VALE COLUMBIA CENTER
ON SUSTAINABLE INTERNATIONAL INVESTMENT
A JOINT CENTER OF COLUMBIA LAW SCHOOL AND
THE EARTH INSTITUTE AT COLUMBIA UNIVERSITY

Columbia FDI Profiles
Country profiles of inward and outward foreign direct investment
issued by the Vale Columbia Center on Sustainable International Investment
January 21, 2010
Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)

U.S. outward FDI: Current flows lowered in weakened global economy but attraction of emerging markets remains

by
Marilyn Ibarra-Caton and Raymond Mataloni Jr.[*]

United States (U.S.) outward foreign direct investment (OFDI) was $65 billion during the third quarter of 2009 (annex figure 1). The average flow during the seven quarters of the current recession (Q1:2008 to Q3:2009) decreased 17 percent, compared with the last seven quarters of the expansion that preceded it (Q2:2006 to Q4:2007; henceforth "expansionary period"). The pronounced decline in U.S. OFDI parallels the broader falloff in business investment worldwide in the current economic recession. Despite the slowdown in U.S. OFDI flows, they remained over 25 percent higher than the average for the preceding five years, which is partly attributable to the continuing attraction of big emerging markets.

A protracted recession

The current recession, which began in December 2007, could rank as the longest U.S. economic downturn since the Great Depression. In addition to the severe economic downturn of the U.S. economy, global economic indicators have registered sharper declines than in the previous two global recessions of 1981 and 1990.[1] Has the severity and duration of the current global recession corresponded with a severe and sustained reduction in flows of U.S. OFDI? During the current recession, these flows fell 17 percent in current dollars, to $483 billion, from $585 billion in the expansionary period. Over three-fourths of the decline occurred in net equity capital flows—largely payments to acquire or establish new foreign affiliates (annex figure 1). During the current recession, equity capital flows were $101 billion, or 50 percent lower than the $202

---

[*] Marilyn Ibarra-Caton and Raymond Mataloni are economists in the Balance of Payments Division, U.S. Bureau of Economic Analysis. The authors can be reached at marilyn.ibarra-caton@bea.gov and raymond.mataloni@bea.gov. **The views expressed by the authors in this article do not necessarily reflect those of the BEA or of Columbia University or its partners and supporters.** This profile does not yet follow the format established for this series. The authors wish to thank Welby Leaman, Robert Lipsey and Theodore Moran for their helpful comments on this *Profile*. ***Columbia FDI Profiles* is a peer-reviewed series.**

[1] M. Ayhan Kose, Prakash Loungani and Marco E. Terrones, "Out of the ballpark," 46 (2) *Finance & Development* (June 2009).

billion in the expansionary period. Changes in the two other components of FDI—reinvested earnings and intercompany debt—accounted for a small decline in flows of U.S. OFDI. Reinvested earnings—the parent firms' share of affiliates' earnings that are reinvested--declined 5 percent during the current recession. Intercompany debt flows—loans between parent firms and affiliates—are a very small component of U.S. OFDI and are extremely volatile; they change direction frequently because the loans, which are often for the purpose of providing short term financing for intra-firm trade, tend to be repaid soon after they are created.

Equity capital flows for new investments experienced a sharp decline (49 percent) during the current recession. The pronounced decline in equity capital flows for new investment coincided with a worldwide decline in global merger and acquisition activity. According to Thompson Reuters, global merger and acquisition activity fell by 40 percent during the current recession, from the expansionary period. In Europe, the value of merger and acquisition activity decreased 34 percent and, in Asia Pacific, it decreased 27 percent. A sharp decline also occurred in the average size of U.S. OFDI transactions which fell by 34% from $230 million in the expansionary period to $150 million in the current recession. This tracks the 34% decline that Thompson Reuters reports in the average size of global transactions between the two periods.

Long term trends in equity capital flows for new investments become more apparent when viewed in the context of a moving average because a single large transaction can dominate flows in any given period. A four-quarter moving average reveals that movements in equity capital flows for new investments have not always paralleled movements in the business cycle (annex figure 2). For example, the increase that began in the third quarter of 2003 peaked in the fourth quarter of 2004 and then began a decline that lasted until the second quarter of 2006; this decline was not associated with a worldwide drop in economic activity, according to data from the United Nations, or with a drop in worldwide M&A activity, according to data from Thompson Reuters (annex figure 2).

The increase in equity capital flows for new investments that began in the third quarter of 2006 and continued through 2007 was propelled by acquisitions or establishments of affiliates in various industries, including finance (except banks) and insurance; oil and gas extraction; wholesale and retail trade; professional, scientific, and technical services; and several manufacturing industries, such as pharmaceuticals, transportation equipment, and machinery.

The decline in equity capital outflows for new investments has been accompanied by a decline in equity capital *in*flows, resulting from the sale of foreign affiliates. Selloffs declined by 48 percent during the current recession compared with the expansionary period; this decrease is similar to the 51 percent decline in outflows. The paucity of sell-offs and new investments may be related to difficulties in financing deals in the current risk-averse environment and to banks' reluctance or inability to renew and extend credit lines and insistence on tighter credit terms. These factors may have played a role in shrinking the pool of potential buyers.

During the current recession, U.S. parents firms chose to reinvest about the same share of their affiliates' earnings as they did in the expansionary period. Unlike equity capital flows which declined at the onset of the recession—in the first quarter of 2008—reinvested earnings and total earnings held up through the second quarter of 2008 as affiliates' earnings were boosted by the depreciation of the dollar against many foreign currencies and by growth in global economic activity through the first quarter of 2008. The share of earnings reinvested trended upward through 2008, indicating that parent firms were still choosing to invest in their foreign affiliates rather than remit their earnings to the United States (annex figure 3).

The attraction of emerging markets

Despite weak economic conditions, U.S. multinationals have continued to expand their investments in newly emerging markets at a more rapid rate than in advanced economies. Average quarterly U.S. OFDI decreased 14 percent for low-to-middle-income countries during the current recession, compared with 39 percent for high-income countries.[2] This pattern primarily reflects the attraction of new, rapidly growing consumer markets in emerging markets where foreign affiliates of U.S. multinationals typically sell most of their output to local customers. To illustrate the potential of one of these new markets, consider that there were only about 10 automobiles per 1,000 people in China in 2005, compared with 500 per 1,000 people in the United States.[3]

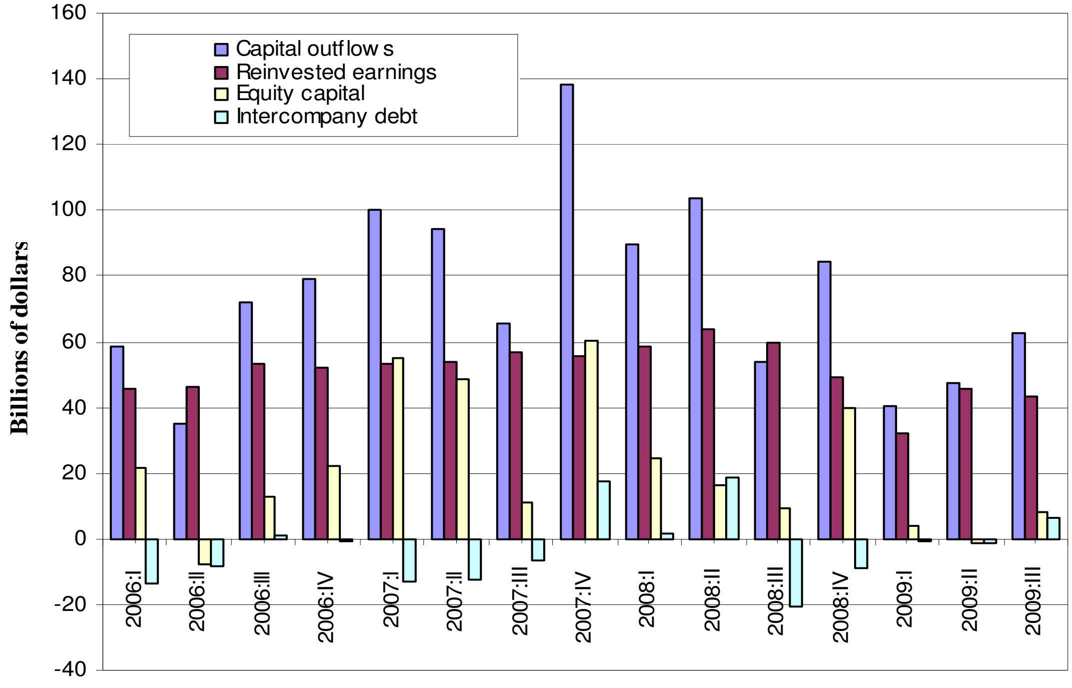
These burgeoning national markets present attractive business opportunities that are at least partially sheltered from the effects of business cycles elsewhere in the world. The rate of return for U.S. FDI abroad has remained significantly higher in the big emerging markets than in the more advanced economies during the current recession. In high income countries, it was roughly 10 percent, compared with nearly 20 percent in low-to middle-income countries.[4] U.S. multinationals have tended to reinvest their affiliates' profits to expand their business ventures abroad and to seek out new opportunities; this pattern has continued in the emerging markets.

[2] These figures exclude investments in countries that tend to host a disproportionate number of holding companies. A significant portion of direct investment capital flows associated with these countries are ultimately destined for use by affiliates in other countries. See, for example, "Holding companies in the data on U.S. direct investment abroad," in Marilyn Ibarra and Jennifer Koncz, "Direct investment positions for 2008: country and industry detail," *Survey of Current Business,* 89 (July 2009), p.25.
[3] L. Alan Winters and Shahid Yusef (eds.), *Dancing with Giants: China, India, and the Global Economy* (Washington D.C.: World Bank, 2007).
[4] These rates of return were calculated as the ratio of direct investment income to the average of the beginning- and end-of-period direct investment positions. The imprecision of the resulting estimates is a result of the denominator being at historical cost, which, in most cases, is the original cost of the investment. Under normal (inflationary) price conditions, older assets will be undervalued relative to newer assets and, thus, yield an overstated rate-of-return. For this reason, the estimates presented here are intended *only to give a rough impression* of the relative rates of return in highly developed economies and in emerging markets. For an exposition of the valuation issues involved, and for a description of methods to estimate rates of return in current-period prices, see Ned G. Howenstine and Ann M. Lawson, "Alternative measures of the rate of return on direct investment," *Survey of Current Business,* 71 (August 1991), pp. 44-45.

Many U.S. firms find that they must serve these foreign markets through direct investment rather than through exports from the United States. Having a local presence allows firms to be more responsive to customers and, in many cases, to offer a lower price. For large markets, like China, foreign affiliates are increasingly conducting their own research and development in order to tailor products to local tastes and to comply with local regulations. Research and development expenditures by Chinese affiliates of U.S. companies, for example, increased from less than $50 million in 1997 to over $1.1 billion in 2007.[5] Production of goods in the host country also allows firms to avoid the shipping costs that would have to be incurred if they chose to serve these markets by exporting from the United States. Production of services in the host country is often necessary, either because proximity to the customer is necessary to deliver the service or because of restrictions on the provision of certain services by nonresidents. Nearly three-quarters of total sales by Chinese and Indian affiliates of U.S. companies were to local customers in 2007.[5] An additional attraction of emerging markets is that labor costs there are usually significantly lower than those in the United States, although finding workers with the necessary skills can be difficult.

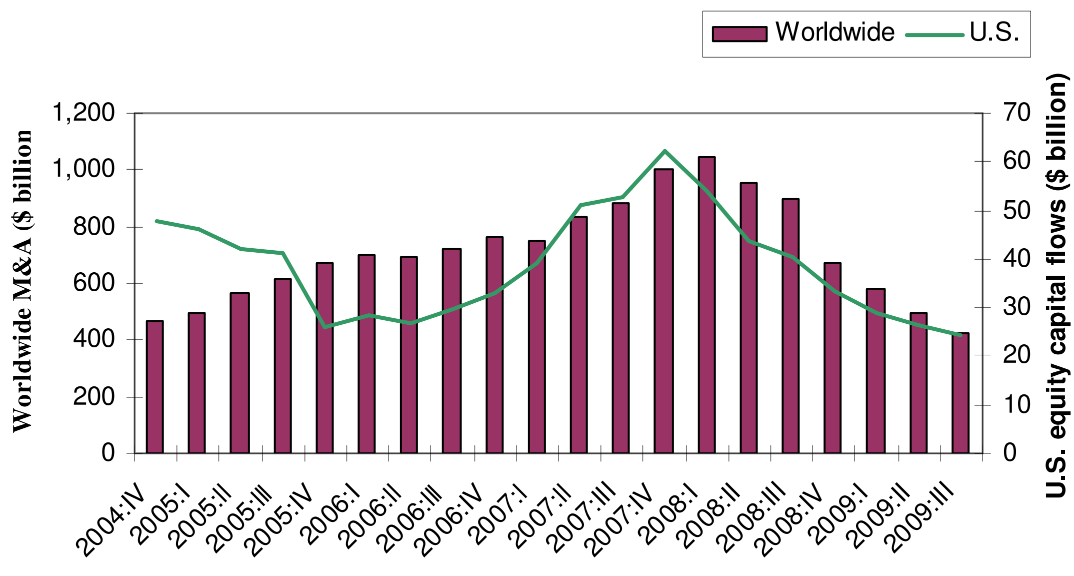
[5] U.S. Bureau of Economic Analysis, https://www.bea.gov.

Annex figure 1. Quarterly flows on U.S. outward foreign direct investment, by component, seasonally adjusted, 2006:Q1-2009:Q3



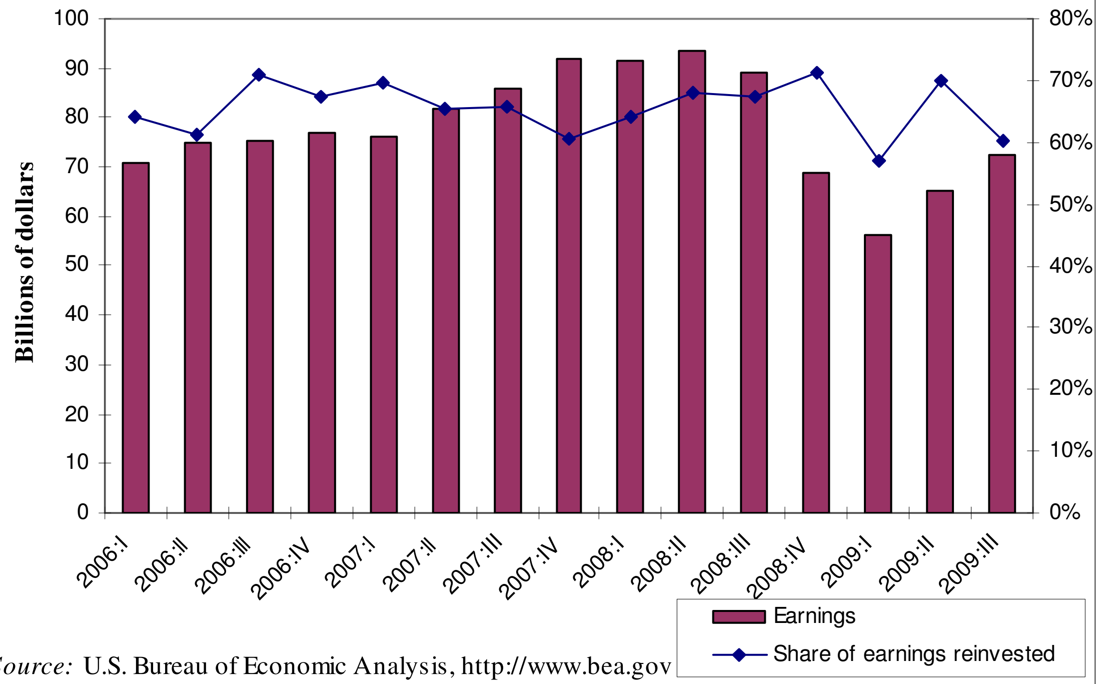
Source: U.S. Bureau of Economic Analysis, http://www.bea.gov

Annex figure 2. Equity capital flows for new U.S. investments abroad and value of worldwide mergers and acquisitions, four-quarter moving average, 1999:Q1 to 2009 Q3



Source: U.S.Bureau of Economic Analysis, http://www.bea.gov, and Thomson Reuters M&A

Annex figure 3. Seasonally adjusted quarterly earnings and the share of earnings reinvested, 2006:Q1 to 2009:Q3



Source: U.S. Bureau of Economic Analysis, http://www.bea.gov

* * * * *

The material in this *Profile* may be reprinted if accompanied by the following acknowledgment: "Marilyn Ibarra-Caton and Raymond Mataloni Jr., 'U.S. outward FDI: Current flows lowered in weakened global economy but attraction of emerging markets remains,' *Columbia FDI Profile, January 21, 2010. Reprinted with permission from the Vale Columbia Center on Sustainable International Investment (www.vcc.columbia.edu)."*

A copy should kindly be sent to the Vale Columbia Center at vcc@law.columbia.edu.

The Vale Columbia Center on Sustainable International Investment (VCC), led by Karl P. Sauvant, is a joint center of Columbia Law School and The Earth Institute at Columbia University. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. VCC focuses on the analysis and teaching of the implications of FDI for public policy and international investment law.

See also:

- *Columbia FDI Profile,* Andrei Panibratov and Kalman Kalotay, "Russian outward FDI and its policy context," October 13, 2009.
- *Columbia FDI Perspective No. 13*. Luís Afonso Lima and Octavio de Barros, "The growth of Brazil's direct investment abroad and the challenges it faces," August 17, 2009.
- *Columbia FDI Perspective No. 12*. Michael Mortimore and Carlos Razo, "Outward investment by trans-Latin enterprises: reasons for optimism," August 17, 2009.
- *Columbia FDI Perspective No. 11*. Jaya Prakash Pradhan, "Indian FDI falls in global economic crisis: Indian multinationals tread cautiously,"August 17, 2009.
- *Columbia FDI Perspective No. 5*. Ken Davies, "While Global FDI Falls, China's Outward FDI Doubles," May 26, 2009.