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USA

The European Economic Challenge

by Professor Gustav Schachter* and Professor Bruce C. Cohen**, Boston, Mass.

For the last three years we have witnessed renewed efforts of European investors to share in the general prosperity in which America is engulfed. Their own rapid economic advancement permits them to do this. European investors have funds to spare and they are shopping in places of best accommodation. Indeed, the rate of long-term European direct investment in the United States has doubled since 1966, and might be expected to redouble by 1970. It seems that le défi Americain of yesteryear might become le défi Européen of the future.

Statistics

Historically, the European economic challenge to America appears to be backed by statistics. For the last ten years, Western European total assets in the United States have been larger than USA total assets in Europe¹. In the early 1960's, the inter-European-United States change of assets was evenly matched with no apparent change. But in just two years, 1967 and 1968, Europeans have invested \$5.4 bn more annually in the United States over the return flow from the United States. These years have witnessed a great break-through in the average growth rate of European investment in the United States². The biggest inroads have taken place in oils and chemicals. The British Petroleum (BP) takeover of Standard Oil of Ohio is the latest chapter in this story. Other sectors also have witnessed the resurgence of European investment. The European investor, amazed with his own ten years

of success in Europe, now seeks greener pastures of investment.

Most European countries achieved full convertibility of their currencies only about ten years ago when the Common Market was also created. But, then, the 1950's economics of underemployment of (now) Common Market partners changed into economics of overemployment; from chronic exchange deficits, France, Germany, and Italy, combined, by the early 1960's have had more gold reserves than the United States. Foreign trade climbed to dazzling heights. Inflationary pressure associated with rapid growth took place, but did not significantly affect the international payment position of these European countries. Low wages lagged behind the rapid growth in industrial productivity. Genuine and forced thrift acted as a valve to domestic demand, making it possible to respond to continuously expanding foreign demand. Between 1963 and 1969, Western Europe's total exports (excluding the United Kingdom) increased by 100 p.c. By 1969, Western European exports (about \$90 bn) accounted for half of the industrial world trade, which was more than double that of the US. Physical imports behaved in the same manner, but because of the difference in composition, larger value added in conversion of exports vis-à-vis imports was recorded. This released funds which could be beneficially used elsewhere. The United States market has been one of the choices of the European investor.

As in the past, the bulk of European investment in the United States has been of the „indirect“ type, that is, United States government obligations and corporate stocks and bonds³. Only 7 p.c. of all European assets in the United States

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¹ In 1961, total European investments in the United States were \$27.4 bn and United States assets in Europe were \$22.7 bn. In 1968, these figures had changed to \$47.9 bn and \$39.7 bn, respectively.

² The rate of change has increased from 5 p.c. annually in the early 1960's to about 12 p.c. in 1967-68.

³ US Government obligations purchased amounted to \$20 bn in 1968 and \$16.2 bn were accounted for by corporate stocks and bonds.

consist of direct investment, that is, plant and equipment. Europeans have usually preferred low risk to a high return. Indirect investment in the United States means participating in the most important, the widest, and the best organized capital market. The European capital market is both narrow and unreliable. On the other hand, opportunities for direct investment have been, as shown, plentiful in the expanding market of Europe for the last two decades; no overt need was felt to enter on a grand scale in foreign industrial ventures.

New Trends of Direct European Investment

Since 1966, it seems that even in the field of European direct investment in the US a new impetus is shown. The rate of European direct investment in the US more than doubled during the 1967-68 over the earlier period. By 1970, the rate may redouble again. In 1960, Western Europe invested \$ 255 mn in US plants and equipment. This investment flow tripled by 1969 to a rate that by 1970 may approach \$ 1 bn annually. While this development appears large, it is a mere pittance (about 1 p.c.) in comparison to the nearly \$ 90 bn rate of investment domestically by US firms. Nonetheless, this is an interesting trend in terms of changes in investment volume, the sectors where investment takes place and the country of origin.

True enough, European's share of direct foreign investment in the US did not significantly change between 1937 and 1969—about 70 p.c. then and now. Between 1950 and 1968, the value of tangible assets of European firms in the US increased three times over from a base of \$ 2.3 bn to \$ 7.8 bn⁴. Of this increase, \$ 1.5 bn is accounted for by 1967-68 alone. For this same period, the Canadian share (which accounts for the biggest non-European proportion) of the increase fell and that of Europe rose⁵. If this trend continues, and it is expected to, will European investors dominate the US economy or sectors of the economy? Will Americans have to face a "European Challenge"?

The Industrial Impact in the US

It already appears that some branches of the economy have been affected, as has been noted for the oil industry. But the sheer size of the United States market is so vast (100 mn cars on the road) and highly developed that the change from domestic Sinclair and Sohio to foreign-owned BP has little more effect than the proverbial fly on the ear of the elephant⁶.

⁴ In 1937 European assets in the US were \$ 1.3 bn.

⁵ Canadian assets from \$ 1 bn in 1950 to \$ 2.7 bn in 1968 of which only \$ 200 mn were recorded in 1967-68.

Other branches of American industry are more vulnerable. The chemical industry might be hard pressed by Rhone-Poulenc, a French industrial giant with world-wide sales exceeding \$ 2 bn. The famous French firm of St. Gobain who, in partnership with the American Certain-Feed Company, only two years after entry into the American market, sold \$ 50 mn of fiber glass for use in accoustical and thermal insulation; this places this team No. 2 in sales in this branch of industry⁷. In the same general field of chemicals and synthetics, Montecatini Edison of Italy and Courtauld of England are already well-trenched in the United States market.

Few of the remaining branches of United States industry are spared new European competition. German investors have moved strongly into machinery and steels and to the surprise of many observers, the French have entered the super-sophisticated American electronics equipment industry. European companies compete even with long established Canadian enterprises in the United States as in aluminum.

The Relative Shares of European Direct Investment

The trickle of European investment in the 1950's turned into rapids in the late sixties and may become a flood in the 1970's. How did the relative shares of the several European countries change?

Historically, the United Kingdom has had the largest share of total European investment in the United States. In 1950, the United Kingdom investment exceeded that of all other European countries combined. This share is steadily eroding, but not because there is an absolute decrease of United Kingdom investment. On the contrary, United Kingdom, along with the Netherlands and Switzerland, which together are second in size, all held their own over the decade⁸. The other European countries have only a small share of the American market but they press hard in some sectors of the United States economy. In the case of Germany, investment rose by 58 p.c. in 1966-68 and France and Belgium experienced a rise of over one-third for the same period. It stands to reason that the Germans, with the strongest economy in Europe, should push the hardest. With exports in absolute terms of \$ 24 bn, Germany ranks just behind the United States and far ahead of the United Kingdom and Japan.

⁶ What might indeed have a significant impact on the oil market would take place if the quota system broke down and the barriers to develop Middle East oil in the United States fell. But then BP and the domestic oil firms would be flooded in the same tide. While this development is economically defensible, it is politically unrealistic at this time.

⁷ Journal of Commerce, August 27, 1969.

⁸ United Kingdom total investment was \$ 1.2 bn in 1950 and \$ 3.4 bn in 1968.

European entrepreneurs have begun to realise the potential of the United States market and are rapidly bettering their position through location of plants in the United States. The new drive of direct European investment is not only because of tariffs—this is part of it—but due to other facilities available in the United States. European entrepreneurs feel that the United States market offers externalities which are often lacking at home: a large and accessible pool of managerial talent, sophisticated marketing analysts, a skilled labor force and, above all, a highly organized capital market.

The United States counterpart in Europe uses funds available in Europe, which accounts for about 90 p.c. of all United States investment, but bring with them their external advantages. Accordingly, the United States firm in Europe is relatively independent of the European economic power structure in their foreign operations. On the other hand, the European firm operating in the United States still depends to a large measure on the United States industrial establishment. This implies that the European entrepreneur requires relatively more skill to survive the stark labyrinth of United States "big business".

The Europeans seem more frightened of United States inroads in Europe than vice-versa. In great measure, this is based on fear of the strength of externalities that United States firms enjoy, and, in addition, superior business organization. The European firm is still largely family oriented, the educational system is still elitistic and leaning heavily towards humanities rather than sciences, and too little is budgeted for research and development. The American firms solved these problems (or it was solved for them by United States society) decades ago.

European Firms Hampered

The European firms in America are further hampered by US Government regulations more stringent than at home. The anti-trust policies are equally applied to domestic and foreign companies. In the case of BP, it took a bit of push and pull to have the Justice Department give the green light for the acquisition of Sohio. In Europe, even though anti-trust legislation exists on the books of most countries, this legislation is sparingly applied, if at all. Also, European firms in the US must face many enforced regulations imposed by such agencies as the Security Exchange Commission, Federal Trade Commission and the Food and Drug Administration, not to mention regulations and taxes imposed by all levels of government, i.e., Federal, State and Local. While legal barriers to foreign direct investment have not been the expressed intent of these laws and regula-

tions, their impact has been to discourage European investors.

The net effects of the investment flows have not had important balance of payments impact for the countries concerned—certainly not in the case of the United States⁹. Because of its strength, the American economic penetration in Europe is not matched by a similar European inroad in the United States. The American firm in Europe can outbid its European rivals in capital flotations, job offers, and in the production and distribution of final goods.

Modern Technology Required

It is apparent that the success of European firms in the US depends both on the transformation of the European economic structure and the United States attitude toward these firms. The Europeans need to revamp their educational system to obtain more high caliber specialists in technical fields. Once trained, special incentives must be forthcoming to retain them. More funds and will are needed for research and development which is necessarily the basis of modern industrial venture—it is difficult to penetrate a foreign market with borrowed technology. Business organization must cross frontiers, loosen the paternalistic and nationalistic ties, and in the process gain new strength to compete with the US industrial giants. The Americans on their part insist that they wish to attract foreign interest to the US, but facts belie their wish. Differentiation must be applied—unless the consumer gets hurt—between rules applied to domestic firms and foreign firms. If indeed America wants more competitive markets, the European firms added to a sector will weaken monopolistic practice and give the consumer a wider choice. Increased foreign investment eases, even marginally, the pressure in the US Balance of Payments and creates new jobs.

As it stands now, the percentage increases in European direct investment in the US over the last three years is spectacular, but its impact on the US economy is minimal. It adds little to competitive forces—US firms complain about the low tariff of imports in many branches but no widespread fear has been shown about European firms in the US. On the other hand, European firms in the US must show enough strength not to fall eventually under the control of their US counterparts. The European firms face a challenge from the American firms at home in the US. Economically strong, Europe can, if it wishes, meet the test.

⁹ In 1968, for example, only 10 p.c. of American investment in Europe was financed directly by the United States investors. About 40 p.c. European investment in the US was financed directly by Europeans.