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A Review of the NICB Report on U.S. Direct Investment

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The National Industrial Conference Board sponsored a study of "company accounts from the standpoint of their foreign exchange implications" and of the U.S. balance of payments "in the light of the investment activities of these companies." The results of the study, including policy implications, have been reported in U.S. Production Abroad and the Balance of Payments: A Survey of Corporate Experience.

The report largely describes the behavior of U.S. manufacturing companies with operations abroad. These companies, the authors believe, are primarily concerned with their ability to maintain market positions, which typically have been established by exporting from the U.S. but which are inevitably eroded by foreign competition. This desire to preserve a market dominates investment decisions; while relative rates of return on various projects are not nearly as important; and the costs of various types of financial capital influence only how foreign investments are financed.

Since exports inevitably lose out to foreign competition, U.S. production that maintains a company's presence abroad does not actually replace U.S. exports. Furthermore, maintaining U.S. presence abroad through foreign production promotes U.S. exports in several ways. First, exports of capital goods and intermediate products are required by initial and continuing investment and by subsequent production abroad. Second, maintaining sales of U.S. products abroad, even when they are produced abroad, creates additional foreign interest in other U.S. products that, initially at least, are exported from the U.S. Third and last, U.S. investment and production stimulate foreign economies and, therefore, raise foreign incomes and foreign demands for imports, including imports from the United States. These additional exports would be lost, according to the authors, if investment were cut back.

But the most important result of curtailing U.S. investment abroad would be the sharp decline in earnings from U.S. manufacturing abroad. Manufacturing facilities, once established, depend on "growing with the market to survive competitively." In other words, "continued earnings normally entail continuing investment." (p. 22) This necessity for continuing investment brings out the essential, "organic" nature of foreign operations, which businessmen universally recognize and which the authors contrast with the hypothetical, "incremental" approach adopted by "analysts" and Government policy makers. The "organic" approach stresses the need for a growing operation to maintain earnings, while the "incremental" approach is concerned only with additions to an earnings flow.

The authors' description of corporate behavior, summarized in the preceding three paragraphs, was based on information they obtained through questionnaires completed by 100 U.S. manufacturing concerns and through follow-up interviews with executives of over 50 of these concerns. Information obtained on the questionnaires, including quantitative data, was used primarily to suggest questions for the interviews; for the authors decided very early that quantitative data available from corporate accounts, which focus on profits earned by an operation, could not be used to indicate the effects of U.S. foreign operations on the balance of payments. Accordingly, in order to discover these effects, they had to turn to a "qualitative" study, one which focuses on corporate attitudes, motives, and methods of operations. The "qualitative" character of their study and their eschewing of quantitative research, however, explain why the report has nothing substantive to add to theoretical analysis or policy deliberations. A major conclusion, for example, that earnings will decline if the voluntary program is continued for a long time, is neither new nor specific enough to be interesting. How sharply and soon earnings will decline, the critical questions, are not satisfactorily examined, although the authors, apparently on the basis of the "organic" approach which they champion, appear to expect a sharp decline almost immediately.

The "organic" approach, however, does not provide credible support for their expectation. For example, let us look at one hypothetical situation employed by the authors to display the essential "organic" character of foreign investments. (p. 133) For heuristic reasons, they assume that, if no investment takes place in a given year, there will be a complete loss of earnings that year; that investment is required to prevent earnings from falling to zero for that year. In this case the earning ability of all prior investment including that of the immediately previous year is zero. But investment of the immediately preceding year, in order to have been a profitable investment would have had to have had a net operating rate of return (after allowing for income taxes but, by definition, before deducting depreciation) of more than a

100 per cent in its first year, an implausible situation on the average. In general terms, the organic concept can only support the authors' concern if the productive lifetime of foreign investments is unrealistically short and unrealistically productive. Otherwise, investments would not make a profit let alone recover the initial financial outlays. (One may wonder, incidentally, if domestic investments are as "organic" as foreign.) Moreover, even if the "organic" approach were a useful model for analyzing the earning potential of foreign investments, it does not necessarily follow that the voluntary program will lead to a decline in total foreign earnings. Investment on a scale of recent years can be financed easily by borrowings abroad and depreciation and depletion allowances, which are not covered by the program, and by capital outflows and retained earnings, which are only kept from rising by the program. Obviously, the authors need more than theoretical examples to support their judgment; they need quantitative support; and without it they have not added anything to the current debate.

The alleged importance of market strategy also should have been examined more critically. Are most companies, for instance, acting "without regard to the rate of return" when they invest additional capital in subsidiaries located in unstable areas "if lack of new funds would result in losing a present or future market that was worth saving"? (p. 75-6) The authors should have attempted to explain why prospective profitability has only a limited bearing on investment decisions instead of having at least the primary bearing on decisions, as is assumed in elementary economic theory. The seemingly irrational, nonprofit criteria may indeed have an economically rational explanation; but the authors do not give an explanation and apparently do not even realize that one is called for.

Similarly, "if very few decisions to invest are reached by comparing different investment opportunities, including opportunities in the United States," the authors should not stress the welfare aspects of free capital movements. (p. 73, 22; my emphasis) Can they be sure that U.S. Government "discouragement of foreign investment is inevitably production-negative, lessening total production of foreign and U.S. economies." (p. 27)

The major mistakes of the authors were to take at face value what they were told, to overlook the theoretical implications of their arguments, and to eschew quantitative hypotheses and tests. Other defects of the report, mostly of a technical economic nature, may be found easily. Basic concepts like residency are abused (p. 128); what should be included in the balance of payments accounts and where they should be recorded are confused; (p. 105, 146) and what the accounts may be used for is misconstrued. (p. 128,155) Multiplier analysis is also misconstrued by the authors. They conclude, without considering the source of financing, that U.S. investment abroad will stimulate both the foreign and the domestic economies; whereas, on the one hand, if the financing is from foreign sources, the assumed purchase of equipment domestically for installation abroad will be a leakage from foreign expenditure flows; and, on the other hand, if the financing is from U.S. sources, the export of the financial capital will be a leakage from U.S. expenditure flows, a leakage that is only partially offset by the equipment exports. (p. 116, 146-48) Finally, the authors referred inconsistently and inaccurately to the general intent and major details of the voluntary program; and their tone is not impartial. They always sympathize with views of businessmen and invariably question and often criticize the actual and alleged positions of the Government and the "analysts." (e.g., p. 152f.) Of course, the voluntary program may be open to criticism on a number of grounds. But the judgments supporting the criticism must be based on detailed, usually empirical, research and not, for the most part, on what businessmen have said.