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"THE FOREIGN CHALLENGE"

Stephen J. Friedman, Commissioner
United States Securities and Exchange Commission

Thirteen years ago, J.-J. Servan-Schreiber, the French journalist, wrote a widely-discussed book called "The American Challenge." The title referred to what seemed to be the inexorable American domination of European industry through direct investment. The book struck chords that resonated with European discontent about American political and economic influence. Today the themes of that book, with a little role reversal, might resonate with concerns in this country about foreign direct investment -- in land, in industry and in financial institutions.

The United States has generally supported free trade and free movement of capital -- our brief experiment with the interest equalization tax and the Foreign Direct Investment Regulations stand as notable exceptions. Some observers have noted that these policies were established when we were the dominant force in foreign investment, when rates of foreign exchange made foreign investment especially attractive for Americans and when our role in the world economy made it possible for the United States to impose its economic policies on the rest of the world.

Now, major changes are occurring. The enormous surpluses generated by OPEC price increases have produced a vast new pool of capital that must be employed in international investment. Depressed equity values have made the acquisition of American businesses an attractive way to acquire business assets. And balance of payments deficits, coupled with inflation, have reduced the dollar's value on foreign exchange markets, cheapening our assets for foreign investors. The Japanese and some European economies save and invest more than we do and have experienced sharply better rates of productivity. In certain sectors of the economy, such as autos and steel, foreign competition has made fierce inroads. In a more fundamental sense, the greater involvement of government in other countries in protecting and directing industrial development has made some people question our basic commitment to the market system.

The response to these trends was predictable: concern about foreign direct investment; proposals for a moratorium on foreign takeovers in certain areas such as banking; and broader proposals premised on the idea that foreign investors should be granted no greater rights here than American investors enjoy in their country. In the trade area, protectionist proposals abound. And beneath the furor is the uncomfortable feeling that, if all the economists are wrong, we shall one day wake up to find that, like Gulliver, we have been ensnared by an army of foreign investors; that our economy, despite its immense size, will be held hostage by an array of outsiders with little knowledge and less concern about the social and political needs of our society.

Current Trends

In thinking about these questions, it helps to have some grasp of the basic facts about current levels of foreign investment. Traditionally, international investment is divided into "direct investment," in which the investor exercises considerable control over the enterprise, and "portfolio" or indirect investment, in which the investor is passive. At the end of 1979, we were host to about $52 billion in foreign direct investment, $150 billion in foreign private portfolio investment and over $180 billion in foreign government portfolio investment (principally in U.S. Government securities). In contrast, foreign direct investment by Americans totalled about $193 billion at the end of 1979. These data understate the foreign control of assets since they do not include the current value of the assets purchased or money borrowed here or raised here as equity by foreigners to purchase assets. When all of these items are included, the total value of assets in this country owned by foreigners is estimated to exceed $750 billion.

On the other hand, recent trends show foreign investment here is growing faster than American investment abroad. The Commerce Department recently reported that the rate of foreign direct investment in this country increased by about 23% during each of 1978 and 1979, almost twice the average rate of increase for the preceding three years. In comparison, the rate of U.S. direct investment abroad increased by 12% in 1978 and 15% in 1979.

At the same time, the absolute levels of foreign investment are not high. The Commerce Department has estimated, for example, that in 1977 U.S. affiliates of foreign firms accounted for only 2% of the total employment of non-bank U.S. businesses. These foreign affiliates owned less than one-half of one percent of the total privately-owned real estate in this country. Even in the banking industry, where foreign direct investment is high, foreign investors controlled only 15% of the $1.5 trillion in total U.S. banking assets, the bulk of which -- 80% -- is represented by local subsidiaries, branches and agencies of foreign banks; only 3% of total U.S. banking assets are under foreign control by virtue of acquisitions of existing U.S. banks.

At the end of 1978, the OPEC countries had a combined level of foreign direct investment here which was only 5% of that of Canada's -- less than one hundredth of one percent of the net worth of all U.S. firms. Their holdings of Treasury securities were less than 2% of the total of such securities and their holding of both total U.S. corporate securities and U.S. corporate bonds were in each case considerably less than 1% of total holdings.

What, then, is all the shouting about? Part of it is, as I noted earlier, just a question of the shoe having switched feet. In addition, much of the difficulty in this area comes from the perceived need to serve simultaneously a number of important interests: stimulating domestic investment, allocating capital efficiently, maintaining the advantages of free capital markets, preserving the national security, promoting international cooperation and an efficient allocation of resources and serving national political interests. At a deeper level, there is some feeling that our commitment to free capital markets stands in contrast to more restrictive policies of other countries, and that this fact should give us pause.

The Existing U.S. Policy of Neutrality.

The Administration's policy recently has been stated by its Economic Policy Group this way:

> "The fundamental policy of the U.S. government toward international investment is to neither promote nor discourage inward or outward flows or activities.
>
> "The government therefore should normally avoid measures which would give special incentives or disincentives to investment flows or activities and should not normally intervene in the activities of individual companies regarding international investment. Whenever such measures are under consideration, the burden of proof is on those advocating intervention to demonstrate that it would be beneficial to the national interests."

The basic premises for this policy were stated by the Policy Group in the following terms:

> -- First, international investment will generally result in the most efficient allocation of economic resources if it is allowed to flow according to market forces.

- -- Second, there is no basis for concluding that a general policy of actively promoting or discouraging international investment would further the national interest.
- -- Third, unilaterial U.S. Government intervention in the international investment process could prompt counteractions by other governments with adverse effects on the U.S. economy and U.S. foreign policy.
- -- Fourth, the United States has an important interest in seeking to assure that established investors receive equitable and non-discriminatory treatment from host governments.

The Administration also opposes a system of mere registration for foreign direct investments; it argues that even such a small impediment to the free flow of capital is inconsistent with our national interests and could trigger retaliatory action by other countries. Moreover, imposing a registration requirement would be difficult to justify in light of our continuing efforts to persuade other countries that they should eliminate precisely the same requirements in the pursuit of free international capital markets.

It seems to me that a number of observations are in order:

- -- It is a mistake to assume that some fundamental economic shift has occurred which means that the United States will no longer benefit from open flows of capital. Open flows of capital have served us well in the past. Our balance of payments accounts have been fattened by repatriation of dividends and interest.
- -- The dangers to our economy from foreign investment have been overplayed and tend to fade under analysis.

-- We live in an increasingly interdependent world in which we are no longer insulated from the international consequences of our domestic policies.

-- If we are to meet the challenges posed by foreign direct investment, we must deal with our basic economic problems rather than merely their ripple effects.

The Evolution of Economic Events

It is virtually a truism that major political and economic events are considered in too short a time frame. That is largely a consequence of the way our national political life is organized, which tends to divide life into two-year segments. Whatever the cause, the result is an assumption that today's successes will continue unabated and that today's failures are evidences of permanent rot.

The latter 1970's were extremely difficult years. We have been plagued by

-- inflation
-- depressed equity values
-- exploding energy costs
-- inadequate levels of savings and investment
-- declining productivity
-- a resulting loss of foreign exchange value of the dollar

At the same time, I think we are truly beginning to come to terms with these problems. Petroleum conservation has been very impressive. The Congress has acted on the synthetic fuels program. Inflation has been acknowledged as a major problem rather than just a political football, and the need for greater savings and investment has never received more serious attention since the Second World War. To the extent that we grapple adequately with these issues, distortions in the relative balance of foreign direct investment caused by the effect of inflation on the value of the dollar in foreign exchange markets will tend to disappear.

Of course, major changes have occurred. The increases in petroleum prices have effected a transfer of real wealth to OPEC countries. That wealth begins as dollars. To the extent these dollars represent surpluses, they must be transformed into financial or real assets. But if the U.S. economy is an attractive home for those dollars, the result is a net gain for us in jobs and physical plant.

There is no doubt that this country is an attractive place for foreign investment. Let me review with you the results of a survey of foreign investors in the 1970's who were asked about the reasons behind their decisions to invest in this country. With respect to foreign direct investment, the incentives are our economic and political stability, our large domestic markets, access to our domestic technology, the current depreciated value of the dollar on the foreign exchange markets, the bargains created by the depressed state of our securities and real estate markets, our abundant supplies of raw materials and the ability to avoid U.S. protectionism and trade barriers by participating from inside the domestic market. Factors which were cited in the context of foreign portfolio investment are similar, but oriented to the peculiarities of that market. They include expectations of long-term capital growth, economic and political stability, the size and liquidity of our capital markets, the organization and regulation of our securities markets, the wide range of specialized investment choices, the "efficiency" of our capital markets, and a variety of miscellaneous investor-specific factors.

That is an enviable list of advantages. With the exception of depressed equity and real estate values and exchange rates favoring foreign investors, there is little in this list that we would like to change. The market system is premised on a competition for capital, and our ability to attract foreign investment reflects the relative strength of our economy. Indeed, concern about foreign investment here seems strange in light of the efforts by other countries to attract foreign investment.

The Economic Effects of Foreign Investment

We have a firm commitment to the notion that free flows of capital result in the most efficient allocation of resources. Moreover, as the Administration's policy statement indicates, we have been a net foreign investor of funds for many years, and we have a strong stake in a system that protects the rights of foreign investors. Accordingly, any suggestions for controls or limitations require the closest scrutiny.

In the end, these questions resolve themselves into assessments of the impact of foreign investment on the domestic economy, on our balance of payments and on our broader relations with other nations. All of these are hard to project with certainty. For example, foreign direct investment undoubtedly brings the benefits of external capital to our economy. As long as there is remaining productive capacity, the result should be an increase in GNP, in jobs and investment. But there are offsetting factors in terms of technology and knowhow transfers.

The effect on the balance of payments is also hard to discern with certainty. Of course, to the extent that foreign investments represent new funds, the result is a short-term balance of payments benefit. But most such investments are leveraged through U.S. borrowings, and the equity committed to an investment often is raised through redirecting earnings of other enterprises or selling equity in the United States.

Once operations begin, if profits are not left here, but are repatriated to the investor's home country, there is an outflow of capital, which will eventually exceed the amounts originally injected into our markets. However, if our economy continues to be an attractive place for foreign investors, these repartriated profits will be reinvested here, and there will be additional new investment.

Foreign direct investment will benefit our balance of payments if the resulting domestic production replaces imports. Of course, the extent of the benefit depends in part upon the extent to which parts and supplies are imported. There is a much smaller benefit if the U.S. facility merely assembles components manufactured abroad.

Finally, it is important to remember that negative effects on our balance of payments are offset by the positive effects of returns from our own direct investments abroad.

The remaining questions about foreign direct investment rest on the assumption that foreign-owned firms will respond differently from American firms -- that they will serve the national interests of the state of their owners rather than merely responding to economic events. Of course, it is true that foreign investors are often subject to very intensive governmental regulation in their home countries, whether through government ownership or otherwise. But there is no hard evidence that foreign investors have acted any differently in managing their U.S. holdings than domestic investors.

Moreover, insofar as information is available, specific industries have not suffered and, in fact, seem to have benefitted from foreign investment in some cases. For example, the Comptroller General recently completed a study of the effects of foreign investment on the U.S. banking industry. This report, though noting that the overall situation bears continued watching, concluded that:

> "For the most part the foreign investors have improved weak U.S. banks and maintained strong U.S. banks they acquired by adding new capital, changing management, improving loan portfolios, and stopping self-dealing transactions."

I should note, because full disclosure is in my blood, that the report also recommends a moratorium on the foreign acquisition of U.S. banks with total assets in excess of $100 million; that proposal was designed to secure time to address the problem of the advantages foreign banks enjoy over domestic banks in the acquisition of medium to large U.S. banks.

In another traditionally sensitive area -- the foreign ownership of U.S. farmland -- the United States Department of Agriculture has recently completed an analysis of data obtained under the 1978 Agriculture Foreign Investment Disclosure Act. It found that a number of misconceptions concerning foreign land ownership were prevalent, including the following:

-- foreign investors pay more than the prevailing price for farmland, thus inflating prices beyond the reach of the small farmer

-- foreign investors more often tend to be absentee owners, with little concern for local community problems, local labor needs or the nearby economy

-- foreign investors are short-term spectators, either interested in abusing the land for immediate gain or letting it remain idle to profit from this speculation

-- foreign investors will import foreign labor, thus intensifying local job competition.

The facts, it turns out, refute these assumptions. As sophisticated investors, foreign investors follow, but do not lead the market in farmland prices. Since 20% of all U.S. farmland is already subject to absentee ownership, and absentee owners (both foreign and domestic) appear to purchase only 15% of the agricultural land coming onto the market from time to time, the participation of foreign investors here does not seem significant in affecting the overall pattern of farmland ownership. If foreign investors do not operate purchased farmland they typically leave existing managers in place. Finally, there is no significant evidence that foreigners operate their farms any differently than domestic owners. In fact, there are significant tax incentives -- which apply to all owners, to invest in conservation practices and other land use improvement.

In summary, what we know and what we think both tell us that the adverse effects of foreign direct investment are overdrawn in the public mind. Without doubt we should continue to monitor the situation and take the appropriate measures to gather and analyze the available information as a foundation for our policy decisions. Anything more is an overreaction.

The Interdependence of World Economies and the Foreign Challenge

In reviewing the list of factors foreign investors find attractive in our economy, I said there were really only two we would like to change: the depressed state of our equity markets and the value of the dollar in international exchange markets. As our financial markets become more international and floating exchange rates reflect the world's view of our domestic economy, it becomes increasingly apparent that what we do here affects both our ability to compete in trade and the relative ability of American and foreign companies to buy going businesses here.

The successes of the Western European and Japanese economies in dealing with the energy problem, moderating inflation and maintaining high levels of savings, investment and productivity pose a great challenge for us. I began today by talking about Servan-Schreiber's call to his European confreres -- to respond to the American challenge of direct investment. He did not suggest a response composed of protectionism and restrictions on foreign investment. He thought the challenge could be met by learning from the American experience and seeking leadership in emerging industries. That advice remains the course of wisdom, for us as well as the Europeans who are now making important investments here.