

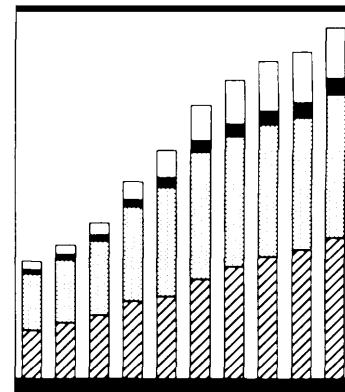
# Part III: Trade and Investment in the Triad

Chapters 5 and 6 analyze the changing nature of global trade and investment, focusing not only on international trends but also on national variations in the behavior of MNEs. These chapters seek to describe the dynamics of trade and investment, unravel the relationship between the two, and assess the implications of contemporary patterns for the U.S. trade balance and—more importantly—the health and relative position of the U.S. technology base.

Since the mid 1980s, the volume, direction, and character of trade and investment across the advanced industrial states has changed substantially. The privatization of assets and the liberalization of investment barriers have stimulated foreign direct investment (FDI), which grew dramatically over the past decade. By 1992, the global stock of FDI reached approximately \$2.0 trillion (in nominal terms). This surge of investment transformed the world economy. Rather than substituting locally produced goods and services for imports, investment also augmented and created trade, often through international trade among foreign affiliates and their parent groups—i.e., intrafirm trade.

Not only has FDI among the advanced industrial states increased substantially, but also a growing portion of global trade and investment now extends beyond the confines of the OECD nations. The world's largest MNEs increasingly trade with and invest in emerging markets, especially those in East Asia and China. Investment in Latin America runs a distant second, while investment in Eastern Europe remains relatively small.

At the same time, the traditional focus of FDI on integrated manufacturing facilities has been augmented by forms of direct investment that promote intrafirm trade. As a result, FDI and trade have become less antithetical and more complementary.



This change, along with changes in the size, source, and composition of FDI across the developed world, has had a major impact on the global diffusion of production processes, the sourcing of high value-added manufacturing parts and components, and on international trade.<sup>1</sup>

Together, chapters 5 and 6 generate a series of findings which suggest that there is little convergence in the behavior of MNEs based in different regions.

### FINDINGS

1. The nature of foreign direct investment has changed fundamentally. Historically, many MNEs used FDI to shift manufacturing facilities abroad, reducing the export of products accordingly. In the 1990s, MNEs are likely to invest in manufacturing, wholesale trade, and service facilities in order to export domestic products for foreign assembly and retail sales through the mechanism of intrafirm trade (IFT). Macro-economic and firm-level data suggest that IFT is particularly prominent within Japanese MNEs and, to a lesser extent, German MNEs (see figures 6-11 and 6-12 in chapter 6).
2. The United States remains an attractive location for foreign direct investment, although the flow of FDI fell from a record high of \$69 billion in 1989 to \$3.4 billion in 1992. In OTA interviews, some foreign investors complained of weak profits in the United States, which they characterized as a mature market (see figure 5-7 in chapter 5). At the same time, they recognize the need to sustain a local presence in the U.S. market because of its size, the access to technology that it provides, and the need to be near major customers.
3. In the last decade, the flow of FDI has increased substantially to non-OECD regions, particularly East Asia and, to a lesser degree, Latin America and Eastern Europe. East Asia, for example, more than doubled its share of global investment stock from 6.2 to 13.6 percent during the 1980s, a period when global investment stock grew dramatically. Labor costs, currency fluctuations, pressures for customization, regional trade agreements, and market access considerations are factors often cited in explaining the spread of FDI.
4. Although the NAFTA and GATT were successfully concluded in 1993, and are likely to assist MNEs in increasing market access and efficiency, no comparable mechanisms are in place to govern international direct investment.<sup>2</sup> The lack of enforceable multilateral investment agreements continues to limit the ability of U.S.-based MNEs to make profitable investments abroad and to obtain foreign technology that would enrich the U.S. technology base. This problem is most pronounced in the U.S. investment relationship with Japan.
5. Access to investment opportunities remains a significant problem for many European and U.S. firms seeking to do business in Japan, despite recent efforts to increase inward direct investment by the Japanese government and some elements of Japanese business. Because they believe that unilateral efforts to invest in Japan are likely to fail, many foreign firms enter into joint venture agreements with Japanese partners. This strategy often results in a minority investment position that limits the ability of the U.S. firm to grow or to use the joint venture as a conduit for trade. The inability of most foreign firms to compete in the Japanese market as independent entities provides Japanese firms with a significant advantage in Japan.
6. Over the past decade, the U.S.-European investment relationship has been reasonably well balanced in scale and composition, and in recent years has stabilized at nearly equal levels

<sup>1</sup>See OECD, Directorate for Science, Technology and Industry, *Globalisation of Industrial Activities: Background Synthesis* Report (Paris, France: OECD, Nov. 26, 1993), p.10.

<sup>2</sup>The TRIMs agreement under GATT is only embryonic for this purpose.

(see figures 5-10 and 5-11 in chapter 5). With respect to the U.S.-Japan relationship, however, broad differences persist in the scale and composition of U.S. direct investment in Japan as compared to Japanese investment in the United States, Japanese direct investment in the United States exceeds U.S. investment in Japan by a factor of 3.1:1. In addition, it is far more concentrated in wholesale operations (and less concentrated in manufacturing) than is European or U.S. direct investment (see figures 5-14 and 5-15). As the stock of U.S. inward and outward direct investment expanded in the 1980s, U.S. investment in Japan failed to keep pace with the overall trend (figure 5-9).

7. As a result of the increase in FDI and the prominence of intrafirm trade, investment is increasingly associated with trade in the 1990s. A comparison of the merchandise, affiliate, and IFT trade balances between the United States and Europe on one hand, and the United States and Japan on the other, yields very different results. The relative convergence of these three measures in the Japanese case (figure 6-4) and their divergence in the European case (figure 6-3) are closely associated with the bilateral balance of foreign direct investment in both cases.
8. Affiliates of foreign-based MNEs account for a substantial portion of the U.S. merchandise

trade deficit (see figure 6-1). Intrafirm trade is a major factor. In 1980, foreign affiliates in the United States imported \$36 billion more from their parents than they exported to them. By 1990, the IFT trade deficit had more than doubled to reach \$88 billion dollars. In 1992, IFT totaled \$331 billion or about 38 percent of all U.S. merchandise trade.

9. The character of U.S. intrafirm trade with Europe differs markedly with the character of U.S. IFT with Japan. Over the past decade, IFT has accounted for 71 percent of all merchandise trade between the United States and Japan as opposed to only 43 percent of all U.S.-European trade (see figures 6-5 and 6-6). Over the same period, Japanese MNEs have dominated intrafirm trade with the United States, accounting for 92 percent of bilateral IFT while European MNEs account for 57 percent of U.S.-European IFT (see figures 6-9 and 6-10). These figures indicate that the U.S.-Japanese trading relationship is heavily weighted toward Japanese MNEs, and that the U.S. relationship with Europe is more evenly diversified across corporate structures and national ownership. The U.S. and European economies are, accordingly, far more integrated than are the U.S. and Japanese economies.