD markets, some least developed countries have nevertheless managed to attract significant amounts of FDI relative to the size of their economies.

Complementary data on MNE sales patterns suggests that the notion of the global firm is also largely mythical. Many large firms have global operations, but the evidence on US and Japanese MNEs suggests that these operations are still only integrated on a regional basis. Global sourcing to produce one variety of product for the global market is still an exception rather than a rule.

Looking ahead, what does a review of long-term trends suggest about future patterns of investment in the 22nd century? One lesson is that FDI flows will not continue to grow by record amounts each year without interruption. As long as the business cycle exists, there will be volatility in investment flows. Over time, the secular upward trend is likely to reassert itself, but even this depends on the continued willingness of host governments to countenance foreign ownership and control over domestic assets.

Globalisation was deemed irreversible in the early part of the 20th century and – in spite of painful experience in the interim – the same belief pervades thinking a century later. Experience has shown, however, that government actions can halt this process – albeit at an increasing cost in terms of economic welfare. The challenge of the next century is not to repeat the mistakes of the previous one.