

Trends in Foreign Direct Investment Inflows

This article briefly examines recent trends in foreign direct investment in Australia, both in the context of the longer-term perspective and relative to the experience of other countries. It also discusses the role of foreign direct investment within Australia's overall investment requirements, and outlines characteristics of foreign direct investment in relation to sector and type of asset acquired.

OVERALL INVESTMENT TRENDS

Business investment growth has strengthened since the early 1990s recession, with the result that in constant price terms investment as a share of Gross Domestic Product (GDP) reached a record level in 1996-97. Surveyed business intentions and continuing favourable economic fundamentals point to ongoing strong growth in the period ahead.

As a result, capital stock growth in recent years has recovered to above average rates, and is forecast to continue to strengthen. Coupled with improvements in the efficiency with which the capital stock is used, this strong growth in the capital stock provides the foundation for sustained strong growth in activity and employment.

Australia accesses foreign saving through either borrowing (debt) or greater foreign ownership of Australian activities (equity). Foreign direct investment (FDI) is one form of the latter. For official measurement purposes, FDI is regarded as an equity interest of 10 per cent or more in an enterprise.

A direct comparison of trends in FDI and capital expenditure (investment) is inappropriate. The latter reflects expenditure associated with the creation of new fixed assets (both related to equipment and machinery and to buildings and infrastructure development) or the accumulation of stocks of finished products and work in progress. FDI can be directed towards the acquisition of existing assets as well as to the acquisition of new assets and the resultant expansion of the physical capital stock, and the official data that is available does not distinguish between the two. That said, foreign investment is a relatively small source of funds for investment in Australia. Over the period since the early 1960s, FDI in Australia has been equivalent to around 7 per cent of gross fixed capital expenditure.

FDI has in the past followed a similar trend to total business investment, reflecting the fact that the same basic factors are needed to give good rates of

return on foreign and domestic investment — macroeconomic stability, microeconomic policies to improve efficiency and flexibility and a skilled labour market. Consequently, the factors currently creating a favourable environment for strong domestic investment growth are also likely to attract foreign investment.

FDI AND THE SAVING — INVESTMENT BALANCE

The Government's fiscal consolidation strategy is designed to reduce Australia's reliance on foreign saving, of which FDI is a component.

Australia has traditionally drawn on foreign saving to fund higher levels of investment than domestic saving alone would allow and to promote faster economic growth and higher living standards. As a result, Australia usually runs a current account deficit (which, over time, equals the excess of national investment over national saving) and this has meant growing net foreign debt and growing foreign ownership of Australian assets as non-residents contributed to capital formation. The widening in the current account deficit in the 1980s resulted in a faster build-up of net foreign debt and ownership. Concern about an 'excessive' build-up in foreign liabilities has focussed policy attention on boosting domestic saving to finance more of domestic investment locally.

The Government's commitment to underlying budget balance over the cycle specifically addresses those concerns, and will see the budget swing into underlying surplus in 1998-99. Reduced public sector borrowing will reduce our net reliance on foreign saving. This is the intended outcome of the Government's fiscal strategy.

While it is difficult to predict the extent to which different forms of capital inflow will be reduced, it is possible that there will be a reduction in net FDI inflows. If that occurs, it would at least partially reflect our greater ability to fund our own investment, rather than a decline in our attractiveness as a destination for FDI.

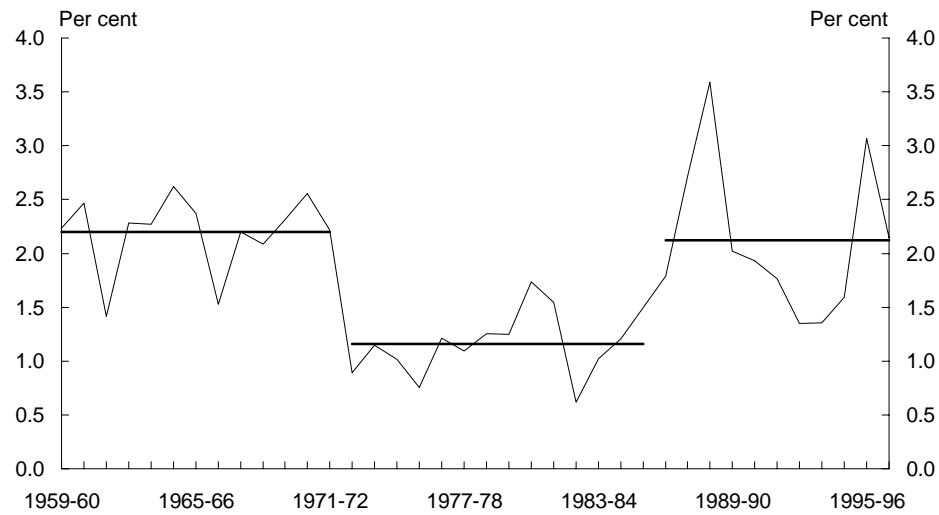
TRENDS IN FDI INFLOWS

Over the past decade, FDI inflows as a share of GDP have returned to levels comparable with those of the 1960s (Chart 1) and have been significantly higher than in the 1970s and the first half of the 1980s. In 1996-97, FDI inflow was a little more than 2 per cent of GDP (and amounted to \$11 billion).

Annual FDI inflows are highly volatile. Depending on the years chosen, FDI can be argued to have grown rapidly from 0.6 per cent of GDP in 1982-83 to 3.0 per cent in 1995-96, or fallen precipitously from 3.6 per cent of GDP in 1988-89 to 1.6 per cent in 1994-95 (see Chart 1). Neither statement is balanced

and the broad conclusion is that there is no evidence of either a declining trend or overall weakness in Australia's FDI inflows in the 1990s compared with the inflows in earlier decades.

Chart 1: FDI Inflows as a Proportion of GDP



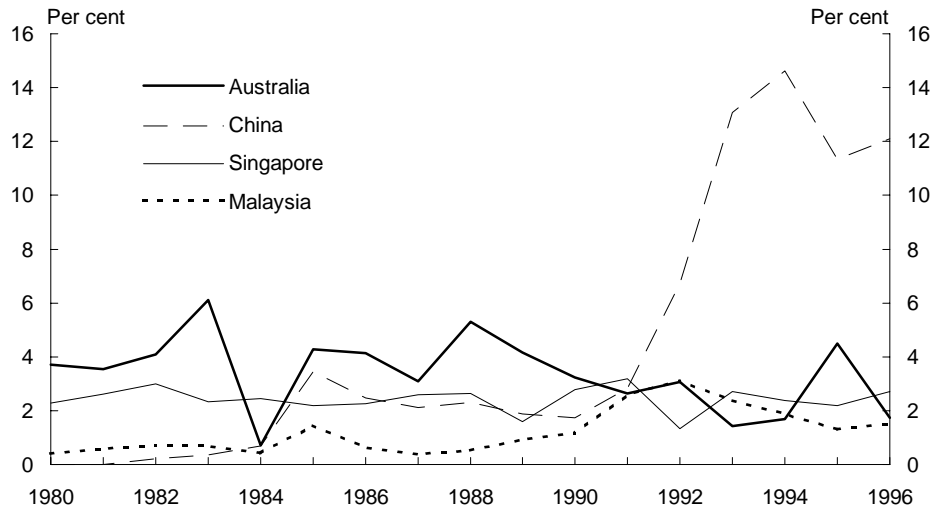
Source: ABS

FDI inflows reached an exceptionally high proportion of GDP in the late 1980s, coinciding with an unsustainable domestic investment boom, and the subsequent decline has to be seen in that context. FDI inflows are also influenced by Australia's business cycle and fell as a share of GDP in the period of weaker economic activity in the early 1990s. Since the mid-1980s, net FDI inflows have on average represented a smaller proportion of net total capital inflows. This reflects increased access to debt financing and increased attractiveness of the Australian share market where net portfolio investment in Australia increased to average 3.6 per cent of GDP since the mid-1980s compared with 1.5 per cent in the period from 1960 to 1985.

Australia's Share of Global FDI Inflows

Australia's share of world FDI inflows in 1996 was lower than it was in 1985 (Chart 2). However, given the sharp volatility of outcomes in the past three years, the extent of the apparent trend decline is unclear. Some decline in Australia's share of global inflows since the mid-1980s would not be unexpected given the rapid growth in China's share in the 1990s (reflecting the effects of the liberalisation of the Chinese economy) and given the rapid growth in GDP and total investment requirements in a number of East Asian economies during this period.

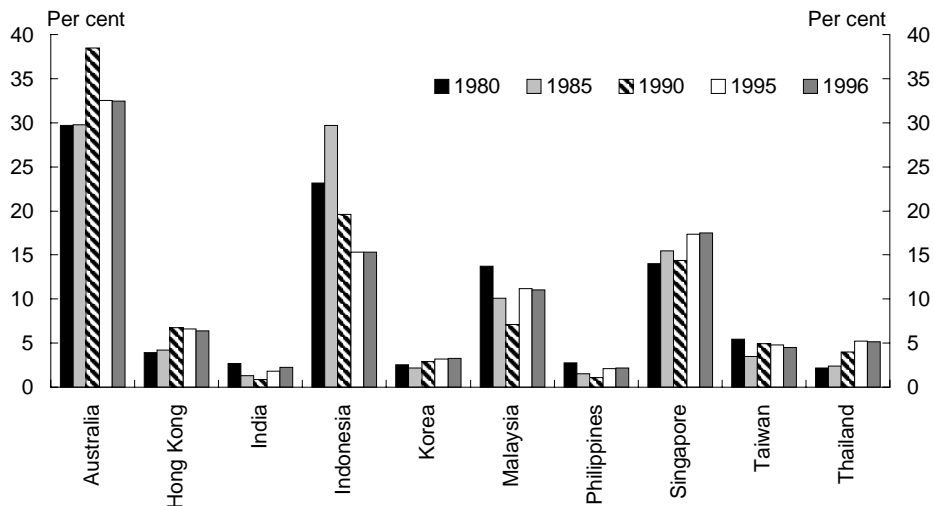
Chart 2: Major FDI Recipients in Asia — Share of Total World FDI Inflows



Source: Department of Foreign Affairs and Trade.

Looking at the stock of FDI reduces the impact of volatility in FDI flows, and hence makes the analysis much less dependent on the particular time period chosen. As illustrated in Chart 3, Australia has the highest share of the FDI stock in East Asia excluding China and it shows no sign of declining over time. Also, while East Asia's FDI stock has increased significantly as a proportion of GDP between 1980 and 1996 (from around 5 per cent to 16 per cent), Australia's stock has risen by a greater proportion (from 8 per cent to 34 per cent), and by much more than the increase for industrial countries (from 5 per cent to 10 per cent).

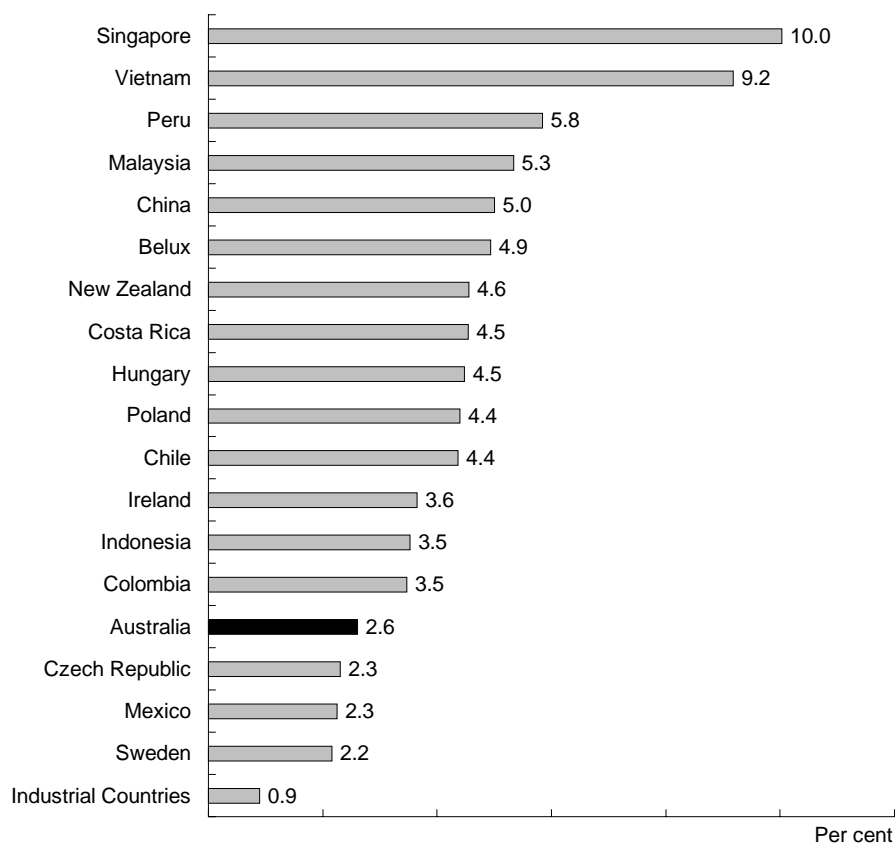
Chart 3: Share of Asian FDI Stock (excluding China)



Source: Department of Foreign Affairs and Trade.

Finally, while Australia ranked among the world's top 20 recipients of FDI relative to GDP in 1996, it is significant that a high level of FDI inflows is not necessarily associated with strong economic performance. With the notable exception of Singapore (and the arguable exception of some others), most of the largest recipients shown in Chart 4 (for example, Vietnam and Peru) are economies in transition or otherwise in need of foreign savings. Many of the highest FDI recipients tend to receive a high proportion of their foreign investment as FDI because (unlike Australia) their relatively underdeveloped financial markets provide limited (if any) alternatives for foreigners to invest in other forms (such as equity or debt securities).

**Chart 4: Largest Recipients of Foreign Direct Investment in 1996
(FDI inflow as a proportion of the recipient country's GDP)**



Source: Department of Foreign Affairs and Trade (overseas data), ABS (Australian data).

Sectoral Composition of Australia's FDI Inflows

While sectoral data on FDI are limited, they do not suggest that FDI inflows go predominantly to any one sector of the economy. Sectoral Australian Bureau of Statistics data on FDI inflows are available only for the 1980s and 1990s and do not necessarily reflect the final industry destination of the investment. That said, the data show only a relatively small proportion (around 4 per cent) has been directed to mining in the 1990s. The remainder has been fairly equally shared among the manufacturing, finance and other sectors. The share allocated to manufacturing has shown no long-term decline.

Similar observations are drawn from Foreign Investment Review Board data. These relate to foreign investment applications received in the administration of foreign investment policy and their reliability as indicators of actual FDI is therefore subject to significant qualification. Nevertheless, they indicate brisk growth in applications in the manufacturing and service sectors in the last four years, with proposed investment increasing more than three-fold for manufacturing (including electricity, gas and water) and over two and a half times for services (excluding tourism). There was a slight fall in the value of proposed investment in mineral exploration and development over this period, although the number of applications increased for that sector.

Some FDI in the 1990s would have involved the partial or full acquisition of existing businesses, particularly as a result of Commonwealth and State privatisation programmes. A distinction is sometimes made between FDI into existing businesses and that involved in establishing new businesses. However, what is crucial for growth of the capital stock is the overall pool of funds available to fund new investment. If FDI involves the purchase of stakes in existing businesses (whether previously privately or government owned), it still contributes to the pool of savings available for investment.

Some attention is given to the fact that FDI in establishing a new business will include an element of technology transfer. While FDI can be a source of technology transfer, this aspect of FDI is more important for developing economies, which lack the economic infrastructure to import technology by other means, than for a developed economy. FDI is a less important channel for technology transfer for industrial countries like Australia — globalisation of the world economy has meant that new technologies spread quickly between industrialised countries.

There are likely to be other benefits to Australia from FDI, for example those that flow from importing management skills or improving linkages with foreign markets. However, this does not require that FDI be associated with new projects — FDI directed to the purchase of existing businesses can also have these benefits attached.

CONCLUSION

Trends in FDI — which can be used for the acquisition of existing assets as well as for increases in productive capacity — should not be directly compared with trends in capital expenditure. Nevertheless, both FDI and business investment will be responsive to factors influencing rates of return on investment, and broad trends in both since the early 1960s have been similar. Recent and anticipated levels of investment are consistent with growth in the capital stock capable of supporting ongoing growth in output and employment.

Abstracting from volatility, recent FDI inflows as a share of GDP are around the average of outcomes experienced since the early 1960s. Furthermore, Australia's share of the total FDI stock is the highest of any country in the Asian region except China.

FDI in Australia is not concentrated in any particular industry sector, and contributes to the overall pool of saving available for productive investment, even if it is itself directed toward existing assets.