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Direct Investment as Seen by German Industry

by Dr Wolfgang Pohle, Düsseldorf †

The pros and cons of direct investment are attracting more and more attention in public discussion. In the following article, Dr Pohle, who was not only a highly successful businessman but also an influential and much respected Member of Federal Parliament, examined the possible positive and negative repercussions of direct investment from the point of view of German industry.

Twice in succession have German business firms with investments abroad lost all their foreign assets with no or, at best, trifling compensation. It is not surprising therefore that the volume of German investments effected abroad since the Second World War does not adequately reflect the position and potentialities of the Federal Republic as one of the strongest industrial and commercial nations in the world.

Small Net Capital Flows

The total net outflow of private capital from the Federal Republic in 1952-68 amounted to DM 14.3 bn, of which DM 8.1 bn went to Europe, DM 862 mn to Africa, DM 4.7 bn to America and about DM 600 mn to other continents. A comparison of these figures with the development of German exports—in 1970 the Federal Republic exported goods to the value of about DM 125 bn—and with the aggregate of capital exports by private firms which in 1970 alone reached about DM 8 bn, shows clearly that over a long period of time there has been a disproportion in the pattern of German foreign trade.

The Federal Republic does not show up well either if its private investments abroad are compared with those by other states. By the end of 1968 US business firms had invested abroad the equivalent of about DM 245 bn; US plants in other countries now produce three and a half times the amount of goods exported directly from the USA. The corresponding figures for Great Britain and France (up to the end of 1967) are DM 54 and 24 bn, respectively.

That German industry is thus lagging behind in what is an extremely important field of business activity must, leaving the psychological impediments of the wartime expropriations aside, be attributed to the economic policy of government. Despite the high risk element of direct financial

commitment abroad, German tax law has hitherto made no distinction between investments abroad and internal investments, a shortcoming which has not been fully remedied by the Development Aid Tax Law and various financial incentives.

It was only in 1968 that a new law enabled German firms to set off losses from foreign plants against domestic earnings. As an immediate consequence of this measure direct investment abroad by German firms (not counting portefeuille investments) increased in 1969 by DM 2.1 bn and in 1970 by DM 2.5 bn. What then are the advantages of direct investment in foreign countries for the investing firms and for the general economic situation in donor and recipient countries?

Motivation of Firms ...

A large variety of motivations may and in fact do give rise to business ventures in the field of foreign investment as in other fields of commercial enterprise. Only a few factors considered essential shall therefore be pointed out here.

A field survey gave the following motivation rates for German firms investing abroad: Safeguarding market position and other compelling motives 82 p.c.; opening up new markets 62 p.c.; tax and financial incentives 25 p.c.; goodwill motivations 22 p.c.; low wages 18 p.c.; safeguarding raw material supplies 12 p.c.; creating additional outlets for other products of the firm 10 p.c.; private motives 10 p.c.; labour shortages in the Federal Republic 5 p.c.; low prices of raw and other materials 4 p.c. (The percentages add up to more than 100 because the question allowed for more than one answer at a time.)

These figures are global ones and cannot be claimed to be universally valid. The manpower shortage in the Federal Republic, for instance, may well be a much stronger incentive for investments abroad than the 5 p.c. shown here sug-

gest, while the safeguarding of a market position and other compelling motives at 82 p.c. probably overstate the case greatly. The survey was merely intended to show up the various motives which may combine in an individual case.

The explanation traditionally given for moving business activities to a foreign country is essentially one of cost considerations. It is a matter of price policy. Reference is generally made chiefly to international cost differentials in wages and capital or credit as determinants of current production abroad and, possibly, its re-export. Today however variations between countries in the cost of power and the incidence of taxation are attaining increasing importance for the location of production plants.

... for Direct Investment Abroad

The tax regulations of the capital importing country—e.g., the rate of profit tax, depreciation allowances and the incidence of turnover and consumption taxes—are also of importance. Investing firms will regard divergencies from the aggregate tax burden in the home country and the features of special laws for the encouragement of investment in individual countries—tax oases!—as significant factors.

Favourable conditions for obtaining the requisite means of production also play a role. The present labour market situation in most western industrial countries as compared with some of the capital importing countries is indeed one of the most important motives for making investments abroad. If there is a reservoir of unemployed labour in capital importing countries and if because of the relative level of wage costs competition by suppliers located in these countries cannot otherwise be countered, a firm will choose to set up its own branch enterprise there. The underlying idea in general economic terms is that it is better to take capital to underemployed countries and operate there more productively than to move labour from these countries to industrialised states with full employment.

The procurement of capital must be considered in this context. Financing opportunities and costs in other countries must be taken into account as well as the situation in the property market and the feasibility of obtaining raw, ancillary and fuel materials on more favourable terms than trade obstacles and transport costs may allow in the home country.

Sales Promotion as a Crucial Factor

Considerations of sales policy must still be regarded as among the crucial factors. Of significance are:

- ☐ The size and foreseeable growth of national income and consumer demand in industrialised and newly emerging national economies;
- ☐ The possibility of cutting down transport costs, transport schedules and transport damages by transferring production abroad;
- ☐ The chance of making the marketing system and selling organisations more efficient by moving them nearer to the market and increasing sales by marketing and servicing on the spot—if only to remind the customer of brand-names and designs—is a motive which applies with particular force to the foreign branches of the export houses;
- ☐ The opportunity to circumvent import restrictions and tariff walls by starting production in other countries;
- ☐ The intention to overcome psychological barriers, for foreign ownership of a company is not always and immediately self-evident.

General Economic Advantages

There are a good many reasons of a general economic nature which also favour increased export replacement by direct investment. These general economic advantages of course also work to the benefit of the individual enterprise. A distinction must be made between the following:

- ☐ Monetary policy aspects: An investment abroad in most cases begins with a money transfer which involves an outflow of foreign currency. For a country with a balance of trade surplus—as, for instance, the Federal Republic—this effect is of twofold importance: On the one hand, the outflow neutralises the inflow of foreign exchange liquidity which might otherwise drain away the foreign currency reserves of other countries. Internally such inflow would result in a possibly undesirable expansion of demand and thus upset the economic balance.

On the other hand, investment abroad, though leading to an outflow of foreign currency, does not result in complete loss of foreign currency. It would be more correct to speak of a foreign currency shift. The actual and potential return flow of foreign currency when holdings in foreign subsidiaries are disposed of, and in particular the dividend receipts which may be expected in the long term, justify the remark that capital investments abroad are partly in the nature of "hidden currency reserves". All industrial nations must attach importance to such currency reserves and steadier currency earnings in general because the risks and uncertainties inherent in export deals and economic relations with the outside world are great.

□ Trade policy considerations: There are many grounds for assuming that the production and supply basis for deliveries to foreign markets needs strengthening. There is, first of all, the threat from protectionism which has not yet been fully banished from international trade; of late it has again become acute. It is advisable on this score alone to establish foreign branches and acquire interests in foreign firms so as to maintain and extend world market positions. Besides, increasing product specialisation and need for adaptation to increasing demand differentiation make it imperative in the case of many products to establish production and marketing facilities close to the consumer and to offer a complete service in conjunction with them so as to maintain previous positions and gain new ones.

Above all, the growing economic strength of some developing countries is such that in view of the import restrictions often applying in these same countries the markets concerned must be won and defended against local and international competitors.

□ Raw material supply factors: The wish to participate in the production of essential raw materials is another aspect of investment abroad. It stems not so much from a need for self-sufficiency as from appreciation of the fact that the shock of economic and political events can today still be absorbed with the help of certain stop-gap and by-pass facilities. Such alternatives are of course more likely to be available if as many firms as possible share in the production of raw materials abroad than they are if important raw material sources are concentrated in a few foreign hands.

□ Reasons of economic policy: Foreign investment acts on cyclical fluctuations essentially as a stabiliser, providing twofold support for anti-cyclical measures against an expanding or excessive aggregate demand at home; a part of the investment demand is diverted from the tight domestic markets for labour, construction services and equipment to other economies. The consequent outflow of foreign currency lowers the banks' liquidity which in the prevailing situation is, from the point of view of steering the cyclical trend, the correct effect. Besides, the individual enterprise and the economy in its entirety are likely to benefit if in the event of a constrictive economic policy or recession the possession of foreign interests enables domestic firms to seek compensation through business outlets established abroad.

Direct investment is of considerable importance however, not only to the capital investing countries, but to the capital importing countries and their economies. Capital imports and exports are of course interdependent. A distinction must be

made, because of their great structural differences, between the mature economies, known as industrialised countries, and the underdeveloped or undeveloped economies, the so-called developing countries. Their operating mechanisms however have some common features. If a country receives direct investments in excess of those which it effects itself in other countries, these investments will in national economies with a tendency towards a balance of payments deficit have the effect of reducing such a deficit; they will thus make a corrective policy less painful than it is as a rule.

Effects for the Capital Importing Countries

On the other hand, they will widen the scope for growth in the recipient economy with, in part, quite desirable side-effects on structural policy. The following aspects may be pointed out:

□ Significance for the balance of payments: The impact on the balance of payments of recipient countries is basically favourable. The capital brought in may possibly be withdrawn later but the imported assets will as a rule be available to the developing countries for a long time. Besides, earnings are not likely to accrue in the early years to any significant extent if at all and the foreign currency position is thus unlikely to be impaired during this period. Experience also shows that a large part of any earnings is re-invested for a number years.

□ Importance for growth, employment and incomes: The transfer of savings from one national economy to another one results in an addition to the capital stock of the recipient country. If the investment ratio remains constant, more is therefore available for consumption; and if the investment ratio is raised, higher prospective consumption in the future need not be paid for by forgoing current consumption.

It will be one of the main preoccupations of developing countries in the long view to incorporate the practically unlimited reserves of labour into a meaningful employment system. Successful foreign direct investment helps to mobilise the national savings in the developing countries and step up gradually the savings and investment rate. Consequent improvements in the capital market and in investment climate allay inclinations towards the expatriation of capital.

□ Impact on industrial efficiency: If market gaps are closed and technically demanding manufacturing operations introduced into a country, the resulting gain in know-how will be of benefit to the executive echelons as well as the operatives with lesser skills. This new knowledge will be spread to the old-established enterprises by the natural fluctuation of labour. Price and substitution competi-

tion by foreign investors also tends to improve efficiency. It speeds up adjustment processes and exercises a stabilising effect on prices, while participation in technical progress raises the growth potential to a higher qualitative level.

In developing countries as elsewhere the continuous introduction of skilled management and know-how provides a gradual training in management attainments and furthers the autonomous evolution of such qualities. The encouragement of market economy patterns and the emergence of a middle class can form the nucleus of an advance to genuinely constructive competition and the establishment of a sound economic order.

Summing-up

Together with the many positive aspects of direct investment abroad which have been described, the investing firms must accept heightened risks and hazards. In this context mention need only be made of the possible difficulties in administration and taxation and the great political un-

certainities often met in capital inviting countries. Besides, there are the currency hazard and the risks arising from differently and perhaps less highly developed legal systems. These difficulties and impediments must be overcome by official incentives since private capital investment in less developed countries benefits both the donor and the recipient countries. Different circumstances in individual cases make for differences in approach and emphasis. But direct investment is bound to have an impact everywhere on market preservation, supplies, economic stability, cyclical upturns and downturns, the labour market and the balance of payments. It is therefore of importance for economic integration on a world scale; for economic growth and technical progress make the trend towards international business groupings, to multinational companies, inevitable. The search for alternative outlets in international markets involves integration with these markets and thus a high degree of exchangeability of technologies both as an aim and in reality. Total and global communication and liberalisation of world trade policies are the consequences to be desired.

Singapore – An Asian Economic Miracle

by Ronald Holloway, Toronto

The island's rapid industrialisation over the past decade and its development as the main trade and financial centre of South-East Asia, supported by a phenomenal growth in tourism, constitute yet another Asian economic miracle.

Aided by trade with Indonesia, increased exports resulting from the war in Vietnam, and a large influx of manufacturing investment, the GDP of Singapore now exceeds US \$1.5 bn and, with growth rates in double figures, the per capita income is one of the highest in Asia. The island republic is also notable for its political stability.

Development Board

Entrepot trade remains the basis of the island's prosperity, closely followed by manufacturing and domestic trade. Military services, once the most important sector of economic activity, are rapidly falling in significance. The cuts in British military spending have not only acted as spurs to industrialisation, however, but have also permitted it, with naval dockyards turned over to commercial shipbuilding and repair, including the construc-

tion of rigs for oil exploration in the area, and with a rapid build-up of commercial aircraft repair and the production of components anticipated as the result of military air bases becoming available for commercial use.

Government policy in recent years has been directed towards the expansion of manufacturing with the emphasis on production for export. Of the many steps taken to achieve this aim, the most important have been the establishment of an Economic Development Board, various tax concessions, the gearing of the educational system to providing the skills needed for factory employment, the provision of the region's first container terminal, the expansion of electricity and gas supplies, and tariff protection. As a consequence, manufacturing employment has more than trebled over the past decade.