VI. TRENDS IN FOREIGN DIRECT INVESTMENT IN OECD COUNTRIES

Introduction

Foreign direct investment has beneficial effects on the economy

Foreign direct investment (Box VI.1) is considered to be an important driver of economic growth in OECD countries (OECD, 2002*a*, 2002*b*). This is because the internationalisation of production helps to better exploit the advantages of enterprises and countries, increase competitive pressures in OECD markets and stimulate technology transfer and innovative activity. In consequence, there is a wide consensus that policy should aim at reducing or eliminating hindrances to foreign direct investment (FDI) as long as this does not conflict with other legitimate policy objectives.

This issue of the Economic Outlook explores several important features of FDI in OECD countries. This chapter reviews recent trends and patterns in FDI and the related activity of foreign affiliates. It is followed by chapters on regulations restricting foreign ownership of businesses and on the quantitative impact of various policy- and non-policy-related factors on FDI.

Patterns of FDI

Box VI.1. **Foreign direct investment: definition and data sources**

FDI is an activity in which an investor resident in one country obtains a lasting interest in, and a significant influence on the management of, an entity resident in another country. This may involve either creating an entirely new enterprise (so-called "greenfield" investment) or, more typically, changing the ownership of existing enterprises (via mergers and acquisitions). Other types of financial transactions between related enterprises, like reinvesting the earnings of the FDI enterprise or other capital transfers, are also defined as foreign direct investment.

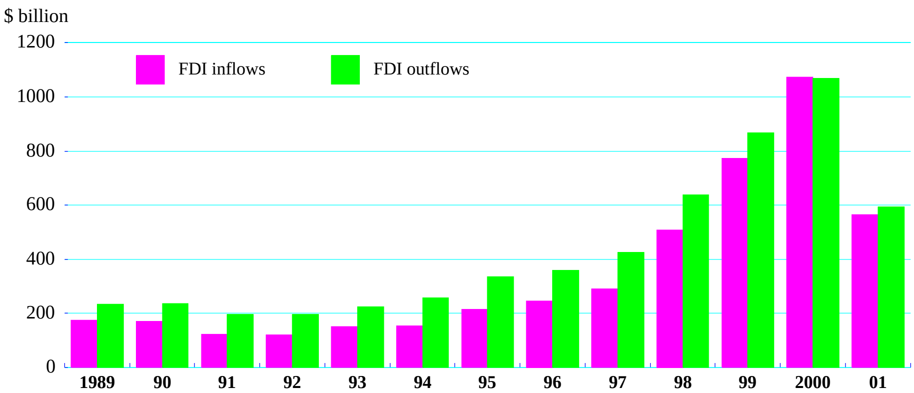
FDI activity can be measured in two different ways: financial investment flows and stocks, and "real" activity of foreign affiliates in host countries. Financial FDI data are compiled according to the concepts used for balance of payments (flows) and international investment position (stocks) statistics (OECD, 2001*a*). Information on the activity of foreign affiliates is collected through national surveys concerning several aspects of business activity, and is compiled by the OECD (OECD, 2001*b*). The country, industry and period coverages of these data are still limited. The coverage of the two measures differs because FDI flows and stocks conventionally relate to ownership of 10 per cent or more of the shares or voting power in an enterprise, while the data on the activities of foreign affiliates include only enterprises with foreign ownership of 50 per cent or more.

While the financial data are more widely available, they suffer from various measurement problems. For instance, reported bilateral FDI flows may not always reflect accurately internationalisation patterns, because the proximate destination of these flows (country or industry-wise) may not be the final one, due to the role played by foreign-owned financial intermediaries in host countries (Borga and Mataloni, 2001). Furthermore, despite substantial progress made in harmonising definitions and data collection methods some cross-country inconsistencies remain: while a majority of countries report data on investment positions at book values, some measure the positions in market values.

Foreign direct investment increased sharply in the late 1990s…

FDI flows remained relatively stable for much of the 1990s; picked up significantly towards the end of the decade;[1] and fell back somewhat in 2001 -- but to levels some three-times those at the start of the 1990s (Figure VI.1). The internationalisation of production hence increased significantly during the 1990s, approximately doubling the real inward FDI position of the average OECD country (measured in constant 1996 purchasing power parities) from USD 81 billion to USD 158 billion over the 1990-2000 period. The marked slowdown of flows at the beginning of the new decade mostly reflected a correction to sustainable levels rather than a reversal of a trend, and the importance of cross-border ownership of assets continues to increase, mirroring the substantial role of MNEs in the global economy.

Figure VI.1. FDI flows within the OECD area[1]



1. Not adjusted for breaks in series.
Source: OECD.

… consisting mainly of mergers and acquisitions in developed countries

OECD countries accounted for over 80 per cent of global outward FDI in 2000, with most of the activity consisting of mergers and acquisitions (including privatisation deals) of existing businesses (OECD, 2002*a*) as compared with greenfield investment.[2] The United States and the EU countries held more than three-quarters of total OECD inward and

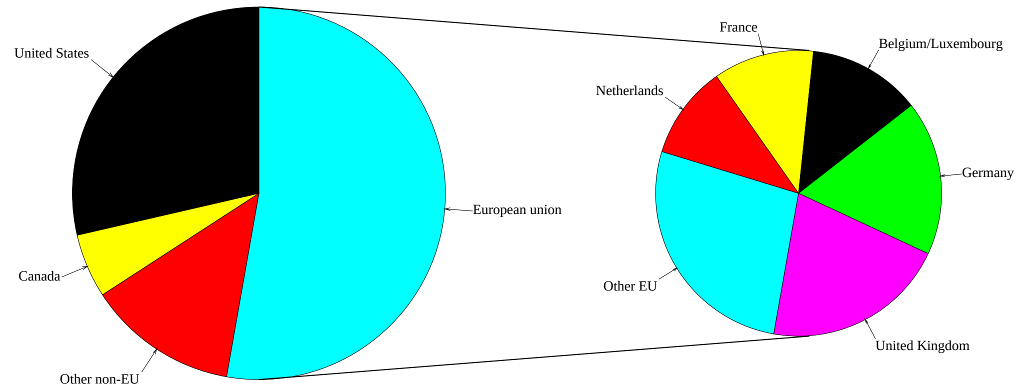
1. The peak in FDI coincided with the sharp equity-price increase in the late 1990s and therefore a significant part of it may reflect a pure valuation phenomenon.

2. Greenfield investment has been very important for the new Central European members of the OECD, but the value of such investment is small compared with the bulk of total OECD investment.

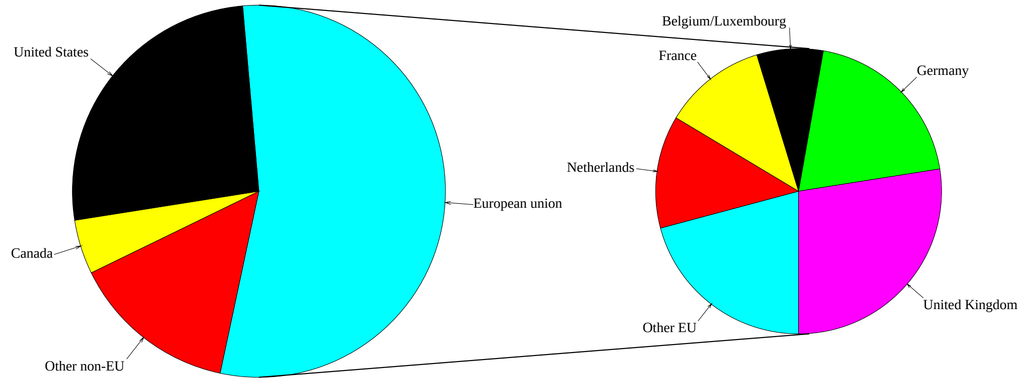
outward FDI positions in 1998 (Figure VI.2). Of the EU countries, the United Kingdom, Germany and France were the largest suppliers and receivers of FDI. The Netherlands was also a notably large investor, while Belgium/Luxembourg was a relatively big host to foreign businesses.[3]

Figure VI.2. Distribution of OECD stocks of FDI positions in 1998[1]

Inward positions



Outward positions



1. The charts are based on bilateral data. As the method used for valuing FDI positions varies across countries, the resulting shares are undervalued for countries that report book values (e.g. the United States).
Source: OECD.

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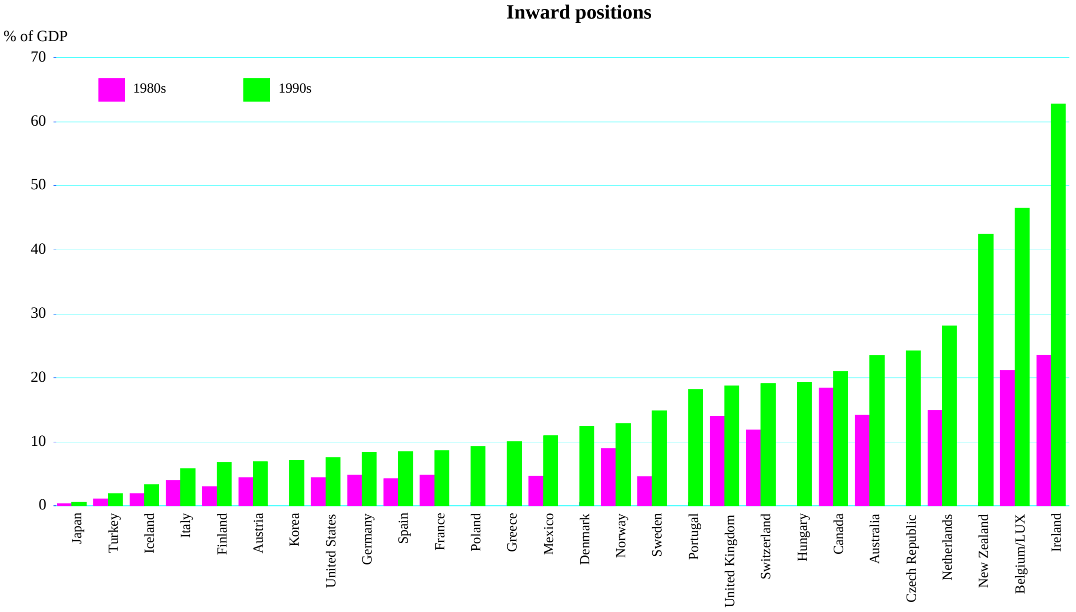
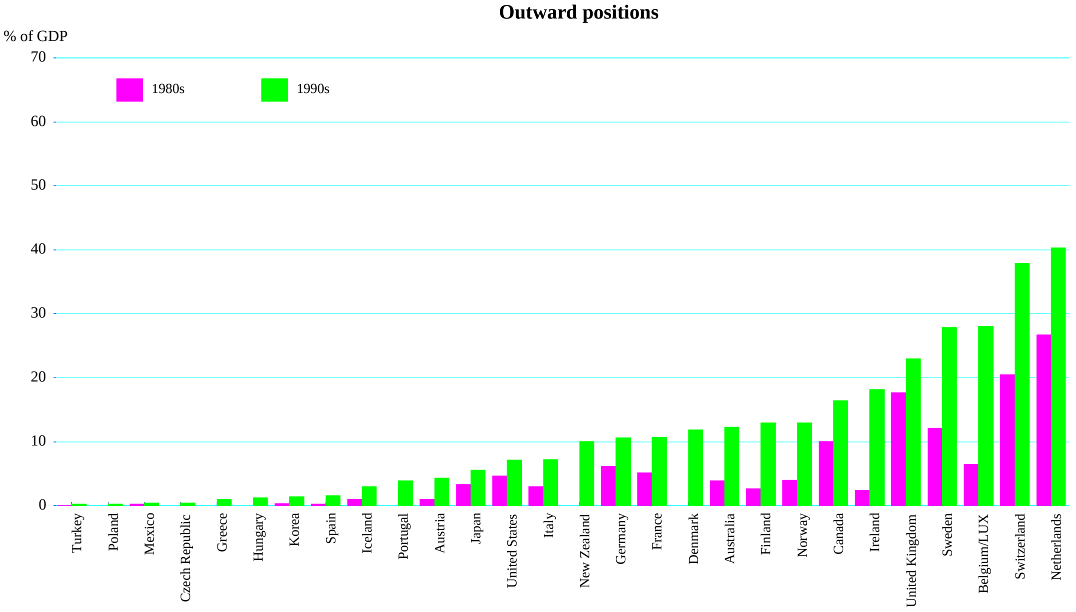
3. Data for Belgium and Luxembourg were only collected at the level of Belgo-Luxembourg economic union until 2002.

Foreign direct investment relative to GDP differs across countries…

FDI positions have grown significantly faster than GDP in virtually all OECD countries over the 1990s (Figure VI.3). Relative to the size of the economy, FDI is particularly large in smaller countries, such as the outward positions of the Netherlands and Switzerland, and the inward positions of Ireland, Belgium/Luxembourg and New Zealand. In new OECD members only inward FDI plays an important role in the economy, while in Japan outward FDI is much higher than inward FDI.

Figure VI.3. FDI positions in OECD countries, 1980s and 1990s [1]





1. Average values over the two periods. For countries where FDI position data are not available, values of bilateral positions reported by their OECD partners were summed up to obtain an approximate measure of multilateral FDI positions.

Source: OECD.

… as do the bilateral patterns…

The patterns of total FDI invested or hosted by OECD countries mask wide differences in the extent of bilateral FDI relations. In 1998 (the latest year for which bilateral data are reasonably complete) the number of host partners varied across investing countries, ranging from below 10 for Hungary and Turkey to above 20 for many EU countries, the United States and Canada. Moreover, while many countries tended to evenly distribute their FDI across partners, some of them (*e.g.* Canada, Korea, Denmark and the United Kingdom) concentrated FDI on a few host countries. Similarly, FDI in some host countries (Austria, Canada, the United Kingdom and Mexico) mostly comes from just a few investor countries.

… with geographical and openness factors playing an important role

Openness and proximity factors are likely explanations for some of these patterns. A significant share of FDI in the OECD area takes place between countries bound by regional trade agreements and among geographically close countries. Thus, most European countries tend to host relatively more FDI originating from EU countries than from elsewhere,[4] while FDI in Canada and Mexico originates to a large extent from the United States. Similarly, Pacific shore countries tend to host more FDI from the United States and/or Japan than from other OECD countries.[5]

Foreign affiliates' activities are concentrated in a few industries

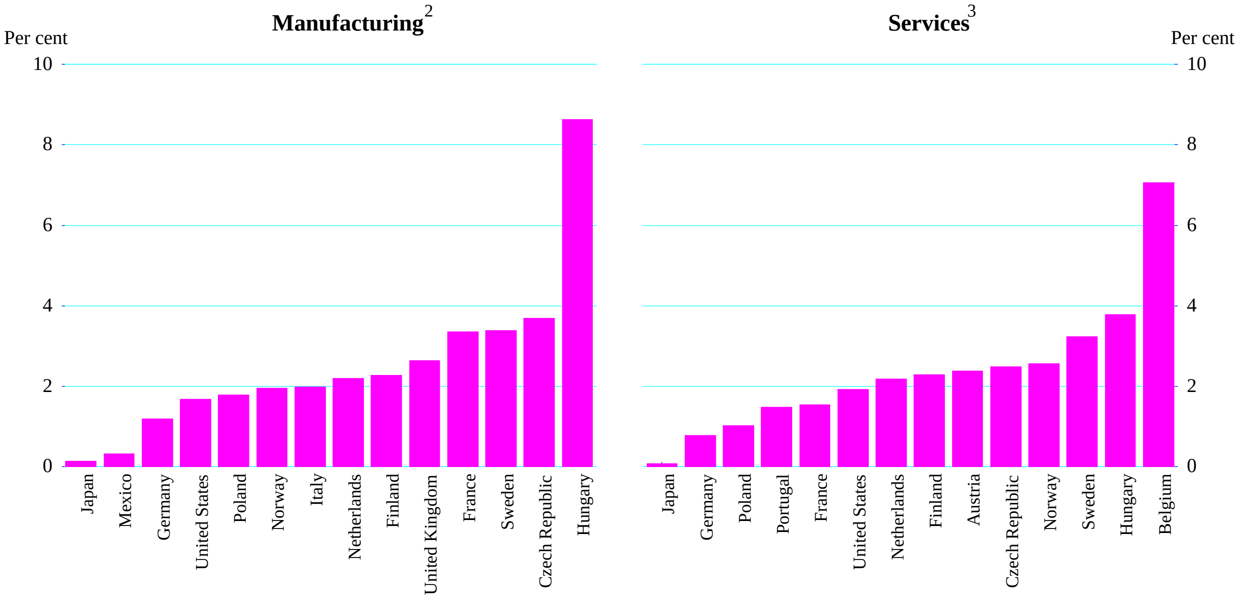
The share of economic activity accounted for by foreign affiliates in host countries (and in each industry) provides a good indication of the actual degree of internationalisation of production in the OECD area. Data on foreign affiliates is sparse, but available information suggests that the surge in FDI flows observed during the late 1990s was mirrored by a significant increase in the activity of foreign affiliates in the OECD area (OECD, 2002*a*). In most of the countries for which data are available for the late 1990s, employment of foreign affiliates generally accounted for 1 to 4 per cent of total business employment (Figure VI.4).[6] Exceptions were Hungary and Belgium, which had much higher shares of foreign affiliates in manufacturing and services, respectively, and, at the other extreme, Japan, where their presence was particularly low in both sectors.

4. Moreover, this "specialisation" pattern has become more accentuated over time with the greater integration of the EU countries spurred by the single market programme and the economic and monetary union.

5. The wide variation in bilateral FDI flows and positions cannot be explained purely by these factors, two counterexamples being Ireland and the United Kingdom whose bilateral FDI positions with the United States are at least as important (as a share in GDP) as those with other EU countries.

6. The shares are computed relative to total business employment to control for possible inconsistencies in the way foreign affiliate and domestic firms are classified across industries (see Box 1).

Figure VI.4. Activity of foreign affiliates in selected OECD countries, 1990s[1]
Employment as a per cent of business sector employment



1. Activities of foreign affiliates are classified into industries according to the principal activity of the affiliate. Data are means over available years.
2. Employment of foreign affiliates in manufacturing is an aggregate corresponding to Total Manufacturing (ISIC rev.3).
3. Employment of foreign affiliates in services is an aggregate corresponding to Total Services (ISIC rev.3).
Source: OECD.

A closer look at the industry distribution of foreign affiliates suggests that their activity tends to be concentrated in a few industries (Figure VI.5).[7] In manufacturing, foreign affiliates' presence (as measured by sectoral employment shares) is particularly high in industries producing ICT equipment, petroleum products, chemicals and motor vehicles. These industries seem to be characterised by relatively high economies of scale, the possibility to transfer and exploit locally the specific knowledge of the parent company[8] and, for some of them, the possibility to fragment production into stages. In non-manufacturing, foreign presence is strongest in industries where proximity to local markets is a particularly important condition for supplying the products: distribution, followed at a distance by business services and hotels and restaurants (*i.e.* tourism).[9] In other industries, the relatively low degree of internationalisation may be partly related to the absence of scale economies and opportunities to fragment production, or to the fact that they have been traditionally sheltered from foreign ownership by national governments (see Chapter VII).

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7. The employment shares are higher in Figure VI.5 than in Figure VI.4 because employment is measured relative to sectoral employment and not relative to total business employment.

8. Technically, this possibility exploits so-called "firm-level" economies of scale, arising when a common input (knowledge in a specific area) can be used in a non-rival way by both the parent and foreign affiliates.

9. Recorded FDI in the services sectors accounts for an increasing share of total FDI flows, estimated to be around 65 per cent at the end of the 1990s (OECD 2002*a*). This is likely to be a conservative estimate of the actual share because some firms are still classified as belonging to the manufacturing sector though they are increasingly offering services.

Figure VI.5. Percentage share of employment in foreign affiliates in selected industries OECD average, 1990s[1]

1. Simple average. The data cover 19 OECD countries. Available years differ across countries.
2. Activities of foreign affiliates are classified into industries according to the principal activity of the affiliate. Sectoral employment is consistent with this classification.
Source: Directorate for Science, Technology and Industry, OECD.

Foreign direct investment and trade

Foreign direct investment is positively correlated with trade flows…

The growing interdependency of OECD economies has not only manifested itself in the increase in FDI over the past two decades but also in a parallel increase in foreign trade. These two phenomena appear to be closely linked:[10] both seem to be at least partly affected by factors related to distance, location and size of the economy (for FDI, see Chapter VIII) and, at the same time, they appear to exert a significant reciprocal influence.

… but the underlying relationships are complex

The relationships between foreign direct investment and foreign trade at the firm or industry level depend on whether the FDI activity is aimed at "substituting" or "complementing" the export activity (Box VI.2). In services, trade and FDI can be expected to be largely complementary, because establishing commercial presence abroad generally brings stronger services trade.[11] In manufacturing, both types of FDI are widely practised. Recent evidence suggests that horizontal MNEs, which aim at accessing foreign markets by replicating abroad the production of a final good, may be prevalent in the OECD area, partly reflecting the increasing similarity in factor costs and endowments among Member countries (OECD, 2002b). However, MNEs' strategies have also been shown to vary across OECD countries, with horizontal strategies dominating in some countries and vertical strategies, in which production is fragmented in stages to exploit cross-country comparative advantages, dominating in others. The co-movement of FDI and trade at the aggregate level may reflect both the balance between horizontal and vertical strategies at the firm level and the influence of third factors that are likely to drive both phenomena, such as the generalised growth in income levels. OECD (2002c) further discusses the relationship between trade and FDI.

Box VI.2. **Trade and different types of FDI**

As pointed out by recent research (Markusen, 2002), the interdependence of trade and FDI derives from the fact that the decision to export or invest abroad for producing locally is increasingly taken by the same units, the multinational enterprise. As the main objective of horizontal MNEs is to access foreign markets, exporting or investing abroad are two substitute activities. MNEs will choose one or the other on the basis of their relative returns, which depend among other things on the cost of trade, the cost of FDI and economies of scale they can enjoy by duplicating production plants in foreign countries. By contrast, the objective of vertical MNEs is to take advantage of cross-country absolute and comparative advantage patterns by locating plants in different countries that specialise in different stages of production. Therefore, trade and vertical FDI are complementary activities: MNEs will typically export components to foreign affiliates and re-export to the home (or other) markets the goods produced abroad.

10. The correlation between various measures of foreign trade and foreign direct investment flows and positions is significantly positive (Nicoletti *et al.*, 2003).

11. Foreign commercial presence tends to increase bilateral trade in transport services (*e.g.* supplying goods to foreign affiliates in the distribution sector), communications (*e.g.* data transactions with foreign affiliates in the financial, telecommunications or tourism sectors), and the like.

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