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**EARNINGS FROM FOREIGN
DIRECT INVESTMENT:
POSSIBLE EFFECTS ON
DOMESTIC ECONOMIES AND
PATTERNS IN EU COUNTRIES**

Grazia letto-Gillies

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EARNINGS FROM FOREIGN DIRECT INVESTMENT: POSSIBLE EFFECTS ON DOMESTIC ECONOMIES AND PATTERNS IN EU COUNTRIES¹

Abstract

The paper deals with the flow of earnings from inward and outward foreign direct investment. The paper starts with a review of some works which stress the intertemporal effects on the balance of payments and from it on the real sector of the economy. This is designed to give an introduction to the possible effects of earnings. Patterns of direct investment and earnings in the EU as a whole and in each member country are analysed. The EU countries show different patterns with regard to both the size and the underlying trends of net incomes from foreign direct investment. This is followed by a more detailed analysis of the UK earnings position with each country of the European Union.

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I Introduction

The impact of the flow of earnings from foreign direct investment (FDI) has received little attention in the economics literature² though the effects of foreign direct investment on home and host economies have been the subject of much writing (Dunning, 1981 and 1993, Enderwick, 1985, Hufbauer and Adler, 1968, Ietto-Gillies, 1992, Reddaway, 1967 and 1968, various UNCTC and UNCTAD, WIR publications).

Yet investment incomes represent a very sizeable component of the flow of business transactions between countries. Moreover, it is a component with certain distinctive features. In particular: (a) It represents a transfer of income across borders. Much attention has been given to the transfer of resources within the EU and this is, in fact, a major component of such transfers. (b) It represents a strong - probably the strongest - intertemporal dimension to integration across countries. (c) It has effects on the balance of payments. (d) It affects the real sector of the economy, partly, through its effects on the balance of payments. (e) It is a component for which there are considerable differences in the size of transfers and in the pattern of credits and debits between countries of the EU.

Investment incomes in general are far from being a negligible component in the integration process. OECD, 1994:19 gives values of the sum of debits and credits for some of the major components of international transactions (exports and imports of goods and services, foreign direct investment, portfolio investment and incomes from portfolio as well as from direct investment) for the total of OECD countries, for the two decades 1970-80 and 1980-90. The values given for foreign earnings on direct and portfolio investment are higher than the combined values of FDI and portfolio investment for both decades: it is 2.25 times higher for the first decades and 1.9 for the second decade.

The earnings from foreign direct investment are, of course, directly related to the activities of transnational companies (TNCs). More than any other component of international

² Reddaway, 1967 and 1968 give estimates of the balance of payments effects of profits from UK outward foreign direct investment.

transactions, they represent a strong intertemporal as well as international dimension of those activities. The current values of investment income credits from FDI are related to the overall stock of capital invested abroad in previous years.³ Thus the history of foreign involvement by a particular country plays a crucial role in its current flow of earnings and, through them, in the structure of its balance of payments. For some countries their FDI history is linked to their colonial past: for example Petri (1994:6-7) notes how the countries which rank high on FDI intensity - measured as ratio of FDI to GDP - are those with long colonial roots.

Moreover, the position of different countries with respect to this particular component is likely to be different. Countries which have been outward investors for some time are recipients of incomes from countries which have been and are host to such investment. From a global perspective, developed countries are the main originators and recipients of FDI. In 1996 they were responsible for 91 per cent of the outward stock and 85 per cent of the outflow of investment as well as for 70 per cent of the inward stock and 60 per cent of inflow (UNCTAD, DTICI, 1997 Annex, tables B1-4). This pattern has been fairly stable in the last 30 years. The developed countries are, on the whole, net outward investors and this means that they are net receivers of investment earnings.

However, within the developed countries there are important differences. As the largest share of FDI is directed towards other developed countries, there is bound to be a considerable number of countries which are net originators of investment earnings alongside countries which are net receivers.

The position of any country in terms of investment income should be seen dynamically, with change taking place in accordance with the evolving pattern of FDI: such changes are bound to occur with lagged and cumulative effects due to the intertemporal relationship between investment incomes and foreign investment.

³ Phelps, 1997 stresses how the 'vintage' of multinational investment is relevant in the understanding of TNCs' trade and of European integration.

The paper proceed, in sections two and three, with a review of some theoretical work that have direct or indirect implications for an analysis of the effects of investment incomes. Section four looks at the dynamics of the links between investment and investment incomes. Section five assesses the position of the EU countries and of the EU as a whole, in terms of patterns and trends in incomes from FDI. Section six looks at some details of the UK position and section seven concludes.

II The impact of foreign investment incomes: theoretical background

As already mentioned investment income is, in many respects, a special component of international flows and of integration across countries. This special role is due to the intertemporal nature of both its causes and effects. Among the latter ones we must include the wide effects on the structure of the balance of payments as well as on the long-term structure of the tradable sector of the economy. Intertemporal elements in relation to the balance of payments have been considered in the economics literature and many authors have attempted to model them. Three specific aspects of intertemporality have been analysed.

Buiter, 1981 develops a model of time preference and overlapping generations for two economies in autarky and open-economy situations. The welfare effects of time-preference for consumption is an issue often considered in the literature and goes back, for example, to Ramsay, 1928. Buiter introduces a comparative analysis within assumptions of closed and open systems with movements of portfolio capital and for different rates of time-preference for consumption in the two economies.

In the open economy case, the country with high time-preference - thus the one in which the residents prefer to consume more when young - will also have higher interest rates. The resultant inward flows of capital will secure the younger generation in this country a higher level of consumption and welfare compared with the country where the time-preference rate is low. There will not be any effects on the older generation in either country.

Buiter's analysis relates to movements of financial capital for lending and borrowing purposes, rather than to FDI. The model is developed in terms of a single commodity. The extension to two commodities would allow a separate analysis of the effects on the tradable sector and on the balance from capital movements.

In synthesis, Buiter's analysis is concerned with the effects of intertemporal consumption choices on international capital flows and of these on the balance of payments and on the level of consumption and welfare in the two countries.

Sachs, 1982 links the structure of the current account to intertemporal plans by economic agents, be those individuals, companies or governments. He writes (p. 147):

For an open economy linked to a world market, one important aspect of intertemporal plans is the time path of net indebtedness of domestic agents to the rest of the world. When agents face an intertemporal budget constraint, a decision to alter current indebtedness implies changes in future consumption possibilities, and so will be based on expectations of the entire future path of key variables, and not just today's variables. For this reason, an economy's current account, which measures changes in national net indebtedness, depends as much on future economic trends as on the current economic environment.

One outcome of these intertemporal links is that a policy of external balance on the current account does not make sense on a year-to-year basis but only on a medium- to long-term basis. "Household welfare is improved by the possibility of running current account surpluses and deficits in response to exogenous shocks" (p.148). Two specific consequences are derived: "...farsighted behaviour by householders and firms makes the current account a function of current and future expected variables..." and "...temporary disturbances have long-run effects through their impact on the optimal intertemporal consumption path of households". One of the indirect effects is that governments can affect the current account balance by policies that lead to the reallocation of resources

between generations. The model is entirely based on consumption and therefore it cannot allow for the effects of domestic or foreign investment, let alone the flow of incomes from foreign investment. Nonetheless, it is interesting in its analysis of the links between the intertemporal choices in the real sector (intertemporal consumption path) and the intertemporal effects on the balance of payments.

Rowthorn and Wells, 1987 analyse the balance of payments in terms of commercial and residual balance. The commercial balance consists of all imports and exports of goods and non-government services (including private transfers, such as migrants' remittances to their dependants abroad), while the residual balance comprises all government payments and receipts (including transfers), together with property income from abroad and long-term capital investment. They also consider the effects of exogenous shocks on the balance and then extend it to effects on the real sector. An exogenous improvement in the UK commercial balance due to surplus in services and/or in oil, leads to a stronger currency and to the acquisition of overseas assets. At first, this outflow in capital counteracts the effects on the commercial account and keeps the exchange rate at a level that will prevent negative effects on the manufacturing balance. However, in the longer run, the outward investment will generate inflows of incomes. These may lead to a surplus on the commercial balance with effects on the exchange rate and eventually on the manufacturing balance. The value of foreign assets may continue to increase due to reinvested profits, even in the absence of new investment funds leaving the country. In summary, the incoming investment incomes related to past outward investment may cause a squeeze on the tradable sector of the economy - particularly the manufacturing one in the case of Britain - while the level of consumption can be boosted by the overseas earnings. Rowthorn and Wells call this situation "the wealth trap" to highlight how, through time, foreign wealth and assets may actually turn out to be a trap for the productive potential of the country. They write (p.92):

Thus, a relatively immature capital exporting country can quite quickly find itself in the "Wealth Trap"; namely, in a situation in which it ceases to be a net capital exporter, and becomes a "rentier" nation - despite the fact that it continues to export foreign assets.

As with other authors, the overall effect on the real sector partly depends on the extent to which the incoming flows - from investment incomes in the case of Rowthorn and Wells analysis - are spent on consumption or on supporting a strategy leading to long-term investment and industrial modernisation. The effects will also depend on the level of exchange rate that the economy is allowed to reach by a combination of the above elements together with specific monetary policies.

The effects of monetary policies on the balance of payments and, through it, on the real sector of the economy, are among the factors analysed in Krugman, 1987. He considers the long-run effects of appreciation in the exchange rate on the real economy. He specifically deals with the currency appreciation due to exogenous factors such as the exploitation of tradable resources, particularly oil (the Dutch disease) or to government policies (Mrs Thatcher's policies). However, the model can be extended to other factors leading to currency appreciation. Among these we could include the exogenous improvement in services - as in the Rowthorn-Wells' analysis - or the effect of net inward incomes from foreign investment.

The crux of Krugman's analysis is the introduction of dynamic economies of scale, consistently with his overall approach to the theory of trade (Krugman, 1985 and 1991). This means that if the appreciation of the currency leads to the loss of domestic industries and their substitution with foreign output and imports, the cumulative effects of economies of scale through time will make it very difficult for the industries to be re-established in the domestic economy even after a correction in the exchange rate takes place. Essentially exchange rates can go up and down fairly flexibly, but this does not lead to similar flexibility in the productive potential. Once industries are lost to the country they may not easily be re-established and the comparative position of the country in the affected industries will be seriously compromised.

These various authors are, in the last analysis, all trying to look at intertemporal links between various variables in the economy and in particular their cause/effect links with the balance of payments. Through these links some authors reach conclusions for possible

effects on the real sector of the economy. In Buiter the emphasis is on inter-country comparisons, on lending and borrowing between them and on consumption levels and welfare implications in the two countries. In Sachs it is more on the effects of exogenous shocks and/or agents' plans and strategies on the behaviour of the economy and on the current balance. Similarly Rowthorn and Wells emphasise the effects of exogenous shocks and give a special role to long-term investment and their incomes. The intertemporal effects in Krugman are of a different nature as they relate mainly to dynamic economies of scale through which the real sector of the economy is affected.

The Reddaway reports (1967 and 1968) assesses the effects on the UK economy of outward FDI including the balance of payments effects of both FDI and the profits from accumulated capital from FDI. It distinguishes between **initial**, short-term effects and **continuing**, long term ones. The initial effects are due to the possible outflow of funds when the investment takes place. The continuing effects are due to the profits from the accumulated assets. The final report stresses the possible conflict between short- and long-term advantages for the balance of payments and gives the following summary of effects (p. 338):

- i. *An average act of direct investment overseas will strengthen the future balance of payments on current account, - even after deducting the interest payable on the overseas borrowing (or the equivalent) by which, at least from the national point of view, such an act of investment is almost wholly financed.*
- ii. *In consequence, a steady rate of direct investment overseas would, if maintained long enough, provide enough of an annual surplus on current account to finance the annual quota of new investment.(...)*
- iii. *Nevertheless each single act of direct investment overseas has an immediate effect on the balance of payments (capital and current account together) which is far larger than one year's 'continuing benefit', so that a restriction of the outflow brings a 'cash' or 'financing' benefit for a substantial number of years.*

The analysis in the two reports in terms of ‘initial’ and ‘continuing’ effects is linked to the intertemporal links between FDI and the related profits and repatriated earnings on the balance of payments. However, what it does not consider is the possible long-term effect on the structure of the balance of payments and through it on the tradable sector of the economy and thus on the structure of the real economy. These are the sort of issues that Rowthorn and Wells, 1987 and Krugman, 1987 and - to a lesser extent - Sachs, 1982 tackle.

The need to analyse the direct and indirect connections between trends and patterns in foreign direct investment and the structure of the balance of payments is - indirectly - highlighted in Davies 1990. This paper considers the industrial components of the UK trade balance in the period 1986-1989 and finds the main deterioration to be due to industrial inputs and in particular to those inputs related to consumption. This is in itself an interesting conclusion. However, the point could be further developed by considering the role of TNCs and FDI in the findings of the paper. Transnational companies are responsible for very large amounts of trade some of which is intra-firm trade⁴ linked to the cross-countries vertical integration strategies of companies. A large amount of inward and outward investment may lead to large volumes of trade, often trade in the same industrial category. This helps to explain why both intra-firm and intra-industry trade have been increasing. One further consequence is that the deterioration of trade in industrial inputs observed by Davies may be connected with the pattern of FDI and with the TNCs’ sourcing strategies for materials and components.

III Foreign investment earnings and the real economy

Some of the effects of investment incomes directly impact on the real economy, for example through the effects on consumption and through the distributive effects on

⁴ Estimates for the USA (UNCTAD-DTCI, 1992:200)) assign some 80 per cent of total trade to TNCs. As regards intra-firm trade the estimates give one third for exports and over two fifth for imports.

resources across countries. There are also effects on the real economy that come about through the balance of payments effects of the flow of investment incomes. Some of these effects have already been mentioned with respect to the Rowthorn-Wells' and Krugman's models.

In terms of assessment of the effect, much, of course, depends on the structure of the balance of payments at the starting point, say at the beginning of a wave of outward investment. For example, Rowthorn and Wells start from the position of a country (the UK) in which an exogenous improvement in the balance of payments (due to improvements in services and/or contribution from North Sea Oil), raises the exchange rate and is in danger of squeezing out the manufacturing contribution.

Inward investment and the resultant outflow of incomes will have opposite effects on the balance of payments and, through it, on the real sector whether the effects are analysed through the Rowthorn-Wells model or the Krugman's one. Moreover, inward direct investment in greenfield plants will have the sort of positive dynamic effects considered by Krugman. Foreign direct investment through mergers and acquisitions may also have dynamic effects if the restructuring and integration of the acquired plants into the rest of the company bring to the company itself and the country economies of scope if not of scale. This is an important issue since in the 1990s mergers and acquisitions across borders represented over three-quarters of the overall FDI flows worldwide.⁵

What we should note here is the fact that foreign investment and investment incomes have a direct intertemporal relationship which compounds with other more indirect intertemporal relationships as the ones analysed by Sachs. Moreover, this particular intertemporal relationship shows two characteristics: first there is a lag between the investment flows and the resultant flows of incomes though the two flows go in opposite directions. Secondly, the effects of investment on the flow of incomes are continuous and cumulative and equal flows of investment give rise to compound effects on incomes flows in future years. Each year's flow of FDI adds to the stock of net assets on which profits are

⁵ Calculation from data in UNCTAD-DTCI, 1997.

earned. These effects and patterns are highlighted in the Reddaway Reports. Moreover, the pattern of FDI and TNCs' activities across countries affects the structure of trade as noted with reference to the findings of Davies, 1990.

IV Dynamic patterns of investment and earnings

In section one I noted the different positions of developed and developing countries on FDI. It was also noted that within the developed countries there are considerable differences in FDI patterns. Given the relationship between FDI and earnings, this is bound to reflect on different patterns of earnings.

Dunning and Narula, 1994 have linked the FDI patterns to stages of development of countries in a model that incorporates Dunning's original eclectic paradigm (Dunning, 1977 and 1981). The paradigm is based on the analysis of ownership, location and internalisation (OLI) advantages by companies and countries. The stages of development of a country, reflected in its GNP per capita, affect the locational advantages of the country and thus the amount of inward investment. It also affects the ownership advantages and competitive position of its companies and therefore its outward FDI. Both locational and ownership advantages are also influenced by government policies, whether they are reflected in the building of attractive infrastructures or in congenial industrial and macroeconomic policies.

Dunning and Narula identify five stages linking GNP and net outward investment (NOI) i.e. the difference between outward and inward FDI. Countries at very low level of development (stages one and two) have negative NOI. At stage three, the NOI increases rapidly; it becomes positive and still growing at stage four. Countries in stage five move towards a position of balance between outward and inward FDI therefore towards a smaller and smaller NOI. Developed countries will fall within stages three and five.

The Dunning-Narula framework can be used to analyse the intertemporal relationship between FDI and earnings. Given the link between FDI and earnings, the development path of FDI is bound to be reflected in a similar dynamic pattern of net outward earnings (NOE) i.e. difference between earnings from outward and inward FDI. However, there is likely to be a lag in earnings as well as a cumulative effect because profits are earned on successive cumulative FDI. In terms of countries' flows of credits and debits, earnings move in the opposite direction to FDI.

Given the interaction between the two paths one would expect a pattern of NOE such that countries will exhibit a position of net payers of earnings (developing countries and developed countries in stage three of NOI) or a position of net receivers (countries in stage four) or one of long-term balance (countries in stage five).

We should, however, avoid the simplistic inference that countries *automatically* move from stage one to five. The stages of development depend on complex socio/political/economic factors. Countries may be stuck into a low level of development at which the infrastructure is too poor to attract inward investment and the development of its corporate sector too low for companies to be able to compete and invest abroad. Indeed, there may be a cumulative causation and spirals of vicious/virtuous circles at work that in some cases give further advantages to companies/countries that have a long history of outward investment, in other cases favours countries that are already receiving inward investment in the allocation of new international projects. Similarly, the root causes of inward and outward investment may depend on a variety of factors not fully captured by the stage of development of the country and its GNP. If countries remain stuck into a pattern of negative NOI - whether due to their stage of development or not - they remain net payers of earnings. In some cases the considerable net outflow of earnings may further contribute to keep them in their current stage of development. On the opposite side some countries may remain in a position of positive NOI for long periods due to the stage of development as much as to historical and political reasons.

V The position of EU countries

The countries of the EU are in different positions as regards the inward and outward FDI and they are also at different stages of development in the FDI path. Table 1 gives details of patterns for each EU country - on current membership - and for the EU as a whole. Three years averages over the period 1983 to 1995 are given, though for some countries the data are available only for a more limited period or indeed not available at all. This is why the data for the EU as a whole is given for 1995: the only year for which all data are available for most countries. The first three columns present values of outward and inward FDI, and the difference between them or net outward investment (NOI). In some countries the net outward investment is positive as their outward investment outstrips the inward flows (third column). Definite results on this are shown by, for all the periods, by Austria, Finland, Germany, the Netherlands and the UK. The next three columns give the corresponding values for investment incomes with the sixth column showing net outward earnings (NOE). In 1995 the EU countries as a whole were net outward investors for \$ 23443 and receivers of net earnings for \$ 15773.

The last two columns give the ratios between incomes from investment and the relevant flow of FDI to which that income is linked. These ratios should not be interpreted as rates of return: the denominators are year to year flows and not capital stocks. They should be seen as percentages of FDI covered by the corresponding earnings. For the EU as a whole the incomes from FDI cover over half of the new flows of investment in 1995: 0.57 for outward and 0.52 for inward investment. However, these cumulative, average ratios disguise great differences between countries. In some countries and for some periods, the earnings are higher than the new flow of investment (ratios greater than one); among these countries are the UK (on both outward and inward sides) Ireland (for the last three years) Germany (on the inward side).

VI Who pays, who earns in the EU?

Table 2 presents ratios related to the position of each EU country - on current membership - and of the total EU on FDI and earnings for both outward and inward sides. Three sub-periods within the 1983-95 years are considered in order to analyse underlying trends: 1983-85, 1988-90 and 1993-95. The ratios refer to: outward over inward FDI and earnings on outward over earnings on inward FDI. Ratios greater than one on the first three columns indicate that the country (region) has invested abroad more than it has received as inward investment. Ratios greater than one for the next three columns indicate that the country (region) is in receipt of earnings from outward FDI to a larger extent than it pays on its inward FDI. The information given in table 2 is similar to the one in table 1 columns 3 and 6. However, the ratios in table 2 - unlike the differences in table 1 - are independent of size.

The EU as a whole is a net outward investor as shown by ratios of outward to inward FDI higher than one and as exemplified by the positive value for NOE (\$15773) in table 1 col. 6. The ratios are decreasing from 1.65 in the period 1983-85 to 1.44 in 1988-90 and to 1.29 in the 1993-95 years. This is an indication of higher growth rates for inward than outward investment most likely caused by the surge of inward investment in the region as European integration proceeded. It must be noted that the data in tables 1 and 2 are inclusive of intra-EU FDI. Thus the surge of inward investment refers to investment both by non-EU countries (such as USA or Japan) and by the individual EU countries investing into each other. The latter flows, of course, appear as both outward and inward FDI in the total for the EU. Nonetheless, it may have contributed to higher growth rates on the inward side since the inward FDI values started from lower figures. There has also been considerable inward investment from non-EU countries in the run-up to the Union (Thomsen and Woolcock, 1993).

This trend in FDI is reflected on earnings from outward and inward FDI which show ratios varying from 1.16 in 1983-85 and 1988-90 to 1.29 in 1993-95. The increasing ratios are likely to be due to the lagged and cumulative relationship between FDI and earnings. The effects of higher growth in inward than outward FDI will be felt on the earnings in a few years time; we can thus expect lower ratios in the future.

Within the EU some countries are net receivers of earnings and thus exhibit a ratio greater than one. Among these are: the UK (whose ratio is increasing from 1.14 to 1.85 and 1.96 in the three sub-periods), Sweden which shows very high though decreasing ratios (from 3.26 to 3.90 to 1.71), the Netherlands and France. Other countries are net payers: ratios consistently less than one are shown by Austria, Greece, Finland, Ireland, Portugal and Spain. Italy goes from a ratio of less than one in 1988-90 to a ratio of 1.85 in 1993-95: a reflection of its improved position on outward investment. Finland's position might, at first sight, appear anomalous since it has ratios of outward to inward FDI considerably greater than one in all the three sub-periods though the earnings ratios are considerably below one in all three periods. However, there are large oscillations in FDI -particularly the outward ones - over the 1983-95 period which account for the above results. The large flow of net outward FDI in the 1993-95 years should produce higher ratios of earnings in the years to come.

VII Details of the UK position

Earnings from FDI and from portfolio investment in general are a very relevant component for the UK economy and its balance of payments in particular. Glover and Parker, 1996 (table 2.6) point out how total investment income contributes over 60 per cent of the total invisibles to both sides of credits and debits.

Table 3 presents details on the UK overall position - in relation to the world as a whole - over the 1974-95 years. Columns B and E give the percentage of FDI financed out of reinvested profits for the outward and inward FDI respectively. Reinvested profits covered 52.5 per cent of the outward FDI and 28.5 per cent of the inward one over the 22 years period. This is again a reflection of the long history of outward FDI by UK TNCs. It must, however, be noted that the data for inward and outward FDI may not be fully comparable because not all countries include retained earnings in their FDI data as the UK does.

The ratio of net earnings to FDI over the whole period is 93.4 for outward FDI and related earnings and 81.0 for the inward FDI side.⁶ Thus, on the whole, the earnings from outward FDI have covered the acquisition of assets abroad to a larger extent than the earnings from inward FDI in relation to the acquisition of assets in the UK by foreign TNCs. The UK, with a long history of outward FDI can rely on a large flow of incoming earnings to fund new acquisitions. The possibility of acquiring assets abroad with little or no outflows of funds or indebtedness is pointed out in Reddaway, 1968: 338, and by Rowthorn and Wells, 1987: 92 (both quoted in sec. 2 above).

The reinvested profits as a percentage of FDI (columns B and E) reflect the micro picture: how companies fund their acquisitions of assets abroad. The ratio of earnings to FDI (columns C and F) give the macro position: how the overall acquisitions of new assets for the country as a whole, matches up with the overall earnings linked to past and present assets.

The last two columns show the UK as a net outward investor (with ratios between outward and inward FDI greater than one). Correspondingly, the earnings position also gives ratios considerably greater than one.

Tables 4 and 5 present respectively the outward and inward pattern for UK FDI and earnings broken down by EU country. In the three sub-periods, the countries of the EU (current membership) absorbed annual averages of 25, 18 and 39 per cent respectively of the UK total outward FDI (table 4). The growing share of FDI is mirrored by a growing share of earnings which moved from an annual average of 20 to 23 to 29 per cent in 1974-76, 1985-87 and 1993-95 respectively. Particularly noticeable is the increase in the post-1992 period.

In the EU as a whole the value of UK earnings on outward FDI (table 4) is lower than the value of new assets acquired though still with quite high percentages of 89, 87 and 76 in the three periods. These percentages are lower than the corresponding one for all UK

⁶ It should be pointed out that since the sub-periods do not include all the years in the overall period, the averages for the full 22-years period do not coincide with the averages of the three sub-periods.

earnings/FDI ratios (table 3 column 4). This is a sign of the acceleration of FDI in EU countries (with growth rates higher than in the world as a whole) particularly in the 1993-95 period. Within the EU the earnings come mainly from Germany, the Netherlands, Ireland, Belgium/Luxembourg and France. The percentage of earnings from Germany is decreasing from 28 to 19 to 12 per cent in the three periods while that of the Netherlands has increased from 13 to 35 to 49 per cent.

Table 5 shows that the countries of the EU as a whole have been responsible for high percentages of FDI in the UK (21, 42 and 29 in the three periods). The EU share of earnings has increased from 15 to 20 to 34 per cent in 1974-76, 1985-87 and 1993-95 respectively. The countries' breakdown shows that the earnings go mainly to Dutch, French and German companies.

The ratios of earnings from inward FDI to FDI in the three sub-periods are 71, 49 and 124 per cent. The high value in the last period is far greater than the corresponding one for all UK inward FDI which shows a percentage of 107.4 (table 3 column 8). This discrepancy is due to the growing share of inward FDI into the UK by companies from EU countries in the last ten years.

Table 6 gives the UK net earnings (earnings on outward minus earnings on inward FDI) with other EU countries in the three periods 1974-76, 1985-87 and 1993-95. It allows us to assess the flow of earnings between the UK and every other EU country. The overall balance for the EU is positive: the UK is a net receiver of earnings not only from the world as a whole, (as from data in tables 1, 2 and 3) but also from the EU as a whole. Particularly high is the net inflow of earnings in the 1993-95 period (£2463m). Moreover, the countries breakdown shows that every EU country - with the exception of France for the last two periods and Sweden for the first two - has been a net payer of investment incomes to the UK.

VIII Conclusions

The paper considers the pattern of earnings from FDI in relation to the pattern of inward and outward FDI. It stresses the intertemporal and cumulative relationship between FDI and earnings and thus, for any given country, the relevance of the history of FDI in today's position as net payer or receiver of earnings.

It reviews some literature on intertemporal effects and the balance of payments and argues by analogy on the intertemporal pattern between FDI and earnings and on possible effects of the pattern of earnings on the balance of payments and the real economy.

It then goes on to give the position of the EU countries as a whole and for each of them in relation to their net earnings with the rest of the world. The EU as a whole is net receiver of earnings as are all the developed countries due to their positive gap between outward and inward FDI. This broad, cumulative pattern conceals big countries differences which are bound to exist within the developed countries and within the countries of the EU in particular, given the high levels of both inward and outward FDI in which they are involved.

Some EU countries are clearly net receivers of earnings from the world as a whole (the UK, the Netherlands, Sweden) others are net payers (Austria, Finland, Greece, Portugal, Spain). For other countries their position varies in different periods. In any case all countries are likely to see changes in their long-term trend in earnings as the FDI pattern evolves. Thus the earnings pattern must be interpreted dynamically and we must expect lagged effects on earnings compared to patterns of FDI.

A section on the UK shows the detailed position of this country with the rest of the world as a whole and in relation to the whole of the EU and each EU country. The UK is net receiver of earnings from other EU countries. In the 1993-95 period 29 per cent of its earnings on outward FDI came from other EU countries; some 34 per cent of earnings on inward investment were destined to companies from other EU countries which have invested in the UK.

A very high percentage of earnings on outward FDI to FDI in relation to the world as a whole (reaching an average of 99.8 per cent in the 1993-95 years) supports the Reddaway prediction that, in the long run, the acquisitions of new assets abroad could be paid out of earnings on past foreign assets. What the Reddaway report could not predict is that a similar trend would evolve on the inward side for which the average ratio of earnings to inward FDI was 107.4 in the 1993-95 sub-period. Nonetheless, the UK's net position is still one of net outward investor and of net receiver of earnings from the world as a whole.

A similar position is held by the UK in the EU and indeed the relative position on outward and inward FDI in the countries of the EU has been strengthening particularly in the run-up to 1992. The UK has been net receiver of investment incomes from the EU as a whole throughout the 1974-95 period. Indeed each country of the EU - with the exceptions of France and Sweden for some sub-periods - have been net payers of investment incomes to the UK.

The Rowthorn-Wells' claim that the increase in earnings from outward FDI would neutralise the balance of payments effects of any outward flows to fund the FDI thus contributing to a stronger pound and negative effects on the goods and services balance, must be qualified with the following. First, the acquisition of assets, at the level of companies, tends to be funded via retained profits to the tune of 52.5 per cent thus limiting the effects on lowering the exchange rate by acquisition of foreign assets. Secondly, their point that the inflow of earnings can neutralise any balance of payments effects of outward FDI is corroborated by the data and trends. However, we should bring into the equation the inward side which is significant and for which the earnings are also neutralising the inflow of FDI. The danger of the UK becoming a 'rentier nation' with foreign incomes substituting for domestic ones must be reconsidered in the light of big increases in inward FDI and related large outflows of investment incomes on this FDI.

Moreover, the inward FDI - particularly those in greenfield plants - will, in the medium- to long-term have the sort of dynamic economies of scale and related positive effect, as discussed in Krugman, 1987. It more debatable whether FDI through mergers and acquisitions can have the same dynamic scale economies. This is an important distinction

for the UK economy for which, in the 1993-96 period 96 per cent of inward FDI took the form of mergers and acquisitions (majority-owned stakes). On the outward side and for the same period, the percentage of majority-owned purchases abroad by UK companies in relation to total outward FDI flows was 56 per cent.⁷ Thus the ratio of new capacity creation (greenfield plants) in total outward FDI is higher than the ratio of new capacity in the FDI hosted by the UK.

To summarize, investment earnings are a very considerable component of international transactions and thus of integration particularly within the EU. It is a component with a strong intertemporal dimension and thus one which is likely to have delayed and cumulative effects on the balance of payments and on the real economy. Moreover, the different countries of the EU find themselves in different positions on earnings. There is likely to be a good amount of distribution of resources taking place via investment earnings whether such earnings are repatriated or used for further acquisition of assets in the host country, as the specific UK case demonstrates.

⁷ Calculations based on data from UNCTAD-DTCI, 1997.

Table 1: Foreign Direct Investment Flows and Earnings. Averages 1983-1995. Total EU and Member Countries.

Values and Ratios. (\$US million)

Country/Area and Period		Outward FDI	Inward FDI	FDI Outward minus Inward	FDI Earnings from abroad	FDI Earnings to abroad	FDI Earnings credits minus debits	Earnings from outward FDI to Outward FDI	Earnings from inward FDI to Inward FDI
		(A)	(B)	(A-B)	(C)	(D)	(C-D)		
Austria	1988-90	959	559	400	241	879	-638	0.25	1.57
	1993-95	1270	1215	55	271	712	-441	0.21	0.59
Bel/Lux	1995	*588	*7464	-6876	3667	5164	-1497	*6.24	*0.69
Denmark	1983-85	188	62	126	na	na	na	na	na
	1988-90	1423	908	515	na	na	na	na	na
	1993-95	2835	3619	-784	na	na	na	na	na
Finland	1983-85	326	111	215	-4	148	-152	-0.01	1.33
	1988-90	2791	611	2180	48	468	-420	0.02	0.77
	1993-95	2422	1086	1336	133	585	-452	0.05	0.54
France	1983-85	2025	2240	-215	516	203	313	0.25	0.09
	1988-90	22939	10659	12280	1163	1431	-268	0.05	0.13
	1993-95	20713	20372	341	4818	3257	1561	0.23	0.16
Germany	1983-85	4150	883	3267	1480	1823	-343	0.36	2.06
	1988-90	17177	3567	13610	4427	5803	-1376	0.26	1.63
	1993-95	22287	3857	18430	5437	4230	1207	0.24	1.10
Greece	1984-86	na	468	na	3	17	-14	na	0.04
	1988-90	na	888	na	9	67	-58	na	0.08
	1993-95	na	1004	na	44	160	-116	na	0.16
Ireland	1993-95	493	1455	-962	519	6451	-5932	1.05	4.43
Italy	1988-90	4752	5126	-374	209	1266	-1057	0.04	0.25
	1993-95	7279	3808	3471	981	530	451	0.13	0.14
Netherl.	1983-85	3788	1499	2289	3099	2369	730	0.82	1.58
	1988-90	12466	8564	3902	6840	5805	1035	0.55	0.68
	1993-95	13502	7835	5667	8889	5882	3007	0.66	0.75
Portugal	1983-85	17	197	-180	3	11	-8	0.18	0.06
	1988-90	109	1756	-1647	3	72	-69	0.03	0.04
	1993-95	373	1152	-779	50	234	-184	0.13	0.20
Spain	1983-85	247	1787	-1540	119	281	-162	0.48	0.16
	1988-90	2077	9811	-7734	341	2200	-1859	0.16	0.22
	1993-95	3352	7918	-4566	409	1749	-1340	0.12	0.22
Sweden	1983-85	1587	303	1284	790	242	548	0.50	0.80
	1988-90	10799	1822	8977	3321	852	2469	0.31	0.47
	1993-95	6267	8073	-1806	4296	2517	1779	0.69	0.31
UK	1983-85	8931	**4956	3975	9898	8669	1229	1.11	**1.75
	1988-90	30697	28132	2565	26667	14380	12287	0.87	0.51
	1993-95	31377	19350	12027	32170	16383	15787	1.03	0.85
EU TOTAL	1995	134962	118395	23443	74721	58948	15773	0.57	0.52

* 1994 data.

** excludes 1984 data.

All data are inclusive of intra-EU flows.

Source: IMF *Balance of Payments Statistics Yearbook*, Washington, various issues.

Table 2: Ratios of Outward to Inward FDI and of Earnings from Outward and Inward FDI analysed by total EU and members countries, 1983-1995. Averages.

Country	Outward FDI / Inward FDI			Earnings on outward FDI / Earnings on inward FDI		
	1983-85	1988-90	1993-95	1983-85	1988-90	1993-95
Austria	0.50	1.72	1.05	na	0.27	0.38
Belgium/Luxemburg	0.35	0.82	*0.8	na	na	*0.69
Denmark	3.08	1.57	0.78	na	na	na
Finland	2.94	4.57	2.23	-0.03	0.10	0.23
France	0.90	2.15	1.02	2.54	0.81	1.48
Germany	4.70	4.82	5.78	0.81	0.76	1.29
Greece	na	na	na	0.18	0.13	0.28
Ireland	na	**0.48	0.34	na	**0.09	0.08
Italy	1.73	0.93	1.91	na	0.17	1.85
Netherlands	2.53	1.46	1.72	1.31	1.18	1.51
Portugal	0.09	0.06	0.32	0.27	0.04	0.21
Spain	0.14	0.21	0.42	0.42	0.16	0.23
Sweden	5.24	5.93	0.78	3.26	3.90	1.71
United Kingdom	***1.80	1.09	1.62	1.14	1.85	1.96
Total EU Countries: ratios : values	1.65 23,670 / 14,338	1.44 112,082 / 77,804	1.29 112,758 / 87,204	1.16 15,907 / 13,763	1.16 49,664 / 37,573	1.29 61,684 / 47,854

na=not available * 1993-94 data for outward & inward FDI flow and 1995 data for earnings. ** 1990 data for outward & inward FDI flows. *** excludes 1984 data.

Source: IMF *Balance of Payments Statistics Yearbook*, Washington, various issues.

Table 3: UK Net Earnings and Direct Investment flows, Outward and Inward, Averages, 1974-1995. (£ million and percentages)

YEARS	OUTWARD FDI				INWARD FDI				Outward FDI / inward FDI (A) / (D)	Income on outward FDI / income on inward FDI (C) / (F)
	Outward FDI (A)	Reinvested profits as % of FDI (B)	Earnings on outward FDI (C)	Earnings/FDI (C) / (A)	Inward FDI (D)	Reinvested profits as % of FDI (E)	Earnings on inward FDI (F)	Earnings/inward FDI (F) / (D)		
	<i>Value</i>	<i>%</i>	<i>Value</i>		<i>Value</i>	<i>%</i>	<i>Value</i>	<i>%</i>	<i>Ratio</i>	<i>Ratio</i>
1974-76	1631	65.1	1821	111.7	756	45.8	762	100.8	2.2	2.4
1985-87	13194	42.2	8742	66.3	6349	43.9	6651	104.8	2.1	1.3
1993-95	20741	58.9	20702	99.8	9749	39.6	10473	107.4	2.1	2.0
1974-95*	9521	52.5	8888	93.4	5951	28.5	4823	81.0	1.6	1.8

* 1984 data are not included

Source: CSO/ONS *Business Monitor MA4 - Overseas Direct Investment*, London: HMSO, various issues

Table 4: UK Total Outward FDI and Total Inflows of Net Earnings on Outward FDI analysed by total EU and member country, 1974-1995. Averages (£ million & percentages).

Country/Area	1974-76				1985-87				1993-95			
	Outward FDI		Earnings on Outward FDI		Outward FDI		Earnings on Outward FDI		Outward FDI		Earnings on Outward FDI	
	Value	%	Value	%	Value	%	Value	%	Value	%	Value	%
UK in EU	410		363		2329		2023		8011		6058	
UK in EU: earnings/FDI				89				87				76
EU as % of UK Total				20				23				29
EU	410	25	363	100	2329	100	2023	100	8011	100	6058	100
Austria	12	100	15	4	31	1	43	2	86	1	56	1
Belgium/Luxembourg	55		50	14	63	3	126	6	151	2	465	8
Denmark	12	3	10	3	-9	0	58	3	235	3	203	3
Finland	4	13	4	1	6	0	10	1	50	1	31	1
France	73	3	43	12	273	12	171	8	744	9	420	7
Germany	112	1	103	28	237	10	377	19	1362	17	739	12
Greece	1	18	1	0	6	0	7	0	95	1	-85	-1
Ireland	38	27	47	13	164	7	167	8	670	8	605	10
Italy	15	0	15	4	177	8	128	6	312	4	198	3
Netherlands	36	9	47	13	1061	46	709	35	3449	43	2944	49
Portugal	4	4	na	na	97	4	50	2	101	1	134	2
Spain	29	9	16	4	192	8	134	7	343	4	196	3
Sweden	19	1	12	3	31	1	43	2	413	5	152	3
		7										
		5										

na=not available

Source: CSO/ONS Business Monitor MA4: Overseas Direct Investment (various issues)

Table 5: UK Total Inward FDI and Total Outflows of Net Earnings on Inward FDI analysed by total EU and member country, 1974-1995. Averages (£ million & percentages).

Country/Area	1974-76				1985-87				1993-95			
	Inward FDI		Earnings on Inward FDI		Inward FDI		Earnings on Inward FDI		Inward FDI		Earnings on Inward FDI	
	Value	%	Value	%	Value	%	Value	%	Value	%	Value	%
UK from EU	159		113		2694		1333		2910		3595	
UK from EU: earnings/FDI				71				49				124
EU as % of UK Total		21		15		42		20		29		34
EU	159	100	113	100	2694	100	1333	100	2910	100	3595	100
Austria	2	1	0	0	2	0	-2	0	38	1	40	1
Belgium/Luxembourg	16	10	23	20	242	9	69	5	116	4	221	6
Denmark	9	6	9	8	34	1	36	3	77	3	79	2
Finland	5	3	1	1	-5	0	0	0	-18	-1	12	0
France	46	29	29	26	557	21	270	20	371	13	443	12
Germany	26	16	14	12	152	6	83	6	1208	42	607	17
Greece	1	1	0	0	na	na	na	na	na	na	na	na
Ireland	11	7	7	6	28	1	70	5	na	na	108	3
Italy	6	4	6	5	59	2	51	4	195	7	na	na
Netherlands	3	2	10	9	1422	53	679	51	831	29	1954	54
Portugal	0	0	0	0	na	na	na	na	na	na	na	na
Spain	0	0	1	1	6	0	6	0	19	1	38	1
Sweden	34	21	13	12	197	7	71	5	73	3	93	3

na=not available

Source: CSO/ONS Business Monitor MA4: Overseas Direct Investment (various issues)

Table 6: UK. Net earnings on FDI from EU countries. Averages, 1974-1995. £ m.

	Earnings on Outward FDI - Earnings on Inward FDI		
Country	1974-76	1985-87	1993-95
Austria	15	45	16
Belgium/Luxembourg	27	57	244
Denmark	1	22	124
Finland	3	10	19
France	14	-99	-23
Germany	89	294	132
Greece	1	na	na
Ireland	40	97	497
Italy	9	77	na
Netherlands	37	30	990
Portugal	na	50	na
Spain	15	128	158
Sweden	-1	-28	59
EU Total Ratio of earnings in Outward to earnings on Inward: £ m	250 3.2	690 1.5	2463 1.7

na=not available

Source: CSO/ONS Business Monitor MA4: Overseas Direct Investment (various issues)

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