
Recent Trends in the Globalization of Business

The rate and extent of globalization of business during the second half of the 1980s, as measured by flows of FDI, was spectacular. Following 1990, with the onset of worldwide recession, the rate of global business expansion slowed considerably throughout much of the world, but early indicators suggest that the expansion rate has picked up substantially since 1992.¹

Whereas the surge of direct investment during the 1980s took place largely among the highly industrial nations, much of the activity of the mid-1990s appears to be directed toward the newly industrializing nations, especially the rapidly growing economies of East Asia, and China in particular. It is not the intention of this book to explain the waxing and waning of international business activity since the late 1980s (on this topic, see Graham and Krugman 1993). Rather, the focus here is on the consequences of the expansion.

FDI largely consists of the equity and debt held by firms in affiliated corporations located in nations other than the home nation of the investor firm.² Flows of FDI thus are an indicator of the international spread

1. The early indicators include, most notably, information on US inward and outward FDI, which is released in advance of information for most other countries. Combined US FDI capital inflows and direct investment abroad outflows were \$113 billion for 1993 and \$98 billion for 1994, up from \$60.2 billion for 1992.

2. Unfortunately, countries are not wholly consistent with respect to how they measure domestic firms' holdings of equity in foreign affiliates. Some nations follow International Monetary Fund guidelines and count retained earnings as part of these holdings whereas other countries do not. This among other things leads to differences in reported FDI flows and stocks among nations. The figures reported in the text are for reported *outflows* of FDI; because of inconsistencies in measurement, these do not therefore equal reported *inflows*.

Table 2.1 World GDP, international trade, and measures of the expansion of international business 1981-93
(annual compound growth rates in dollar value)

	1981-85	1986-90	1991-93
FDI outflows	0.8	28.3	5.6
FDI stocks	5.4	19.8	7.2
Sales of multinational corporations	1.3	17.4	-2.6
Exports of goods and nonfactor services	-0.1	14.3	3.5
World GDP	2.1	10.6	3.3

Source: UNCTAD, *World Investment Report, 1995*, table I.1.

of corporations. What can be seen in table 2.1 is that FDI and related activity was lethargic during 1981-85, surged dramatically during 1986-90, and then slowed considerably during 1991-93.

Focusing for a moment on the figures for the surge period (1986-90), the figures in table 2.1 contain an inflationary component that must be netted out to give real growth rates. If this component is roughly 5 percent per annum, then world income grew at a real rate of roughly 6 percent per annum over this period, exports at roughly 9 percent, and FDI flows at about 23 percent—a rather astounding figure. Independently, other scholars have looked at the FDI surge of the 1980s. Julius (1991), for example, calculates the annual real growth of outward FDI flows from the G-5 nations (the United States, Japan, Germany, France, and the United Kingdom) to be 27 percent over roughly the same period. This figure, which has been widely cited, seems to be slightly on the high side. Nonetheless, FDI grew at rates little short of spectacular.

The exact magnitude of the current stock of world FDI is not known with great precision, but reasonable estimates suggest that it is a very large number. For example, the United Nations estimated the stock of FDI worldwide to have been about \$503 billion as of the end of 1980 (UNCTAD, *World Investment Report 1995*), rising to \$1.70 trillion at the end of 1990 and \$2.14 trillion at the end of 1993. Julius (1991) arrives at a somewhat lower estimate, calculating the stock of the G-5 nations to be \$929 billion at the end of 1989; she further estimates that these nations held somewhat more than 75 percent of total world stocks of FDI, suggesting a total worldwide figure of something like \$1.2 trillion.

Whatever the exact figure, it must be noted that the FDI figures cited here measure the historic value rather than the market value of the sum of equity of foreign affiliates and net lending of parent firms to those affiliates. (FDI is not, as is sometimes mistakenly claimed, the assets of these affiliated firms.) In drawing a clear picture of the extent of

FDI, it would be ideal, of course, to have current market value estimates. But the current market value of all the world's FDI is not known. However, it is almost surely significantly higher than the historic value.

In order to arrive at a crude estimate of the current market value of FDI stock worldwide, one can extrapolate from US government estimates. Unlike other national governments, the US government prepares estimates of the current market value of FDI as well as its historic cost value. One might think that the "wedge" between the current and historic values of the stock of US outward FDI would be higher than for FDI of most other nations; foreign affiliates of US firm are older on average than foreign affiliates of firms based in other nations, and it is reasonable to expect that the wedge would grow with time.³ In particular, it might be expected that the wedge between the market value of US outward direct investment would be greater than that for FDI in the United States because the latter is, on average, of more recent vintage. This is, in fact, the case. The value of the stock of US inward direct investment (the "inward direct investment position") at historic cost at the end of 1994 was \$504.4 billion while the estimated market value was \$771.1 billion. Calculated as the ratio of the market value to the historic value, the wedge for US inward FDI was about 1.53. For US direct investment abroad, the value of the stock (the "outward direct investment position") at historic cost was \$612.1 billion, and the estimated market value was \$1,048.4, yielding a wedge of 1.71.

Using the average of these two estimated ratios (1.62), the market value of FDI worldwide can be estimated to have been slightly less than \$3.5 trillion at the end of 1993, using as the historic base value the UN estimate. But, as just suggested, this figure must be taken only as a very crude approximation and nothing more.

The stock of FDI grew more slowly than flows during the surge of the late 1980s, which is what might be expected given that the stock of FDI at the beginning of the period was already quite high whereas flows were somewhat suppressed due to worldwide recession of the early 1980s. Nonetheless, the real (inflation-adjusted) annual compound growth rate of the worldwide stock of FDI was upward of 11 percent over the whole decade.

As impressive as the figures on the growth of FDI are, they may actually understate the true extent of the internationalization of business during the past decade. For example, by and large these figures do not fully capture the spread of so-called nontraditional forms of international business. Important among these are "strategic alliances" among firms from different countries. These alliances take the form of joint ventures and other cooperative activities between firms that are other-

3. This last is true, if for no other reason, because of inflation, which tends to raise the current nominal value of any asset over its nominal value at time of acquisition.

wise rivals. Strategic alliances appear to be particularly prevalent in the high-technology industries, and more is said about these later. For the moment, let it simply be noted that these and other nontraditional forms of international business (including nonequity participation of one firm in the activities of another) are believed to be of considerable significance but that it is very difficult to measure their magnitude.

The spread of international business via FDI has led to the creation of several thousand firms whose operations span national boundaries; such firms are termed variously multinational enterprises (MNEs), multinational corporations (MNCs), transnational corporations (TNCs), and global corporations. Some analysts have attempted to differentiate among these terms, and in the following chapter there is a discussion of the resulting differences in nomenclature. Despite these efforts, no widely accepted taxonomy exists; indeed, to a large degree these terms have been used interchangeably. The United Nations estimates that there were upward of 37,000 such firms in existence in 1992 but admits that there is some double-counting in this estimate (UN Center for Transnational Corporations, *World Investment Report 1993*). In that year, these firms controlled about 200,000 affiliates in nations other than their home nations and employed worldwide an estimated 73 million people on a full-time basis.

The figures on direct investment do not include the value of parent organizations' equity but only the equity value of parents' holdings in their overseas affiliates. Unfortunately, there are no data series on global corporations' consolidated net worth. But to hazard a very crude guess, if we assume that the book value of equity in overseas affiliates represents 35 percent of the consolidated net worth of the average global corporation,⁴ then the combined net worth (total equity at historic value) of all of these corporations is in the range of \$6.5 trillion. But, again, this figure is likely to understate the current market value of these corporations significantly. Using the market-to-historic ratio of 1.62, as estimated above, this market value amounts to \$10.5 trillion—again, a very crude guess.

For some purposes, it might be desirable to know the value of assets under the control of these corporations. Again, no global data series exist on this value, so once again we must hazard guesses based on US data. One guess can be made on the basis of asset-to-equity ratios. The ratio of assets of majority-owned affiliates of US firms to owners' equity in 1989 was slightly greater than 3.9.⁵ If this figure is assumed to be

4. This 35 percent figure is the approximate percentage of the assets held by the world's 100 largest multinational firms outside their home countries (UNCTAD, *World Investment Report 1995*, 19).

5. 1989 is chosen because it is the most recent year in which comprehensive "Benchmark Survey" data on US direct investment abroad are available from the US Commerce Department (1992).

equal to the assets-to-owners' equity ratio for all multinational firms worldwide in 1993, then the global value of the total assets of these firms would have been more than \$25 trillion in that year. A less crude guess by the United Nations puts the assets under control of the world's largest 100 multinational firms at \$3.7 trillion in 1993, or a little less than 15 percent of the \$25 trillion estimate.

The \$25 trillion total asset estimate includes financial assets as well as fixed assets and inventories—that is, total assets do not represent a measure of stock of the real capital held by these corporations. For nonbank affiliates of US multinational firms, net fixed assets—the best measure of real capital stock—were almost exactly 25 percent of total assets. If this ratio applies to all multinational firms worldwide, the net fixed assets of these firms would be about \$6.25 trillion.

FDI and Trade

Foreign direct investment has by some measures become even more important than international trade, although only marginally so. The United Nations estimates that the total value of all exports of goods and nonfactor services was about \$4.8 trillion in 1993, whereas the total sales of foreign affiliates of multinational firms was about \$5.2 trillion (UNCTAD, *World Investment Report 1995*, table I.1).⁶ For US-based firms, the ratio of sales of overseas affiliates to US exports is higher than these figures would suggest. Julius (1991) estimates, for example, that in 1987 the local sales of overseas affiliates of US-based firms worldwide exceeded US exports by a factor of over 2.1 to 1. Similar results are presented by Encarnation (1992).⁷ This probably reflects the longer average experience of US firms with global business compared with that of firms from most other nations.

Additionally and importantly, international trade itself is increasingly dominated by the operations of multinational corporations. In 1991, for

6. It is somewhat tempting to claim on the basis of the sales figure that overseas affiliates and their suppliers account for about 23 percent of world GDP (estimated to have been \$23.3 trillion in 1993). Such a claim would ignore, however, that a substantial but unknown portion of the sales of these affiliates consists of intermediate goods and services bought as inputs by other such affiliates and hence would have to be subtracted from the aggregate sales figure to avoid double counting. What can be said is that these affiliates and their suppliers do account for some very substantial percentage of world GDP (e.g., if the double counting were one-third of aggregate sales, this percentage would be about 15 percent.)

7. A comparison of sales of multinational firms to exports raises something of an “apples to oranges” problem. It would be better to compare the value added by multinationals to exports. Alas, such data are simply not available at an international level.

example, exports to majority-owned overseas affiliates of US firms accounted for about 26.2 percent of total US exports of merchandise, while exports of foreign-owned enterprises in the United States accounted for another 23.3 percent.⁸ Likewise, in that same year US firms' imports from their overseas affiliates accounted for upward of 18.5 percent of total US imports of merchandise; foreign-owned enterprises in the United States accounted for another 36.5 percent of these imports. Thus, intrafirm trade by MNCs accounted for almost 50 percent of US exports and well over 50 percent of US imports of merchandise in 1991.⁹

The United Nations has calculated the share of intrafirm trade of MNCs in total world trade to be about one-third (UNCTAD 1994). The higher percentage for US-based firms, again, probably reflects these firms' longer experience, on average, with linking overseas affiliates via trade than have firms based in most other nations.

A long-standing (and largely unresolved) issue involves the relationship between international trade and direct investment: are they substitutes or complements? If they are substitutes, an increase in the stock of FDI would reduce trade. If FDI and trade are complements, an increase in FDI would increase trade. The issue cannot be resolved theoretically; there are theoretical reasons to support either side. But a fair amount of empirical evidence has also been gathered and analyzed.¹⁰ The best evidence would suggest that, in the manufacturing sector, net FDI and both exports and imports are complements and not substitutes. To the extent that this is true, further growth of FDI will thus move in tandem with world trade growth.

FDI and R&D

Multinational firms figure heavily in the development of technology worldwide, and, indeed, one of the major reasons countries seek FDI is to

8. These percentages are calculated from figures on exports and imports reported in the following sources: for US-based MNCs, US Commerce Department, Bureau of Economic Analysis (BEA), *US Direct Investment Abroad: Operations of US Parent Companies and their Foreign Affiliates*, revised 1991 estimates (1994); for foreign-controlled affiliates in the United States, BEA, *Foreign Direct Investment in the United States, Operations of US Affiliates of Foreign Companies*, revised 1991 estimates; and for US exports and imports of merchandise, BEA, "US International Transactions 1991," *Survey of Current Business*, March 1993. These percentages are not adjusted to reflect the slightly different bases of reporting of the data among these three sources.

9. These estimates might understate multinational firms' share in the total amount of US trade; they do not include, for example, exports or imports generated by sales or purchases of US-based MNCs to or from unaffiliated foreign entities.

10. The relevant literature is reviewed, and some original analytic results presented, in Graham (1996).

encourage technology transfer by multinationals. Alas, no global data are available on the technology-related activities of these firms. Again, some insight can be gained from US data. US multinational firms in 1989 expended \$82.2 billion on in-house research and development—that is, R&D performed by themselves—of which \$57.6 billion was for their own use, \$21.9 billion was for the use of the US federal government, and \$2.7 billion was for the use of other parties.¹¹ In addition, in this year these firms also expended \$2.3 billion in the United States for R&D for their use that other parties performed. In addition, overseas majority-owned affiliates of these firms performed \$7.9 billion in the same year, of which \$6.3 billion was for their own use and \$1.6 billion was for the use of other parties. These affiliates also spent \$0.7 billion on R&D for their use that other parties performed.

The total R&D performed by US parent firms (\$82.2 billion) represented over 58 percent of all R&D done in the United States and over 80 percent of the R&D done by private firms in the United States. The R&D performed by these firms for their own use (\$57.6 billion) represented over 88 percent of all R&D performed by firms for their own use in the United States. Thus, from almost any perspective, global firms dominate industrial research and development in the United States. And while R&D performed by these firms abroad as a percentage of all R&D performed by these same firms (8.8 percent if one considers all R&D performed by these firms, or 9.9 percent if one considers only R&D performed for their own use) is not large, the amount of R&D these firms did outside the United States, in absolute numbers, is very significant.¹²

National Comparisons

The vast bulk of flows of FDI in the 1980s both originated in and went to the nations of the “triad”—that is, the nations of Western Europe, North America, and Japan. Table 2.2 gives some indicative figures. (The reader is cautioned to read the source notes to the table.)

Several points stand out. Compound rates of growth of FDI were

11. Again, data are for 1989 because this is the most recent year for which the extensive “benchmark” data are available.

12. This R&D is significant from a qualitative perspective also. Several Nobel prizes, for example, have been awarded to researchers for work performed in non-US laboratories of US-owned firms. But also, several Nobel prizes have been awarded for work performed in US laboratories of non-US-owned firms.

Nonetheless, it should be noted that the best evidence suggests that all multinationals, and not just US-based ones, conduct the bulk of their R&D inside their home countries (or, in the case of large multinationals based in certain smaller European nations, within Europe if not within the home country). On this, see Cantwell (1994).

Table 2.2 Stocks and flows of inward and outward FDI by region, 1985 and 1993^a
(billions of dollars except where noted)

Region	Outward stock		Rate of growth (percent)	Inward stock		Rate of Growth (percent)
	1985	1993		1985	1993	
North America	292.5	647.0	9.9	264.1	593.1	10.1
United States	251.0	559.7	10.0	184.6	445.3	11.0
Canada	40.9	86.3	9.3	64.7	106.0	6.2
Mexico	0.5	1.0	8.7	14.8	41.93	13.0
Western Europe	312.3	1063.9	15.3	242.2	883.5	16.2
EU	286.3	962.0	15.1	223.8	832.1	16.4
Other	23.4	101.8	18.3	18.3	51.4	12.9
South and East Asia						
Japan	44.0	259.8	22.2	4.7	16.9	16.0
Singapore	1.3	6.3	19.7	13.0	50.8	17.0
China	.13	11.8	56.3	3.4	57.2	35.2
Other	4.2	71.7	35.4	47.9	138.0	13.2
Rest of World	25.0	80.1	14.5	152.6	340.0	10.0
World Total	679.4	2134.6	14.3	727.9	2079.5	13.1

Source: UNCTAD, *World Investment Report, 1995*, annex tables 3 and 4.

a. Stock figures are for year end. The estimates are derived from national government sources which use somewhat different accounting standards (e.g. Japan and several European nations do not count retained earnings by affiliates of foreign firms as FDI, whereas most other nations do). Hence, reported total inward flows do not equal reported total outward flows.

quite high for almost all categories indicated in table 2.2 but were especially high for inward and outward FDI to and from Japan, Western Europe, Singapore, and China, and outward FDI from (but not into) other East Asian nations. Categories for which FDI flows were low included FDI into and out of Canada and into and out of “the rest of the world.” Bear in mind that the magnitudes of the figures for Japan are somewhat understated relative to other figures, given that the Japanese authorities do not count as direct investment the retained earnings of either foreign affiliates of Japanese-based firms (in the case of outward FDI) or Japanese affiliates of foreign firms in the case of inward FDI (as do most other nations).

FDI stocks in Japan grew rapidly mostly because they started from a low initial level in 1985; indeed, even at the end of the period these stocks remained low relative to the size of the economy, at least when Japan is compared with other advanced nations. This is a fact that has been widely noted (e.g., Julius 1990 and 1991; Lawrence 1993; Encarnation 1992; Yoshitomi and Graham 1996). Indeed, Japan stood alone among the advanced industrial nations in not having a significant foreign-owned business presence in the domestic economy. This is largely due to major

official restrictions on inward FDI into Japan that persisted until the early 1980s (Mason 1992; Tamura 1996).

The growth of stocks of outward direct investment from Japan is another story because this FDI did not start at particularly low levels. Indeed, Japanese direct investment became the subject of much interest during the late 1980s and early 1990s, inspiring a number of popular books, including at least one fictional bestseller (Crichton 1992). Many of these have taken a critical or even hysterical tone (e.g., Burstein 1988; Choate 1990; Frantz and Collins 1989). Japanese investors have been accused of little less than attempting to conquer the whole world by dominating important markets and systematically annihilating their non-Japanese competitors.

But the facts as depicted in table 2.2 fail to bear out this view: despite the rapid growth of Japanese outward FDI, Japan accounted for less than 13 percent of the world's stocks of FDI at the end of 1993, and since 1991 the Japanese share of the stock of world FDI has been falling. Stocks of Japanese FDI were less than half of those held by US direct investors and less than a third of those held by EU direct investors. Despite the rapid buildup of Japanese FDI during the 1980s, relative to the size of the Japanese economy Japan remains somewhat underrepresented as a home nation to FDI when compared with either the United States or the EU nations.

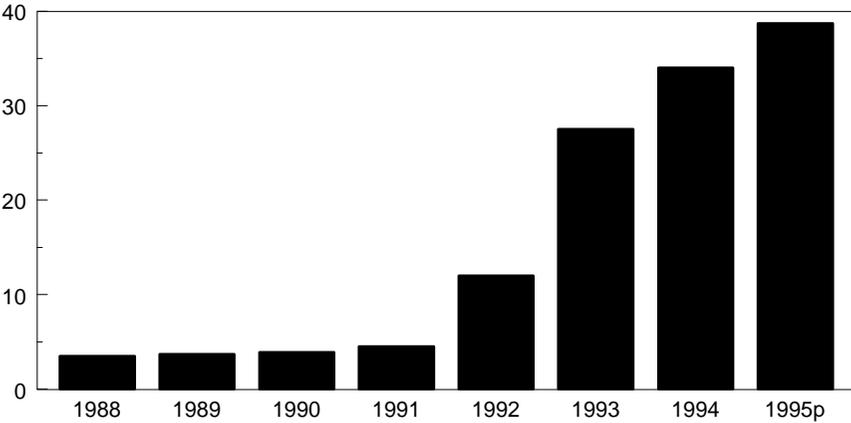
Given that Japanese firms are widely perceived to hold managerial and technological competencies more advanced than those of major non-Japanese rivals, and given that current thinking about the ultimate determinants of FDI emphasizes firm-specific advantages (see chapter 4), perhaps the major surprise about Japanese FDI is that there was not more of it sooner. Thus, the surge of Japanese FDI that took place during the 1980s is probably better viewed as a catch-up phenomenon rather than as the emergence of a new and possibly sinister force in the world economy (for an insightful and rational account of the internationalization of the operations of Japanese firms, see Emmott 1992; see also Graham and Krugman 1995).

The most spectacular growth of FDI in Asia occurred in China. Figure 2.1 indicates the inflows of FDI into China from 1988 through 1995. As can be seen, these inflows did not really accelerate until 1992, and from 1992 through 1995 the growth was truly explosive. Whether this growth will continue is, of course, not known. But even if inflows stabilize around 1994 levels, it will be only 10 years or so until China surpasses the United States as the largest host nation to FDI.

Much of the growth of European FDI stocks, both inward and outward, that was reported in table 2.2 represented direct investment from one European nation to another. This intra-European FDI presumably was stimulated at least in part by the "Europe 1992" program to "complete" the internal market. Indeed, large European firms were by most

Figure 2.1 FDI flows to China, 1988-95

billions of dollars



Source: 1988–94 data from International Monetary Fund, *International Financial Statistics*; 1995 preliminary data from China's Ministry of Foreign Trade and Economic Cooperation (MOFTEC).

accounts the most important single driving force behind the “1992” program. It has been noted that whereas Western European integration prior to the 1980s was achieved largely by expansion of trade flows among the EC nations (and between the EC nations and those of the European Free Trade Association, or EFTA), the 1980s were unique in that they were characterized by intra-European FDI (e.g., Cantwell 1992; Thomsen and Woolcock 1993). Analysts note that a likely effect of intra-European FDI is that interdependence among European nations will become more irreversible than in the past.

With respect to the slow growth of FDI into and out of the rest of the world, the affected nations are mostly developing ones. Indeed, the fact that FDI has been slow to enter most developing nations has sharply shifted the nature of these countries’ concerns regarding FDI. During the 1970s, developing world analysts and intellectuals severely criticized FDI and transnational corporations, and numerous developing nations restricted these firms’ entry into their economies and strictly regulated the behavior of firms that did enter. But during the late 1980s developing countries’ concerns over exploitation were largely replaced by concerns over the paucity of FDI they were receiving. And these new concerns were justified: although the gross value of FDI flows to many developing areas was greater during the 1980s than during the 1970s, the share of world FDI going to developing nations during the 1980s shrank considerably from shares typical during the 1970s.

FDI flows to developing nations have accelerated during the 1990s, but, as already noted, these have been concentrated in a handful of the more rapidly growing of these nations, such as Mexico, Brazil, China,

and certain (but not all) of the ASEAN nations. Some areas of the developing world have hardly witnessed any new FDI at all, including most of Africa, much of Latin America, most of western Asia and the Middle East, and much of southern Asia.

Changes in Policies Toward FDI

Partly in response to declining shares of inward FDI and partly as an element of overall liberalization of economic policies, a number of developing nations significantly liberalized their policies toward this investment and multinational corporations during the late 1980s and 1990s (UN Center for Transnational Corporations, *World Investment Report 1991*). The changes were most pronounced in the newly industrializing economies (NIEs), where the focus was on lifting restrictions on foreign ownership of domestic activities. In certain countries that made marked policy changes (e.g., Mexico), the liberalization of policy toward FDI was part of a larger movement away from state intervention and toward market-oriented policies. Even some nations traditionally considered somewhat hostile toward MNC participation in their economies (e.g., India) have recently taken steps to open internal markets to such firms.

China is worthy of special note in this regard.¹³ During the first three decades of its existence, the People's Republic of China was for all practical purposes closed to FDI. A partial opening was achieved in 1979 with the passage of the Law on Joint Ventures Using Chinese and Foreign Investment, and the window that this law cracked was opened wider with the passage of the Law Concerning Enterprises with Sole Foreign Investment in 1986 and the Sino-Foreign Cooperative Joint Venture Law in 1988. These laws established that FDI was welcome in China (but not in all sectors) and furthermore granted foreign investors preferential treatment not accorded to most domestic firms. In particular, foreign-invested enterprises (the translation of the Chinese term for affiliates of MNCs) were granted (1) exemption from or reduction of corporate income taxes for two to three years after profits were first recorded, (2) exemptions from tariffs and value-added taxes on imported capital goods and materials, (3) the right to maintain foreign exchange accounts, (4) subsidized land, water, power, and other services,¹⁴ (5) greater freedom in the hiring of personnel than is accorded to domestic enterprises, and (6) some special export rights. In addition, foreign-invested

13. A comprehensive but already somewhat dated history of China's policies toward FDI is Jio (1994).

14. Foreign-invested enterprises were given access to these resources at the same costs as state-owned enterprises, which are lower than those local private companies pay.

enterprises that bring advanced technologies to China or export substantial proportions of their output receive further preferential tax treatment. In June 1995, the number of sectors open to FDI in China was significantly enlarged; in particular, foreign firms now have limited access to service industries that previously were off-limits.

Much of the preferential treatment received by foreign-invested enterprises in China has been the result of their freedom from state-imposed regulations that apply to domestically owned firms. But over the past few years, regulatory reform in China has reduced foreign-owned firms' relative advantage in this regard. In December 1995, the Chinese government announced that it would end exemptions and reductions of tariff and value-added taxes for foreign-invested enterprises on imported capital goods and materials, but this was accompanied by tariff reductions applicable to all imports.

Not all nations have likewise liberalized their policies. Some countries have even adopted somewhat more restrictive policies. Most notable in this regard is the United States, long the principal advocate of open FDI policies and the major instigator of international efforts to liberalize FDI policies among nations. (See chapter 4 for a recounting of US efforts to liberalize FDI.)

In particular, in 1988 the United States enacted the Exon-Florio provision of the Omnibus Trade and Competitiveness Act, a provision enabling the president to block foreign takeovers of US firms on national security grounds.¹⁵ Neither the Bush nor the Clinton administration has implemented Exon-Florio in a manner that is particularly restrictive toward FDI, but the bill provides a legal foundation on which a future administration could do so (see discussion in Graham and Krugman 1995).

During the 103rd Congress (1993-94), a number of bills were introduced that would have altered the traditional US policy of unconditional national treatment of foreign-controlled firms—that is, the principle that these firms, with some exceptions, are to be treated no less favorably than US firms in similar lines of business are treated. None of the bills that sought to introduce varying degrees of “conditional” national treatment actually passed, but they did seem to reflect the mood of much of the Congress. These are examined in more detail in chapter 6.

Interestingly, the United States has not experienced a particularly rapid rate of growth of FDI relative to the rest of the world (table 2.2). Indeed, the growth has been significantly less than in many other nations. Much of the furor over FDI in the United States was a reaction to trends in the late 1980s, when in fact FDI grew very rapidly, and to a significant degree, the furor has since died down.

15. The Exon-Florio provision was modified slightly by 1992 legislation; the statute as originally passed is discussed in detail in Graham and Ebert (1991).

The United States has not been unique, however, in its alarm over the rapid growth of FDI. The European Community also pondered more restrictive FDI policies when FDI from Japan during the late 1980s grew rapidly and continued into the first half of 1991 (although these flows started from a very low base and hence even in 1991 were not extremely high in absolute terms).¹⁶ One manifestation of this was the inclusion of locally assembled automobiles in Community-wide quotas on Japanese automobiles.

By and large, however, European policy toward FDI has not been overtly restrictive so much as it has been regulated. European nations have been eager to attract what they consider to be “good” direct investment—specifically, direct investment in high-technology industries or in high value-added activities. To this end, most European nations have offered substantial incentives to direct investors in the form of direct subsidies, low-interest (or even interest-free) loans, tax relief, and subsidized land and/or infrastructure. More often than not, a condition for receipt of these incentives has been the investor’s agreeing to performance requirements, often in the form of “assurances” negotiated between the recipient firm and the government offering the incentive.

For example, most European national governments have been especially eager to lure semiconductor manufacturing to their territory. In doing so, governments have often competed to offer the most attractive incentives. Yet these governments have also suspected that direct investors in this industry will perform only “downstream” operations (e.g., assembly and testing) in Europe, keeping “upstream” activities perceived to generate large external benefits at home. Governments thus have sought assurances from direct investors that a fully integrated fabrication facility will be built, that certain levels of employment will be provided, and that the domestic content of the output be above a certain percentage. Consequently, the semiconductor investment has been scattered throughout the European Union, probably resulting in losses in economic efficiency—for example, because plants have been built at suboptimal scale and economies associated with clustering may have been lost (see Tyson 1992; Tyson and Yoffie 1992).

Gaster (1992) offers an account of how European governments have used performance requirements to affect the operations of multinational firms in Europe. But while Gaster claims that these performance requirements have been of benefit to Europe, he provides scant evidence that this in fact has been the case.

Whether or not performance requirements on FDI have significantly enhanced local economic performance (at some cost to global economic

16. As with much of the rest of the world, FDI flows into Europe from Japan (and elsewhere) tapered off dramatically in late 1991, and thus the impetus to enact restrictive measures was reduced considerably.

Table 2.3a Rates of return on Dutch outward direct investment by host nation or region, 1986-90

United States	6.3
Other North America (Mexico, Canada)	10.5
European Union	7.7
Other Europe (EFTA)	14.4
Japan	6.3
Southeast Asia	17.6

Source: van Nieuwkerk and Sparling 1985, from base data from the Central Bank of the Netherlands

efficiency), some European governments have begun to wonder whether they are getting value from their investment incentives. Even Ireland—an EU state that has honed the tailoring of these incentives into a fine art—has questioned the value of granting lavish incentives (*Financial Times*, 10 July 1992). Both investment incentives and performance requirements are discussed further in chapter 4.

Predicting Which Way FDI Will Flow

Differential Rates of Return Don't Tell Us

Exactly why FDI flows during the 1980s were so concentrated in the triad nations is not wholly clear. Rates of return on FDI in the triad were not higher than elsewhere; rather, available evidence suggests they were lower.¹⁷ Dutch data on outward FDI of firms based in the Netherlands clearly show that rates of return on their FDI activities outside the triad are significantly higher than on such activities within the triad (table 2.3a). The US data are partly corroborating. Table 2.3b presents “naive” data on rates of return on US direct investment abroad, calculated simply as the average of income from direct investment over the direct investment position (on a historic cost basis) by nation or region. They suggest that returns are significantly higher both in Africa (other than South Africa) and the Asia Pacific (other than Japan, Australia, and New Zealand) than in the triad, but that rates of return in the triad seem to be higher than in Canada, Mexico, South America, or Australia, New Zealand, and South Africa (the published base data for these last three nations are aggregated together). The US data also show that rates

17. In this data, profits are reported as originating within a region. However, because MNCs have worldwide operations, operations in one region can affect returns realized in other regions. Thus, reported profits within one particular region may not truly reflect the value to the entire firm of their operations in that region.

Table 2.3b Rate of return on US direct investment abroad by host nation or region, 1986-1990

European Union	15.1
Other Europe (EFTA)	15.4
Japan	13.9
Other Asia and Pacific, except Australia and New Zealand	22.3
Mexico	7.5
Canada	9.3
Africa, except South Africa	17.8
South America	10.3
Australia, New Zealand, and South Africa	11.1

Source: Calculated by the authors from data in U.S. Commerce Department, Bureau of Economic Analysis, "US Direct Investment Abroad: Detail for Historic-cost Position and Balance of Payments Flows, 1990," *Survey of Current Business*, August, 1991, table 17. Rate of return is calculated as average income divided by average historic cost direct investment position in the country or region.

of return for the EFTA countries are virtually the same as for the EU nations. Both sets of data do suggest that rates of return on FDI vary substantially from region to region and that FDI does not necessarily flow from regions with low rates of return to ones with high rates, as classical theory of capital movements suggests.

Defenders of classical theory would argue that capital should move from areas where marginal rates of return are low to those where it is high, and that the data in tables 2.3a and 2.3b, which indicate average rates of return rather than marginal ones, do not necessarily rule this possibility out. But it is not a huge leap of faith that marginal rates are correlated with average ones, and hence that the data in these tables are suggestive of flows moving contrary to the predictions of classical theory. Certainly the data do not suggest that rates of return on FDI in either the United States or Europe are extraordinarily high relative to those in Japan and thus fail to support the classical theory explanation of why FDI should flow from Japan to these two areas.

Likewise, the substantial two-way flows of FDI between the United States and Europe cannot readily be explained on the basis of different rates of return. Indeed, given the dismal returns on FDI in the United States (profits on FDI in the United States as reported by the Bureau of Economic Analysis would suggest that the Dutch experience is not unique; see Graham and Krugman 1995), one might well wonder why this investment came at the rates and magnitudes that it did during the late 1980s. It has been suggested that the low rates of return in the United States could be the result of transfer price manipulation—that prices of

goods and services imported into the United States by local affiliates of foreign-owned multinational firms were raised to above-market levels so that profits actually earned in the United States could be reported somewhere else in the world. However, research into this issue indicates that such transfer price manipulation, if it occurs, can only account for part of the low profitability of US affiliates of foreign-owned firms (see, e.g., Grubert, Goodspeed, and Swenson 1991).

In the next chapter, reasons for FDI other than differential rates of return are discussed. For the moment, let us simply note that, on the surface at least, the classical theory of international capital movement fails to explain these flows.

Globalization in Historical Perspective

As spectacular as the globalization of the past 10 or so years has been, it is not really a new phenomenon. The globalization of significant numbers of corporations began during the 19th century (Wilkins 1970, 1974, and 1989), and significant cases can be found where firms “globalized” their activities even earlier (e.g., the East Indies Company during the 18th century).

Indeed, during the late 19th and early 20th centuries, enormous sums of long-term capital investment flowed across national boundaries. By some measures, the world economy was more integrated on the eve of World War I than it is today (Krugman 1989). It is not known how much of the long-term capital flow of this era was direct investment. A Brookings Institution study published during the 1930s (Lewis 1938) estimated that about 90 percent of these flows represented portfolio rather than direct investment, and economic historians accepted this for about 40 years. However, beginning in the middle 1970s, the evidence was reexamined (see, e.g., Houston and Dunning 1976). It was found that in 1913 stocks of UK direct investment abroad represented almost 35 percent of UK long-term foreign assets. At that time, the United Kingdom was the largest international investor nation, and hence the new estimates for the composition of UK overseas assets cast some doubt on the accuracy of the 90 percent estimate.

More recent research suggests that even the 35 percent figure might be low. For example, Corley (1994) estimates that, of the accumulated overseas assets of £4,165 million the United Kingdom held in 1913, £1,681 million—or about 45 percent of the total—represented direct investment.¹⁸

18. At exchange rates then prevailing, £1,681 million equaled about \$8 billion. This represented a higher fraction of the total domestic net worth of Britons at that time than Britain’s current portfolio of direct investment now represents, despite the fact that the UK stock of outward direct investment today is, relative to the size of the economy, the highest in the world.

Other recent work has resulted in upwardly revised figures for other countries.¹⁹

British corporations operating overseas fell into two basic categories: those whose overseas operations were essentially an extension of home-based ones (e.g., J.& P. Coats Ltd, which set up a US subsidiary in 1869) and those established primarily to operate overseas, (e.g., the holdings of Thomas Lipton in the tea industry; see Stopford 1974).

The first highly international American manufacturing firm was the Singer Manufacturing Company, whose operations in Europe date from the 1860s and which by the 1880s had manufacturing operations in four countries and sales offices in dozens (Wilkins 1970). Resource-based firms of the United States also established extensive overseas operations during the 19th century. Leading the list was the Standard Oil Company, which established operations in numerous countries. Indeed, when the Standard Oil trust was broken up under court order in 1911, 9 of the 34 successor firms were themselves multinational in extent. By 1914, at least 37 US manufacturing firms operated in three or more foreign nations, and a number of US financial institutions, especially insurance firms, had established multinational operations.

Foreign-controlled business activity in the United States before World War I was also very significant. Most such businesses were held by British or continental European investors, including some that are today household names (e.g., Rolls Royce, Daimler-Benz). However, substantial numbers of these foreign-controlled operations in the United States ceased to exist (or to be under foreign control) following World War I. Nationalization of German properties during and after this war, the closing or selling of businesses during the Great Depression, and the sell-off of certain British-controlled properties under the terms of the Lend-Lease Act after the outbreak of World War II in Europe all contributed to the attrition of foreign-controlled business in the United States.

Although manufacturing-sector MNCs did exist before World War II, the bulk of MNC activity was concentrated in resource-based (extractive and agricultural) industries and in the utilities and transportation sectors.²⁰ Also, the bulk of direct investment in these industries was North-South in nature—that is, the host nations were predominantly developing countries. In 1914 more than 53 percent of British FDI was in the resource-based industries, and another 31 percent was in utilities and

19. Schröter (1984, cited in Jones 1994), for example, calculates that the direct investment Germany held in 1914 was about \$2.6 billion, in contrast to the Houston and Dunning (1976) estimate of \$1.5 billion. Likewise, Gales and Sluyterman (1989) estimate that the direct investment of the Netherlands in 1914 was about \$925 million, almost twice the Houston and Dunning estimate.

20. “Transportation” in this case means the provision of transport services (e.g., railroads) rather than the manufacture of transportation-related goods (e.g., auto manufacturing).

transportation (Houston and Dunning 1976). At least 59 percent of British FDI was in developing countries (Corley 1994). The stock of US FDI was also concentrated in the resource-based industries (68 percent), utilities, and transportation while only slightly over 18 percent was in manufacturing industries; over 54 percent of this stock was in developing countries (Wilkins 1970).

By 1929, however, the share of total US FDI in resources, utilities, and transportation had shrunk slightly to about 61 percent as the result of rapid expansion of manufacturing affiliates of US firms during the 1920s, especially in Canada, Europe, and South America (Wilkins 1974). During these years, Ford established extensive operations in the United Kingdom and used these as a base for entering the rest of Europe, and General Motors responded by acquiring firms in Germany (Opel) and the United Kingdom (Vauxhall). However, the bulk of US FDI remained in developing countries; indeed, the share of these countries in the total stock of US FDI rose to 59 percent, mostly because the holdings of US petroleum firms in Latin America, Asia, and Oceania were expanded greatly.

In contrast to the 1920s, the years of the Great Depression witnessed the virtual halt of the international expansion of most MNCs, except for that of the international oil companies. During the 1930s, much of the world economic landscape came to be characterized by international cartel arrangements in many industries, often with government encouragement (Hexner 1945). Many of these cartel agreements contained territory-splitting provisions whereby firms agreed not to operate in certain geographic areas, reserving these for competing firms. Some MNCs even sold or closed foreign subsidiaries to comply with these agreements. The outbreak of World War II in 1939 further subdued international business activities. The overall result was that by 1949 MNCs accounted for a substantially smaller fraction of world economic activity than in 1929.

During the 1950s, international business activity resumed its rapid expansion, which continued for about 20 years (Vernon 1971). The leading foreign direct investors of this period were mostly US-based firms in the manufacturing sector, although the major petroleum firms (both US and non-US) also expanded their international activities significantly. Many new firms entered the ranks of the MNCs during this period.

By 1967, three-fourths of *Fortune* magazine's list of the 500 largest US industrial firms had manufacturing operations in at least one country other than the United States, and 187 of these had manufacturing operations in six or more foreign countries. Unlike earlier times, the bulk of the postwar US FDI went to advanced countries, especially the European nations and, to a lesser extent, Canada. Between 1950 and 1970, the stock of US manufacturing direct investment in Europe increased almost 15-fold. Consequently, the share of US FDI in developing coun-

tries declined dramatically. By 1970, less than 40 percent of the stock of US FDI was located in these countries. Also the share of resource-based industries, utilities, and transportation in the US stock of outward FDI had fallen to less than 40 percent, the bulk of which was in the petroleum sector.

Given this short history of the globalization of business, what was new to the surge in globalization of the 1980s was that both the number of firms that created international operations and the number of nations that became “home” to such firms increased dramatically.²¹ As recently as 1970, two leading scholars of multinational enterprises predicted that, over the following 20 years, about 300 firms would become truly multinational and that the home nations of these would overwhelmingly be either the United States or the nations of Western Europe (Hymer and Rowthorne 1970). Some scholars criticized Hymer and Rowthorne at the time for overstating the likely spread of multinational business. But by the early 1990s, there were at least 1,000 firms that could meaningfully be called multinational (Julius 1991) and perhaps many times this.²² The home nations included the United States and most of the nations of Europe but also Japan, Korea, Taiwan, Brazil, Mexico, India, Israel, and numerous others.

Hymer and Rowthorne worried that many sectors of the world economy would fall under the dominance of tightly knit oligopolies composed of stateless firms that would be accountable to no one. By and large, this has not happened. Indeed, one of the benefits of the globalization of the 1980s is an increase in competition in many sectors and national markets, with attendant benefits to consumers.

Whereas in 1970 the term “global” might have applied to less than 200 corporations that called the United States home (Vernon 1971) and a handful of firms with European homes (Tugendhat 1970), the greatest change since that time has been the growth of international operations of non-US-headquartered firms. One important consequence is that such firms greatly expanded their operations in the United States during the 1980s to the point where, as noted earlier in this chapter, the inward direct investment position of the United States in terms of book value does not now greatly differ from its outward direct investment position. The United States, long the largest home to global corporations, has also become one of the largest host countries, even when measures are ad-

21. The “home” country of a firm is the country in which the firm maintains its headquarters. In most cases, this coincides with the country in which the firm was founded. A number of firms maintain headquarters in two or more nations—for example, Unilever and the Royal Dutch/Shell group—but their numbers are small and pose no great difficulty to this definition of “home” country.

22. As noted earlier, the UN counts upward of 37,000 multinational firms but admits to some double counting. Also, many of these firms are quite small.

Table 2.4 United States: total employment accounted for by US affiliates of foreign-controlled firms (1992)

All Industries	5.1	Textiles	6.9
Manufacturing	11.6	Other transportation	4.9
Chemicals	32.0	Apparel	2.8
Petroleum	31.0	Lumber and wood	2.4
Stone, clay, glass	21.0	Other mfg.	9.9
Electric and electronic	17.2	Mining	12.3
Primary metals	16.1	Insurance	6.4
Rubber and plastics	14.8	Finance & banking	6.3
Food	11.9	Wholesale trade	5.7
Instruments	11.8	Transportation services	5.1
Motor vehicles	11.1	Retail trade	4.0
Machinery		Other services	2.4
except electrical	10.8	Real estate	2.2
Fabricated metal		Communication and	
Paper and allied	7.3	public utilities	2.2
Printing and		Agriculture and related	1.7
publishing	6.6	Construction	1.5

Source: US Department of Commerce, *Survey of Current Business*, July 1994, 161, table 7.

justed to account for the size of the US economy—a stunning reversal of the conditions of only one decade ago. Indeed, FDI in the United States represents perhaps the most important example of globalization of business that occurred during the 1980s.

Despite the extent of the globalization of business, the world economy is still very imperfectly integrated. For example, the extent of globalization varies a great deal across industries. Some of the most telling evidence is to be had from FDI in the United States. The percentage of employment in major industries accounted for by US affiliates of foreign-controlled firms varies from more than 30 percent in petroleum and chemicals to 1.5 in construction (table 2.4). Manufacturing is more “globalized” by this measure than most other sectors, but within the manufacturing sector there is much variance. In those industries in which foreign-controlled firms play a major role in the United States, US-controlled firms often play a major role outside the United States. Such industries include petroleum, chemicals, electric and electronic equipment, and motor vehicles. They thus seem to be characterized by significant amounts of intra-industry FDI. But this is not true of all industries. For example, foreign-controlled firms account for 21 percent of US employment in the stone, clay, and glass industry, but US firms are not major outward direct investors in this sector.

Table 2.5 Outward foreign direct investment of major investor nations or regions by major host region, 1990 (percentages)

Investor nation or region	North America	Latin America	Europe	East Asia	Other
North America	24	16	44	14	2
United States	17	18	48	15	2
Europe	34	6	49	8	3
Germany	28	6	59	5	2
United Kingdom	47	7	27	15	4
East Asia	42	13	21	22	2
Japan	44	13	19	21	3

Source: Petrie 1994, from data in UNCTAD, *World Investment Report 1993*.

Just as reported stocks of FDI are concentrated in certain industries, there is some evidence that FDI by individual enterprises is concentrated in the regions in which these enterprises' home nations are located (Petrie 1994). Thus, for example, a firm whose home nation is Japan tends on average to hold greater shares of its direct investment in other Asian nations than does a firm whose home nation is in North America or Europe. There is also some correlation between clustering of FDI and clustering of trade flows, but this would naturally follow if trade and FDI are net complements. It should be noted that the evidence for regional bias in FDI as reported by Petrie is in fact rather weak in the sense that the bias does not hold for all nations that are home to significant direct investment. Data for the United Kingdom, for example, indicate that its direct investment in Europe is a lower percentage of total outward direct investment than is the case for the United States (table 2.5).

The overall picture, then, is that the world economy in the mid-1990s is still far from perfectly integrated but that the globalization of business activities is quite extensive.

Regionalism and the Global Firm

In the last chapter, we sketched a long-term trend toward increased globalization, marked by periods of ebb and flow. One hypothesis is that this trend will continue into the next century. The major competing hypothesis is that, rather than globalization, protectionist regional trading blocs will be the wave of the future (see, e.g., Lawrence 1994). It has been hypothesized in particular that the world economy will devolve into at least three such blocs, generally assumed to be the European

Union, North America (or perhaps the Western Hemisphere), and East Asia, with many countries that are now outside these groups joining a particular bloc.

Identification of these blocs poses some conceptual issues. For example, the European Union exists as a formal grouping of European nations, complete with administrative and legal institutions while a treaty formally creates NAFTA but without any administrative organization. No functioning association of East Asian nations exists, save for the rather dysfunctional Association of Southeast Asian Nations (ASEAN) and the yet-to-coalesce East Asian Economic Caucus (EAEC). Furthermore, there are international economic organizations that transcend the three blocs just identified, notably APEC, which links East Asia and North America (and certain other Western Hemisphere nations) and the Organization for Economic Cooperation and Development (OECD), whose membership includes nations in all of Europe, North America, and East Asia. Nonetheless, the devolution of the world economy into three protectionist trading blocs is not so wild a possibility that it defies imagination. Some authors have postulated a two-bloc world (Bergsten 1993; Whalley 1996)—one encompassing East Asia and the Americas, the other Europe and perhaps Africa.

Perhaps the first thing to be said about a three-bloc or two-bloc world is that, if either were to come about, many of the world's multinational corporations would be well-prepared. The operations of most very large MNCs already extend into virtually every conceivable trading bloc. These firms could thus continue to function effectively even if interbloc trade were greatly restricted. Representatives of these firms often claim that a world of protectionist trading blocs would therefore make very little difference to them. While these firms might prefer that the world trading system remain open, they could survive and even prosper in a protectionist world, especially if they could still transfer technology and other intangible assets among their operations in different blocs.

Having said this, however, it must be stressed that most MNCs prefer an open world economy. In a provocative paper, Raymond Vernon (1995) argues that this preference is likely to grow as these enterprises continue to enlarge their horizons. In particular, these firms increasingly make their decisions on the basis of what is good for their global networks of operations. One result is the growth of intrafirm trade. Aware of their need to compete with rival firms that are often based in countries other than their own home countries, these firms are driven constantly to seek new sources of vital inputs, including both tangible ones such as raw materials and intangible ones such as technology. Vernon notes that the result is a strong propensity of these firms to reach beyond the existing boundaries of their networks.

Vernon notes further that this tendency coexists with the propensities of nations that are members of preferential trading arrangements to pursue

special ties with nonmembers. The reasons for this are several. National governments do not want the most powerful nation in the bloc (say, Germany within the European Union and the United States within NAFTA) to dominate them, and they would like to exploit the competitive advantages of producers outside of the arrangement (and thus to reduce the costs of imported goods and services). In turn, nonmember nations of preferential arrangements seek these ties in large part to circumvent the discriminatory features of the arrangements. The discriminatory aspects of the arrangements thereby erode over time, as the “loopholes” are extended to an increasing set of nations.²³

Only time will tell what the future course of globalization will be. Trends toward regional groups certainly can be discerned, but whether these will prove to be Lawrence’s “stumbling blocks” toward an integrated global economy remains to be seen. The best guess of this author is that globalization will indeed continue, though the actual course of events will zig and zag around this trend. It is an easy guess, given that it describes so well the history of the past century or so and that the past is almost always the most reliable guide to the future. The real question is how great and how enduring will be the zigs and the zags, and the answer to this is almost surely unknowable.

One thing can be said for sure. For at least the next few years, the most rapid expansion will continue to center on the dynamic, newly industrializing nations, spurred in large part by policy liberalization in these nations. In turn, the nations have sought to reap the benefits from inward transfer of technology and other intangible assets of global firms, to the end of furthering the already rapid growth taking place in their economies (see appendix A, a survey of scholarship on the impact of “technological spillovers”).

23. The European Union is the prime example of this trend, with its special relations with several sets of nonmember countries (i.e., the EFTA nations, those of the Maghreb, and a large number of nations that formerly were colonies of EU members). Also, and perhaps more important, the European Union has over time simply enlarged its membership. Vernon notes that in 1994, of those nations that have substantial trade with the European Union, only 12 do not have some sort of preferential arrangement. (These 12 “complete outsiders” include both the United States and Japan.)

APEC, to the extent it could be called a regional group, has gone out of its way to avoid discriminatory features. As called for in the various blueprints of the APEC Eminent Persons Group reports (APEC 1993, 1994, and 1995), APEC holds out for “open regionalism,” seeing its cooperative arrangements essentially as the leading edge of more global arrangements.