Special Commentary — February 23, 2023

Globalization in Retreat: Implications for the U.S. Economy

Part II: Foreign Direct Investment

Summary

- Flows of direct investment capital, both inbound to the U.S. economy and outbound, rose significantly starting in the 1990s. However, FDI flows have been more or less flat in recent years.
- Direct investment by foreign-owned companies accounts for about 15% of the eightfold increase in the U.S. capital stock over the past four decades. Strong investment helps to drive productivity growth, which in turns leads to rising real income. The doubling in per capita real income in the United States since 1980 is due in part to foreign investment.
- Employment at American affiliates of foreign companies grew significantly faster than total payrolls during the economic expansion of 2010-2019, and compensation at those affiliates is higher on average than among domestic companies. If FDI inflows were to downshift in coming years, then growth in productivity and real income could weaken marginally.
- The value of directly invested capital held abroad by American companies rose from about $200 billion in the early 1980s to roughly $6.5 trillion in 2021. Foreign affiliates of U.S. companies generated $1.5 trillion in net income on revenues of $7.7 trillion in 2019. With the global economy growing faster than U.S. real GDP, foreign operations represent important growth opportunities for American companies.
- Despite strong inflows and outflows of capital over the past few decades, the performance of the U.S. economy is determined largely by domestic factors. U.S. businesses account for the vast majority of American employment and the capital stock. Smaller flows of direct investment capital would have some negative repercussions for the U.S. economy, but the effects likely would not be catastrophic.

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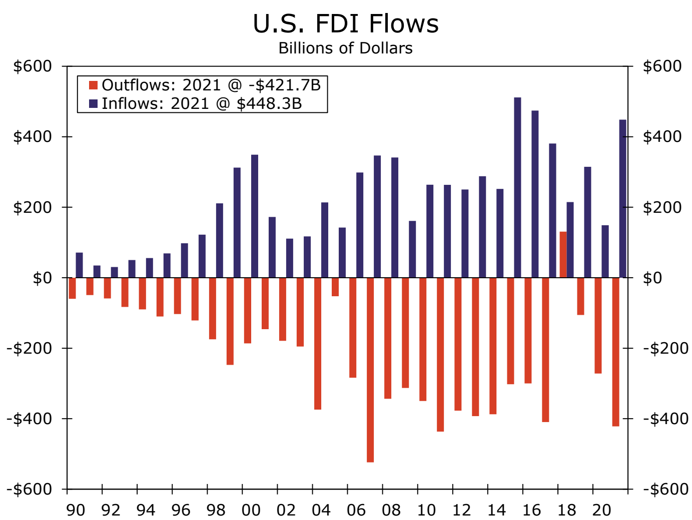
Globalization in Retreat

Part I: Introduction

Inflows and Outflows of FDI Have Stagnated

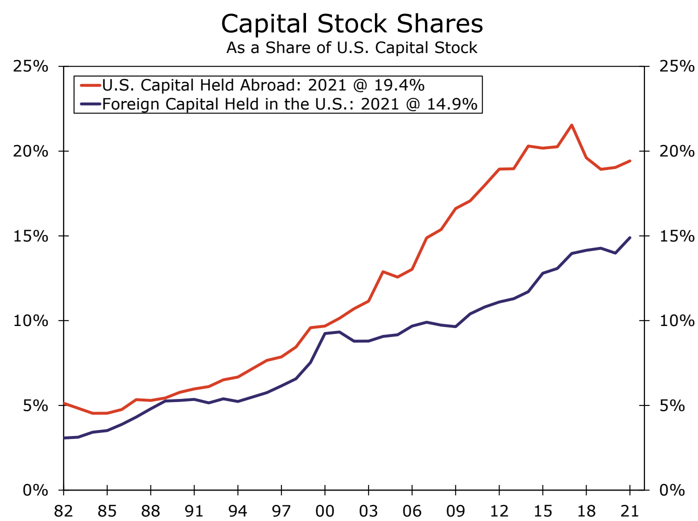
In the introductory report to this series, we highlighted some observations that suggest the process of globalization, which has been under way for the past few decades, may be topping out if not going into reverse. For example, the ratio of international trade to GDP has trended lower in recent years, both globally and in the United States. We will discuss the implications of less extensive international trade for U.S. employment and U.S. inflation in Parts III and IV of this series. The focus of this current report is on another sign of receding globalization, namely, stagnant flows of direct investment capital into and out of the U.S. economy. Figure 1, which we originally published in Part I of this series, shows that foreign direct investment (FDI) flows into the United States peaked in 2015, while outflows have not exceeded their 2007 high in the subsequent 14 years.[1]

Figure 1



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 2



Source: U.S. Department of Commerce and Wells Fargo Economics

Capital investment, whether by domestic or foreign businesses, adds to an economy's capital stock, which tends to grow over time. For example, the value of the capital that foreign-owned businesses held in the United States totaled $125 billion in 1982, which was equivalent to about 3% of the total capital stock of the U.S. economy that year (Figure 2). Years of strong flows of direct investment into the United States caused the value of foreign-owned capital to grow to roughly $5 trillion (historical cost basis) in 2021, which was equivalent to 15% of the total capital stock of the American economy.

The value of capital held abroad by American businesses has also risen considerably over the past four decades, growing from about $200 billion in the early 1980s to roughly $6.5 trillion in 2021. When expressed as a percentage of the domestic U.S. capital stock, the ratio rose from 5% in the early 1980s to nearly 22% in 2017 (Figure 2). But that ratio has receded in recent years. In other words, American businesses are currently choosing to hold relatively less of their capital abroad than they were a few years ago. If globalization reverses further, then it seems reasonable that FDI flows, both into and out of the country, would continue to stagnate if not trend lower. How would the U.S. economy be affected if FDI flows weaken in coming years?

FDI Inflows Have Helped to Boost the U.S. Capital Stock in Recent Decades

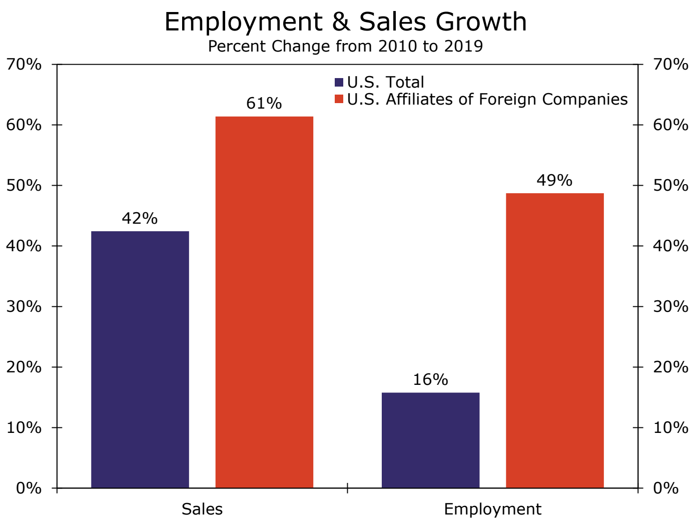
Investment by foreign companies has been an important source of rising living standards.

Let's start with the inbound side of international capital flows. Direct investment by foreign-owned companies has accounted for roughly 15% of the eightfold increase in the value of the U.S. capital stock over the past four decades. Because investment is an important source of productivity growth, which raises real income, investment by foreign companies in the United States has contributed to the rising living standards among Americans. Specifically, real disposable per capita income has risen from roughly $21K per year in 1980 to $45K per year at present. That is, the living standard of the average American has more than doubled over the past 40 years, and investment in the U.S. economy by foreign companies has played a role, at least at the margin, in boosting real income over that period.

Furthermore, American affiliates of foreign companies tend to be rapidly growing enterprises. The revenues of all companies located in the United States rose by 42% during the long economic expansion of 2010-2019 (Figure 3). But the revenues of American affiliates of foreign companies grew 61% over that economic upswing. These foreign-owned enterprises are also important job creators. Employment at American affiliates of foreign companies rose 49% between 2010 and 2019, far outpacing the 16% increase in total U.S. payrolls over the same period. Moreover, the jobs that U.S. affiliates provide are generally high paying. As shown in Figure 4, compensation among all U.S. employees averaged nearly $76K in 2019, but the comparable average at American affiliates of foreign companies was more than $83K per employee.[2] In addition, these affiliates are hardly freeloaders in terms of the government's coffers. According to the Bureau of Economic Analysis, American affiliates of foreign companies paid $65 billion in taxes in 2019.

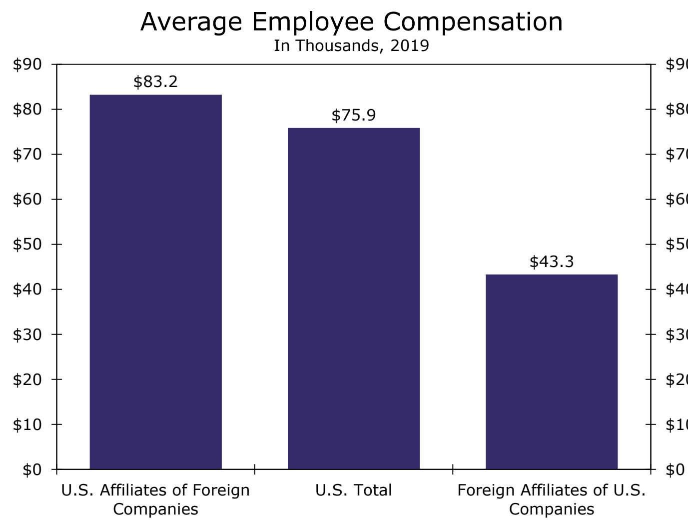
If inflows of FDI capital were to downshift in coming years, then growth in productivity and real income in the United States could weaken marginally, everything else equal. In addition, growth in employment could downshift a bit, and high-paying jobs may not be quite as prevalent. Because American businesses account for most of the employment base and the capital stock of the United States, weaker inflows of foreign capital would not be catastrophic to the U.S. economy. But a downshift in inflows of FDI into the United States could weigh on rising standards of living, at least at the margin, in coming years.

Figure 3



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 4



Source: U.S. Department of Commerce and Wells Fargo Economics

Weaker FDI Outflows: Implications for American Companies

Let's now turn to the implications of weaker outflows of FDI capital from the United States. As noted earlier, the outstanding stock of U.S. direct investment abroad was valued at roughly $6.5 trillion (historical cost basis) in 2021. The foreign affiliates, which are capitalized by this investment, are significant earnings engines of U.S. companies—they generated nearly $1.5 trillion of net income in 2019 on sales of about $7.7 trillion. Moreover, American companies did not establish these affiliates abroad simply to produce goods and then export all of their output. Yes, the United States imported $400 billion worth of goods from foreign affiliates of American companies in 2019, and these affiliates likely exported to other countries as well. But having production facilities close to local markets, many of which are growing rapidly, undoubtedly was a strategic rationale for the direct investment by many U.S. companies.

Foreign affiliates of American companies employed 16.7 million individuals in 2019 to whom they paid average compensation of $43.3K that year (Figure 4). As noted previously, average compensation in the United States was roughly $76K in 2019. Lower compensation in foreign affiliates of American companies should come as little surprise, because many U.S. enterprises moved production facilities abroad in order to reduce labor costs. In that regard, employment at foreign affiliates of American companies rose 24% between 2010 and 2019, while U.S. nonfarm payrolls grew only 16% during the same period.

According to the International Monetary Fund, global real GDP grew at an annual average rate of 3.0% between 2010 and 2019, whereas U.S. real GDP rose 2.3% per annum over the same period.[3] Therefore, a less intensive presence of American companies in foreign economies via weaker FDI outflows could weigh on the growth potential of those companies. Furthermore, retrenchment in American investment abroad could have implications for U.S. employment, wages and prices as production shifts back to the United States. We will analyze affects on employment and wages in Part III of this series before addressing implications for inflation in Part IV.

Less intensive investment abroad could weigh on the growth potential of U.S. companies.

Conclusion

The U.S. economy undoubtedly benefited from the strong inflows of foreign direct investment that were registered during the recent era of globalization. Investment in physical capital helps to drive productivity growth, which in turns raises real income. The doubling of real disposable per capita income that the United States has enjoyed over the past 40 years or so is due in part to FDI inflows. American affiliates of foreign companies employ nearly nine million individuals, and these workers earn more on average than their fellow residents who work for domestic companies. Everything else equal, growth in real income in the United States may downshift, at least at the margin, if FDI inflows were to weaken on a secular basis.

The effects on the U.S. economy of American FDI abroad are arguably more ambiguous. After all, the era of globalization was associated with a sharp decline in U.S. manufacturing employment, which we noted in Part I. Individuals who were displaced when their employers moved operations abroad suffered income losses, at least for some time. But foreign operations have become important growth engines for many American companies as foreign affiliates generated $1.5 trillion of net income on sales of about $7.7 trillion in 2019. Moreover, the global economy is growing faster than U.S. GDP at present. A pullback from globalization could weigh on the growth prospects of many American companies in coming years.

That said, foreign ownership accounts for only 15% of the physical capital stock of the U.S. economy, and only 6% of the American workforce is employed by foreign companies. In sum, smaller flows of direct investment capital, both inbound and outbound, would have some negative repercussions for the U.S. economy, but the effects likely would not be catastrophic.

Endnotes

1 FDI outflows turned negative (i.e. the red bar in Figure 1 moved into positive territory) in 2018 when the Tax Cuts and Jobs Act (TCJA) led businesses to repatriate profits that were held abroad. That is, the gross inflow of repatriated profits from foreign affiliates of American companies exceeded the gross outflow of new investment abroad. (Return)

2 A few highly paid employees can skew the average higher than the median. Data on median employee compensation are not readily available. But the Federal Reserve's triennial Survey of Consumer Finances shows that average U.S. family income was $106.5K in 2019, while median family income was only $58.6K. We suspect that median employee compensation is lower than average employee compensation as well. (Return)

3 The IMF derived this estimate of global GDP growth by using market exchange rates to aggregate GDP in individual economies. Using purchasing power parity (PPP) exchange rates to aggregate individual GDP data produces an annual average growth rate of global GDP of 3.7%. (Return)

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