Foreign Direct Investment and Employment in Sweden

by

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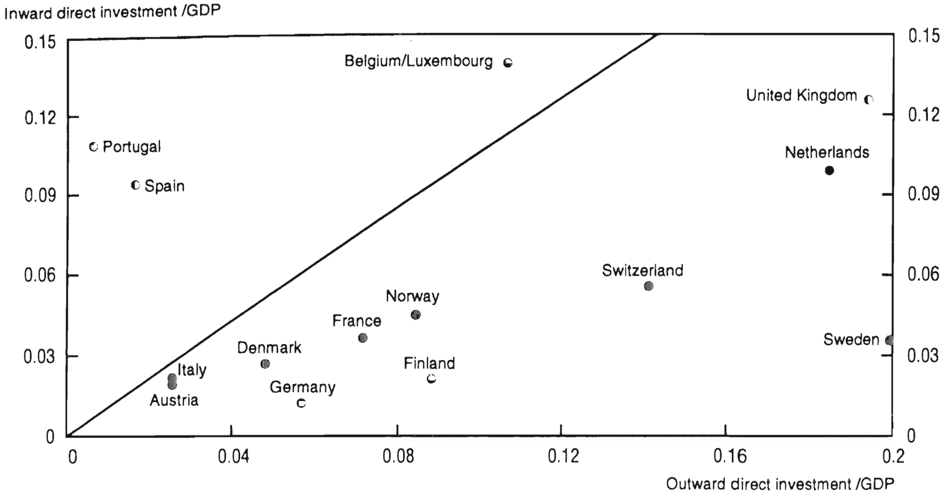
Introduction

Direct investment, through which multinational firms control affiliates in foreign countries, has become a major factor in the internationalisation of economic activities. There are still substantial question marks regarding the impacts on national economies. In contrast to portfolio investment, direct investment cannot be explained by cross-country differences in the marginal return to capital, but is motivated by advantages of internalising firm-specific assets rather than trading at arm's length (Dunning, 1977; Caves, 1982). Resource allocation and welfare are affected by the transfers of technology and skills rather than through the provision of capital *per se.*

Multinational firms today exert a major impact on production and trade and play a key role in the development and diffusion of modern technology, but their direct impacts on employment are less significant. The efficiency of labour markets is primarily determined by macroeconomic and institutional conditions. Due to the presence of unique assets, however, the opportunities offered by one multinational firm cannot automatically be replaced by those of another, and certain organisations and functions will depend on each other. For example, Wheeler and Mody (1992) found "agglomeration economies" to be the main locational determinant of United States direct investment abroad. Although multinational firms generally account for only a modest share of employment, a multitude of small and medium-sized domestic firms may be directly dependent on them as customers, distributors, suppliers, etc.

While most direct investment used to emanate from large economies, the last decade has seen increased outflows from small countries, especially in Western Europe. Here, the operations of multinational firms tend to weigh particularly heavily. In the 1980s, the Swedish economy attained an extreme position. The country is found in the lower corner at the bottom right of Figure 1, reflecting the largest outflows but modest inflows relative to the size of the economy.

Figure 1. **Inward and outward flows of direct investment 1981-1990 in European countries relative to gross domestic product**



Source: Andersson and Fredriksson (1993).

Studies of direct investment are often weakened by the lack of information about intra-firm transactions. The Swedish development can be studied in detail, however, due to a unique data base developed by the Industrial Institute for Economic and Social Research (IUI) between 1965 and 1990. On this basis, the present study briefly discusses the consequences of direct investment for the Swedish economy, with special emphasis on employment and the late 1980s.

New patterns

The focus of this study is on manufacturing, which is where multinational firms exert the largest influence on employment. In the Swedish case, this sector also accounts for the bulk of direct investment. It may be noted, however, that the boundary lines between industries as well as between categories of work have become less meaningful than they used to be. Many employees are now engaged in services irrespective of industry.

On the whole, expansion by Swedish multinational firms abroad has contributed to growth of manufacturing at home as well. By investing abroad, firms have been able to expand their overall market shares thanks to, *e.g.*, an upgrading of their information about foreign markets, improved after-sales service, exploitation of cross-country differences in factor costs, etc. Thereby, foreign investment has helped firms to exploit economies to scale, and enabled them to invest more in R&D, marketing, and so forth.

Table 1. **Employees in Swedish manufacturing, in domestic part of Swedish multinational firms and share of employment, 1970-1990**

(thousand of employees and per cent)

	1970	1974	1978	1986	1990
Total manufacturing	922	930	874	777	728
Swedish multinational firms	396	432	420	375	311
% of manufacturing employment accounted for by Swedish multinational firms	43	46	48	48	42

Source: Industrial Institute for Economic and Social Research (IUI).

The complementary relationship between direct investment and industrial growth at home was demonstrated in analyses of exports from the parent companies (Swedenborg, 1979). It is also indicated by the advancement of industrial output and employment in Swedish multinational firms at home compared to Swedish industry in general. This can be seen from Table 1, which reports all employees in manufacturing, employees in Swedishowned multinational firms (in Sweden) and the ratio between these two aggregates. The share of employees engaged by Swedish multinational firms increased steadily between 1970 and 1986. This was, however, followed by a decline from 48 per cent in 1986 to 42 per cent in 1990.

Inward investment

One reason for the declining share of employment in Swedish multinational firms at home is found in the advancement of employment in foreign-owned manufacturing. Table 2 shows that the share of employees which worked in foreign-owned firms grew from 11 per cent in 1986 to 18 per cent in 1991. It should be noted, however, that a substantial part of the increase occurred in the last year. Affiliates owned by firms originating in other members of the European Free Trade Association (EFTA) accounted for most of the increase, followed by those from the European Community (EC). Firms based in the United States recorded low growth, reflecting lack of new investment in European countries outside the EC during this period. The substantial shift over time in the origin of inward investment is illustrated in Figure 2.

Looking more closely at firms originating in North America and Western Europe respectively, there were sharp differences during the 1960s and 1970s. Firms from North America were primarily attracted by competence in ''blue-collar'' intensive production, and exported more than 60 per cent of sales, covering several European markets (Samuelsson, 1977). Firms from Western Europe rather emphasised the local market, however, exporting less than 25 per cent of output.

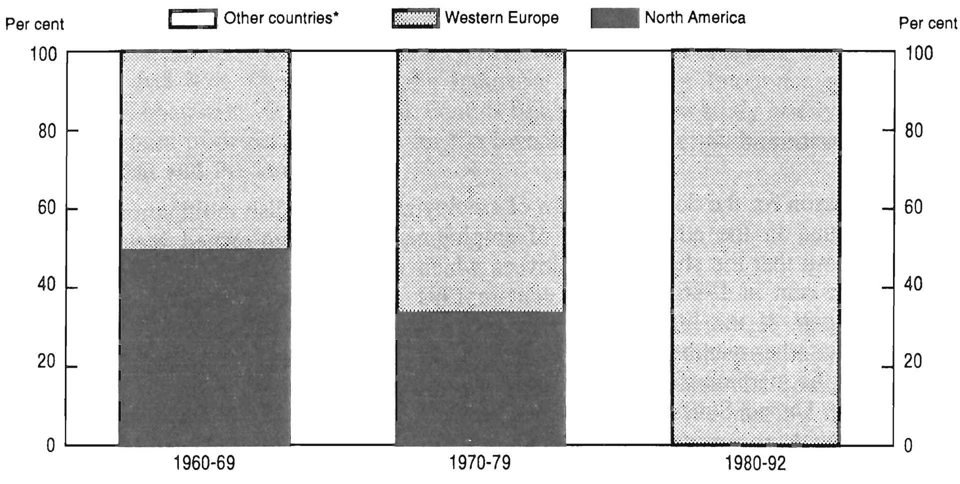
Table 2. **Employees in foreign-owned manufacturing firms, and share of total employment in manufacturing in Sweden, 1986 and 1991**

(thousand of employees and per cent)

Region	1986		1991	
	Thousand employees	Per cent of total in Swedish manufacturing	Thousand employees	Per cent of total in Swedish manufacturing
European Community (12 countries)	37	4.8	44	6.2
EFTA	33	4.3	66	9.2
North America	16	2.1	21	2.9
Others	0	0.0	0	0.0
Total foreign owned firms	**86**	**11.3**	**132**	**18.4**

Source: National Bureau of Statistics.

Figure 2. **National origin of inward direct investment in Sweden 1960-1992**



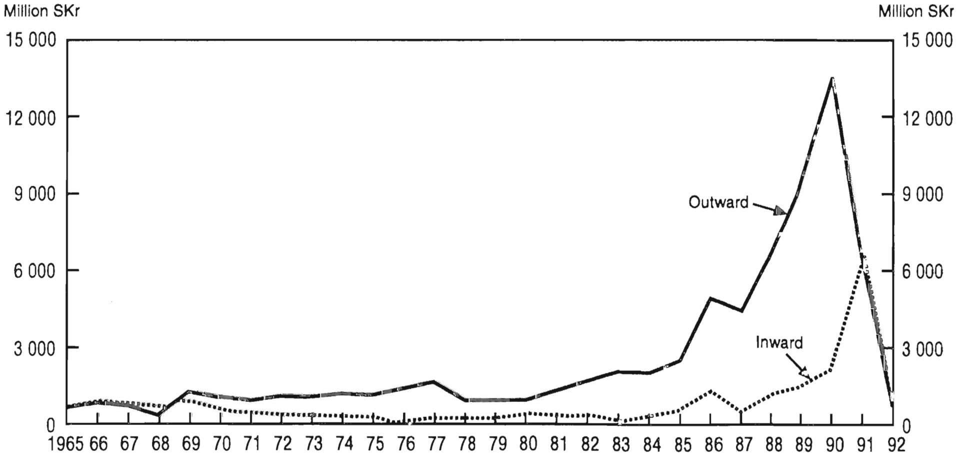
* This share is so small that it does not show up in the graph.
Source: Central Bank of Sweden.

By 1991, these differences had been significantly reduced. The North American companies exported 55 per cent of total output, while the corresponding figures were 42 and 49 per cent respectively for firms from the EC and EFTA (National Bureau of Statistics, 1993). However, there was still a major difference in the extent to which exports were internalised, *i.e.* went to customers within the same company group. The share of intra-firm exports was less than 32 per cent in EC-companies and 35 per cent for companies from EFTA-companies, while American companies exported more than two thirds internally. This shows that United States affiliates were more closely integrated with operations abroad than European ventures. Again, the former have ceased to expand while the latter have gradually become predominant in Sweden over time. On the whole, the inflows of investment have increasingly targeted sales on the domestic market, and to some extent those of the neighbouring countries.

Changes in outward flows

The sharp decline of manufacturing employment in Sweden, and particularly in the Swedish multinationals, cannot be explained by the growth of the foreign-owned sector. Rather, we have to examine how the Swedish multinational firms have organised their operations as a whole. The cut-back of their employment at home in the late 1980s was paralleled by a dramatic expansion abroad. The magnitude of outflows as well as inflows is illustrated in Figure 3, with reinvested earnings excluded. About 80 per cent of the

Figure 3. **Outward and inward flows of direct investment in Sweden 1965-1992, fixed prices, base year = 1968**



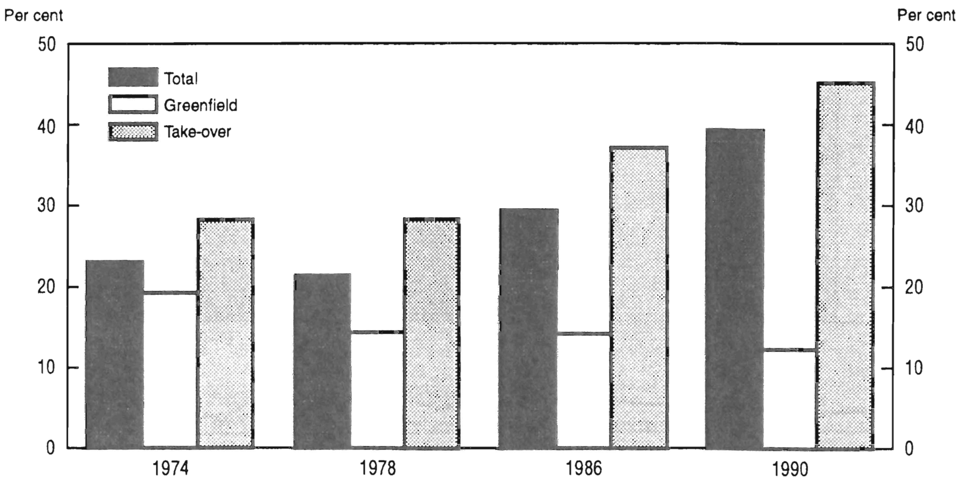
Note: Reinvested earnings are excluded.
Source: Central Bank of Sweden.

outflows between 1986 and 1990 targeted the EC and consisted of acquisitions of already existing companies.

Not only did the production in foreign affiliates become much larger at this time, but their relationship with the parent companies also shifted markedly. This shows up in, *e.g.*, many more affiliates which did not import from home, especially among acquired firms (Figure 4), greater exports from affiliates, smaller exports from Swedish parent companies and an increased emphasis on exports of intermediate products rather than finished products to manufacturing affiliates, especially in the EC (Figures 5 and 6). As shown by Svensson (1994), the linkage between production abroad and home exports became significantly negative in the Swedish case from the late 1970s onwards (Svensson, 1993).[2]

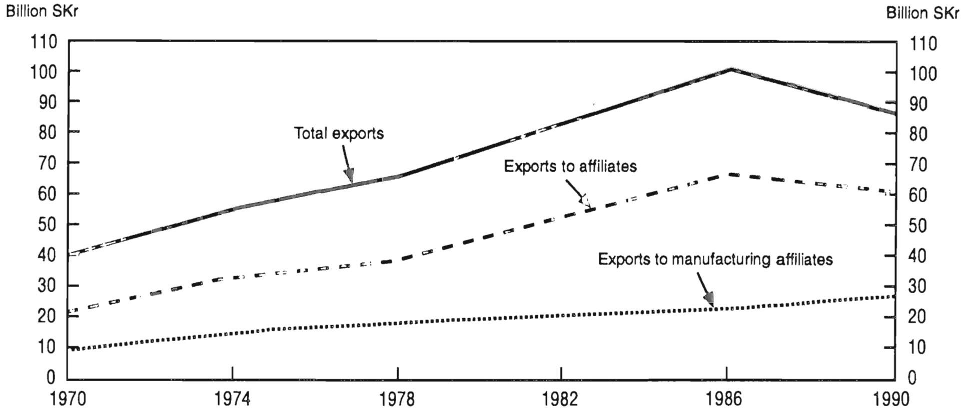
Altogether, these developments reflect a marked orientation towards international integration of production within the EC during the period 1986-1990. Operations in the other west European markets does not display a similar trend but, like in the case of inward investment in Sweden, there are indications of a greater emphasis on the local market. While units in the EC have grown and became more closely integrated with each other, the Swedish parent companies obtained a less focal role in the company groups.

Figure 4. **The share of Swedish affiliates in the EC, which did not import from the parent companies, by mode of entry, 1974-1990**



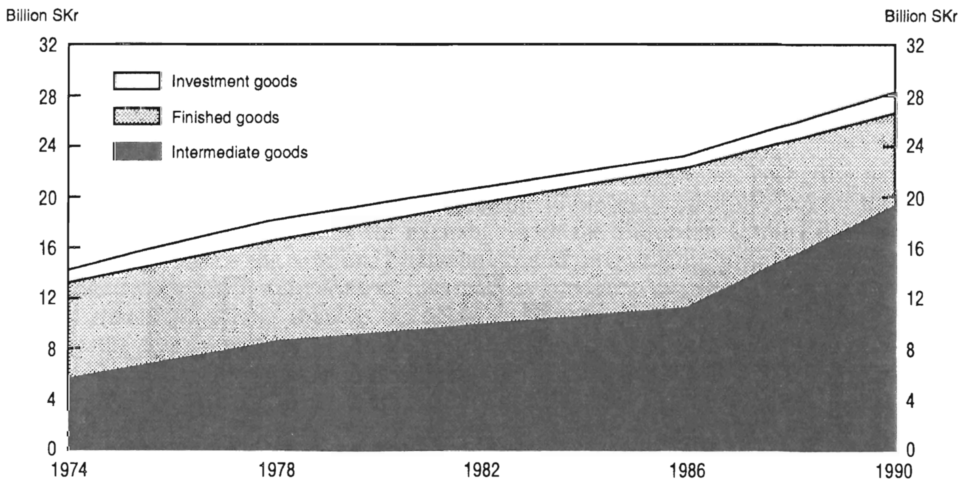
Source: IUI.

Figure 5. **Exports by Swedish parent firms in engineering, 1974-1990, fixed prices, base year = 1990**



Note: Figure is based on identical firms, *i.e.* only those firms are included for which data are available from every questionnaire. The shift over time looks about the same if all firms are included.
Source: IUI.

Figure 6. **Composition of exports by Swedish parent firms to manufacturing affiliates, 1974-1990, fixed prices, base year = 1990**



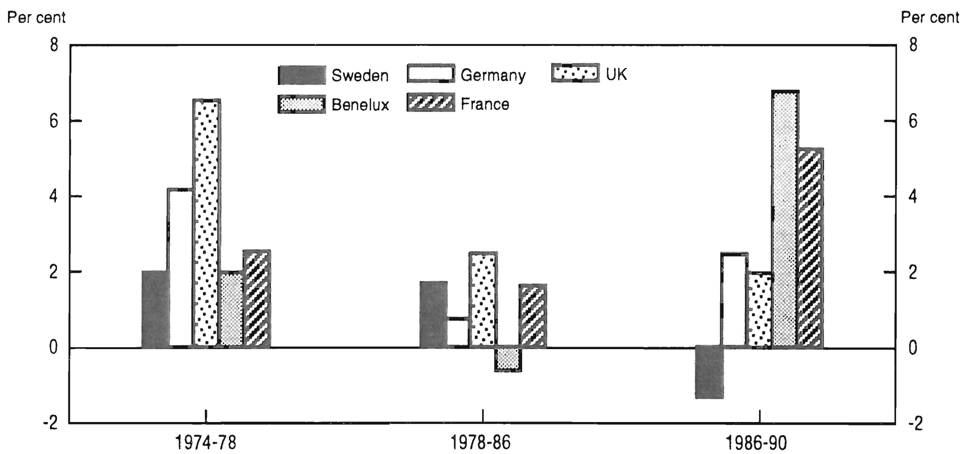
Source: IUI.

This does not apply to all manufacturing but concerns mainly engineering. Except for a decline in exports, production and employment at home, the parent companies also displayed a weak record in productivity, measured as value added per employee. As can be seen in Figure 7, this was paralleled by strong productivity growth in affiliates in the European Community.

In fact, a relatively weak productivity growth at home was mainly characteristic of industries and firms classified as knowledge intensive based on investment in R&D or expenditures on training of employees. Expansion abroad in natural resource based industries was not accompanied by a contraction of employment or reduced value added at home (Andersson, 1994). The natural resource intensive activities are highly capital intensive, however, and their impact on overall employment is relatively insignificant.

On the whole, the restructuring of the late 1980s had adverse consequences for employment in Sweden. This concerned not only the activities of the multinational firms themselves, but many domestic subcontractors could not follow their customers abroad, contributing to a severe cut-back of employment in such firms as well. The scope of these difficulties was not observed immediately as excess labour was absorbed by the public sector. In the early 1990s, however, falling domestic demand, de-industrialisation and an attempted trimming of the world's largest public sector as well as most rapidly growing public deficit, led to the largest unemployment figures in the after-war period. Renewed investment by private companies has become a necessity for restoring economic growth, managing public finances and getting the employment situation under control.

Figure 7. **Average annual growth in value added per employee in Swedish manufacturing affiliates, selected EC-countries, engineering, 1974-1990**



Source: IUI.

The underlying causes and the future

The reasons behind the restructuring of the late 1980s are to some extent found in the possibilities and risks that emanated from the regional integration in the EC, which represents the main market for Swedish firms. This can be seen from enquiries about the motives for investment, systematic differences between European countries in the pattern of investment at that time and the variation in investment between activities (Andersson and Fredriksson, 1993). With increasing competition, it became important to exploit opportunities for specialising production in different countries. Swedish firms also stepped up their local presence in the EC in order to diminish the risks of discrimination. Although there are individual differences, West European ''outsiders'' generally responded in a similar way, resulting in a greater net outflow from the EFTA-countries as a whole. The EC, on the other hand, experienced a tilt towards a smaller net outflow.

More fundamentally, however, multinational firms adapted to the unfavourable conditions for manufacturing which prevailed in the Swedish economy during the late 1980s. In several respects, there was a crowding out from the expansion of the public sector, which absorbed financing as well as human capital. Abrupt deregulation of financial markets opened the door for a construction boom and sky-rocketing real estate prices. Regarding qualified labour, supply was also hurt by too weak incentives for upgrading of competence (Lindbeck *et al.*, 1993; Andersson *et al.*, 1993).

For such reasons, the restructuring process stimulated a reduced role for the Swedish parent companies, especially in knowledge-intensive activities, while affiliates in the EC became more important nodes in their international networks. Many of the investments undertaken abroad by Swedish firms in the late 1980s turned out to be costly in a medium-term perspective, however, due to the ensuing recession as well as the depreciation of the krona. Following this and additional economic reforms, the Swedish economy has become more attractive for industrial ventures as of the early 1990s. Headquarters and R&D activities have mostly remained at home and there are again prospects for an expansion of manufacturing. A certain revival of investment by Swedish firms as well as greater foreign direct investment further suggest that the changes of the late 1980s can be reversed.

Future development will greatly hinge on domestic policy, including the design of infrastructure and whether policy makers are able to present a credible plan for managing public finances. The conditions for exchange with the European Union (EU) will also continue to influence the size and characteristics of investment, however. For activities with intense intra-firm deliveries of intermediate products, even small barriers to cross-border transactions may involve major disadvantages and, hence, rule out operations outside the major markets in the EU. It remains unclear to what extent the European Economic Area will establish sufficiently open and reliable conditions for exchange. Under all circumstances, non-membership in the EU does not allow any influence on its determination of new standards and provides no guarantee that they are to be adopted, discouraging firms which operate in fields characterised by rapid technological change. Investment in knowledge intensive activities may for such reasons forego Sweden if it rejects membership, possibly risking a continuation of the trends perceived in the late 1980s.

Concluding remarks

What are the lessons from the Swedish experience of internationalisation in the late 1980s? Above all, it demonstrates industry's increased ability to adapt to new conditions and thereby achieve a remarkably rapid process of restructuring across national borders. Although direct investment enables a more efficient allocation of resources on the whole, there is a possibility of adverse impacts from the perspective of individual countries. In the case of Swedish outward investment, the previously complementary relationship between expansion abroad and at home ceased in the late 1980s. This involved a major cut-back of employment in the parent companies, parallel with low productivity growth, in knowledge intensive production.

Effects such as these operate not only on the margin but concern the entire structure of an economy. Thus, the consequences will not automatically be compensated for by adjustments in prices and exchange rates, but may lead to lasting impacts through agglomeration effects and clustering.

Any attempts to "lock in" resources through regulations are not only likely to be ineffective, but will most probably be counterproductive since firms are thereby impeded from raising efficiency. This will most probably lead to the definite decline of industries. In addition, new investment would be discouraged by such action. The responsiveness of multinational firms rather puts increased demands on policy makers as well as economists to disclose and address policy or market failures more rapidly. At the same time, the behaviour of multinational firms will help to reveal when conditions have become "wrong" in some sense, and thus hopefully pave the way for corrections at an earlier stage.

Notes

1. Director of International Research Programme, Industrial Institute for Economic and Social Research (IUI), Stockholm, when the article was written. Currently Head of Structural Policy Secretariat, Ministry of Industry and Commerce, Stockholm.
2. Svensson's (1993) study partly recapitulates Swedenborg's earlier work, but also includes exposés of countries where no production is undertaken as well as substitution by exports from affiliates in the EC on parent exports to the EC as a whole.

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