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**Diskussionspapiere
Discussion Papers**

Discussion Paper No. 133

**Interregional Foreign Direct Investment
- The case of APEC and EU -**

by
Siegfried Schultz

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Deutsches Institut für Wirtschaftsforschung

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I Introduction

Beginning in the 1980s, the global surge in foreign direct investment (FDI) has transformed world economic relations as FDI has become an essential element in today's complex corporate production strategy. Reflecting the globalisation of business activity, the world-wide FDI network is becoming tighter; interregional relations are of growing importance.

The purpose of this paper is to shed some light on the status of APEC-EU linkages in the field of FDI. This will be done against the background of trends at the global level. The interrelation of APEC and the EU will be discussed with the emphasis on East Asia vis-à-vis Western Europe and, where appropriate, with some details regarding Germany. In this context, the motivation of potential investors and their choice of location within Europe will be covered as well. The final section will deal with the extent to which the regional and the multilateral approach of organising world trade and FDI may be reconciled.

I.1 Global and regional trends

Irrespective of the data source employed (UN, OECD, and Eurostat), in the last 30 years world-wide FDI has grown four times faster than GDP and three times faster than trade. The rapid increase in sales of foreign affiliates makes FDI one of the most important mechanisms of international economic integration. The spectacular rise in FDI has probably in most cases complemented and created trade, not substituted it (irrespective of a possible causal relationship also in the opposite direction). Conservative OECD estimates show that at least 40 per cent of world trade is intra-firm trade, thus establishing a link between trade and investment. If compared to trade, FDI flows are only a fraction of international trade flows (around 5 per cent). This comparison is, however, misleading insofar as an investment typically involves a long-term commitment. Its world-wide effects on integration surpass the comparatively limited effects of trading relations.

The European Union (EU)¹ is by far the most attractive destination for foreign direct investors. Of the world's total FDI, which - in terms of stocks - amounted to 1650 billion US-\$ in 1992, about 30 per cent is hosted by the EU (European Commission 1995)². At the same time, the EU is one of the most important sources of FDI representing also about 30 per cent of world-wide outward FDI (470 billion US-\$). The non-OECD countries play a minor, but increasingly important, role. The EU, the US and most other OECD countries have a more or less balanced situation with regard to inward and outward FDI stocks. Japan is an important source of outgoing investment exceeding incoming FDI by far. The same is true for Germany. The non-OECD countries are still mainly net recipients of FDI.

The OECD countries remain responsible for the bulk (95%) of outward FDI in terms of flows, but recently their share of inward investment flows has declined markedly; it went down to half of its previous size within five years. The most notable feature of recent FDI development is the vigorous expansion of investment flows towards non-OECD countries.

At the same time, the more dynamic economies of South East Asia and Latin America have themselves begun to invest abroad, predominantly but not exclusively in other countries of their region, with total FDI outflows of around 9 billion US-\$ in 1992 and 14 billion US-\$ in 1993. FDI from these countries is also directed toward the mature industrial economies of Europe and North America. After Japan had turned up as a major global investor, the Asian Newly Industrialising Economies (NIE) of Hong Kong, Korea, Singapore, and Taiwan emerged as important regional investors after 1987, but have yet to become significant global investors.

As to the type of investment, FDI entry by mergers and acquisitions has become the dominant form, exceeding greenfield entry. There has been a clear increase in the

¹ For the statistical purposes of this paper, the EU comprises of twelve member states (EU-12).

² Based on UN 1994, excluding intra-EU stock (estimated).

numbers of mergers and acquisitions in the major industrial countries during the 1980s, including an increase in larger transactions. It is clearly related in part to the "globalisation" process in the sense that a significant portion of the mergers and acquisitions are *international* transactions. Moreover, besides traditional green field investments or take-overs, modern operators resort to forms of business co-operation, e.g. joint ventures, strategic alliances or the pooling of research and development resources. Particularly if there are explicit restrictions on foreign investment, companies tend to find alternative ways of gaining access to foreign markets. Alliances among enterprises of different nationalities turned out to be an effective way of entering the market, even without straight FDI.

I.2 Development of East Asian direct investment abroad

Although investment flows from some Asian countries - in particular those from Japan - recently shrank considerably, "stocks" (measured in terms of accumulated flows) went up further. This increase has been particularly marked in the case of China and Thailand; it has been noteworthy as well in Korea and Taiwan [see Table 1].

Japanese and Korean companies have focused their attention on North America and Europe while Hong Kong, Singapore and Taiwan have put the accent on investment in the Asian region. For East Asia as a whole, the share of investment going to Western industrialised countries was rising. While North America continues to be the main destination, Europe's share of East Asia's capital transfers also increased temporarily in the run-up to the completion of the European Single Market. In the outgoing flows the following pattern is discernible: in the Asian countries of destination and in North America the aspect of cutting costs is overriding, and it was mainly a matter of establishing new production facilities, whereas in Europe investment in services played a strong role. Germany participated in particular in direct investment from the more important newly industrialising countries.

Table 1

East Asian overseas direct investment
- cumulated flows, in mill. US-\$ -

Country of origin	1980	1985	1990	1992	1993	Average annual increase (%)	
						1990/85	1993/90
Japan	16570	42030	202450	250430	264170	36.9	9.3
Hong Kong ¹⁾	148	640	1511	..	2015 ²⁾	18.7	10.1
Korea	142	487	2056	4460	5516	33.4	39.0
Singapore	652	1320	4276	5468	6235	26.5	13.4
Taiwan	97	204	12888	16443	18854 ²⁾	129.1	13.5
Malaysia ³⁾	414	413	753	763 ⁴⁾	..	14.4	..
Thailand	13	14	399	702	..	95.4	..
China	..	131	3686	8599	..	94.9	..

¹⁾ In 1995 the time series for Hong Kong was drastically revised by the UN; the values are now about one tenth of those given in the year before. For 1992 there is no revised figure.- ²⁾ Preliminary.- ³⁾ Stocks.- ⁴⁾ 1991.
Sources: IMF, Balance of Payments Statistics, Part 1, Washington D.C., 1994; for Hong Kong, Taiwan: UN, World Investment Report, 1995; DIW calculations.

Table 2

Outward direct investment flows
- mill. US-\$ -

Year Region/Country of origin	Average		1989	1990	1991	1992	1993	1981-1993
	1981-1985	1986-1988						
World Total	45.191	133.870	228.613	241.215	193.971	183.914	187.982	1.663.260
of which:								
Europe	25.656	75.706	124.128	144.124	113.600	111.684	100.557	949.490
North America	11.344	25.216	41.417	34.675	37.157	44.660	65.025	355.303
Asia	6.322	27.166	56.242	59.424	38.504	24.853	17.995	310.124
of which:								
Japan	5.094	22.737	44.160	48.050	30.740	17.240	13.740	247.611
Hong Kong	705	1.798	2.921	2.397	3.014
Korea	77	148	305	820	1.357	1.047	1.056	5.414
Singapore	143	168	882	1.570	444	748	767	5.630
Taiwan	52	1.630	6.951	5.418	1.854	1.691	2.421 ¹⁾	23.485
Malaysia	71	-50	121	191	10 ¹⁾
Thailand	2	65	50	140	167	136
China	180	648	780	830	913	4.000

¹⁾ Devided from Table 1.

Sources: IMF, Balance of Payments Statistics Yearbook, Part 1, Washington, D.C., 1994; DIW calculations.

In a world-wide context, new foreign investment took place on a considerably lower level since 1991. This contrasts with the figures available for China.³ The rest of the Asian countries remained at about the previous level, with one important exception: Japan experienced a significant decline, and within three years the flow of new investment shrank to somewhat more than one fourth of its previous volume. In comparison to other newly industrialising Asian countries, Taiwan maintained a high level of outgoing FDI over the whole of the period 1981-93 [see Table 2].

For Asia's dynamic economies - as was the case for the old industrial countries before - foreign direct investment is one of the ways to successful integration into the world economy. They became actors in this field as, on the one hand, consecutive export surpluses had fulfilled an important prerequisite for the exportation of their own capital and, on the other, pressure to keep costs down and to secure markets also forced more and more firms in newly industrialising countries to establish foreign bases. Corresponding with the development of the current account and depending on the repayment of public debt - not considering special factors (e.g., Taiwan's relations with mainland China) - phases of increasing liberalisation of capital transactions abroad could be observed.

As protection against actual, or simply against expected, protectionist measures, investors from East Asia increased FDI in the US and Western Europe in the second half of the 1980s. Towards the end of this period, the imminent completion of the European Single Market triggered a surge of additional investment flows.

For companies from newly industrialising countries there are different motivations to make overseas investment. The main motive is to establish foreign branches in order to ensure continuous access to advanced technologies, production techniques and organisational structures. Investment does not necessarily have to replace exports,

³ The official amount, however, is probably exaggerated, as it includes funds which were injected into Chinese subsidiary companies abroad. In a kind of roundabout fashion, these funds were subsequently channelled back into China, making full use of the preferential treatment given to foreign investors.

instead both may be mutually supportive. This occurs in two ways: Firstly, investment supports the export of services. Secondly, secure and growing markets ensure returns to scale which enable firms to remain competitive in their financial scope for acquiring advanced technological capability. In addition to this, there is design and quality improvement, where market proximity is advantageous.

In as far as East Asian firms have constructed their own production plants in Europe, the supplier system has already been partially 'exported'. Small and medium-sized suppliers tend to follow large multinational firms - their main customers. In some cases the Japanese effectively transplant their keiretsu networks abroad. Also with the local production of components in the host country the political demand for increased use of domestic intermediate goods and higher shares of value added can be met. In fact, Japanese companies are the most advanced on this way to globalising production; however, competitors from Korea and of various Chinese origin (People's Republic, crown colony, Taiwan, Singapore) are moving in the same direction. Dominated by large associations, the organisational structure of Japanese enterprises is in favour of this trend. A similar structure can be observed in Korea ("chaebol") and in China ("guanxi") although they operate on a lower scale yet.

Manufacturing is indeed the standard starting point for extensive investment in industrial countries, but a comparatively high proportion of Japanese and Korean firms have ventured into Europe in the service sector. Besides trade-related investment (banking, distribution), the EU's increased attractiveness - particularly with respect to (Japanese) financial services - was a result of the completion of the Single Market.

The large enterprises from East Asia which are permanently active abroad are trying to effect a long-term orientated strategy with the aim of continuously expanding investment abroad - largely independent of the economic situation in the country of origin and in the host country. In this context a hierarchy in the geographical preference is noticeable. Asia remains the preferred region, with particular attention being paid to China. Recently, investment in EU countries had not necessarily been given high priority, because some major projects had been completed and Europe's economic slow-down

had begun to take its toll. Because of their long-term interest in the opportunities to participate in a growing market, most firms actively engaged in Europe are gearing themselves towards increased sales and reducing distribution costs. The greatest changes are being witnessed by the manufacturing sector in respect of the discontinuation of border controls and customs clearance and the establishment of general standards for safety, health and environmental protection.

In the end, the volume of direct investment from East Asia into the EU will also be dependent on how the foreign trade and payments regime looks in practice. The more restrictive the import procedures, the greater the attraction for foreign investors to enter the market from within the Single Market.

It can be anticipated that the future spectrum of foreign investment from newly industrialising Asian countries will also be complex. Their outward direct investment has now developed a momentum of its own. Medium-sized firms, which are engaged in strong competition with each other, as well as firms with an oligopolistic position on their home market, create a "pull-effect" on their way abroad: firms from the same branch follow in order not to lose ground to their rivals. The aim of the development of global entrepreneurial ventures is clearly discernible in the strategy of firms from NIEs. Korean firms, as well as firms from China and Taiwan, have focused their eyes on the dynamic growth area in East Asia and the Pacific region. At the same time, however, they do not refrain from participating, by means of direct investment, in the economic potential of other important regions.

II The EU's interregional investment relations

The EU has become increasingly important as a destination for foreign direct investors, and has seen rapid growth between 1986 and 1989. However, the high level of investment attained in 1989 and 1990 was followed by a slump beginning in 1991. For 1993, a decrease of 7% was registered. Investment abroad has also been increasing since 1984, with a peak in 1989. Except for 1990 and 1992, the EU has always been a net exporter of FDI capital (Eurostat 1995).

For comparison: The flows *within* the EU have been growing rapidly in recent years. As from 1989, the intra-EUR12 outgoing flows remained higher than the extra-EUR12 flows. This also applies to receipts; member countries received larger flows from their EU partners than from EU-external enterprises. To give an example: In 1993, incoming extra-EUR12 FDI stood at 21 billion Ecu in contrast to 27 billion of *intra*-EU flows, while direct investment going to the outside world was 22 billion as compared to 34 billion going to member states. The EU's overall contribution to world-wide direct investment amounted to slightly over 40% of the total in 1993; as mentioned above, the lion's share is being distributed within the EU. The same order of magnitude applied to incoming FDI [Chart 1].

II.1 Main investors

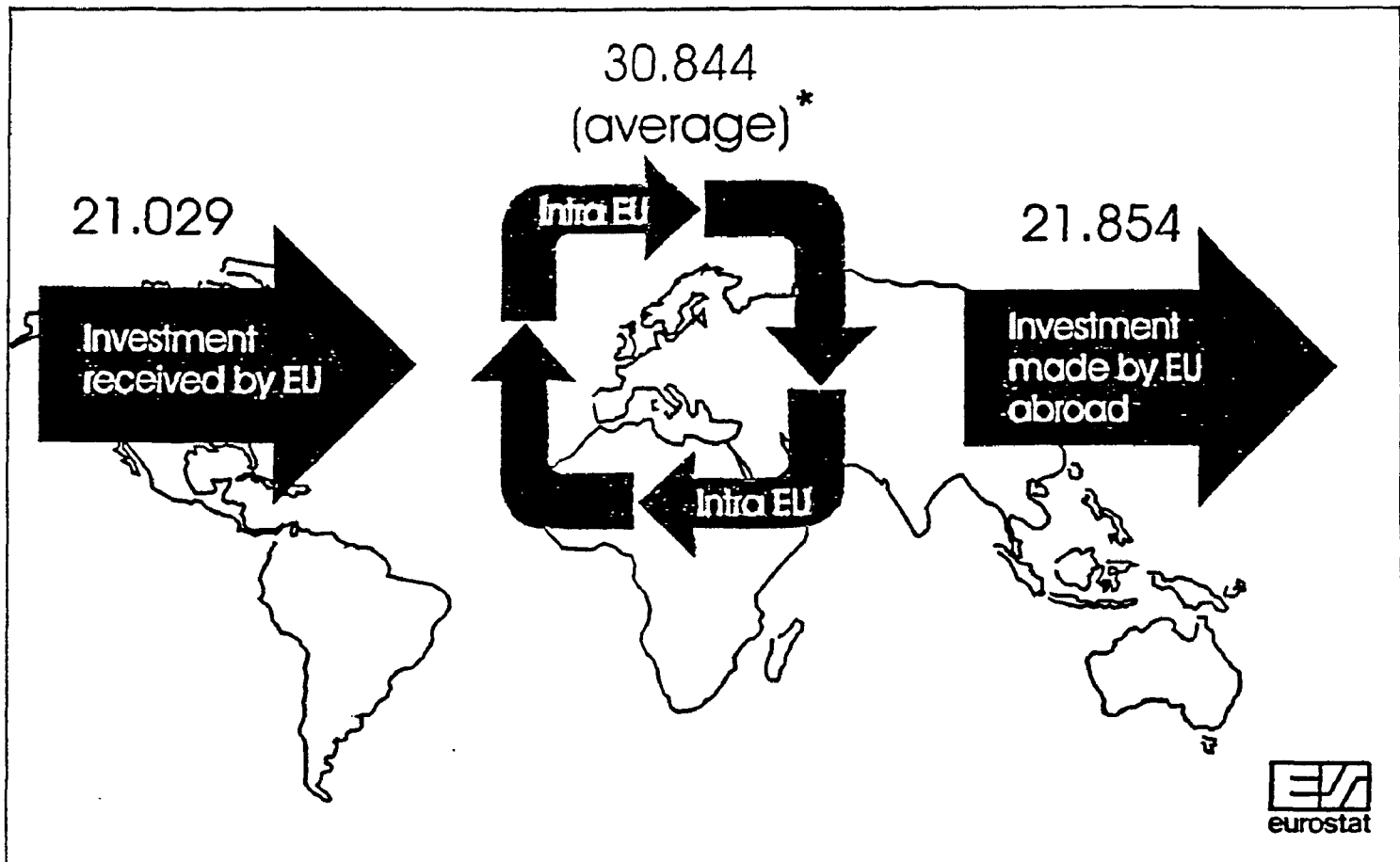
The cumulative flows over the period 1984-93 show that the US and EFTA countries together accounted for slightly under two thirds of the total investment made in the EU by outside investors.

The US was the single largest contributor with one third of the EU inflows, just beating EFTA-sourced FDI. However, in recent years, the EFTA countries have been losing ground as a supplier of capital to the EU. This trend is going to be accentuated by the virtual dissolution of the EFTA due to Austria, Finland and Sweden joining the EU. Moreover, new investors from East Asia came to the fore. Japanese investment represented about 11% of the total cumulated flows. Japanese investment in the 1990s fell,

Chart 1

EU-12 Direct investment, 1993

- Mill. of Ecu -



* To dampen the effect of asymmetry, an average has been calculated on the basis of the reported investment amounts of both the investing and the receiving country.

and has been stabilising at 8% since 1991. Japanese investors are more attracted by the US market. During the past ten years, the US hosted more than 50% of Japanese investment abroad, in 1985 it was 40%.

In 1993, US investment accounted for 43% of the EU's FDI received from the outside world (1992: 51%). The EFTA contribution totalled 17%, leaving the EFTA countries as the second largest investor; dominating the EFTA contribution is Switzerland. With Japan being the third largest investor in the EU, the share of these three investors together left about one third to other investors in the EU. 14% of the total flow to the EU stem from APEC members, *except* the US and Japan. Among the rest, offshore centres were playing a major role, contributing 13% of the EU inflows in 1993.

Conversely, the US was by far the biggest recipient of EU direct investment capital, receiving around 70% of the total EU investment abroad. Even after the substantial slowdown in 1990, the US remained the number one receiver of EU investment. The second largest recipient were the EFTA countries. In 1993, the US absorbed more than 47% of the outgoing EU investment (1992: 37%). This is an increase compared to the period 1990-1992, but it is still far from the high level reached in the 1980s. The EFTA members Sweden and Switzerland were, after the US, the main single recipients. Regarding Japan, EU investors were repatriating more capital than bringing in new flows to the country in 1993. This confirms that despite recent Japanese efforts to attract foreign investment, Japan remains a marginal target area for EU and US business in terms of direct investment. EU investment in other areas is gradually becoming more important, out of which APEC countries (*beyond* the US and Japan) attracted 7% of the EU outgoing flows.

In particular, EU investment has been stepped up in the direction of its neighbours to the East, with the countries of Eastern Europe attracting 11% of EU outflows in 1993. In fact, these countries were catching up to the level of investment received by EFTA countries. For a variety of reasons, the successor states of the former Soviet Union apparently remained on the sidelines, and the investment efforts made by the EU, US and Japan towards this part of the world are either negligible or estimated close to zero.

In the Asian region, the NIEs and China received only 5% of total EU investment abroad in 1993, the US too directed investment in the same order of magnitude to this area while the figures for Japan (13% in 1993) express the country's higher investment commitment in these countries. With regard to the rest, the offshore centres continue to play a role, drawing a biased picture of the real destination of FDI flows: 8% of EU flows abroad have been declared towards offshore centres in 1993, "and it is not possible to distinguish whether these flows are in transit towards other destinations, or if they remain as holdings" (Eurostat 1995). The imbalance in the EU flows has been shrinking continuously, substituting the large surplus until 1988 by a subsequently more balanced situation with regard to incoming and outgoing flows.

With particular reference to APEC-EU investment relations, in 1990 and 1993 these flows were (with the exception of EU outflows) generally dominated by the US and the UK.⁴ Germany's and Japan's weight as source countries shrank drastically; both are negligible as destinations [see Charts 2 and 3].

In terms of investment volume, APEC's relations with the EU are more or less accounted by four countries. Measured by incoming FDI, in 1993 90% of the total was carried out by investors from the US, Japan, Australia and Canada [cf. Table 3].

Judging by multi-annual averages, Western Europe became more important for the Asian source countries of direct investment. While the EU's weight in Japan's direct investment abroad increased to more than one fifth of its total, the share of the Asian NIEs' direct investment destined for Western Europe was moderate but grew over time [see the black wedges in Chart 4].

⁴ After APEC was launched in 1989, the subsequent year was used as base period. The most recent data presently available are for 1993.

APEC - EU mutual direct investment relations

EU-12 inflows and outflows by main actors

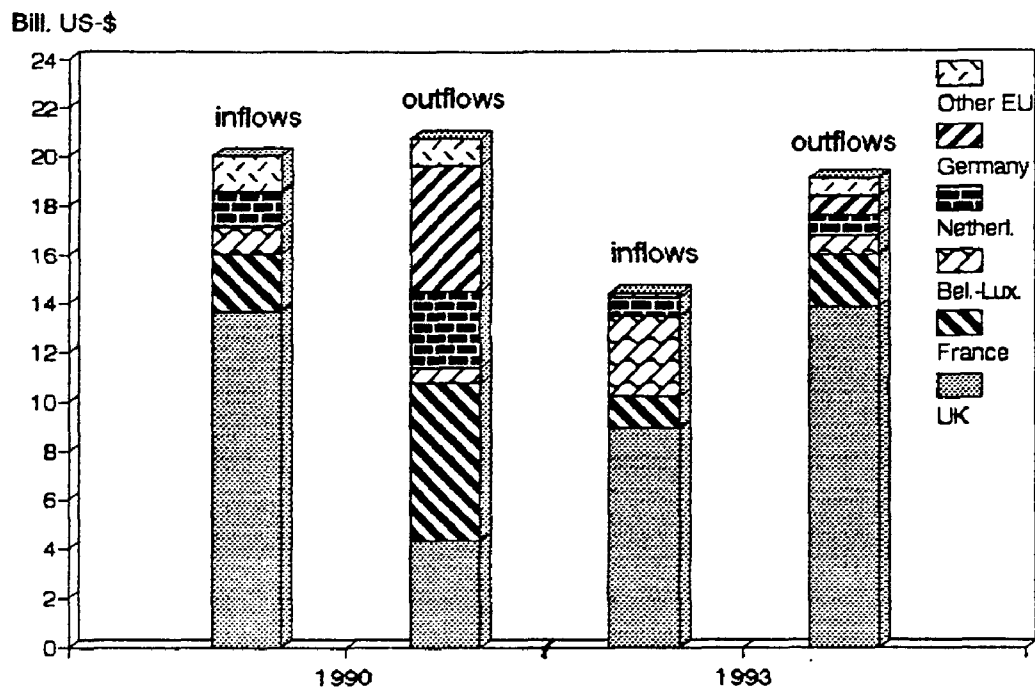
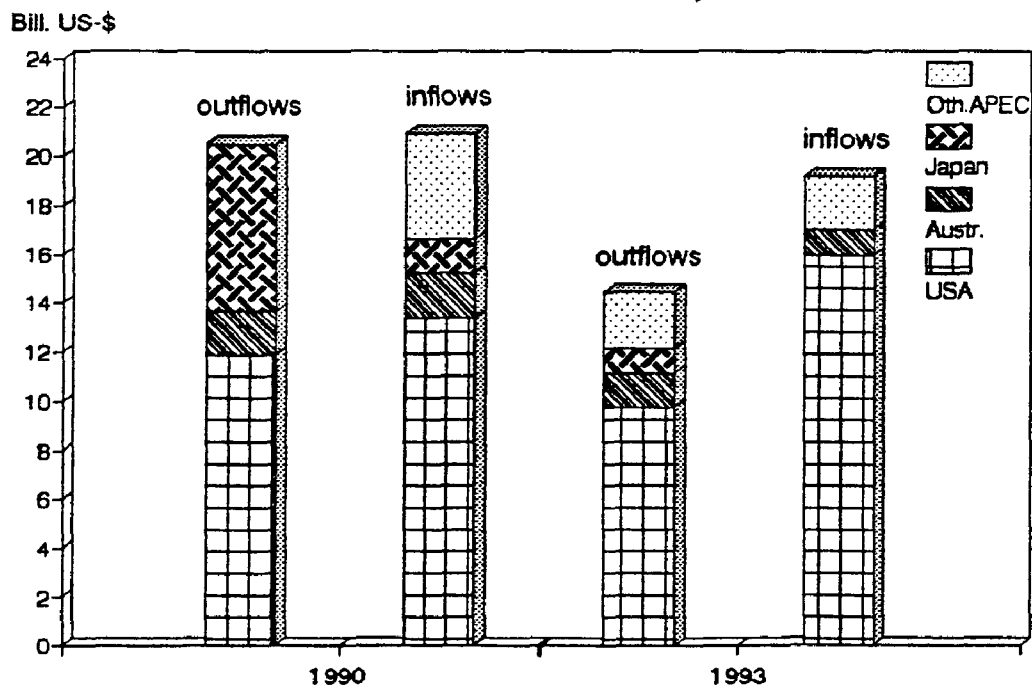


Chart 3

APEC outflows and inflows by main actors

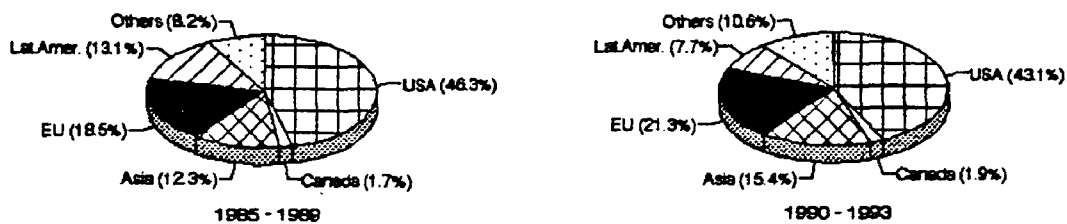


Notes: Extra-EU flows only. - In 1993, for Germany repatriation exceeded new flows; thus the net inflow was negative. The same applies to Japan.

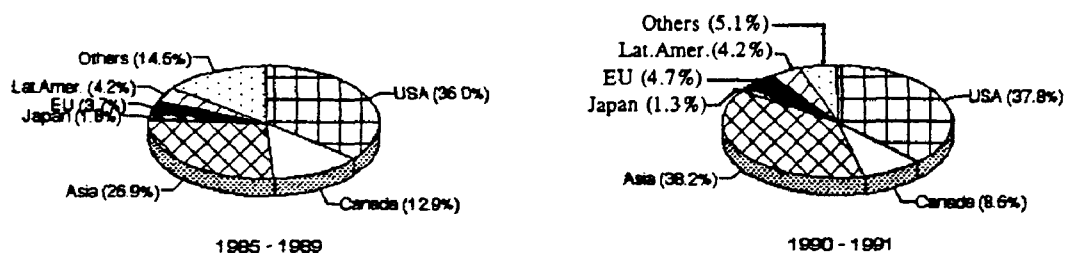
Source: OECD 1995b; DIW calculations.

Destination of direct investment abroad
(expressed in percentage of outgoing flows)

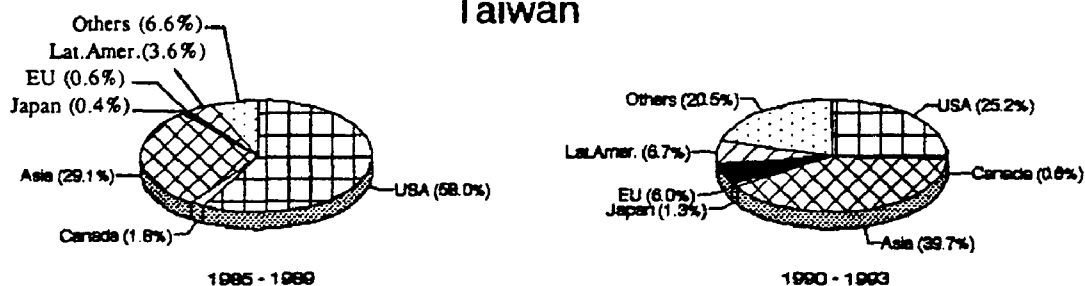
Japan



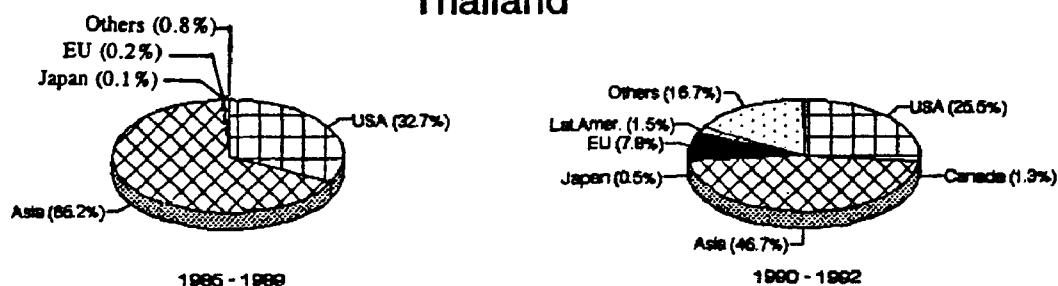
Korea



Taiwan



Thailand



Notes: The sector "Asia" does not include Japan.- In the case of Canada no separate data are available for Asia as a whole and Latin America.

Sources: OECD 1993, 1994, 1995b; DIW calculations.

II.2 Sectoral distribution

Today the service sector has become both the largest and fastest growing part of advanced economies. As services can be incorporated in goods or can 'travel' with persons providing them, most services must be produced at the location where they are consumed (like in professional consultancy) or used as intermediate inputs (e.g., banking). This requires investment in local subsidiaries. But, to an increasing extent, also international trade requires investment facilitating sales across national frontiers.

The cumulative flows over the period from 1984 to 1993 indicate that more than 60% of the flows made by foreign investors in the EU were hosted by the service sector, and about one third were destined to industrial activities. Splitting the period in two parts (with the deviding line drawn at 1988/89) highlights interesting features: The share of industrial activities declined from 40 to about 30% while in the service sector the corresponding figures were 37% initially and more than 60% more recently. In the majority of cases, FDI transactions in the service sector were linked to financial and banking activities. Deregulation and privatisation (beginning in the mid-1970s in the US, the early 1980s in the UK and in the mid-1980s elsewhere) have opened large and previously protected industries to international competition. For outflows, the pattern resembles the situation as for inflows. Total services accounted for more than 60% of outgoing direct investment. The manufacturing sector abroad attracted only about a quarter of the EU flows going to other regions of the world.

Regarding Germany, the gap between direct investment coming into and leaving the country is evident: For years, Germany has been a net exporter of capital (reflecting the current account situation of the balance of payments) [see Chart 5]. Focussing attention on incoming FDI in Germany, almost one third originated from other EU countries in 1994, the bulk of 41% came from EFTA countries at that time. The US accounted for 15%, the whole of Asia for about 6%. The sectoral breakdown indicates a clear dominance of service activities attracting FDI. In fact, for years manufacturing faced a net outflow [see Table 4].

Chart 5

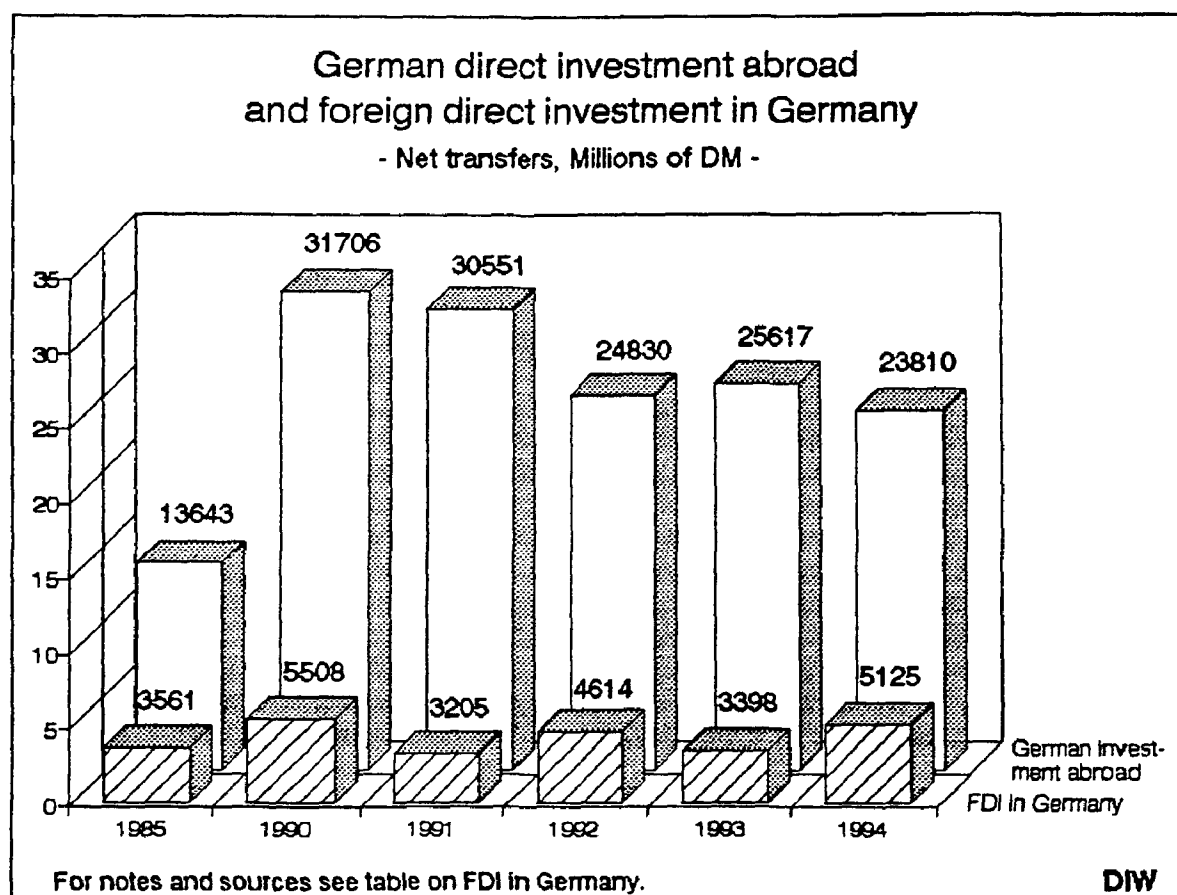


Table 4

Foreign direct investment in Germany
 - Net transfers¹⁾; Millions of DM -

<u>A. by regions and countries of origin</u>		1990	1991	1992	1993	1994
Total		5,508	3,205	4,614	3,398	5,125
Europe		1,375	2,477	2,280	1,733	3,720
EU		1,195	2,426	2,298	785	1,623
EFTA		101	-10	-779	617	2,077
Central and East European Countries		33	3	73	7	-2
Russia [before 1992: former Soviet Union]		5	33	9	305	21
America		1,378	-578	1,093	1,278	1,094
North America		665	-907	1,370	1,015	841
USA		673	-2,057	1,323	803	774
Central America		692	329	-273	311	287
Latin America		21	0 ³⁾	-2	-48	-34
Asia		2,695	1,286	1,186	361	316
of which:						
Japan		1,169	983	1,075	227	293
Korea (Rep.)		80	30	15	62	48
Africa		1	2	30	39	0 ³⁾
Australia, New Zealand, Oceania		20	17	24	-11	-5
<u>B. by sectors</u>		1990	1991	1992	1993	1994
Total		5,508	3,205	4,614	3,398	5,125
Agriculture		-19	1	13	13	26
Energy, mining		2	5	-10	-71	0 ³⁾
Manufacturing ²⁾		-1,486	-3,798	-2,686	1,495	-1,257
of which:						
Chemical products		-2,113	-592	-871	467	-868
Electrical industry, electronics		446	-279	-517	670	137
General machinery		24	145	104	240	-28
Road vehicles		41	182	-262	-647	-281
Services		6,980	7,074	7,211	2,217	6,648
of which:						
Holding companies		4,976	3,832	4,969	5,200	5,580
Wholesale and trade mediation					571	967
Other services (incl. business and management consultancy)				prior to 1993 different reporting system	272	586
Other		33	-77	86	-258	-291

¹⁾ Gross investment ./. repayments, liquidations and sales of shares. Amounts do not include reinvested earnings and investment in commercial real estate.- ²⁾ Incl. construction.- ³⁾ Net transfer less than 0.5 mill. DM.
 Source: Federal Ministry of Economics, Bonn, "Runderlaß Außenwirtschaft", various issues.

III Direct investment from the perspective of countries of origin

III.1 Factors determining locational choice within the EU

The uneven regional distribution of Asian direct investment in Europe, as well as its concentration in few countries, gives rise to the following questions: What are the factors of location? Why are the UK and the Netherlands the preferred destinations of foreign capital? Why is Spain relatively attractive to industrial investors? Why does Germany rank only middle of the foreign investment league table?⁵

With regard to firms in the service industry, particularly those in the *financial* sector, there obviously is a strong inclination to agglomerate. The large, well-known financial centres of Europe attract foreign finance companies like a magnet. The subsidiaries of Asian finance companies settle in Europe according to a similar pattern to that followed by regional finance companies. The major concentration of such companies is in the Netherlands and the UK. There is only a few cases of overseas finance companies locating in Germany. *Trading* establishments tend to locate in those countries which offer large markets. This helps explain why hitherto the trade sector is dominating FDI activity occurring in Germany and France.

What determines the choice of location for *industrial* investment, however, is less clear. Although basic patterns in the structure of the locational choice of countries and sites for direct investment abroad do exist, these decisions do not fully conform to formalised procedures (Min 1991). It is not merely a question of maximising profit whilst considering labour costs, technology, intermediate supplies and market outlets. A series of socio-economic factors play their part too, such as labour force specifications, the ability of local management, national attitudes, language and social infrastructure. Government incentives for FDI may not be a decisive factor when selecting a location for investment among different regions of the world, but it does influence the decision taken when selecting production sites *within* a given region like, e.g., the EU.

⁵ This section draws on the results of research by Ernst and Hilpert (1990).

Up until now, the most crucial determinants of investment in **Germany** were the size of its market, its favourable position for distribution throughout Europe and the quality of its workforce. Furthermore, its infrastructure, with particular reference to that of its transport, is regarded as clearly superior to that of other European countries. Factors which fare less well in Germany than in the most important countries of comparison are, above all, the cost of labour, the general command of the English language and other 'soft' factors of location.

Unlike Germany's, the **UK's** attractiveness, as far as Japanese industrial firms are concerned, is due more to the language and other factors, which are important for the establishment of production plants, than to factors related to the domestic market. Whilst the quality of the UK's workforce is not different to that on the Continent, the UK with its low labour costs is considered far more favourable a location for investment than are Central European countries. That this advantage could be lost -since the average productivity of labour in the UK is clearly lower than in Germany - seems either to have gone unnoticed by overseas investors, or they assume that they will achieve above average labour productivity in their plants. On the whole, also the British infrastructure is regarded as positive. In addition, low taxation in the UK and the numerous national, regional and local programmes for encouraging investment are regarded as attractive locational factors. Moreover, investment projects which promise to be of particular national benefit are supported by the Department of Trade and Industry. A lower strike rate and increased union flexibility became known to a wider public and the old negative image of British industrial relations has been reversed.

Industrial productive capital is attracted to the **Netherlands**, above all, due to its central position in Europe, its highly acclaimed standard of English and other workforce related qualities. In addition, its components supplying industry and its transport network rank among the best.

As is similar in Germany's case, **France** is chosen as a location for investment, above all, because it represents a large market and is a good location for distribution. However, the perceived limited knowledge of English makes a negative impact.

Spain stands out against other countries due to its low labour costs (as does Portugal). In contrast, investors from the Far East class Spain's infrastructure as inferior to that of Central European countries.

Of course, these assessments leave some questions unanswered. It is clear that the catalogue of criteria is inadequate as "other factors" often rank highest among the locational criteria in the whole of Europe and in individual countries. Thus, approximately one third of the criteria for deciding upon a location for investment seems to consist of subjective judgements, to a certain extent even influenced by emotional factors, and the remaining two thirds is made up of hard factors (Ernst/Hilpert). To a certain extent, personal experience played an important role in earlier contacts established with Europe, particularly when senior officials were involved influentially in the decision to invest. Among the criteria mentioned above were contacts made by executive personnel with people on the spot in connection with studies and periods of professional training in Europe. Another 'irrational' factor is the attitude shown towards foreigners. Not least, the racist incidents in Germany have had their effects on the choice of location for investment. Even though such factors have probably only been absolutely decisive for decisions to invest in the fewest of cases, one can, nevertheless, conclude that such factors do have repercussions and their effects should not be underestimated.

At the top of the list of the most significant decision-making criteria for objectively choosing a location for investment is the policy employed to entice investors. This applies to the basic attitude towards firms as well as the practical incentive measures employed for assisting firms to settle. For example: the popularity of the UK as a host country was established at the end of the 1980s to a significant extent on the basis of the energetic and confidence-building acquisition efforts of Mrs. Thatcher and her cabinet. Whilst Asian investors were certainly not always welcomed in the UK during the 1970s, the British government did systematically encourage the location of such industrial firms as a means of revitalising the country's industry. Subsequent policy has been geared towards job creation - particularly in structurally weak regions - and the establishment of technologically sophisticated production. Given the previous far-

reaching decline of the British motor industry and in view of the subsequent FDI-driven establishment of motor production plants, this objective seems to be in the process of being realised. Such policy by British central government has and is flanked by industrious recruitment and incentive measures at a regional and local level.

Policy in **France** is characterised by a rather more reserved or ambivalent attitude towards Asian investors. Public opinion in France differs widely on this topic. On the one hand, the contribution of Asian investment to the revival of British industry is widely recognised. On the other, a marked aversion to the influx of foreign, in particular Japanese, capital into France, as well as a fear of local industry being dominated, exists. This anxiety is similar to the misgivings concerning American investment during the 1960s, which then gradually subsided. This is in stark contrast to the assiduous efforts of prefectures and communes with respect to Asian investment. In particular, Brittany and Alsace have been very active. The fact that France has a prominent place with regard to the number of production plants of Asian investors demonstrates that decentralised initiatives have more than compensated for the lack of enthusiasm shown by central government.

In the eyes of foreign management **Germany** has no explicit interest in a forced expansion in the presence of Asian investors. Indeed, the acquisition efforts of the *Bundesländer* and individual local authorities are noticeable, however, there is the impression that a reserved position at a national level is intended to demonstrate that Germany, on the basis of its strong technological position and competitiveness, does not need to actively recruit foreign investors. Considerations regarding the market framework (*laissez-faire*) also play an important role here.

How do incentives to settle influence investors when deciding upon a location for their investment? Those countries which have made particular effort in actively attracting investment from industrial firms, seem to have been able to entice these investors most frequently with what are, to a certain extent, massive locational subsidies (the UK and Ireland, for example). Naturally, firms have taken advantage of such financial assistance. This applies to investment aid which was awarded in the context of supporting

structurally weak regions in specified development areas. Generally speaking, it is reported that in those local authorities where foreign firms wanted to settle more effort was made and higher levels of funding injected in order to improve the general economic setting for investors. This ranges from the establishment of special transport links to the provision of land which had been tailored to the demand of the respective investors.

The attitude of those foreign firms represented in Europe towards *direct* subsidies is not clear. Quite a few firms refuse to make use of these funds, either because they do not, in principal, want to be dependent on state assistance, or because they want to avoid possible public criticism in the host country. Such reservation seems less apparent with respect to *indirect* subsidies such as those which are offered by local authorities for the development of business parks. The effectiveness of subsidies as a means to attract investment is ambivalent: There are indications that subsidies entice no additional investment to Europe, but rather influence its distribution *within* Europe.

A further fiscal factor of location, which may be classified among 'other factors', is the level of taxation specific to any particular country. Frequently criticised in Germany were the high levels of income and corporation tax, whereas the attractiveness, in particular, of the Dutch and British levels of taxation were praised. Business taxation in Germany is indeed considerable. Furthermore, the German tax system is regarded as too complicated.

A factor, which is not directly quantifiable but nevertheless significant in many sectors of the economy, is the technologically competitive position of the host country. Particularly in cases of share holding and take-overs, investors are largely concerned with coupling their technology with those of leading suppliers in European countries. Through partnerships with technology leaders, firms, which have a leading position on their home market, but as yet not on the world market, seek to strengthen their international position and achieve their goal of globalisation. This strategy can be observed particularly in the chemical and pharmaceutical industries. Quite often this results in

links stemming from a previous longer-term co-operation which was not based on the amount of capital employed.

Finally, the factor quality of the workforce is ranked high on the list of criteria. The standard of most of the German education system is considered as superior to the more theoretical and school-type approach of Germany's neighbouring countries, a valuation which is reflected in the good image of Germany's skilled labour. In addition, one can see parallels with various Asian countries with respect to their style of training as well as the opportunity for a smooth and, therefore, cost-effective transfer of technology in industrial production.

Foreign investors named the following as Germany's weak points as a location for FDI:

- High costs with respect to both wages and the provision of non-traded goods and services.⁶
- Complicated administrative regulations, tax systems, licensing procedures and similar framework conditions make it difficult for foreign executive personnel to check over the requirements of the authorities.
- Overseas firms complain about the insufficient supply of information from German authorities, be that about restrictions or privileges. They maintain there is very little information available in English.
- Language is considered far less a handicap in internal business affairs than in external contacts with authorities and the public.
- The excellent quality of the workforce is made to look less impressive on the basis of various deficiencies: a lack of flexibility with respect to working hours (reluctance to work overtime, limits on overtime and 1 ban on

⁶ Obviously, only limited attention is paid to productivity and its likely future development relative to other potential locations.

Sunday trading) as well as a lack of willingness to take on jobs which do not fit into the traditional job description are quite apparent. Job segmentation is considered too rigid, the overlapping area between related fields of training too narrow.

- The only limited, co-operative attitude of the employees can be attributed to excessive social security and over powerful unions. By Asian standards, the German employee can be very critical of the running of the firm and has limited belief in authority.

When directly addressed, however, the majority of foreign firms regard Germany's locational quality as positive on balance, despite these criticisms.

III.2 Incentives in the target area

The prime concern of investment promotion, not only when mobilising domestic saving but also when inviting FDI, ought to be the provision of conducive macro policies, as the overall economic environment is the prime factor in determining FDI flows. If potential investors are indifferent with regard to competing locations' attractiveness or if there are (actual or alleged) disadvantages which must be compensated for, extra government measures are important.

A number of measures are available to host authorities wishing to encourage the establishment of foreign manufacturing plants, including tax concessions, export subsidies, training schemes and preferential access to local credits, in addition to the various location grants which may be automatically available, discretionary, or a combination of both. Projects are increasingly sought by both local and regional authorities as well as agencies of national government. In practice, the most important instruments in favour of projects in target regions and zones are tax privileges, accelerated depreciation, loan subsidies, and R&D support.

Despite continuous efforts to curb ongoing competition of public subsidisation in the past, budget means have been employed to attract internationally mobile investment projects practically all over Western Europe. On the basis of an assessment made in a British study⁷, the activity of countries involved may be roughly classified as follows:

very active	fairly active	less active
Ireland	Austria	Italy
France	Belgium-Luxembourg	Spain
Netherlands	Germany	
United Kingdom	Portugal	
	Sweden	

Grants and financial incentives have been part of the regional policy tool box for several decades in Western Europe, with two main objectives usually being pursued: (i) to increase the growth (and improve efficiency) of the indigenous sector of the economy, and (ii) to attract inward investment, either from neighbouring European countries, or - more likely - from international investors with their headquarters in the US and Japan.

Other objectives have also often existed, such as stimulating new technology or encouraging decentralisation. The latter used to be important in Britain, and is still very much the case in France. Inputs to the local economy and the creation of employment are not the only objectives sought by local or national authorities, given that foreign firms have a 'demonstration effect' for the region or country in which they establish themselves.

The attraction of inward investment has become the main purpose for offering incentives in most countries, and there is evidence that some internationally mobile firms are quite responsive if there are substantial amounts of grants and/or tax incentives available. Consequently, the provision of significant financial inducements as part of an incentive package to attract inward investment can indeed have an impact on locational

⁷ Prepared for the Department of Trade and Industry; see Strange 1993.

trends for foreign manufacturers, although other factors, such as transport and telecommunications, and the social environment should not be ignored.

From a supranational point of view it can be easily gathered that competitive bidding with regard to investment incentives will be counterproductive. Incentives - a specific species of subsidy - in many countries are granted mostly by non-federal governmental bodies, e.g., the individual states in the US and Australia, the provinces in Canada, and the "Länder" in Germany, and the federal governments in each of these countries have been reluctant to impose restrictions. But also, where issues of federalism are not as pronounced, subsidies are used actively as instruments of industrial policy by central governmental agencies, and governments have been reluctant to give up any power to use these subsidies.

Looking at the matter from an overall perspective - the OECD has been doing so and keeps trying to convince member countries -, investment incentives represent an inefficient use of scarce public funds. The reason behind this assessment is that incentives have distortive effects similar to those of trade impeding measures. Investment incentives would tend to have little impact on the investment *total*; rather, they have an effect on the geographical *distribution* of the investment taking place anyway. In particular, they become most problematic when governments bid against each other to win a particular investment project (OECD 1995a). However, as long as incentives are not eliminated altogether they will continue to be exploited by potential investors to gain as much external support for their projects as possible. In this way, investors tend to perceive incentives as a windfall but base their decisions on more fundamental considerations.

IV Going regional or multilateral - or both?

A crucial question to be addressed is whether regional integration is resulting in an increased regionalisation of the international economy, i.e. a tendency for economic exchange to expand more quickly *within* a region than between that region and the rest of the world. Traditionally this assessment has been based on trade flows alone. Today the globalisation of production has led to a growth in trade and investment between related parties, so trade by itself is no longer an adequate guide. Foreign investment flows are also influencing the balance between regionalisation and globalisation. Investment flows suggest that, as for trade, faster growth in the share of intra-regional investment has gone hand in hand with faster growth in investment between regions. Intra-regional investment quadrupled within the EC over the period 1985-89, largely in response to the Single Market programme. But European investment in North America also quadrupled over the same period, and also grew dramatically in Asia, although from a lower base (OECD 1995c).

Within East Asia there was also a rapid growth in intra-regional investment, with Japan and, to a lesser extent, the NIEs as the main sources. As with intra-regional trade, intra-regional investment in East Asia has grown much faster than in Europe. This has been both a cause and a result of rapid growth in the region.

Since the end of the Cold War, regional integration arrangements have been part of a search for a stable international order and are, therefore, issues of high political priority. They always ought to be considered in terms of their strategic importance as well as in terms of their impact on the multilateral world economic system⁸.

One of the outstanding features of the multilateral world economic system is the extensive coverage of the world economy by different forms of regional integration -

⁸ Although GATT rules in general do not approve of regional groupings of a preferential nature (Art. I), departures from the obligation of most-favoured-nation (m-f-n) treatment are possible, provided they meet (soft) conditions as specified in Art. XXIV, which were amended in the GATT-94 version (e.g., inclusion of trade in agriculture).

from particularly deep formal integration in the EU, to informal, market driven integration, like in East Asia. In recent years, the trend to formal regionalisation has accelerated markedly, with the extension of the EU, the formation of NAFTA, CEFTA and MERCOSUR, major developments in APEC, and initiatives elsewhere.

Differences in the shape of agreements are closely related to objectives and policy choices. In fact, the approaches embodied in existing regional and multilateral arrangements are quite different. This helps to clarify how the various schemes compare with the traditional distinction made between (trade) liberalisation and integration. While "liberalisation measures discipline the use of national policies without questioning their existence, integration involves changes in the domestic policies of the countries concerned" (OECD 1995c, p.37). The liberalisation matter corresponded to the multilateral approach of the GATT/WTO system, and integration to the regional approach (of the EU-type). This distinction has, however, become less neatly cut in recent years. Indeed, some issues in GATT/WTO (like the stipulations for government procurement) touch upon national sovereignty in a way that only deep integration has done in the past. In contrast, important regional initiatives, such as NAFTA, are using the liberalisation approach, although going further in some aspects (e.g., dispute settlement and partially affecting domestic policies). This is why it is important to be clear about the approaches used in both regional and multilateral arrangements.

The EU and APEC are outstanding examples of fundamentally different approaches in coverage and ultimate objectives to be achieved: The EU is aiming at far-reaching integration in a number of important policy areas (e.g., the Common Foreign and Security Policy as outlined in the Maastricht Treaty). The coverage is comprehensive, convergence of national policies an explicit target. The concept of competition among rules, made operational by mutual recognition of regulations in the country of origin, inserts an element of dynamism. The European approach is backed by institutionalised enforcement mechanisms on the supranational level and the jurisdiction of the European Court of Justice for EU rules.

On the other hand, APEC is not (yet) an entity constituted by a formal integration arrangement. As APEC is still in the process of identifying areas of joint activity as well as developing institutional structures, the governments of member states are in full control of their various policies. There is no supranational element, and enforcement is strictly on a national level. As the matter presents itself to the external observer, there is no intention to change this basic layout in the foreseeable future. The Committee on Trade and Investment takes care of a policy dialogue on issues of member countries' interest. Because APEC investment principles are non-binding in nature, enforcement and dispute settlement procedures are generally irrelevant (Brewer/Young 1995). As the ultimate objectives of APEC are not fully spelled out yet, it seems like more weight will be given to some looser form of co-operation and to market-led integration rather than a formalised approach to integration. The basic idea is non-discrimination, with the notion being to strengthen economic relations among members, while also making the region more open to trade and investment with the rest of the world ("open regionalism").

In the interrelationship between the regional and the multilateral approach, the crucial question is whether regional agreements 'distract' political and economic efforts at the expense of multilateral negotiations, or is there a synergy between regional and multilateral negotiations? On the one hand, it has been argued that regional agreements distract from multilateral solutions. On the other, there were successful negotiations on the multilateral track running parallel to regional negotiations. The negotiations of the GATT Kennedy Round took place while the EEC was created, the Tokyo Round was concluded at the time the EEC was enlarged, and the Uruguay Round was accompanied by the completion of the EC Single Market, the founding of the US-Canadian arrangement and of NAFTA. Surely, the regional agreements comprise fewer countries with, in general, comparable levels of economic development than in multilateral negotiations; this facilitates mutual understanding. Regional agreements have sometimes also offered a more rapid route to liberalisation while, by contrast, multilateral negotiations, with the ultimate goal of achieving an agreement, are overlaid by the wide range of interests of a large number of countries with quite divergent domestic policies and at different stages of development. Market-led initiatives of countries with a high level of economic

interdependence may turn out to develop the proper driving force to successfully push agreements ahead.

With regard to the impact of regional negotiations on the multilateral process there is in fact a high degree of interaction between regional and multilateral processes. Although this may have negative as well as positive effects, as yet the net effect has been positive more often than not. Case studies, carried out in an OECD research effort (see below), gave proof that experience in the process of regional integration is ultimately supportive to the acceptance of the need for international rules on the part of national governments and interest groups. Among the factors contributing in favour of more general solutions is the awareness of interdependence and the use of regional solutions as the test ground for more comprehensive approaches.

There obviously are examples of synergy or cross-fertilisation of ideas between regional and multilateral negotiations (OECD 1995c). Among others, investment provides an example of how regional agreements have helped realise objectives set at the multilateral level. The OECD had provided the basic principles for investment in the shape of the OECD Codes. What was needed were concrete decisions to implement these principles. These were taken unilaterally by some countries (Australia, United Kingdom). But decisions taken at the regional level have extended such approaches to many more countries. The EC decision to remove all capital controls in 1988 is a clear example of this. The liberalisation of capital controls within the EC also spread to neighbouring EFTA countries (Sweden and Austria) which had retained quite extensive controls on investment. In the North American integration scheme, the liberal US regime was extended to Canada; and NAFTA extended liberalisation to Mexico as a middle-income country.

Undoubtedly, occasionally multilateral solutions have been hampered or at least delayed by a lack of progress in regional arrangements. On balance, however, developments at a regional level seem to have tended to facilitate progress at the multilateral level. In addition, regional integration has prepared minds to accept multilateral liberalisation and wider competition, even in less liberal countries. Globalisation of competing companies

also operates in the same direction, since there is a trade-off between companies' desire to keep a strong, possibly protected, national or regional market and their interest to be hooked on to the world-wide network of sourcing and selling.

V Concluding remarks

As has been illustrated above, FDI relations between the EU and the countries constituting APEC are substantial. Since all major players in the world economy are members of either one of these two schemes their mutual transactions come very close to the world's total. The catalytic effect of the formation of APEC on such flows can hardly be proven for the past, its potential will have to be developed in the future.

There does not seem to be evidence of an overall trend towards regionalisation of investment. More often than not, regional arrangements have been 'laboratories' for new forms of cooperation which were not to the detriment of the multilateral system. Rather they were compatible and supportive to the world economic system organised on a multilateral basis. In this respect the market-driven, only moderately formalised approach in the APEC region may serve as an important impulse.

The "open regionalism" approach during the period of uncertainty with respect to the Uruguay Round negotiations has been a good basis for the 'global option' that can be pursued now, after the conclusion of the Round. However, this does not preclude ongoing competition among schools of thought within APEC (fear of free-riding vs. unconditional liberalisation). Also, the interrelationship between APEC and the 'subregional' arrangements (AFTA, ANZCERTA, and NAFTA) might be subject to review aiming at increased consistency. Furthermore, differing notions on how to treat the agricultural sector within APEC ought to be reconciled at the outset. Here an important lesson can be learned from the EU's experience.

Admittedly, during the Osaka summit another important step has been taken to turn the "APEC vision" into reality. It will be the member states' liberalisation programmes, to be tabled next year in Manila, which will provide the prerequisite for the business

community in order to considerably step up investment in the region (with repercussions to the presence elsewhere). In this context, the "flexibility" formula - presently a euphemism covering up diverging philosophies of how to proceed with liberalisation in practice - has to be specified in detail. As yet, there is a wide spectrum of national points of view with regard to how closer economic cooperation is to be interpreted, ranging from Malaysias clearly limited geographical concept to the approach of binding rules and targets preferred by the US in order to turn the common enterprise into a success story. Thus the assessment that the "Asian way" will be more effective than Western style formal agreements still has to pass the litmus test.

At any rate, APEC could play a crucial role in becoming a regional caucus within the wider multilateral negotiations. Further, there is an opportunity to push ahead substantive issues such as combining the subject of FDI with issues like trade policy or competition policy. In the multilateral negotiations APEC could make an important contribution inasmuch there is demand for more fully integrating developing countries into the multilateral negotiating process. Because APEC includes several emerging economies that are both host and home economies for FDI, APEC might turn into a platform for better consideration of the positions of emerging economies.

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