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Foreign Direct Investment and Business Performance

Report by Lionel Fontagné et Farid Toubal

EDITORIAL

Relocation is currently a major source of debate both in France and abroad.

This report by Lionel Fontagné and Farid Toubal examines the issue against the broader context of globalisation, foreign direct investment (FDI) and the business strategies of major multinational groups. While their analysis focuses in particular on outgoing foreign direct investment by French groups, it also looks at incoming direct investment in France by foreign groups.

The authors' findings explore the different gaps between horizontal and vertical FDI and the income and substitution effects of overseas expansion, the aim being to closely examine the conditions under which one prevails over the other.

Backed by supporting figures, the authors also analyse the extent to which business performance is linked to international expansion, as much in terms of outgoing FDI as incoming FDI.

Christian de Boissieu
Executive Chairman of the CAE

What makes a company decide to develop overseas? What kind of companies take that decision? What impact does globalisation have on the performance of domestic businesses when they set up abroad or when they are acquired by a foreign group? This report by Lionel Fontagné and Farid Toubal looks at all of these questions, and more specifically at the impact of globalisation on performance at a critical time for the authorities as the economic crisis reawakens fears amongst the public opinion of the consequences of relocation and the repurchase of struggling companies by foreign groups. For those companies covered by the survey, the answers clearly show the net benefits of globalisation. Nevertheless, the authors draw the reader's attention to the large number of existing effects (selection, substitution, income, etc.), and to the discrepancies in the impact of globalisation when it comes to independent businesses or group companies and, in the case of the latter, when a group's parent company is French or foreign. They also reveal the very unequal distribution of the benefits of globalisation across France. These important subtleties automatically disqualify the adoption of a pre-defined set of principles when it comes to state intervention in foreign direct investment. Having said that, this report does advocate changes in economic policy and examines the core methodology that should be used (and should be avoided) when analysing the business activity of multinational groups.

This report was discussed on January 26, 2010, in the presence of Mrs. Anne-Marie Idrac, French Minister for Foreign Trade. This letter was published under the responsibility of the permanent group and presents the main conclusions drawn by the authors.

Impact of overseas expansion

The impact on business performance in France (activity, employment, wages, etc.) of the overseas expansion of French companies is a delicate economic policy issue. French businesses that have developed abroad are expected to be more productive than the average (and perform better than exporting companies that, in turn, should be more productive than purely domestic companies). But is it a relationship of cause and effect – globalisation leads to performance–, or the simple selection of the best-performing businesses by international competition? This report highlights a dual relationship: the best-performing companies expand overseas and, depending on their status, can become even more productive. There are several major conclusions to be drawn:

- *Companies set up overseas in order to exploit a specific asset* (technology, brand, etc.), which, once they are established, gives them a competitive advantage over the companies in place. Overseas expansion does not come down to a simple transfer of capital, nor access to cheaper production resources (workers): foreign direct investment is a means of exploiting a competitive advantage;
- *It is the best-performing businesses that set up overseas*. The gap in performance in rela-

tion to comparable companies who have chosen not to develop abroad is even greater when they belong to a group and that group is a foreign group: employee numbers, wages, productivity, added value, etc. are systematically higher;

• *Overseas expansion has no negative impact on the employment of the firm in France*. On the contrary, the effect is even positive when a company belongs to a French group. At worst, the consequences of the French subsidiary of a foreign group investing abroad are minimal. This is probably because these are companies which, from the outset, are the most efficient and therefore have the least margin for progress;

• *Overseas expansion strengthens the performance of investing companies, except when it comes to productivity*. Setting up abroad does not make a company more productive but allows it to increase its revenues, to create more added value and to pay out higher wages, etc. in France;

• *French multinationals primarily invest in developed countries*. The majority of French group subsidiaries are located in developed countries, as are their sales and expatriates. Activity overseas is primarily concentrated in the retail sector followed by manufacturing sectors such as the chemicals industry or transport equipment. When French companies step up their overseas activities in countries where income levels are average (China, Morocco, Brazil, etc.) or high (United Kingdom, Germany, United States, etc.), the correlation with group payrolls in France is positive;

• *Only a small percentage of the overseas entities of French multinationals are located in low-income countries* (3% of the French multinationals included in the survey). Where the overseas operations of a group are located in low-income countries, the impact on employment in France is negative but insignificant in statistical terms. Other studies have shown that relocations (vertical structures) can have a negative impact on unqualified employment figures in France, and that the replication of production units (horizontal structures) in order to facilitate access to the foreign markets has a positive impact on qualified employment figures. This suggests that the globalisation of production resources can be assimilated with technical progress that is biased towards qualified employment. Having said that, the fact remains that, on the whole, overseas expansion (which more often than not is both horizontal and vertical) does not penalise employment.

All told, the extent of the effects therefore depend on the type of investment made, the host country and the status of a company (independent versus group, French group versus foreign group). In general terms, however, the conclusion of the report is that French investment overseas (outgoing direct investment) works in favour of the best companies that take advantage of the situation to capitalise on their assets.

Impact of acquisitions by foreign groups

What is the impact of the acquisition of a domestic company by a foreign group?

• *Domestic companies bought by foreign groups perform better than the average*. It is not the ailing French companies that attract foreign groups. On the contrary, what appeal are the flagship businesses of the French economy. Foreign investors setting up in France do what is referred to as 'cherry picking', i.e. they select those businesses that show the most potential. They then combine this with the specific advantages of the parent company of a foreign group, or greater financing for investments, which enables them to fully exploit this potential;

• *Domestic companies acquired by foreign groups are able to enhance their performance except when it comes to exports*. This is achieved in two phases: in the year in which the target company is bought it undergoes restructuring during which productivity, employment, revenues, added value and exports are down. Once the adjustments have been made, the impact of the acquisition becomes positive and remains that way for a period of three years. The explanation for this is as follows: once it has become the French subsidiary of a foreign group, the target company's exports are melted down within the group's global strategy. This means that the subsidiary loses all autonomy when it comes to exports, triggering a substantial drop in its propensity to export. Nonetheless, a drop in a company's propensity to export (defined as the ratio of exports to revenues) can just as well be prompted by a more rapid increase in revenues than in exports;

• *Companies located in France and belonging to a foreign group fare better than companies belonging to a French group, which in turn outperform independent companies*. These companies do indeed create more jobs, export more, import more and are more profitable. Two effects come into play when explaining this hierarchy in terms of performance. First is the effect of selection: companies bought by foreign groups are acquired for their potential (cherry picking) and logically become the best-performing countries in France. Second is the fit between the two: target companies benefit from the specific assets of the parent company of a foreign group which enable them to realise their potential.

In short, foreign investment in France (direct incoming investment) targets the most efficient companies and reinforces their potential (except in terms of exports) by restructuring them and combining their assets with those of a foreign group.

Impact in terms of economic policy

Of course there is nothing neutral about these conclusions when it comes to economic policy. They recommend ensuring that the economy remains open to foreign investment particularly at a time when protectionist tendencies could resurface. In addition, they advocate concentrating more on companies that are unable to expand abroad rather than those that already invest overseas or that have been acquired by a foreign group. French companies established overseas are not at risk, quite the opposite, since their global expansion has enhanced their performance. Globalisation should not therefore be feared. Moreover, French companies already generate 50% of their revenues abroad, and a substantial part of activity, employment and industrial exports is generated by the French subsidiaries of foreign groups. In a 'flat world', France, which represents 5% of global GDP, should realise 95% of its activity overseas in relation to global GDP. As such, there is great potential for globalisation, particularly in consideration of the country's high 'domestic bias'.

For those companies with operations abroad, imports 'count'. They mean improved performance and, most importantly, a much higher level of profitability: the best-performing companies are also those that import the most. However, to say that these results demonstrate that it is more profitable to import than produce in France would be to misinterpret. In a global economy, companies that operate worldwide benefit from the variety of intermediate consumption, technologies and distribution products on the global markets, making those that import more efficient. As this report was drawn up at the request of the Secretary of State for Foreign Trade, the authors have no hesitation in underlining the fact that the competitive nature of industry in France and its capacity to generate wealth also depend on its imports, making it important to retain an open market.

In establishing a strong and positive link between a business's performance and its international target, this report is intended to bring the authorities' attention to the impact of their actions on the capacity of foreign companies to set up operations in France and, at the opposite end of the scale, the capacity of French companies to set up part of their activities abroad. Measures applying on a strictly national scale would undoubtedly have an asymmetrical effect: policy that is coordinated at an international level, and above all at a European level, is by far the better solution.

The positive effects of globalisation are demonstrated in this report which insists on the difference in impact depending on a company's status (independent or group subsidiary, subsidiary of a French group or subsidiary of a foreign group), host country and so on. Adopting a cut-and-dried stance when it comes to economic policy that results in systematic intervention when it comes to foreign direct investment would have complex and probably adverse consequences. This does not disqualify government intervention, but rather the adoption of a predefined set of principles.

Lastly, the results put forward in this report are not intended to embellish the motivation behind foreign investment. French companies investing abroad and foreign companies investing in France have the same goal: to heighten performance by better exploiting the benefits to be gained. At the end of the day, it would be futile to rely on foreign groups to support French businesses in difficulty because they simply do not have the profile required!

The importance of methodology

This report also focuses strongly on methodology. Macroeconomic data on foreign investments is often used to assess the activity of multinationals, and yet foreign direct investment (FDI) figures make for a very poor approximation of this activity. This is because, at best, balance of payment figures only relate to the total amount of capital invested without isolating the investment dedicated to real activity. What is even more significant is that, more and more, direct investment figures in a balance of payments fail to reflect the economic reality given the scale of intra-group loans and the increasing number of specific entities set up by French groups in order to centralise their financial operations outside of France. This point also applies to other countries. Hence the OECD advises in the new edition of the *OECD Benchmark Definition of Foreign Direct Investment* which was published in 2008, to draw up and publish the figures that cancel out intra-group financial transactions which to a large extent explains the increase seen in FDI statistics.

For the time being, only France has published any revised statistics on dual accounting, making it impossible to compare with the gross figures published by other countries. A correct comparison will only be possible in a few years when the main source and host countries of direct investment have followed OECD guidelines and published their own revised statistics.

Rather than focusing on FDI macroeconomic data which have not yet been corrected in all countries with intra-group flows, and for which there is no global reference in any case, the report insists on the need to use individual company figures. The models used for estimation in the report are based on the individual company figures (*FATS-Inward* for incoming investment and *FATS-Outward* for outgoing investment) collected by the French National Institute of Statistics and Economic Studies (INSEE), but also on yearly company surveys, Customs data, LIFI statistical surveys, etc. The method used is based on the latest academic contributions. The first step involves matching up each company established abroad with an equivalent domestic company. The second is to identify companies that have changed status (domestic or foreign) over a given period of time. The third is to calculate the performance gap (in the form of a 'premium') between companies that have operations abroad and those that do not.

If 'what we measure affects what we do', any mistakes could lead to untimely actions. In its own way, the methodological content of the report also constitutes a recommendation in terms of economic policy!

Comments

Michèle Debonneuil stresses the importance of distinguishing between horizontal FDI that target foreign markets, and vertical FDI looking to relocate production in order to benefit from lower labour costs. In her opinion, the results presented are convincing and reassuring when it comes to horizontal entities, and she reiterates that trade, including this new form of corporate flows, remains favourable for growth and employment in the countries concerned. However, she also considers that the results obtained do not adequately reflect the consequences of vertical set-ups. The estimations put forward in the report, which demonstrate that the relocation of companies to countries with lower labour costs has not had a destructive effect on employment in the source countries concerned, reflect the past much more than they predict the future. For Michèle Debonneuil, the negative impact of relocation will depend entirely on the capacity of developed countries to innovate and develop more sophisticated products in order to stay ahead of emerging countries in terms of expertise.

Anne Épaulard underlines the importance of this report given the fears caused by the increasing globalisation of companies. Does public opinion feel that foreign investment by French companies is synonymous with unemployment? In her view, this empirical and innovative work by Lionel Fontagné and Farid Toubal shows that globalisation is not a threat to employment and that, on the contrary, French companies that have set up abroad perform better (in terms of activity, employment, etc.) than those that have not. She does nonetheless insist on the need to bear in mind that these results have been obtained over a period in which the majority of the companies taken into consideration have chosen to expand to high-income countries (563 groups out of the 807 studied), and that these results bear less meaning when it comes to low-income host countries. If the globalisation strategy amongst French companies in the future were to turn more towards expansion in low-income countries (i.e. where costs are lower), there would be grounds to verify whether the impact on employment and exports is still positive. Another important point underlined by Anne Épaulard is linked to foreign investment in France. Here again, it is those companies that perform the best that attract foreign investment. There are two probable explanations for this: either French companies benefit from the advantages, expertise, etc. that comes with belonging to the foreign groups that acquire them, or their acquisition affords them better access to capital. This in no way implicates the same conclusions when it comes to economic policy. In the first instance, it is France's appeal that should be the first concern of the public authorities. In the second, it is much more the question of financing the growth of companies in France that comes into play. ■

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