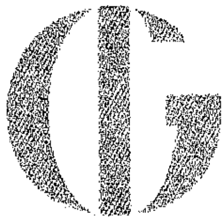

GLOBAL COMMENTARY

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LETTER FROM THE CHAIRMAN

William C. Dunkelberg, Ph.D.

Historically, Philadelphia has been one of the most important cities in the United States, playing an important role in both our political and economic development. Everyone is familiar with the city's place in our political history, but most are unaware of its economic importance. Philadelphia's geography provided a naturally protected port that was critical for world trade and also served as an important gateway to the middle of the country. Today, probably even more than was the case 200 years ago, this economic activity continues "out of sight." Few are directly aware of the volume of trade flowing through our economy.

A small number in Philadelphia comprehend how important trade is to our economy. Unfortunately, this means that few see the potential in nurturing and developing our city as an international center for business, trade and tourism. Our thinking and our politics are far too local. As a result, we are missing great opportunities to help Philadelphia grow and prosper.

GIC, along with many other outward looking organizations in Philadelphia, has partnered with the Department of Commerce to develop a strategic plan for the city that seeks to capitalize on all available opportunities. Beginning with an identification of our assets and liabilities as a city and a region, the plan will seek to coordinate the efforts and activities of the many international organizations in the area, market the city globally, capitalize on our relative strengths to improve employment in the region and create an independent oversight organization that will transcend political change and keep our efforts on course.

Philadelphia is a great city, but it can be so much more than it is today. As the world economy grows, we cannot afford to let the Philadelphia region be left behind. The quality of life in our region will depend a great deal on how effective we are at identifying and taking our place among the international cities and regions of the future.

The following is a collection of works authored by GIC members who have invested in our region. They have made global interdependence a cornerstone of their lives and offered to share their views in GIC's inaugural issue of *Global Commentary.*

GIC Calendar of Events:

June 19: Russian Reception: Business, Economics and Law, speakers Dr. Vladimir Kvint, Fordham Univ. and Gene Burd, Marks & Sokolov, Pyramid Club, Phila., PA, 5:30-7:30 p.m.
July 9: Annual black tie **Gala** celebrating **"All of the Americas,"** Four Seasons Hotel, Phila., PA.
Aug. 14: SARS topical program, University of Pennsylvania, Phila. PA.
Aug. 21: Central Bank Series with speaker William Poole, President Federal Reserve Bank of St. Louis.
Oct 2-3: 22nd International Monetary & Trade Conference, "Two Years after 9/11: Where Are We Now?"

In all instances, the authors' views are their own and should not be attributed to the Global Interdependence Center, its board of directors, its members, or its sponsors.

Inside this issue:

4
The Eurosystem and the Federal Reserve System Compared
Robert Solomon. Ph.D.

7
A Perspective on Foreign Direct Investment in the United States
Richard M. Stein

12
China: The Waking Dragon
Victoria Marklew, Ph.D.

15
Rethinking U.S.—India Strategic Relations
Armeane Choksi, Ph.D.

18
China and Taiwan: Growing Interdependent Across the Fault Line
Terry Cooke, Ph.D.

22
The WTO Referees U.S. and EU GMO Battles
Joseph W. Bowley

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A Perspective on Foreign Direct Investment in the United States: Its Role and Implications

Recently, the business activities of Chinese billionaire Li Ka-shing, of Hong Kong, were once again under scrutiny and subject to criticism in Washington, D.C. (5) In particular, the Committee on Foreign Investment in the United States (CFIUS), made up of officials from several U.S. government agencies, reviewed the roles of Mr. Li and Hutchison Whampoa—Mr. Li's flagship company—in a proposed takeover of Global Crossing, the bankrupt fiber optic telecommunications company. While CFIUS deliberated the impact on national security of Hutchison Whampoa's role in Global Crossing because of links to China, it appears that Singapore Technologies Telemedia, owned by Singapore's government, will face no difficulty if it chooses to purchase a 61.5 percent share of Global Crossing.

Central to this example are issues relating to international economic relationships—in this case, foreign business transactions and investment activity inside the United States. This article provides a brief overview of some of the issues relating to one aspect of such relationships—foreign direct investment (FDI) in the United States.

What is FDI?

The U.S. Department of Commerce defines foreign direct investment as "ownership or control, directly or indirectly, by one foreign person of 10 percent or more of

the voting securities of an incorporated U.S. business enterprise or an equivalent interest in an unincorporated U.S. business enterprise" (1). The International Investment and Trade in Services Survey Act details reporting requirements relating to FDI. Data is collected by the Bureau of Economic Analysis (BEA) by means of mandatory surveys of U.S. affiliates of foreign companies. Estimates of new FDI reported by BEA cover U.S. business enterprises acquired or established by foreign direct investors.

Direct investment implies a lasting interest and some degree of control over operations and management of a business enterprise. Foreign investment that is not direct investment is considered to be portfolio investment.

BEA collects three categories of data: (1) balance of payments and direct investment position data, which tracks transactions and positions of new and existing U.S. affiliates of foreign parents; (2) financial and operating data of U.S. affiliates, which provides an overall picture of U.S. affiliates' activities; and (3) establishment and acquisition data, which tracks new direct investments, irrespective of whether the invested funds were raised in the United States or abroad.

Data on FDI and portfolio investment (which is collected by the U.S. Treasury Department) is reported in BEA's balance of payments U.S. international transaction accounts and in the U.S. international investment position.

Why Measure FDI?

The Department of Commerce definition clearly does not identify all ownership or control as FDI, which leads to the question, "What is it that FDI attempts to measure?"

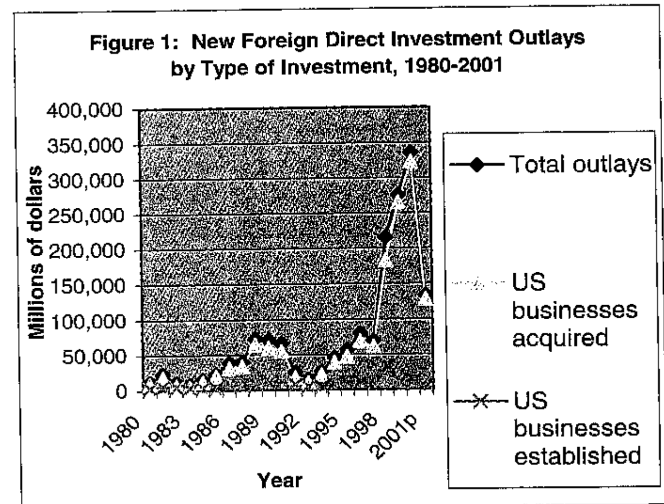
FDI attempts to measure foreign control of U.S. productive assets. The rationale is that foreign ownership and control could have important economic and/or national security implications. In the past, surges in FDI have caused debate regarding the size and importance of such investment and have led to questions such as:

How much is invested?

Who from abroad is investing?

What industries and what states are most affected?

Figure 1: New Foreign Direct Investment Outlays by Type of Investment, 1980-2001

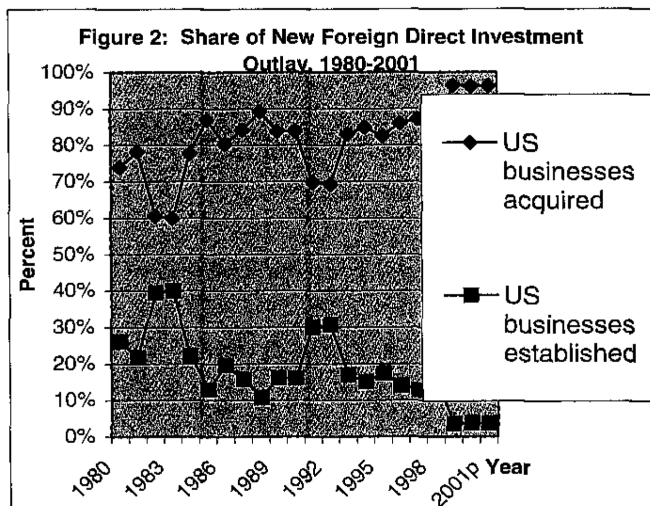


As Graham and Krugman note, it is not always easy to identify the nationality of firms or what constitutes control (4). For example, many multinational firms have their headquarters outside the United States but have as many or more operations and employees here, while other firms are headquartered here but with as many or more facilities and employees abroad. In both cases, firms may exhibit similar behavior, so it would be difficult to categorize specific actions of some of the firms as "foreign behavior."

Furthermore, the definitional requirement that a single foreign investor control at

least 10 percent of a U.S. firm can also lead to unusual results. It could understate FDI and fail to identify control exercised by a group of foreign investors, each of whom owns less than 10 percent. Alternatively, there is the possibility of overstating FDI, by including assets where the 10 percent criterion is met but where de facto operational and managerial control remains within the United States—for example, through stock ownership and board oversight.

Besides simple under- and over-reporting possibilities with respect to operational control and the use of BEA's 10 percent criterion, there are other challenges associated with measuring FDI. Alternative



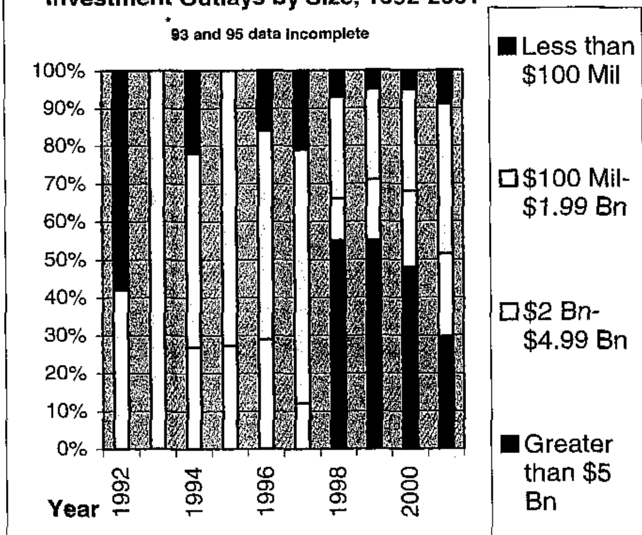
means of measuring FDI exist to address some of those issues in the United States. The process is further complicated when making international comparisons.

FDI Trends

Figure 1 shows outlays of new investment for acquisitions and establishment of new businesses by foreign direct investors in the United States for the past two decades.

Acquisition of existing firms in the United States has always been a larger source of growth in FDI than establishing new businesses. The trend accelerated in recent years, as shown in Figure 2.

At the same time, the size of investment transactions also increased, as shown in Figure 3. In 1992, just over 30 percent of investment outlays, based on dollar volume, went to establish new businesses in the

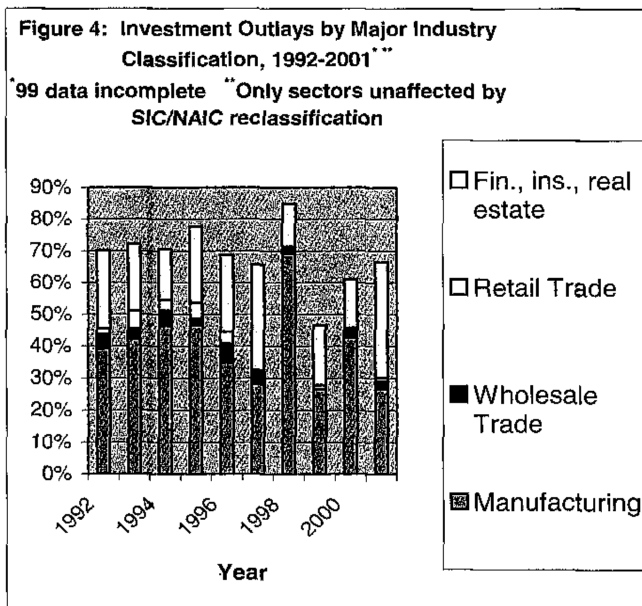


United States. Also in that year, all of the investment outlays were for transactions under $2 billion. Over the past decade, the number of large transactions increased, so that since 1998, transactions larger than $5 billion dominated. From 1998 through 2000, those transactions accounted for about half of the volume of activity.

A corollary to the shift in the distribution of investment outlays by size is that such large investments tend to be concentrated in sectors where large businesses predominate, especially certain manufacturing and financial services sectors. The most recent (2001) data shows that the largest outlays were in "finance (except depository

institutions) and insurance," which are attributable to several large acquisitions of U. S. life insurance companies. Other large outlays occurred in manufacturing, in particular in food and computers and electronic products. Over time, manufacturing and financial services have been the sectors with the largest outlays, as shown by Figure 4.

Since reaching a peak in 2000, FDI to acquire or establish U.S. businesses is down dramatically. This reflects a slowdown in the U.S. and world economies and, in particular, a drop in worldwide merger and acquisition activity.



FDI by Ultimate Beneficial Owner (UBO)

Among the reasons for measuring FDI is that foreign ownership and control could have important economic and/or national security implications. BEA also records investment outlays, by country, of ultimate beneficial owner. The UBO is "that person, proceeding up a U.S. affiliate's ownership chain, beginning with and including the foreign parent, that is not owned more than 50 percent by another person" (1). New FDI outlays may be financed either with funds supplied directly by foreign direct investors or by funds from existing U.S. affiliates. Outlays funded directly by foreign investors are recorded in the financial account of the U.S. international transaction accounts as part of the total capital inflows for foreign direct investment in the United States. Outlays financed by existing U.S. affiliates may be from retained earnings or from inter-company debt (i.e., net lending) and would not be covered in the acquisition and establishment data or the balance of payments data.

During past surges in FDI, much attention was paid to the country of UBO. For example, during the 1980s and early 1990s, as the U.S. current account deficit grew, Japanese direct investment in the United States attracted particular attention. Certain newsworthy acquisitions by Japanese investors, especially in banking, real estate and manufacturing, heightened the public's concern. In fact, today Japan's investment outlays continue to shrink. Furthermore, Graham and Krugman point out that even at its peak, Japanese FDI was not the threat to U.S. assets—not in banking or elsewhere—that alarmists and doomsayers led one to believe (4).

In recent years, European countries have been the FDI leaders, with the United Kingdom leading for five of the past six years, while France, Germany, The Netherlands and Switzerland each made significant contributions. Outside Europe, Canada was the largest FDI participant over much of the past decade.

FDI by State

If FDI has economic consequences, they are most likely to occur in states with the largest foreign presence. Figure 5 shows the share of U.S. total gross book value (of property, plant and equipment) of U.S. affili-

ates of foreign companies for the top 10 states. Together, they account for 54 percent of total gross book value and 52 percent of employment for U.S. affiliates of foreign companies.

The share of total state employment by U.S. affiliates of foreign companies, ranges from 4 percent (LA) to just over 7 percent (NJ) for the 10 states with the highest FDI, and from 2.1 percent (SD) to 10.1 percent (HI) for all of the states. In California, with almost 12 percent of U.S. FDI and 11 percent of all employment in U.S. affiliates of foreign companies, those jobs represent just 5.1 percent of the state's employment. For the United States, the share of total employment in affiliates of foreign companies is 5.3 percent.

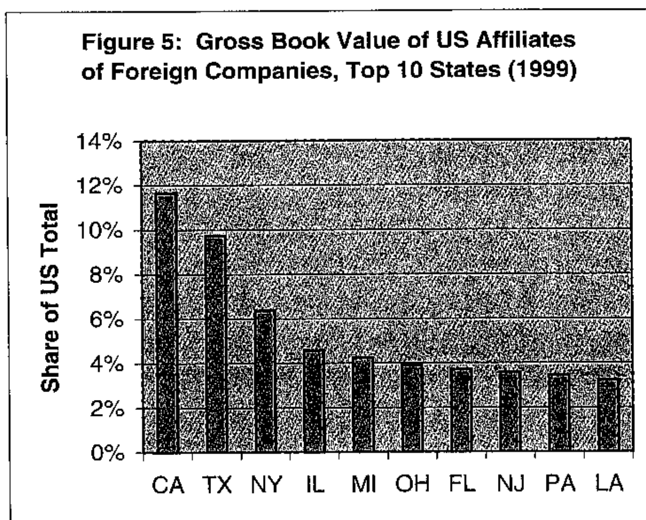


Figure 5: Gross Book Value of US Affiliates of Foreign Companies, Top 10 States (1999)

Conclusions

There are several alternative ways to measure foreign direct investment, each with its own advantages and limitations. Outlays for FDI tend to follow the pattern of overall economic activity and have declined significantly, of late. Acquisitions continue to dominate new business establishments as the predominant mode of FDI, while the size of transactions has increased. From year to year, the industry sectors that show the most FDI vary in accordance with trends in industry, however the larger size of transactions is generally reflected by an increase in FDI in sectors with larger companies.

While concern is occasionally expressed over the magnitude and consequences of FDI for the U.S. economy, there is little evidence that foreign-controlled firms exhibit different behavior, in terms of operations and management, than domestic firms. This article is too brief to discuss all of the differences, real or imaginary, between foreign-controlled and domestic firms.

There may be issues arising around FDI in relation to national security and international conflict. Again, this paper is too brief to provide a detailed analysis. To summarize, there can be difficulties in times of conflict between a host country and the home country of a foreign enterprise. Furthermore, domestic affiliates of foreign enterprises can be a source of intelligence leaks for classified and unclassified information. Lastly, certain industries may be regarded as too vital to the national interest for foreign investment.

Finally, there is also evidence of positive benefits in the form of knowledge spillovers that may accrue as a result of FDI, particularly where the investment is accompanied by improved technology and productivity enhancements.♦

Richard M. Stein is the founder and president of KLIOS, Inc. He specializes in quantitative decision support, entrepreneurial business strategy, and economic and policy analysis. He has earned degrees from the Wharton School at the University of Pennsylvania and the London School of Economics.

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