

CHAPTER IV

THE GROWTH OF FOREIGN DIRECT INVESTMENT IN THE 1980s: THE BULGE IN THE TREND

During the past two decades, flows of FDI have followed an upward trend averaging 13 per cent annually with year-to-year fluctuations. Two surges followed by falls stand out: during the period from 1978 to 1981, growth averaged 11 per cent per year and, from 1986 to 1990 it averaged 28 per cent per year (figure IV.1). Even excluding Japan—which became a sizeable outward investor from 1985¹—the second period still showed remarkable growth. However, the declines in 1991 and 1992, though not uniform across all countries, may cast some doubt as to whether FDI will continue to grow at the same pace. To address this issue, the present chapter divides the various influences on FDI into three categories: short-term, policy-related and structural. The analysis seeks to explain the increase in the flows of FDI in the 1980s and their subsequent fall in the 1990s, as well as their likely future performance.

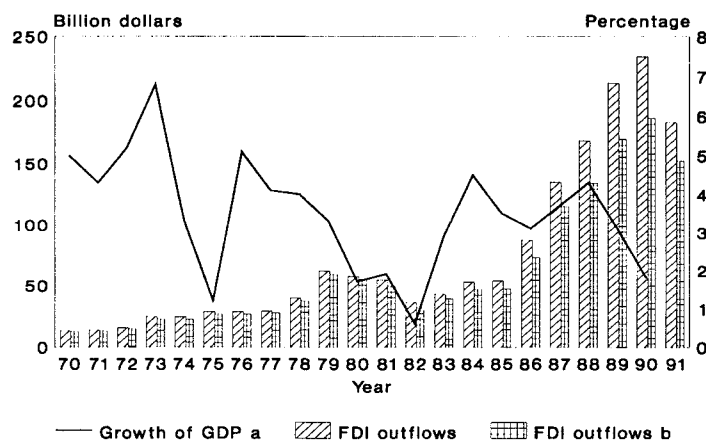
The unprecedented growth in the flow of foreign direct investment (FDI) in the periods from 1986 to 1990 and its subsequent decline raise an important question: Were the favourable conditions for FDI in that period the result of short-term stimuli causing a bulge in the underlying upward trend? In other words, did the trend undergo a temporary surge over and above what might have been expected had no short-term factors been at work? The rapid economic growth after the recession of the early 1980s, the mergers-and-acquisitions boom and the initial reaction to policy changes were powerful short-term factors for stimulating the growth of FDI flows. These factors were at work against the backdrop of long-term factors that influence the underlying trend, namely, changes in policies and pressures arising from the structural transformation of the world economy as a result of the activities of transnational corporations (TNCs). The inter-play of short-term, policy-related and structural forces created the favourable circumstances that led to the bulge in the flows of FDI. While economic growth has declined in the early 1990s and mergers-and-acquisitions activity has subsided, the continuing effect of policy changes and

structural pressures will, most likely, ensure the continuation of the previous trend in FDI flows over the next decade and into the next century.

A. Short-term factors

Rapid economic growth in the 1980s and the boom in mergers and acquisitions undertaken by TNCs were among the principal factors that led to a surge of FDI flows during the period from 1986 to 1990 (box IV.1). Expenditures on capital goods by foreign affiliates were similarly affected. There were, however, differences among sectors and in the method of financing FDI flows that resulted from the cyclical fluctuations in economic activity. The initial reaction by TNCs to one-time policy changes (e.g., the announcement of the Single Market by the European Community) also contributed to the rapid growth of FDI in that period. The impact of such policy changes tends to be prolonged, and it is discussed later. This one-time boost in FDI flows was, however, temporary: as economic growth receded and the conditions that led to the popularity of mergers and acquisitions ceased to exist, their stimulus to the growth of FDI abated.

Figure IV.1. Foreign-direct-investment outflows and rate of growth of real gross domestic product, 1970-1991
(Billions of dollars and percentage)



Sources: UNCTAD, Programme on Transnational Corporations, based on International Monetary Fund (IMF), balance-of-payments tape, retrieved in February 1993; OECD estimates; UNCTAD, 1993e; TCMD, 1993h; and DESD, Development Policy and Analysis Division, DPAD data bank of world development statistics.

- a 1980 prices.
- b Excluding Japan.

1. Business-cycles

(a) Cyclical influences on foreign-direct-investment flows and capital expenditures

The growth of FDI outflows is closely correlated with the growth of output.² In short, and not surprisingly, the decision by TNCs to invest abroad is affected by cyclical fluctuations in economic growth (business cycles), both at home and abroad. The impact of business cycles on global FDI flows operates through the interactions between home and host-country economic conditions. This is partly owing to the fact that, as regards the supply-side of FDI, the foreign investment decisions of TNCs are affected by the availability of investible funds from corporate profits or loans, which are themselves affected by conditions at home. However, demand-side factors also play their part: growing markets abroad can give TNCs an impetus to invest, especially if domestic conditions are deteriorating. Indeed, growing foreign markets may be particularly attractive for TNCs based in

countries experiencing a cyclical downturn. In 1991, these factors helped to raise the share of developing countries in total inflows rose to 25 per cent from an average of 17 per cent during the period 1985-1990 (chapter I). Nevertheless, the interdependence of the world economy suggests that, as recession spreads, growth will slow down almost everywhere, and that will depress the flow of FDI world-wide.

A strong cyclical upswing in the developed countries after the recession of the early 1980s contributed to the growth of FDI flows (figure IV.2). Since so much of total FDI occurs between developed countries, the cyclical

Box IV.1. Foreign-direct-investment flows in the 1980s: was the surge exceptional?

Regressing the log of FDI flows on a time variable, fitting a line through the calculated values and comparing the fitted line with the actual observations shows a clear upward trend in the growth of FDI and a cyclical pattern in their movement.

$$\text{LNFDI} = 0.52 + 0.13 (\text{TIME})$$

$$(0.68) (13.52)$$

$$(R^2 = 0.90)$$

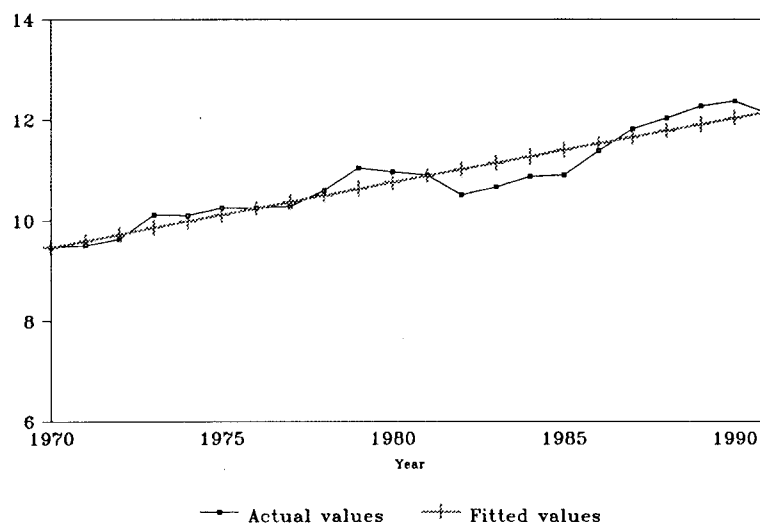
$$\text{LNFDI} = \text{log of foreign-direct-investment outflows}$$

$$\text{TIME} = 1970-1991$$

From 1970 through 1991, global FDI flows grew at an average rate of 13 per cent per year. That pattern of trend and cycles is consistent with the picture that emerges from a casual observation of the year-to-year movements in FDI flows. What is not apparent from observing FDI flows is that the bulge in the second half of the 1980s is similar to that in the late 1970s (figure 1). Instead, it is the drop in these flows in the early 1980s that appears to be an aberration in the underlying pattern. That drop may be ascribed to the severity of the economic recession in the early 1980s, which appears to have influenced FDI flows after a time lag of one to two years. In fact, the size of the drop might help explain the subsequent increase, suggesting that some "overshooting" might have taken place as FDI flows sought to resume their growth along the trend line. At the same time, important policy changes and structural re-alignments coincided with the recovery of the mid-1980s, accelerating the upward movement in FDI flows.

The cyclical pattern that emerges from comparing actual values to the time trend implies that business cycles play an important role in the investment decision of TNCs. It is also apparent that the oscillations of FDI flows around the fitted trend line were wider in the 1980s compared to the 1970s, suggesting that those flows became more prone to the influence of short-term factors that caused them to diverge from the underlying trend. Those oscillations appear to have continued into the 1990s. Given the past pattern of FDI flows, it could be expected that the upward trend will continue, as the decade proceeds, accompanied by short-term deviations.

Figure 1. Outflows of foreign direct investment, 1970-1991
(Logarithmic values)



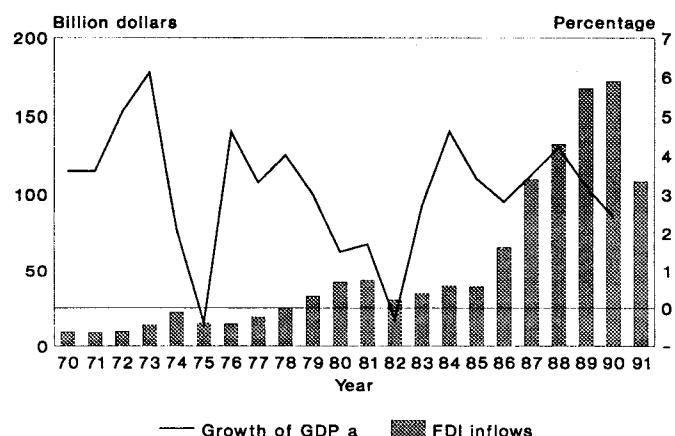
upswing helps explain the surge in investment flows in the 1980s, as well as their subsequent fall in the early 1990s. As for developing countries, FDI inflows in the 1980s also increased in response to the cyclical upswing in developed countries, where most FDI originates (figure IV.3).

Investment expenditures on capital goods (plant and equipment) by foreign affiliates is also influenced by business cycles. Taking the activities of TNCs based in the United States, the capital spending of their foreign affiliates world-wide, as well as their domestic investments, have followed a cyclical path (figure IV.4).³ Planned and actual spending of those affiliates jumped considerably in the late 1980s in response to the earlier cyclical upswing (table IV.1), suggesting the existence of time-lags.

When growth rates change, TNCs adjust their investment plans accordingly. That happened in the early 1980s, and again during 1991 and 1992, when growth in the United States was sluggish.⁴ Japanese TNCs have also modified their spending plans, partly because deteriorating domestic economic conditions damaged their profits.⁵ This climate seems to have affected small and medium-size TNCs in particular, since they are more susceptible to fluctuations in domestic demand owing to their low degree of transnationalization.

The above observations lead to some conclusions regarding the role played by business cycles in influencing the post-1985 boom in FDI flows and subsequent fall in the early 1990s. The growth of the world economy after the recession of the early 1980s appears to have stimulated FDI flows with a time-lag of about two years. Similarly, the downturn beginning in 1989-1990 led to a decline in world-wide FDI flows starting in 1991. Business cycles may also induce growth rates of different countries to diverge more by affecting some countries more severely than others. The cyclical downturn that began in 1989 is one such example: GDP growth in the early 1990s in developing countries was significantly higher than in developed countries, and the difference between their growth rates is expected to increase substantially.⁶ This suggests that business cycles, to the extent that they cause a greater divergence between the growth rates of developed and developing countries than would otherwise have taken place, have stimulated flows of FDI to the latter.

Figure IV.2. Foreign-direct-investment inflows to developed countries and rate of growth of real gross domestic product, 1970-1991
(Billions of dollars and percentage)



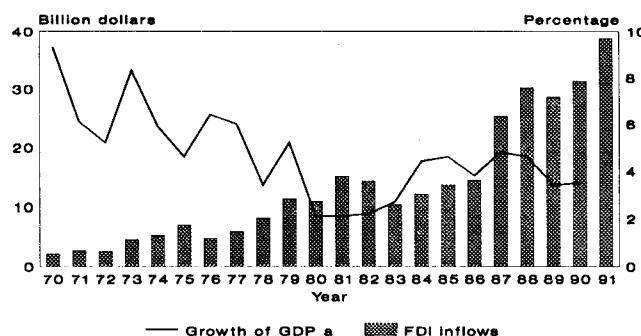
Sources: UNCTAD, Programme on Transnational Corporations, based on IMF, balance-of-payments tape, retrieved in February 1993; OECD estimates; UNCTAD, 1993e; and DESD, Development Policy and Analysis Division, DPAD data bank of world development statistics.

a 1980 prices.

(b) Sectoral differences

For FDI outflows from the major home countries, investments in services tend to be less volatile than primary- and secondary-sector investments. For the majority-owned foreign affiliates of United States services TNCs, for example, capital spending has been less volatile than that for manufacturing and petroleum firms (figure IV.5). However, the rapid economic growth of the 1980s boosted the growth of services FDI more than either primary or secondary FDI (chapter III), as TNCs sought to invest in services industries previously closed to them. This raises the question of whether business cycles affect different sectors in different ways.

Figure IV.3. Foreign-direct-investment inflows to developing countries and rate of growth of real gross domestic product, 1970-1991



Sources: UNCTAD, Programme on Transnational Corporations, based on IMF, balance-of-payments tape, retrieved in February 1993; OECD estimates; Transnational Corporations and Management Division, UNCTAD, 1993e; and DESD, Development Policy and Analysis Division, DPAD data bank of world development statistics.

a 1980 prices.

Table IV.1. Planned and actual capital expenditures by majority-owned non-bank foreign affiliates of United States transnational corporations
(Percentage change over previous year)

| Year | World | | Developed countries | | Developing countries | |
|------|---------|--------|---------------------|--------|----------------------|--------|
| | Planned | Actual | Planned | Actual | Planned | Actual |
| 1974 | 22 | 23 | 21 | 26 | 38 | 28 |
| 1975 | 3 | 6 | 1 | 5 | 18 | 18 |
| 1976 | -5 | -8 | -3 | -5 | -12 | -19 |
| 1977 | 12 | 11 | 15 | 15 | 11 | 9 |
| 1978 | 15 | 12 | 14 | 14 | 25 | 13 |
| 1979 | 22 | 25 | 20 | 25 | 28 | 20 |
| 1980 | 24 | 30 | 24 | 29 | 22 | 38 |
| 1981 | 7 | 3 | 1 | -2 | 28 | 23 |
| 1982 | 6 | 1 | 4 | -2 | 12 | 11 |
| 1983 | -4 | -18 | -1 | -16 | -6 | -20 |
| 1984 | 12 | -6 | 14 | -3 | 10 | -13 |
| 1985 | 15 | 2 | 15 | 5 | 15 | -4 |
| 1986 | 2 | -7 | 5 | -2 | -6 | -18 |
| 1987 | 3 | 5 | 4 | 9 | 1 | -8 |
| 1988 | 23 | 24 | 21 | 24 | 29 | 18 |
| 1989 | 15 | 13 | 11 | 11 | 31 | 18 |
| 1990 | 17 | 19 | 16 | 18 | 27 | 22 |
| 1991 | 3 | .. | 1 | .. | 10 | .. |
| 1992 | 4 | .. | 3 | .. | 10 | .. |

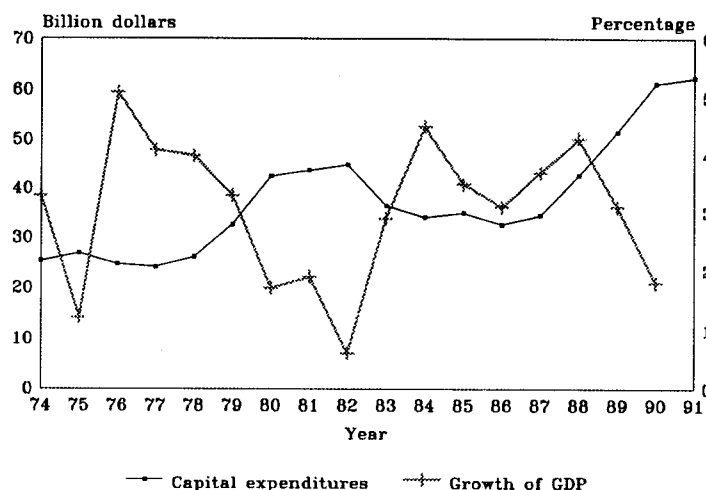
Sources: United States Department of Commerce, *Survey of Current Business*, various issues.

Typically, services TNCs rely more on FDI for delivering services to host countries than manufacturing TNCs, because of the non-tradable nature of their output. Consequently, a cyclical downturn is less likely to impact FDI in services to the same extent as in manufacturing. Conversely, because services TNCs are less transnationalized than manufacturing companies, they are willing to expand abroad, even during periods of slow growth, in order to attain a desired level of foreign investment. Thus, capital spending by services TNCs appears to be more resilient to business cycles than that by manufacturing firms. In addition, it may well be that, given the less-tradable nature of most services, market positions abroad have to be maintained through continuing investments, rather than by switching to exports (as can happen in manufacturing).

(c) *Financing methods*

The financing of FDI flows has varied significantly over time. Its variability comes through clearly in looking at investment outflows from the five largest home countries (France, the Federal Republic of Germany, Japan, the United Kingdom and the United States). During the second half of the 1980s, total outflows grew rapidly, but their components—equity, reinvested earnings and intra-company loans—did not all grow at the same rate. In particular, equity investments and intra-company loans grew faster than reinvested earnings (figure IV.6). In that period, reinvested earnings accounted for 39 per cent of total FDI outflows from

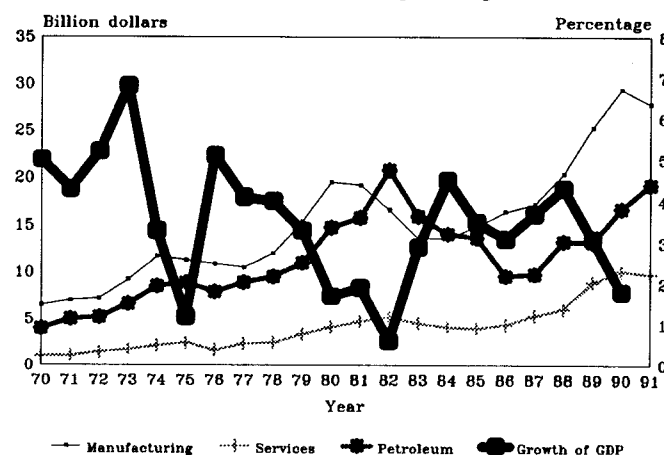
Figure IV.4. Actual capital expenditures by majority-owned non-bank foreign affiliates of United States transnational corporations and growth rate of real gross domestic product,^a 1974-1991
(Billions of dollars and percentage)



Sources: United States Department of Commerce, *Survey of Current Business*, various issues; DESD, Development Policy and Analysis Division, DPAD data bank of world development statistics.

a 1980 prices.

Figure IV.5. Actual capital expenditures by majority-owned non-bank foreign affiliates of United States transnational corporations, by sector, and growth rate of real gross domestic product of the world economy,^a 1974-1991
(Billions of dollars and percentage)



Sources: United States Department of Commerce, *Survey of Current Business*, various issues; DESD, Development Policy and Analysis Division, DPAD data bank of world development statistics.

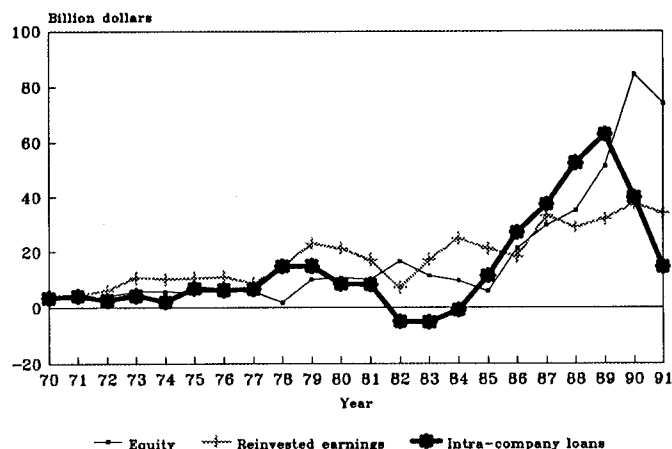
a 1980 prices.

developed countries, down from 60 per cent during the period 1981-1985 (table I.5).

Business cycles are likely to affect differently the shares of equity, reinvested earnings and intra-company loans in total FDI outflows.⁷ During a cyclical upswing, TNCs may be inclined to finance investments abroad through equity or loans to their affiliates. Conversely, during a recession, TNCs may be inclined to change methods of financing investments abroad; for example, a decline in profits of the parent companies may induce them to use profits earned in the host country for investment purposes. On the other hand, foreign profits may be needed at home during a downturn, and this seems to be the case with the largest home countries, for which the ratio of reinvested earnings to total FDI outflows decreased in 1991 (figure IV.7).

Intra-company loans can also be affected by cyclical fluctuation in economic activity. If parent firms face favourable domestic conditions, which increase their operating profits and make them expand their investment plans at home and abroad, it is plausible to suppose that loans from parents to their affiliates will increase. That is indeed what happened with three of the largest outward investors (the Federal Republic of Germany, the United Kingdom and the United States) in the 1980s, while the reverse took place during the period 1989-1991 (figure IV.7). However, the same pattern did not occur during earlier periods of slow growth. This might suggest that the home-country cycle has become more important. Specifically for the United States, the sharp drop in operating profits of United

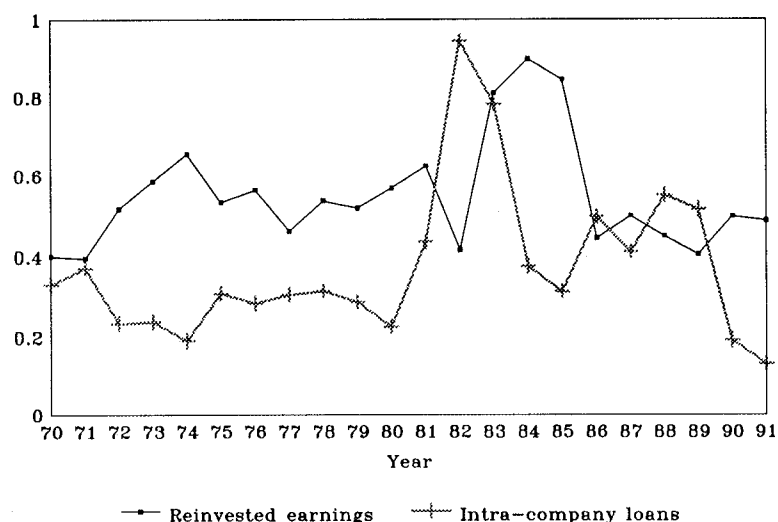
Figure IV.6. Foreign-direct-investment outflows from France, the Federal Republic of Germany, Japan,^a the United Kingdom^b and the United States, 1970-1991
(Billions of dollars and percentage)



Sources: UNCTAD, Programme on Transnational Corporations, based on IMF, balance-of-payments tape, retrieved in October 1992.

- a Does not include reinvested earnings.
- b Does not include equity.

Figure IV.7. The ratio of reinvested earnings and of intra-company loans to foreign-direct-investment outflows for the Federal Republic of Germany, the United Kingdom and the United States, 1970-1991
(Billions of dollars and percentage)



Sources: UNCTAD, Programme on Transnational Corporations, based on IMF, balance-of-payments tape, retrieved in October 1992.

States TNCs during 1990 and 1991 considerably limited their ability to lend to their affiliates abroad (Scholl *et al.*, 1992). In fact, affiliates repaid more than they received, and the share of total outflows from the United States accounted for by intra-company loans fell.

* * * * *

The strong growth of the world economy appears to have stimulated FDI flows during the second half of the 1980s and, correspondingly, the recent fall in those flows may be attributed partly to deteriorating growth conditions. These conditions are confined mostly to developed countries, which are, however, the principal sources of FDI. A cyclical upswing that rekindles economic growth would help stimulate FDI flows in the 1990s.

2. Mergers and acquisitions

During the second half of the 1980s, many TNCs saw acquisitions as a less expensive way to gain a foreign foothold than establishing new production facilities. Indeed, the majority of FDI in the United States and Western Europe took the form of acquisitions. The merger wave of the 1980s was partly a result of macroeconomic conditions in most developed countries especially the end of the recession at the beginning of that decade. That, combined with stronger international competition, created substantial excess capacity in many low- and medium-technology industries, such as petroleum and consumer durables. Other factors were easier credit, the valuation of many companies below their break-up values and innovations in corporate finance, such as the growth of the "junk" bond market and the use of leveraged buy-outs. Many TNCs sought to narrow their business base, but others thought conditions were ripe for expanding into new markets or activities. The programme for a single market in the EC encouraged mergers and acquisitions as TNCs sought a quick means to gain a foothold or to rationalize their operations there (UNCTAD, 1993f).

The mergers-and-acquisitions boom and its subsequent decline coincided with the duration of the business cycle. It is difficult, however, to separate this cyclical impact on the rise and decline of mergers-and-acquisitions activity from the influence of other factors, such as interest rates and stock-market valuations. Nevertheless, it appears that the economic slow-down was linked to the slow-down of mergers and acquisitions, because acquired companies tended to become less profitable and potential buyers were hampered by declining profits at home, although clearly other factors were also at work.

B. Policy changes

Although short-term factors may explain the surge of 1986-1990, they were not the sole reason accounting for the rapid growth of FDI in this period. Other factors that played a part included the initial reaction of TNCs to one-time policy changes. The influence of those changes on FDI flows, however, is of a longer duration. Transnational corporations may react quickly to policy changes that have an impact on their strategies, but their

response usually continues long after the initial reaction to the new policy has taken place. The initial adjustment in the flow of FDI in response to policy changes was a factor that contributed to the surge of FDI. Nevertheless, it is the continuous response of TNCs to the one-time policy changes that explains partly the trend underlying the growth of FDI flows.

1. Trade liberalization

The links between FDI and international trade are close (UNCTC, 1991a; TCMD, 1993a). For the largest home countries, TNCs account for most exports and imports (80 per cent for the United States in 1989), while intra-firm trade accounts for between one fourth and one third of total international trade (TCMD, 1992a, chap. VIII). Measures to liberalize trade can boost FDI by allowing TNCs to establish production facilities in low-cost sites from which they can export their output, by allowing TNCs to outsource inputs, by enabling the formation of regional networks and by allowing the integration of production regionally or globally.

Trade liberalization, which began in the post-war period with the establishment of the General Agreement on Tariffs and Trade (GATT), accelerated in the 1980s, especially in developing countries (DIESA, 1991). In spite of the overall trend towards trade liberalization, non-tariff barriers have been used by some countries to restrict imports in selected industries. For example, through voluntary export restraints, Japan was compelled to reduce its exports of automobiles and semiconductors to the United States. Such policies have led to fears about the future imposition of non-tariff barriers in other industries and to the growing necessity to preserve market access through FDI. Non-tariff barriers, coupled with threats of other trade restrictions, encouraged Japanese automobile manufacturers during the second half of the 1980s to become established in host-country markets, especially in the United States.

2. Exchange rates

From the viewpoint of TNCs, the cost of acquiring assets in different countries depends on prevailing exchange rates. If the host country currency falls against a TNC's home-country currency, that will boost the inflow of FDI, and vice versa. For example, the decline of the dollar against the yen in the second half of the 1980s made United States assets less expensive to Japanese firms, and was one reason for the growth of Japanese investment there (Froot and Stein, 1991; Krugman and Graham, 1992).⁸

Beyond that effect, other factors were pushing in the same direction. The large rise in the yen (coupled with rising production costs and a shortage of skilled labour at home) raised the prices of Japanese exports so much that they found it difficult to retain market share. As a result, operating in the United States became an imperative for many Japanese firms.

3. Liberalization and privatization

The trend towards a liberalization of FDI policies, which accelerated during the 1980s, especially in services (UNCTC, 1988a, chap. XVII), created a new framework for TNCs and helped boost flows of FDI. There is strong evidence that the trend towards liberalization is continuing. In 1991, almost every change in the investment regimes of some 30 countries was a liberalizing change; in 1992, all countries on which regulations data could be obtained moved in that direction (annex table 6). Not only do all countries allow FDI, but they often compete to attract such investments.

Regulatory reforms to attract FDI have been complemented by privatization programmes, but mostly in the past few years. In 1990, more than 70 countries had active privatization schemes, and they sold state enterprises to the value of over \$185 billion (TCMD, 1992a, p. 86). Despite the shortage of firm data on the involvement of TNCs in the process of privatization, they appear to have been sizeable buyers in Latin America and in Central and Eastern Europe (Minor, 1993a and 1993b).

4. Regional integration

The single market programme of the European Community and the Free Trade Agreement between the United States and Canada have sparked significant investment to and within the regions involved. The desire by TNCs from third countries to become regional "insiders" led to a faster growth of FDI in the European Community than would have otherwise been expected.⁹ At the same time, TNCs already located there began to reorganize and rationalize their investments, taking a Community-wide approach. This led to a substantial rise in intra-regional investment flows and in cross-border mergers and acquisitions. Similar changes were made by TNCs from the United States in response to the Free Trade Agreement with Canada. Investment from outside also increased, with third-party TNCs viewing North America more and more as an integrated market (UNCTC, 1990b).

Given that these were one-time policy changes, it is plausible to suppose that the growth of investment flows to the European Community and North America (including intra-regional flows) would eventually slow down. That seems to have happened in 1991 in the case of the European Community, at least as regards investments from Japan. However, there are likely to be dynamic effects arising from the formation of the Single Market. The expansion of markets and the growth of demand are likely to present new investment opportunities and encourage new inflows of FDI, even after the completion of the Single Market by 1993.

C. Structural factors

The structure of the world economy, characterized by a large and growing stock of FDI and by international production of an increasingly integrated nature, plays a role in explaining the underlying trend of the growth of FDI flows. Its influence is long-lasting and extends beyond the second half of the 1980s, suggesting the

continuation of the trend even in the absence of short-term or policy-related factors. Given the drop in FDI flows in the early 1990s, however, the growth of FDI flows will resume from a lower level.

1. The growth of the stock of foreign direct investment

The stock of global FDI has increased steadily in the post-war period and, in 1992, was estimated to have reached about \$2.0 trillion in book value (table IV.2).¹⁰ It grew by an annual average of 15 per cent during 1985-1991, compared with 10 per cent in 1980-1985.¹¹ Associated with that stock, world-wide sales of foreign affiliates more than doubled between 1985 and 1990 (table IV.2). The fact that a sizeable stock of FDI is already in place is likely to lead to a self-sustained growth of investment and resource flows associated with the activities of TNCs. The constantly increasing stock of FDI suggests that its capacity to generate output and income will also continue to grow. In particular, its capacity to generate earnings, a portion of which will be reinvested, may continue to increase as well.

2. The emergence of integrated international production

The sizeable stock of FDI attributable to the 37,000 TNCs, and their world-wide sales of about \$5.5 trillion mean that about one third of the world's private sector productive assets are under the governance of TNCs and that, therefore, international production has become a central structural characteristic of the world economy. Partly, this is the result of the technological revolution in communications, which has greatly improved coordination and integration between parent TNCs and their affiliates. Even small and medium-size firms are now able to operate as TNCs, and to take advantage of falling transport costs to export their output. These technological developments have brought about changes in the organizational structure of TNCs, driven by heightened competition and the growing awareness among companies of the necessity to invest abroad in order to serve domestic markets better.

The trend to organize production on a regional or global basis implies that more and more of a country's resources (including capital) are involved in the building of an integrated production system. Within this framework, the nature of cross-border transactions is changing, even if many (especially intangible) activities are not reflected in the conventional measures of investment flows. Furthermore, TNCs have established many non-equity links, in-

Table IV.2. World stock of foreign direct investment and sales of foreign affiliates, 1982-1992
(Billions of dollars)

| <i>Year</i> | <i>Outward stock</i> | <i>Sales</i> |
|-------------|----------------------|--------------|
| 1982 | 629 | 2 400 |
| 1983 | 672 | 2 300 |
| 1984 | 725 | 2 500 |
| 1985 | 778 | 2 500 |
| 1986 | 866 | 2 900 |
| 1987 | 1 000 | 3 500 |
| 1988 | 1 169 | 4 200 |
| 1989 | 1 382 | 4 400 |
| 1990 | 1 616 | 5 500 |
| 1991 | 1 799 | .. |
| 1992 | 1 949 | .. |

Sources: Chapter I and UNCTAD, 1993e.

cluding strategic alliances, which are not captured in the FDI statistics. In other words, the rise of the international production system is creating a self-sustaining momentum, with major implications for the growth of FDI and other forms of cross-border transactions.

* * * * *

The strong economic performance of the world economy and the popularity of mergers and acquisitions are the principal explanations for the bulge in the trend of FDI flows during the second half of the 1980s. These short-term factors ceased to influence favourably the growth of FDI after 1989, as deteriorating growth conditions set in, particularly in developed countries, and mergers-and-acquisitions activity dwindled. The 1980s also witnessed the continuation of the influence of two other forces: policy-related changes and pressures arising from structural changes in the world economy resulting from the actions of TNCs. Essentially, policy changes and structural changes explain the underlying trend in FDI flows, with short-term factors amplifying temporarily that trend. Given that the impact of these changes is long-term, a question arises regarding the future outlook for the flow of FDI, which is discussed below.

D. Future prospects

In general, of course, firms with tangible or intangible assets arising from ownership will continue to use them best by internalizing transaction costs and by investing in countries that offer suitable locational advantages (Dunning, 1993). This approach will ensure that firms continue to engage in international production and to locate value-adding activities abroad. However, the fall in investment flows in 1991 and 1992 raises the question of whether they will continue to increase in the future. Assuming they do, a related question is how fast that increase will be. Policy changes and structural changes in the world economy make it very likely that investment flows will continue to grow, although from a lower level than that reached in 1990. An economic upswing would amplify further the impact of those changes. The rest of this chapter is devoted to these issues.

1. The future of policy

(a) *Liberalization of trade and investment*

If trade liberalization continues, TNCs will have an incentive to invest in countries where costs are low and from which their output can be exported. Trade liberalization may also accelerate the organization of international production into regional or global networks of firms by allowing the movement of goods (and, increasingly, services) that is necessary for the pursuit of complex integration strategies (chapter V).

Despite progressive liberalization of FDI regimes, there is still more to be done. In services, which now account for over half of total FDI flows from the major home countries, the regulatory framework for foreign

investment could be opened up further, especially in developing countries. The opening of telecommunications, transportation, public utilities, insurance and other services to FDI, coupled with the relatively low tradability of services, are likely to keep TNCs investing heavily abroad. It is also likely that privatization will play a bigger role, as some countries (especially in Latin America) are already replacing debt-to-equity conversion schemes with privatizations as the principal incentive to attract FDI.

(b) *Regional integration schemes*

Foreign investment will also be boosted by further regional integration in Western Europe and North America. The same is true in Asia, where TNCs are integrating their production even in the absence of a formal institutional framework. Specifically, the closer links between the European Community and the European Free Trade Association (EFTA), leading to the formation of a European Economic Area, are likely to result in greater intra- and extraregional flows of investment. Similarly, the extension of the United States-Canada Free Trade Agreement to include Mexico under the North American Free Trade Agreement (NAFTA), which has already led to substantial investment flows to Mexico (\$4.8 billion in 1991), will help promote investments there. The envisioned creation of a free trade zone in the Western Hemisphere (the Enterprise for the Americas Initiative) could also aid the growth of FDI. Those effects will continue to make themselves felt. If regional integration results in permanently faster economic growth, FDI, too, will grow faster.

2. Imbalances in transnationalization

Although there is no reason why countries, industries or firms need to converge towards any particular degree of transnationalization, it is possible that international competition will force young and ambitious companies, as well as more mature TNCs, to invest abroad. At the same time, services TNCs may continue to invest abroad at a rapid rate. The degree of transnationalization in their sector may eventually catch up with that of manufacturing.

(a) *Country imbalances*

The imbalance between inward and outward FDI for Japan, as well as the low ratio of inward FDI stock to GDP, is not in line with the experience of the European Community and the United States (TCMD, 1992a, p. 20). This is likely to change as perceptions of foreign TNCs change or actual barriers to inward FDI come down. As for outward investment, countries tend to differ according to their position on the development path. Relatively mature investors, such as the United Kingdom, have a high degree of transnationalization of their firms. Despite the rapid growth of its outward investment between 1985 and 1990, Japan is still a relative newcomer (table IV.3) (UNCTC, 1989). It is therefore likely that investment outflows from Japan, despite their recent slow-down, will pick up again before long.

The same is true of those other countries which accelerated the pace of transnationalizing their economies in the 1980s. The Republic of Korea and Taiwan Province of China are two prominent examples. China itself is rapidly expanding its investment position abroad. Other countries in Asia and Latin America could follow suit.

It is even conceivable that some countries in Central Europe could become sizeable outward investors, once they have completed their transition to market economies.

(b) Sectoral imbalances

At the sectoral level, the degree of transnationalization varies considerably (chapter III). Services are usually behind manufacturing, despite the rapid growth of their share of GDP in many countries. Taking the case of the United States as an example, 21 per cent of the assets of its transnational services corporations were abroad in 1990, compared with 27 per cent for its manufacturing TNCs (United States Department of Commerce, 1992a). This disparity is largely due to restrictions on inward investments in services, which have only recently started to be reduced. It may therefore be expected that investment flows in services may well grow substantially over the next decade.

Table IV.3. Ratio of foreign-direct-investment outward stock to total assets of the home country, 1990
(Percentage)

| Country | Ratio |
|-----------------------------|-------|
| Japan | 4 |
| United States ^a | 8 |
| Germany | 15 |
| United Kingdom ^b | 26 |

Sources: TCMD, 1993c.

a For 1991. Foreign-direct-investment stock at historical cost adjusted for the finance (except banking), insurance and real estate industry of the Netherlands Antilles.

b Ratio of non-bank foreign-direct-investment stock to non-financial assets in 1987.

3. Projecting foreign-direct-investment flows

As with all forecasts, projections of FDI inflows must be treated with caution. They depend on certain assumptions about the future course of the independent variables in the model used for forecasting (box IV.2), and those assumptions may turn out to be wrong. Moreover, timing is crucial: forecasts will be wrong if lags are longer than expected. Thus, world-wide FDI inflows are projected to grow, but not as rapidly as in the second half of the 1980s.

Projections of FDI inflows were made in the late 1980s on the basis of data through 1988, owing to significant lags in the availability of a suitable data set. The projection are based on three methods of forecasting the independent variables (see table IV.4), and indicate that the increase between 1984 and 1988 continued in 1989—a finding confirmed by the actual behaviour of FDI flows in that year. Using this same approach, FDI, on average, is projected to grow in real terms during the first half of the 1990s in most regions, but more slowly than in 1984-1988. In particular, it is expected to grow faster in developing regions (Latin America, Africa and Asia) than in developed, albeit from a small base.¹² The highest growth rates are projected for Latin America and Africa, although the pace depends on the forecast method used. Investment inflows in Asia are also expected to grow rapidly, at about 11 per cent annually, a finding confirmed by all methods of forecasting.

In an alternative long-term “scenario” of the world economy, based on assumptions of secular growth and further rapid policy liberalization in developing countries (leading to higher incremental output-capital ratios in these countries than during the 1980s), global FDI inflows are expected to about \$800 billion (in 1990 prices) by the year 2020 (box IV.3 and figures IV.8 and IV.9). The main beneficiaries of that increase will be developing countries, which are projected to receive about half those inflows, compared with their present share of 25 per cent.

Box IV.2. The determinants of foreign-direct-investment inflows: a model for projections

The Transnational Corporations and Management Division of the United Nations Department of Economic and Social Development initiated a project on projecting FDI flows for developed and developing countries, by region, and separately for the United States and Japan. The projections are based on a single-equation model reflecting the principal determinants of FDI inflows, and tested using regression analysis for 1972-1988.

$$FDI_t = a_0 + a_1 GNP_{t-1} + a_2 \Delta GNP_t + a_3 (I/GNP)_{t-1} + a_3 XR_t + a_4 V(XR)_t$$

where:

FDI_t = inflow of FDI to a region in year t ;

GNP_{t-1} = gross national product in year $t-1$ (signifies the size of the market);

ΔGNP_t = the change in GNP between years $t-1$ and t ;

$(I/GNP)_{t-1}$ = ratio of domestic investment to GNP in year $t-1$;

XR_t = the exchange rate (defined as the ratio of the domestic currency to the dollar);

$V(XR)_t$ = the squared variation of the exchange rate from its mean over the period 1972-1988.

The level of gross national product (GNP) with a one-year lag, a measure of the size of the economy of the region, captures the opportunities available to foreign investors for supplying a large market. The annual change in GNP represents the attractiveness of a growing region to foreign investors, as well as cyclical (demand or supply-induced) fluctuations in the rate of growth of GNP. Both the level and the growth rate of GNP are expected to be positively associated with the inflow of FDI. A depreciation of the exchange rate, defined as the ratio of domestic currency to the dollar, is expected to boost FDI inflows by allowing TNCs to acquire domestic assets more cheaply. On the other hand, the extent of its volatility—indicated by the variance of the exchange rate—reflects uncertainty that could hamper FDI inflows. Domestic investment as a proportion of GNP—a measure of the rate of domestic capital formation—reflects the attractiveness to foreign investors of a region which invests a large proportion of its domestic output; that variable would be expected to be positively related to FDI inflows.

To capture region-specific developments, additional independent variables have been included for Latin America and Africa. In the case of Latin America, the sum of exports and imports as a proportion of GNP (O_{t-1})—the degree of openness of the host economy of the country—and the level of external indebtedness (XDB_{t-1}) are expected to have, respectively, a positive and negative impact on FDI inflows. In the case of Africa, a dummy variable (D) has been introduced to capture unforeseen jumps in FDI inflows that occurred in 1979, 1981 and 1985, attributed to special political and economic circumstances in the region's largest recipient countries.

Source: UNCTAD, 1993a.

**Table IV.4. Actual and projected growth rates of foreign-direct-investment inflows,
1972-1988 and 1989-1995
(Percentage)**

| Countries | Annual average growth rates | | | | |
|---------------------------|-----------------------------|-----------------|------------------------|------------------------|------------------------|
| | Actual | | Forecast ^a | | |
| | 1972-1988 | 1984-1988 | 1989-1995 ^b | 1989-1995 ^c | 1989-1995 ^d |
| Developed countries | 10.4 | 22.0 | 8.3 | 9.6 | 8.1 |
| European Community | 8.6 | 23.8 | 6.3 | 11.1 | 8.5 |
| Other developed countries | 16.4 | 28.4 | 7.9 | 5.2 | 4.2 |
| Japan | -- ^e | -- ^e | 9.0 | 13.8 | 9.5 |
| United States | 42.8 | 44.7 | 8.7 | 6.1 | 5.7 |
| Asia | 12.5 | 21.1 | 11.3 | 11.6 | 11.8 |
| Latin America | 19.0 | 16.4 | 17.9 | 15.6 | 12.2 |
| Africa | 12.2 | 4.4 | 6.3 | 16.3 | 16.1 |

Source: UNCTAD, 1993a.

a Derived from deflated FDI flows.

b Based on least-squares estimates of the average rate of growth of the independent variables during the period 1972-1986, on the assumption that the same growth rate will continue to prevail in the forecast period 1989-1995.

c Based on forecasts generated by Project Link of the United Nations Department for Economic and Social Information and Policy Analysis, with regional growth rates of the independent variable being constructed as weighted aggregates of these variables for individual countries. The projected growth rates of FDI inflows based on Project Link forecasts of the independent variables are generally higher than those based on the other methods of forecasting.

d Based on IMF and World Bank projects of the average growth rates of the independent variables over the period 1990-1995 (the lack of annual forecasts does not allow cyclical fluctuations in the growth rates of these variables to be reflected).

e The growth rates are not meaningful because the underlying series becomes negative for several years.

These exercises and their projected FDI flows (figure IV.9) carry several implications. First, FDI flows will continue to grow, but with year-to-year fluctuations. The speed of their growth will depend on the rate of economic growth in host countries. The conditions that are likely to encourage FDI inflows to developing countries will also encourage domestic investment. Still, the share of FDI inflows in total investment could increase, given that, on average, the growth of FDI may exceed the growth of that investment. Secondly, the share of developing countries in global FDI inflows is expected to rise, given the higher profitability of investments there and provided that these countries continue to liberalize their FDI regimes.

* * * * *

As the importance of structural factors and policy changes increases, the long-term trend in FDI flows might also increase. Nevertheless, FDI, like domestic investment, will continue to respond to business cycles (and such fluctuations may well be transmitted faster world-wide as a result of the growing integration of national economies through integrated international production at the level of firms, discussed in chapter VII). In view of those developments, the transnationalization of the world economy is likely to increase, strengthening the role of TNCs as integrating forces and co-ordinators of cross-border transactions.

Box IV.3. A long-term scenario for foreign direct investment

It is a paradox that year-to-year changes in FDI are so volatile, whereas decisions by TNCs to make cross-border investments rest on long-term considerations. One way around the problem of cyclical volatility is to construct a long-term forecast based only on the structural parameters driving FDI. The difficulty with that approach is common to all long-term forecasts: the range of uncertainty around the future parameters increases with the forecast horizon.

Scenario planning is a technique for thinking about the uncertain, long-term future in a structured way without forecasting or assigning probabilities to the outcome. The basic difference between scenario planning and forecasting is that the former is used to rehearse what *could* happen to prepare for contingencies that one may think are unlikely, rather than to plan for what one thinks *will* happen. Some companies use scenario planning to avoid the dangers of conventional forecasting and the complacency it spawns in a world where the unthinkable is increasingly common. This approach has been used to develop a scenario for global FDI flows over the period to the year 2020.

Over such a long period, business cycles can be ignored and FDI can be considered in the context of overall economic growth and investment. Just as, for most countries, exports represent a small part of production, so FDI represents only a small part of investment. At the same time, high investment (as a share of income) both leads to and results from rapid economic growth. Though less conclusively established, a further structural assumption is that high FDI inflows (as a share of total investment) are associated with an open or opening policy framework. During the 1980s some developed countries did much to privatize and deregulate their service industries. This sector was the biggest recipient of the massive increase in their FDI flows.

Where will growth be highest and policy liberalization strongest in the 1990s? A plausible assumption is that it will be in the developing countries. The Asian region has been growing faster than the developed countries for more than two decades, and growth is accelerating in Latin America and parts of Africa. Examples of market-oriented economic reforms abound in every region: from Chile to Ghana to Poland to China. The reforms invariably include a greater role for the private sector and more open policies for trade and FDI.

A key result of successful policy liberalization is to raise the return on investment, both domestic and foreign. Countries reap greater gains in output per unit invested. Freeing business from excessive regulation and stimulating competition between firms—public and private, domestic and foreign—increases the productivity of investment. This is beginning to show up in the United Kingdom and the United States, as they recover from their recessions following major industrial restructuring, particularly in services.

An aggregate long-term measure of the return on investment for an economy as a whole is the incremental output/capital ratio. This is calculated by dividing the economic growth rate (percentage change in real GDP per year) by the investment ratio (average share of investment in GDP over the same period). It provides a rough measure of the productivity of investment, under the simplifying assumption that all of the incremental growth was due to capital accumulation. That is clearly an oversimplification because, for example, it does not take account of changes in the labour force. However, it is a useful tool for comparing aggregate investment returns for a single country, or a fixed set of countries, over different time periods.

For developing countries as a group the incremental output/capital ratio was 24 per cent over the period 1965-1980 (figure IV.8). On average, a dollar invested produced a real return to the economy as a whole of 24 per cent. Meanwhile in the slower-growing and already capital-rich developed countries, the return on investment was lower—around 19 per cent. However, this expected relationship was reversed during the 1980s, a period that has been called the “lost decade” for many developing countries. The second oil-price shock in 1979, the early-1980s recession in their main export markets, the sharp increases in interest rates and the appreciation of the dollar through 1985 culminated in the debt problems that paralysed growth in many countries. This is reflected in their incremental output/capital ratio, which fell to 13 per cent over the 1980s, even below that of the developed countries. Under those conditions it is little wonder that FDI flows to many of the developing countries were lower in real terms in the 1980s than in the 1970s.

Given the recent changes in many developing countries, it seems plausible to assume that average investment returns over the next 25 years will be more like those of the 1960s and 1970s than the very low ones of the 1980s. An iterative model relating economic growth and investments was used to derive an incremental output/capital ratio in developing countries of 21 per cent for the 1990-2020 period, somewhat below what was achieved in the 1965-1980 period, but considerably above that of the 1980s. Meanwhile, the ratio in the developed countries would continue its gentle downward drift to 13 per cent on the assumption of diminishing marginal returns.

With investment returns of 21 per cent and a slight increase in the investment ratio of developing countries to 27 per cent of GDP (it was 24 per cent in 1990 and has been over 30 per cent in the East-Asian developing countries for more than a decade),

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(Box IV.3, cont'd.)

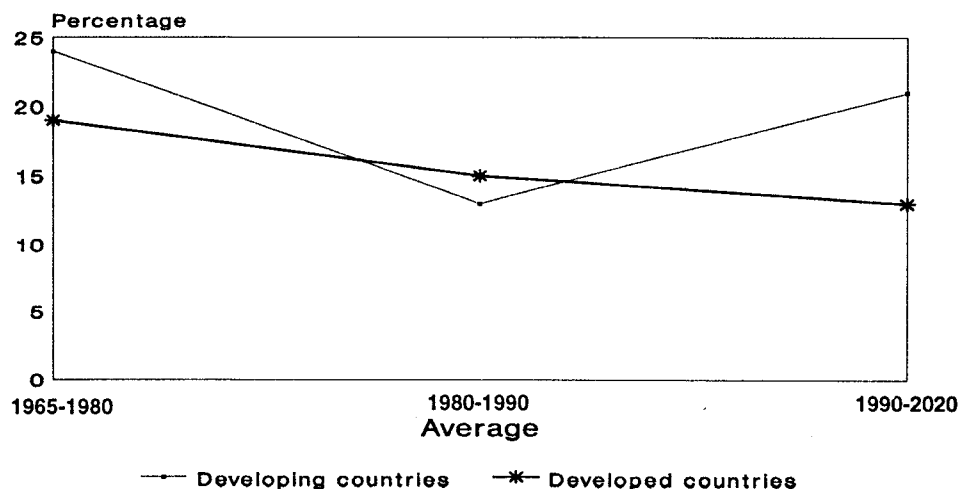
economic growth in the developing countries would average 5.7 per cent over the full period through 2020. Not every country would grow at this rate, but, equally, some would grow faster. Compared with the 1980s, this scenario suggests that growth in East Asia would slow, while growth would accelerate in Latin America and South Asia. Globally, a 5-6 per cent growth rate in the developing countries would be lower than the average 6.5 per cent achieved during the 13-year period before the first oil shock, but it would be a major improvement over the 3 per cent of the 1980s. Such growth results from the policy-induced rise in the output/capital ratio which leads to an average growth in developing country investment (including both domestic and foreign inflows) of 6.2 per cent per year.

These trends imply a widening gap between returns to investment and growth in the developing and developed countries. Provided economies are open to foreign investors, provided political risks are reduced by the willingness of developing countries to follow international norms of investor protection, and provided tax regimes on TNCs are no more onerous in the developing countries than in the developed countries, the result would be a major increase in FDI to the developing world. Under this scenario—which assumes all of the above—FDI would grow from \$32 billion in 1990 to around \$80 billion in the year 2000 and to nearly \$400 billion by 2020 (all in 1990 dollars). In that year, it would account for half of the world FDI of nearly \$800 billion, up from only one fifth in 1991.

Although those figures sound massive, they imply a surprisingly modest move towards further globalization of investment. By the year 2020, the share of FDI in total investment would have risen to 6 per cent in the developing countries and 7 per cent in the developed countries. This compares with 1990 shares of 3 per cent and 4 per cent, respectively. There is scope for the shares to be much higher; they have already reached levels of 8 per cent to 15 per cent in such open and mature international investors as the United Kingdom and the United States. The long-term future for FDI may be even more dynamic than this scenario suggests.

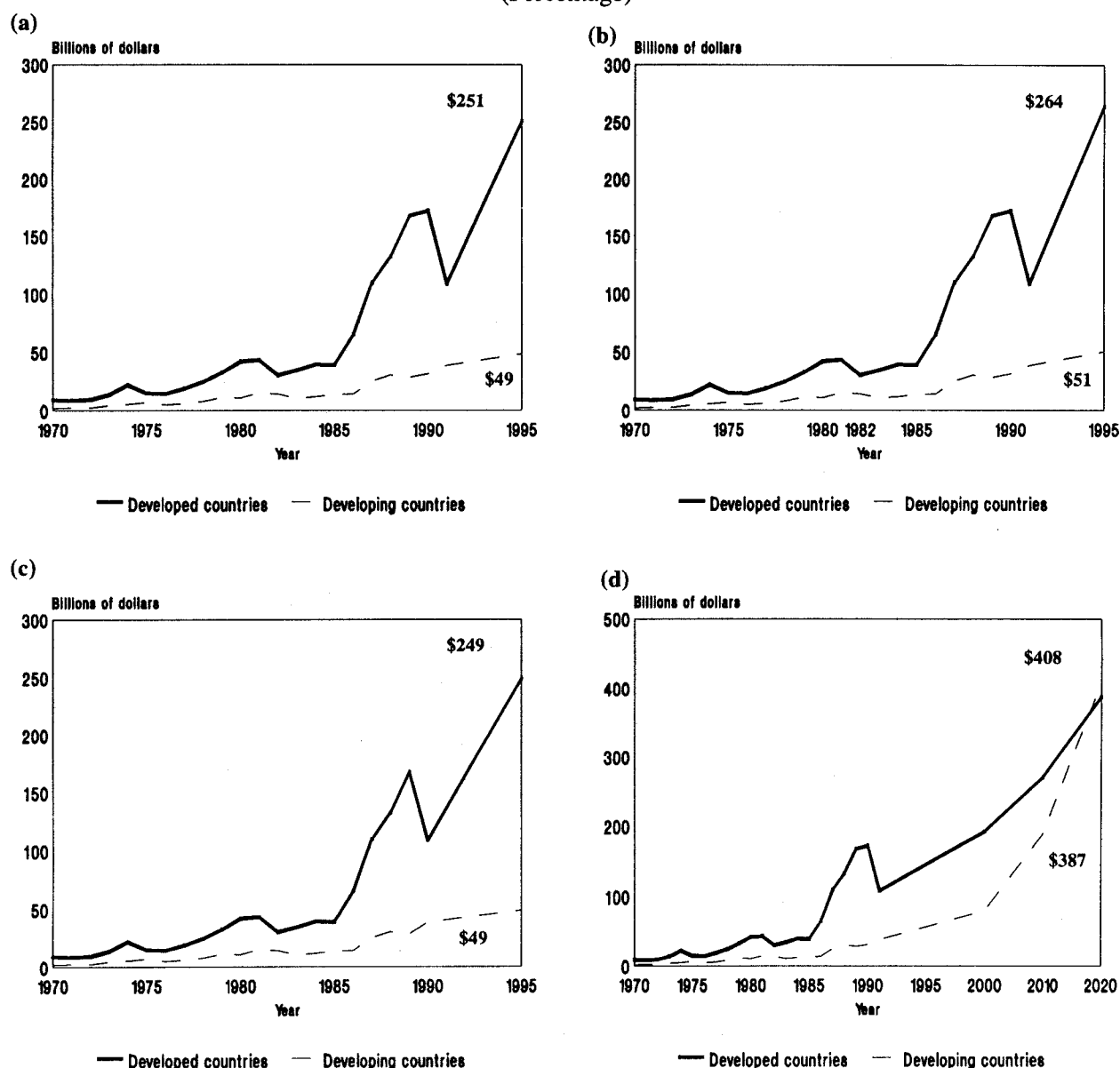
Source: Based on Julius, 1993.

**Figure IV.8. Incremental output/capital ratio
(Percentage)**



Source: Shell International Petroleum Company Limited, Group Planning.

Figure IV.9. Actual and projected inflows of foreign direct investment to developed and developing countries, 1970-1995 and 1970-2020^a
(Percentage)



Source: Projected FDI inflows in (a) are based on least-squares estimates of the average rate of growth of the independent variables during the period 1972-1986, on the assumption that the same growth rate will continue to prevail in the forecast period 1989-1995; in (b), on forecasts generated by Project Link of the United Nations Department for Economic and Social Information and Policy Analysis, with regional growth rates of the independent variable being constructed as weighted aggregates of these variables for individual countries; in (c), on IMF and World Bank projects of the *average* growth rates of the independent variables over the period 1990-1995 and (d), on Julius, 1993.

a 1990 prices.

Notes

- 1 Japanese FDI outflows increased consistently from \$6 billion in 1985 to \$48 billion in 1990.
- 2 The regression equation $FDI = -61.75 + 4.5 (GNP)$ where FDI is the percentage change in world-wide FDI outflows and GNP is the percentage change in world-wide GNP, and $R^2=0.93$) shows that the growth of FDI outflows is highly correlated with the growth of GNP. The growth of aggregated FDI outflows (FDI) for France, Germany, Japan, the United Kingdom and the United States is also closely correlated with the growth of output (GNP) over 1970-1991, as shown by the estimated regression equation $FDI = -55.48 + 4.23 (GNP)$ ($R^2 = 0.89$). See also Julius (1990).
- 3 Planned domestic capital expenditures by all United States companies are closely correlated with capital expenditures of majority-owned foreign affiliates of United States parent firms (Fahim-Nader, 1992a).
- 4 According to a survey taken by the United States Department of Commerce, Bureau of Economic Analysis in June 1991, majority-owned affiliates of United States TNCs planned to increase capital expenditures in 1991 by 10 per cent; in the survey taken in December 1991, that figure was revised to 3 per cent (Fahim-Nader, 1992b). Similarly, planned capital expenditures for 1992 were revised downward in the survey taken in June 1992 in comparison to the survey taken in December 1991 (Fahim-Nader, 1992a). This is similar to the experience in earlier periods of slow growth: based on a survey taken in December 1981, the growth of planned capital expenditures of these affiliates was 11 per cent; in the survey taken in June 1982, the growth of these expenditures was revised downwards to 6 per cent (Kozlow, 1982, p. 43).
- 5 See Anthony Rowley, "Ebbing streams: Japanese firms curtail their overseas forays", *Far Eastern Economic Review*, vol. 155 (18 June 1992), pp. 78-79.
- 6 Based on forecasts of the Department of Economic and Social Development, the growth of GDP (1988 prices) in developing countries is substantially higher than in developed countries in 1991 and 1992.
- 7 In addition to business cycles, other factors, such as the cost of capital in host countries or changes in exchange rates, may influence the mode of financing FDI flows. For example, foreign affiliates may consider it more advantageous to raise capital in the host countries if interest rates are favourable than to borrow from the parent firm. Other factors can affect the extent to which earnings are repatriated or reinvested. The cost of alternative types of capital may be one influence; exchange rates may be another. A high cost of capital in host countries, for example, may induce affiliates to reinvest their earnings rather than borrow from host-country equity markets. On the other hand, a fall in the exchange rate of a host country may discourage affiliates from repatriating profits, because that would reduce their value when translated into the currency of the home country. (Exchange-rate fluctuations also influence the valuation of reinvested earnings and hence total investment flows. The United States, for example, has excluded changes in flows attributed to sizeable exchange-rate fluctuations from the reported foreign-direct-investment data.)
- 8 In 1985, the average exchange rate was 239 yen per dollar; in 1986, the yen appreciated to 169 yen to the dollar and continued to appreciate until 1988, when it reached 128 yen per dollar.
- 9 For a discussion of the impact of the completion of the European Community Single Market by 1993, see TCMD (1993a).
- 10 To the extent that investment outflows are positive, the outward stock increases.
- 11 The conversion of global foreign-direct-investment stock data from national currencies into dollars is bound to reflect valuation changes resulting from exchange-rate fluctuations. Nevertheless, even when stocks are reported in SDRs, their annual growth rate during the second half of the 1980s is almost two times higher than that during the first half.
- 12 It should be noted that the forecasts reported here are for regional groupings and most likely differ from forecasts for individual countries for which there may be a considerable degree of variation.