FDI in Emerging Markets: A Home-Country View

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ABSTRACT

In the 1950s and 60s, the American view of foreign direct investment (FDI) in emerging markets, then called less-developed or developing countries, was that it was desirable for three reasons: as a vehicle for economic development and a partial substitute for foreign aid; to promote economic stability and democracy; and as part of the strategy to contain Communism. In the 1990's, the relationship between such investment and economic development is regarded as more uncertain, the Cold War is over, and many of the developing countries have emerged as serious players in global competition, thus altering the context in which such FDI is viewed.

Over the 40-50 intervening years, the U.S. economy has shrunk as a proportion of the global total and has become much more open to foreign trade, thus increasing the exposure of American firms to the global economy and reducing their market power. At the same time, both the nature and the scale of FDI have changed substantially, and the general stance of emerging market countries toward such investment has moved from widespread hostility and suspicion to widespread efforts to attract it.

For all these reasons, U.S. policies regarding FDI in emerging-market countries are far more affected by fears regarding its impact on our own economy than they used to be. Among the concerns are the effects on American jobs, wages, income distribution, trade and payments balances, the pace of R&D and innovation, the size of the domestic stock of capital, and the possibility of a global "race for the bottom" in environmental and labor-rights policies. Although most of these concerns are misplaced, such investment does create both winners and losers and thus can give rise to political and public controversy. Therefore, U.S. government policies toward FDI in emerging markets today are ambivalent. While some, including a number of initiatives in the GATT negotiations and the World Trade Organization, are supportive, others, including export controls, the Foreign Corrupt Practices Act, and certain types of import restrictions are either hostile to such investment or seek to limit it in various ways.

Keywords: foreign direct investment, emerging markets, emerging economies, developing countries, multinationals, globalization

FDI IN EMERGING MARKETS: A HOME-COUNTRY VIEW

With this paper, my academic career comes full circle, back to where it began. That is because its topic, the attitude and policies of the U.S. government regarding foreign direct investment (FDI) in countries that are now called emerging markets, was also the focus of my master's thesis, my doctoral dissertation and my first book, published in 1965 by the Princeton University Press (never let it be said that I don't squeeze a subject for all it is worth). In them, I described and analyzed the various U.S. government programs and agencies whose mission was, at least in part, to encourage private FDI at a time when it had been interrupted for several decades, first by the Great Depression and then by World War II.

Two of those institutions survive today. One is OPIC, the Overseas Private Investment Corporation, which offers insurance against a variety of hazards that may confront FDI in developing countries.[1] The other is an international agency in whose creation the U.S. played a major role, the International Finance Corporation (a subsidiary of the World Bank).

The Evolving Context

The context framing U.S. policies toward FDI has changed considerably, however, since I wrote about these programs in the late 1950s and the first half of the 60s. At that time, such investment was generally viewed as highly desirable, and the U.S. government offered a number of reasons for encouraging it. First, it was seen as an instrument for stimulating the economic development of poor nations, and thus as a partial substitute for foreign aid. And, unlike such aid, FDI did not come out of the government's budget and the taxpayer's pocket.

In addition, at that time belief in a positive relationship between economic development and political democracy, or at least movement toward democracy, was virtually an article of faith in the United States. Therefore, government encouragement of FDI in less-developed countries (as they were called in those days) was seen as part of the strategy to contain communism, one of the West's weapons in the Cold War.

The view in the 1990's is much more complex. First of all, as Caves and Graham discuss in their papers, the relationship between FDI and economic development is seen as much more complicated and uncertain today than it was then. Second, the Cold War is over and clearly our side won. So there is no more need to contain Communism, which was the central focus of our foreign policy at mid-century.

Finally, there are many more players today in the global competitive game, which American firms had essentially to themselves in the 1950s and 60s. And when countries turn from economic backwaters into competitors, views regarding appropriate policies toward them tend to change. In fact, participation in the global marketplace has enabled a number of countries to climb up the income scale. And even some of those still at the lower end of the global income distribution have become players in the global competitive game.

The very evolution of the words we use to describe these countries indicates the change in the way they are regarded. In the decades immediately following World War II, they were called less-developed countries (LDC's). Then they became developing countries, and today they are called emerging economies or emerging markets. That progression says something about what's been happening.

Changes in Characteristics and Attitudes

In addition to changes in the background context, the characteristics of the home country, the host countries, and of FDI itself have all changed in significant ways.

Looking at the U.S. economy first, its share of world output and world exports have both shrunk considerably since the immediate postwar decades that preceded the global economic shocks of the early 1970s. In addition, its interaction with, and therefore exposure to, the global economy has increased substantially. The average of exports plus imports as a share of GDP, which was less than 5% in 1960, was 17% in the mid-90's. Perhaps even more telling, merchandise exports as a share of tradable goods production went from 11% in 1960 to 31% in 1990.[2]

The market power of large American firms, as reflected in several different measures, has also declined. Their profit margins on sales have fallen sharply, from an average of 16-17% in the 1950's and 60's, to 11% in the 1990's, (through 1997), despite the very strong profit performance of 1995-97.[3] And, if one takes imports into account, concentration ratios in U.S. manufacturing have declined significantly since 1958.[4]

Concomitant with their decline in global market power has come American firms' increasing exposure to global competitive pressures. This shift can be seen not only in the increased share of trade and FDI in the U.S. economy as a whole, but also in some more detailed measures available for the manufacturing sector. These include the relative importance of exports in U.S. manufacturing output, the share of imported inputs in goods production, and the scale of import penetration, all of which came close to doubling between the mid-1970s and the mid-90s.[5]

The nature of U.S. FDI has also changed over the decades since mid-century. The American firms that pioneered a revival of such investment in the years after World War II established their foreign operations primarily as stand-alone affiliates designed to serve the national markets in which they were located. Such a structure was well-suited to a world of national markets largely insulated from one another. But, as trade barriers fell, global demand patterns converged, and distances shrank in the face of advances in

transportation and communications technologies, American multinationals and their foreign subsidiaries increasingly became part of more complex and interdependent globalized production processes.

This change in structures and strategies is reflected in a number of developments. It has underpinned the growing importance of intra-firm trade, which today constitutes somewhere between a third and a half of the merchandise trade of the United States. It is associated with an increased substitution of FDI for exports as a way of serving foreign markets. And finally, it has produced a divergence between the share of world manufactures produced in the United States, which declined by more than one-third between the mid-1960's and about 1990, and American-owned multinationals' share of the global total, which remained roughly constant over the same period. This discrepancy between the location of production and the ownership of firms has given birth to a controversy over how an "American" firm should be defined, in terms of the nationality of its controlling ownership or the extent to which it employs American workers, as many European and Japanese multinationals with affiliates in the United States now do. This ambiguity gave rise to Robert Reich's now-famous query "Who Is Us?", a question that has never been satisfactorily resolved.[6]

Along with changes in the characteristics of the U.S. economy and in the structure of FDI, the attitude of emerging market countries toward FDI within their borders has also undergone considerable transformation. In the 1950s and 60s, the prevailing attitudes ranged from suspicion to outright hostility. The goal of most developing countries was so-called "balanced" development relying heavily on import-substitution, as championed by a reigning expert on economic development, Raul Prebisch.[7] In this view, multinational firms were regarded primarily as exploiters.

Today, in contrast, virtually all emerging economies, even those like China and Vietnam, which are ostensibly communist, are trying to attract multinational investment. This sharp change in attitude is reflected in the virtual disappearance of expropriation of FDI by host governments. Such acts of expropriation declined from a peak of 83 recorded incidents by 28 different countries in 1975, to exactly one such incident in 1985.[8] And, while I don't have data for more recent years, I'm virtually certain that the number has remained at or near zero. A number of developments underlay this shift, including the decline in foreign aid and the collapse of bank lending to such countries in the 1980's, along with increasing evidence of the failure of the Prebisch model of economic development and growing recognition of the benefits that FDI can bring in the form of capital, technology, and managerial skills.

Home-country Concerns

Given this change in context and in the characteristics of all the participants, how have the home-country views that underlie policies affecting FDI in emerging markets responded? In answering that question here, I will focus on the responses of the United States. This is partly because this country not only has the longest history of FDI in the post-World War II world, but also remains today the largest source, as well as the largest recipient, of such capital flows. In addition, a number of the pressures and concerns regarding FDI in emerging markets that surfaced first in the United States have also arisen, with some lag, in a number of other major industrialized countries as well.

The concern that looms largest in the minds of both politicians and the general public is, of course, the "giant sucking sound" made famous by Ross Perot, the fear that American jobs will be exported to low-wage countries along with American FDI. On an aggregate basis, that fear is based on pure myth. That is, the unemployment rate and the rate of job growth in this country (as well as in most other large industrialized countries)

are determined primarily by domestic macroeconomic policies, not by the less than 5% of American FDI that goes to emerging economies to produce goods for import back into the United States.

In fact, the data show that an increase in the US trade deficit is associated with a decline rather than an increase in our aggregate unemployment rate. That does not imply, of course, that a deficit increase causes an expansion of domestic jobs. Rather, the relationship runs the other way; in an economic expansion, imports tend to grow faster than exports. At less aggregate levels, however, the story is different. FDI can indeed affect production patterns in ways that reduce the number of jobs available in a particular industry, a particular community, or a particular region of the home country. And such shifts do cause fear on the part of the potential losers and pressure on the politicians who represent them.

Closely related to the fear about exporting jobs is a concern that outward FDI to poor countries and the trade associated with it will exert downward pressure on the U.S. wage level, particularly for workers in industries where such capital outflows are occurring, but with a knock-on effect on workers with similar skill levels in other industries as well. The actual evidence from wage developments that occurred as the nations of the European Union integrated their economies, as well as from the fact that the wages paid by U.S. firms engaged in trade (which are largely multinationals engaged in direct investment as well) average some 15% higher than American manufacturing wages as a whole, suggests that the upward pressure on wages in FDI-receiving countries is stronger than the downward-pull on wages in the FDI-sending ones.[9]

Intermingled with the wage question is the issue of domestic income distribution. Does outward FDI tend to make the poor poorer the rich richer in the home or capital-exporting country? There is by now an enormous body of both theoretical and empirical

literature on this question of the contribution of trade and foreign direct investment, particularly where low-income countries are the recipients, to the marked increase income inequality in the US in recent decades. The issue is by no means definitively resolved, but the mainstream conclusion appears to be that by far the most important cause of this growing inequality is skill-biased technical change, with trade playing a substantially smaller role. Estimates of trade's contribution to earnings inequality vary widely, but tend to cluster around 10-15 percent.[10] There are also important interactions, of course, between skill-biased technical change and the globalization implied by the increased importance of trade and foreign investment.

The effect of FDI in emerging economies on the U.S. trade balance is also a matter of concern. The net impact of these flows is inherently uncertain because no one knows how to specify adequately the counter-factual situation, what would have happened to America's international trade and payments if this investment had not occurred. But the fact that the complementary relationship between U.S. trade and U.S. FDI overall is stronger on the export side than on the import side at least suggests that a positive impact on our trade balance is more plausible than a negative one.[11] This should reassure those who regard the trade balance as a matter of national concern and therefore an appropriate issue for public policy.

Two additional questions about outward FDI have to do with its impact on capital formation and on the rate of innovation—the two main sources of growth in economic well-being—at home. In fact, most R&D by American multinationals is still performed at home, and virtually all the rest is done in other industrialized countries, not in emerging economies. Although the issue remains a subject of controversy and ongoing research, the bottom line at the moment appears to be that outward FDI tends to

accelerate technological innovation at home (as well as diffusing its results abroad), perhaps because of the stimulus of increased rivalry among multinational firms.

The effect of outward FDI on the home country's stock of capital is more problematic; some investigators call it indeterminate while others have found it to be negative, as intuition would suggest, although by no means on a dollar-for-dollar basis.[12] However, since U.S. outflows and inflows of FDI have moved toward balance in recent years, the effects on the nation's capital stock should more or less cancel each other out.

Finally, there is a question that has become a very hot issue recently. That is whether FDI in less-advanced countries has or will become the vehicle for a "race for the bottom" as regards environmental pollution and labor rights, with these nations relying on low standards or weak enforcement in these areas in order to hold down production costs and attract multinational investment.

In fact, anxieties about a race to the bottom appear to be considerably overblown; advancing economic integration in such regional groups as NAFTA and the European Union, as well as the behavior of multinationals themselves, appear to exert pressure to raise such standards rather than lower them. Statistical studies of patterns of outward FDI by U.S. multinationals have found little or no evidence that such investment is attracted by weak environmental regulation. A recent investigation of patterns of investment by U.S. multinationals in four developing countries found no statistically significant relationship between these patterns and the cost to a particular industry of pollution abatement in the United States. The same study also found that the operations of multinational corporations in those developing countries used less energy and cleaner fuels than local firms in the same industries.[13] Furthermore, multinationals that adopt a single stringent global environmental standard have higher stock-market valuations than firms that default to less stringent or poorly-enforced host-country standards.[14]

Findings regarding the behavior toward workers of multinationals versus locally-owned firms are similar. For example, foreign ownership appears to have a positive effect on wages in two developing countries, Mexico and Venezuela, and in the United States as well.[15] More surprising is the finding that the poorer the country, the higher the wage paid by affiliates of American multinationals compared to average income in the country.[16] None of this necessarily refutes critics' claims that the environmental performance or the pay and working conditions offered by one particular overseas affiliate of a U.S. multinational are deplorable. But on average, the pressures exerted on local standards by multinationals appear to be upward rather than downward. And, clearly, the lowest-wage countries are not thereby globally competitive; our biggest competitor in trade and investment is certainly not Bangladesh.

But this issue does raise an interesting questions about what might be called the harmonization paradox. That is, the more integrated the world economy becomes, the more differences in domestic laws and regulations detract from both economic efficiency and the perceived fairness of a "level playing field". At the same time, the differences in national preferences that underlie them do command political legitimacy, at least in countries where governments are democratically chosen. How should these two often inconsistent principles be balanced off against one another? Such trade-offs are particularly difficult because the changes in the home-country economy brought about by trade and FDI, like any economic shift, create both winners and losers and, in real life, the latter are never fully compensated for their losses by the former. In addition, the losers are generally more visible and easier to identify than the winners.

The Ambivalence of U.S. Policies

The concerns described here, and the political issues they raise, have engendered considerable ambivalence in U.S. government policies toward foreign direct investment

in emerging economies. On the one hand, certain of the nation's policies are highly supportive of such investment. Strong American pressure for national treatment for our foreign direct investors, as well as for stronger provisions by host countries for the protection of intellectual property, has for some time been a prominent feature of bilateral treaties, regional economic arrangements (such as NAFTA and APEC) and multilateral treaties (specifically, the GATT/WTO) entered into by the United States. And the major targets of this pressure have been the emerging economies.

A network of industry advisory groups to the U.S. Trade Representative was set up specifically to insure that the views and concerns of American companies are taken into account in the formulation of U.S. policies and negotiating strategies regarding trade and FDI. And one of these groups is focused specifically on issues relating to the protection of US direct investment abroad. In addition, the U.S. government has from time to time given what is politely called "embassy assistance" (a euphemism for arm-twisting of foreign governments) to the efforts of an American-owned firm to improve its competitive position abroad, although our government is by no means the world champion in this sort of activism.

Finally, issues relating to American-owned FDI are sometimes the focus of our trade disputes with other nations. The recent "Banana War" between the United States and the European Union, for example, has nothing to do with domestic banana production, which is close to if not actually at zero. Rather, it stems from the fact that many of the banana-producing activities in Caribbean and Central American nations that are disadvantaged by the EU's discriminatory policies regarding banana imports are owned by an American multinational firm.

In all of these ways, U.S. government policies are supportive of foreign direct investment in emerging economies. At the same time, we have a number of policies that

are either hostile to such FDI or limit it in some way. Our rules on export controls, for example, were created for purposes of national security, to keep militarily-useful technologies out of foreign hands. But many people regard these rules as both excessively rigid, working to the disadvantage of U.S.-based firms, and ultimately ineffective, because countries that want such technologies, or the products that embody them, will often be able to purchase them somewhere else.

Similar criticisms have been directed at our Foreign Corrupt Practices Act, which prohibits American-based firms from engaging in a variety of activities that although illegal at home, are routinely practiced in many developing countries. Until recently, the United States was the only major industrialized country that had such legislation, leading to complaints that American firms were disadvantaged in their efforts to compete abroad against firms based in more permissive nations. As a result of active and insistent leadership by the United States, the member nations of the OECD (that is, the industrialized countries) recently signed a multinational Anti-Corruption Agreement, which promises to level the playing field somewhat. But how effectively our major competitor countries will enforce its provisions remains to be seen. Will France, for example, cease to allow bribes as legitimate tax deductions?

At home, protectionist pressures for import restrictions that would impact US multinationals' global production strategies are rising. The effects would be felt not so much directly, since very little of the FDI in emerging nations is to produce for export back to the United States, as indirectly, through retaliatory actions on the part of other countries or simply a slowdown in the global liberalization process. Indeed, such a slowdown may already be underway as a result of slackened U.S. leadership, exemplified by the refusal of the Congress to renew the President's authorization to conduct trade

negotiations under expedited "fast track rules". Meanwhile, the incidence of trade disputes involving the United States as either plaintiff or defendant is rising.

The proliferation of contentious issues surrounding FDI led, several years ago, to efforts to negotiate a Multilateral Agreement on Investment (MAI) among the OECD countries. But these negotiations collapsed abruptly some months ago, and no effort to revive them has yet emerged. The opposition that killed these negotiations was spearheaded by the French, but the effort was also weakened by a very strong anti-FDI backlash in the United States. Full-page ads in the New York Times and the Wall Street Journal decried the evils of foreign direct investment, particularly in emerging economies. At the same time, the freedom to make such investments and rules to protect them are a key issue for the largest and most powerful members of the U.S. business community.

Under these conditions, U.S. policies toward such investment are bound to remain somewhat ambivalent. Nonetheless, this country's commitment to a relatively unregulated style of market capitalism suggests that these policies will continue, on balance, to be more supportive than hostile, more liberal than restrictive.

Generalization from the American Experience

To what extent can we generalize these observations regarding American attitudes toward FDI in emerging markets, and the policies they have generated, to fit other leading exporters of such capital? Certainly other industrialized home countries have similar concerns regarding the impact of FDI outflows on their domestic economies. The terminology is different; what Americans term "deindustrialization" is called "delocalization" in Europe and "hollowing out" in Japan. But the phenomenon is the same: the fear that when FDI goes to poorer countries it will take good jobs along with it.

None of these other industrialized nations, furthermore, has the same level of comfort as do Americans with the effects of free market capitalism. In most of the countries in Continental Europe, for example, the pressures of globalization are threatening the survival of the "social market" system and the generous welfare benefits and strict labor-market regulations that are its major characteristics. This tension has been exacerbated by the fact that 11 of the 15 EU countries have recently elected center-left governments whose goals and promises are very much at odds with the demands of global capitalism and the FDI that is intrinsic to it. In Japan, these same pressures are impinging seriously on the strong social cohesion and widespread commitment to lifetime employment and seniority-based wages that have long been hallmarks of that society

More generally, Dani Rodrick argues in his much-discussed little book entitled "Has Globalization Gone Too Far?", industrialized countries are experiencing growing tension between the demand for social insurance created by the economic uncertainty associated with increased openness, on the one hand, and the growing limitations on a country's ability to tax highly mobile factors of production, particularly capital, on the other. This problem is evidenced, Rodrick argues, by the growing share of taxes borne by less-mobile labor in industrialized countries.[17]

The conclusion I draw from the all the developments described here takes the form of a question. That is, will the ambivalence of home countries' attitudes toward FDI in emerging market countries produce a trend toward greater encouragement of such FDI, or more tensions and limitations? For now, it looks as if the American-style laissez-faire approach is in the ascendancy. But, the future is likely to depend on how well the concerns that I've cited are dealt with, and how effectively economic flexibility at the

macroeconomic level can be combined with a reasonable degree of economic security for individuals and families.

Policy responses to this challenge fall into three broad categories. One includes measures to increase the mobility and adaptability of the workforce to match the demands of rapid economic change. A second encompasses policies to increase the rate of sustainable growth, which really means accelerating the pace of increases in productivity, because dislocation and change are far more easily dealt with in a growing economy than in a relatively stagnant one. And, finally, there must be effective measures to ameliorate the special problems of low-skilled workers, difficulties that take the form of persistently high unemployment rates in continental Europe and of increasing earnings inequality in the United States. Whether the future home-country environment for FDI in emerging markets is supportive or hostile, liberal or restrictive, is likely to depend heavily on the success of such policies in preventing social and political backlash against the impacts, real or imagined, of such investment on the domestic economy.[18]

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[1] OPIC is the acronym for the agency that currently performs this insurance function. This activity has been housed in a number of different agencies, each with a different name and acronym, during its history.
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[18] A recent book by one of the most highly-regarded scholars of multinational corporations takes the pessimistic view that multinationals are headed for increasing conflict with both home and host governments Vernon, Raymond. See: *In the Hurricane's Eye: The Troubled Prospects of Multinational Enterprises.* Cambridge, Mass. and London, Harvard University Press, 1998,.