Three Common Misperceptions About Foreign Direct Investment

by Gerald H. Anderson

In the last few years, Ohioans have seen foreign investors acquire or increase their equity interest in such well-known Ohio firms as Schlo, Libby-Owens-Ford, Hanna Mining Company, White Consolidated Industries, General Motors Terex Division, and many others. At the same time, foreign firms have established new subsidiaries in Ohio, the best known of which is Honda of America Manufacturing, which produces both motorcycles and automobiles.

This increasing foreign presence in Ohio is part of a national trend of accelerating foreign investment in America. While many Americans have welcomed the infusion of foreign capital and entrepreneurship, some have worried about its implications for U.S. economic independence. These three common views are based on misperceptions about the causes, sources, and implications of foreign direct investment.

I. The increasing purchase of U.S. assets by foreigners in recent years has been blamed on the current account deficit, which has been a positive amount of IDI in every year, even though the current account has been in deficit in only 10 of the last 15 years. Chart 1. Chart 3 does not suggest any obvious relationship between the size of the current-account balance and IDI. In fact, careful examination of the chart reveals that the changes in the two series have the same sign almost as often as the changes have opposite signs, thus failing to support the idea that changes in the size of the current account deficit cause changes in the size of IDI.

II. Similarly, a current account surplus should be accompanied by a net capital outflow of equal size.

III. Some other countries also have some of these attributes. In addition, some have low labor cost or raw materials or topical growing conditions that are not as readily available in America. Consequently, U.S. investors may make direct investments in other countries. Geographic diversification is also a reason for outward direct investment. Until 1980, U.S. outward direct investment in a year usually exceeded inward direct investment.

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The tendency for the annual, current-dollar volumes of IDI to grow through time may result from the world economy's real growth, which fosters growth of the volume of abroad-saving available for investment, and from the decline in the purchasing power of the dollar. 

Recently, some additional developments have encouraged IDI, probably contributing to its upturn in the last four years. Perhaps most important is the fact that the dollar has depreciated greatly against other major currencies since early 1985, making it more difficult for goods produced abroad to be competitive in the U.S. market. For example, the depreciation has caused the dollar value of wage rates in some other major countries to rise relative to U.S. wage rates. Consequently, foreign firms who want to sell in the U.S. market have increased incentive to produce their goods here. Moreover, dollar depreciation has lessened the cost of purchasing U.S. production facilities when measured in the currency of the potential foreign investor. The U.S. stock-market crash of October 1987 also has reduced the cost of purchasing existing U.S. firms, which probably will encourage IDI in 1988.

Another likely cause of the recent acceleration of IDI is that the persistent large U.S. trade deficits of recent years have strengthened protectionist sentiment. Some foreign firms, especially Japanese vehicle manufacturers, could have decided to produce their products in the United States to soften protectionist sentiment and to hedge against the possible loss of market share if protectionist legislation were to be enacted. The persistency of the current U.S. economic expansion probably adds to the attractiveness of IDI.

The rise in IDI in the late 1970s was probably encouraged by the depreciation of the dollar and by the U.S. economic expansion that continued. Therefore, appreciation in the first half of the 1980s, together with the recessions in the 1980-1982 period, probably contributed to the fall-off in IDI volume in 1981, 1982, and 1983.

**Direct Investment Positions**

At the end of 1987, foreign investors had accumulated a direct investment position in the United States totaling $262 billion. Similarly, U.S. investors had accumulated a direct investment position abroad valued at $390 billion.

The difference between those two positions, $47 billion, is the net direct investment position of the United States.

The net position declined from $132 billion in 1980 to $47 billion in 1984 and then leveled off, with no net change in the last three years (see chart 2). The sharp decline in the 1980-1984 period resulted as the U.S. position abroad stagnated, declining by $54 billion, while the foreign position in the U.S. doubled, rising by $82 billion. Important contributors to the stagnation of the U.S. position abroad in 1980-1984 were the appreciation of the dollar, which caused foreign-currency-denominated U.S. assets abroad to translate into fewer U.S. dollars, and borrowing by U.S. parent companies from their foreign affiliates.

European investors held two-thirds of the $62 billion foreign direct investment positions in the United States at the end of last year. British investors held the largest share, 25 percent, while Dutch investors held 18 percent. Despite all of the publicity that Japanese investment in the United States has received, the Japanese share of the total was only 13 percent.

Other measures also fail to support the popular perception that Japan, with its massive surplus in trade with the United States, is the largest foreign direct investor here. For example, Japanese spending to acquire or establish U.S. enterprises was less than that of the United Kingdom and Canada in 1986, and less than that of the United Kingdom in 1987. Moreover, Japan ranks behind the United Kingdom, Canada, West Germany, and the Netherlands as a source of inward direct investment to the United States.

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**Foreign-Owned Firms’ Shares of the U.S. Economy**

Recent increases in foreign direct investment in the United States have raised concerns about the degree of foreign influence in our economy. The foreign direct investment position here at the end of 1987 was 95 percent larger than just four years earlier. Foreign-owned firms' shares of U.S. employment, assets, and sales show that foreign involvement in the U.S. economy is substantial and growing. Employment by foreign-owned non-bank firms in 1986 (latest data available) accounted for 3.5 percent of employment of all nonbank firms in the United States, up from 3.2 percent in 1981. In manufacturing, employment by foreign affiliates accounted for 7.8 percent of total U.S. manufacturing employment, up from 6.5 percent in 1981.

Foreign involvement in U.S. manufacturing is even larger when judged by shares of sales and assets. Foreign affiliates held a 9.9 percent share of the sales of all U.S. businesses in manufacturing in 1986, including shares of 50 percent in chemicals and allied products, 20 percent in stone, clay, and glass products, and 19 percent in primary metal industries. The foreign share of manufacturing employment was 12.5 percent, including shares of 33 percent in chemicals and allied products, 25 percent in stone, clay, and glass products, and 21 percent in primary metal industries.

Foreign investors are much more likely to acquire an existing enterprise than to start a new one. In 1987, for example, foreign investors used $25.6 billion to acquire existing enterprises in the United States, up from $23.4 billion in 1986. Moreover, because most foreign ownership of U.S. assets is lodged in major industrialized democracies that are friendly to America, the possibility is very remote that foreign governments would prevail upon foreign owners to use their U.S. holdings in a way that is detrimental to us. The possibility is even more remote that U.S. legislation could not successfully counteract any such hostile efforts.

**Conclusions**

Contrary to popular belief, foreign, or inward, direct investment is not an inevitable result of the recent large

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**CHART 1** DIRECT INVESTMENT VS. CURRENT-ACCOUNT BALANCE

Billsions of dollars


**CHART 2** DIRECT INVESTMENT POSITIONS

Billsions of dollars


U.S. position abroad

Foreign position in U.S.

This cursory analysis suggests that the current account balance does not provide a simple and complete explanation of IDI, and that IDI is not an inevitable result of the large U.S. current account deficits.

While the current account balance provides no simple explanation for the level or the changes in the volume of IDI, several other factors help to explain the rather continuous inflow of direct investment, the tendency for IDI to grow through the

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**Source:** U.S. Department of Commerce, Bureau of Economic Analysis.

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