Nout Wellink: Business cycles and foreign direct investment

Speech by Dr Nout Wellink, President of the Netherlands Bank and President of the Bank for International Settlements, at the Chamber Luncheon of the American Chamber of Commerce in the Netherlands, Amsterdam, 23 September 2004.

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I feel honoured to speak to this distinguished group of people today. To the general public in the Netherlands, the 'AmCham' may not be a well-known organization. However, the list of its members proves that its goals and purposes have wide support in the Dutch business community. As we have known since centuries, foreign investment and trade between countries enhance welfare in both countries, and it is vital to sustain and promote this in a globalizing world economy. Your active role in this process is highly appreciated.

Traditionally, Dutch-American trading and investment relations have been extensive. In particular, on average around a quarter of outward Dutch direct investment flows is directed towards the United States. Over the last ten years mutual direct investment flows have increased. This increase was similar to the global increase in foreign direct investment that started in the 1980s. In 2000, the Dutch foreign direct investment position in the US had a value of around 20% of Dutch GDP, which is a quarter of the total Dutch foreign investment position. Fifteen years earlier, in 1985, this value was just 12%.

In my talk this afternoon, I will further explore the effects of increased direct investment exposures. In particular, their effects on the behaviour of international business cycles. I will start by elaborating on two observations concerning business cycles. First, in contrast to the past, when business cycles generally became more moderate over the longer term, the Dutch business cycle has become more volatile recently. Moreover, Dutch and US business cycles have become more synchronized.

Let me elaborate on the increased volatility of the Dutch business cycle first. According to our current knowledge, the Dutch economy has passed the trough of the cycle around the end of last year. Last year, GDP growth reached its lowest rate in the past twenty years, at a negative rate of 0.9%. Compared to other European countries, our growth rate was exceptionally low; more than one percentage point below the average. This low performance was in strong contrast with performance in the second half of the nineties. In those years Dutch GDP growth was consistently higher than the euro area average. This illustrates that the Dutch economy has acquired a kind of boom-bust character, which indicates a more volatile cyclical growth pattern. Another indication is given by the rise in the standard deviation of growth rates. This measure of volatility has almost doubled over the last four years, compared to the four years before. For a significant part, the comparative strength of the upturn and the severity of the downturn in the Netherlands can be attributed to the open character of the Dutch economy. The spectacular growth of world trade since 1995 and the declining exchange rate of the euro have boosted exports. The downturn that followed had an opposite and - again - comparatively strong effect on the Dutch economy. However, more can be said about the latest Dutch business cycle - I will return to that later. First, we should take a view from a longer term, more global perspective.

Although the volatility of economic growth during the latest Dutch business cycle was higher than before, the long term, global pattern is very different. Since a long time, at least since 1960, but even more pronounced since 1980, the volatility of GDP growth [measured by the standard deviation] has shown a downward trend. In other words, from a longer term perspective, the business cycle has become more stable. All G7 economies, as well as the Dutch economy, have become more stable. This increasing stabilization has been labelled by economists as 'the Great Moderation', especially with respect to the US economy. To give a quantitative illustration, the standard deviation of quarterly growth rates in the Netherlands was 2.4% in the 1980s; over the period since 1990 it has fallen to 1.4%. Similar figures have been found for the US.

Extensive research has been devoted to an explanation for this moderation of the business cycle over the past twenty years. There are two explanations which I would like to focus on in this speech.

The first explanation that has been proposed is structural change. This explanation suggests that there have been improvements in the ability of modern economies to absorb shocks. For example, due to improved methods of inventory management, there are less severe fluctuations in inventory stocks. Other examples are deregulation of financial markets, and the improved resilience and strength of the financial sector. Financial institutions are more able to diversify their risks, both internationally and among types of financial products. Therefore, the supply of credit to the private sector has become more sophisticated, enhancing the ability of firms to smooth their activity during the business cycle. Second, economic research convincingly shows that the number and size of shocks hitting economies has diminished over the past twenty years. In this sense, the observed moderation of business cycles since the 1980s can be seen as the result of good luck. However, as a consequence, it is possible that we may experience an increase in volatility again, if we run out of luck.

Besides volatility, there is a second characteristic of recent business cycles that deserves attention: international co-movement - or synchronization - of cycles. Business cycles in modern economies tend to move together. For example, the rate of correlation between the US and Dutch growth rates varies between 0.4 and 0.5, since 1960. An extensively studied question has been whether there has been an increase in the amount of synchronization of business cycles. In general, the available evidence indicates that there is no overall tendency towards closer synchronization or co-movement, over the past quarter century. However, at a more detailed level, the picture is different. There are cases of increased synchronization within groups or pairs of countries. For example, within the group of euro area countries, synchronization has become closer since the nineteen-eighties. Moreover, in the latest cycle, correlation between US and Dutch growth rates has increased significantly, to a value of 0.65. From this, we may conclude that Dutch and US growth rates have become more synchronized in the most recent cycle.

In general, there are two sources for co-movement of economies. First, it is clear that general shocks to the economy, which affect many countries, lead to correlated national economic developments. This reflects a common reaction of more or less comparable countries to the same exogenous factor. Examples are energy price shocks, or major developments in technology. Second, in addition to common shocks, country-specific shocks are important, to the extent that they spill over to other countries. Spill overs of shocks require economic linkages between countries, like trade and financial flows. Hence, stronger linkages raise the probability of co-movement. For example, an increase in economic activity in one country boosts activity in its trading partners because of higher foreign demand.

More recently, another transmission channel between countries has increased in importance: foreign direct investment, or FDI. Several factors have contributed to the strong increase of FDI flows since the mid-nineties, like the liberalization of capital flows, reduced trade barriers and the widespread use of ICT-technologies.

Interestingly, results from empirical analysis at DNB have shown that countries with comparatively large bilateral FDI positions tend to have a higher correlation of output growth rates. In other words, FDI may intensify co-movement of business cycles. In particular, this appears to be the case in the period 1995-2001.

There are two ways in which FDI acts as a transmission channel for economic shocks, depending on where the shock occurs: in the home country or the host - the foreign - country. First, shocks in a foreign investor’s home country may affect its financial position at home, and force it to cutback its activity in host countries as well. Second, due to shocks in a host country, the value of a firm’s investments abroad may be affected. Consequently, that firm’s net worth at home is affected as well. Net worth, in turn, is related to financing costs, so it is obvious that a reduction of the value of foreign investments may reduce investments in the home country, because of higher costs.

Let me try to integrate what I have said so far. On the one hand, international economic linkages, like trade and FDI flows, have become stronger and more sophisticated. In itself this would lead to more co-movement (or synchronization) of business cycles, because common and country-specific shocks are transferred more ‘effectively’ and rapidly between countries. For example, accounting problems in the US not only had national effects, but were also transferred to European countries through channels within multinational firms (like Ahold and Anderson).

On the other hand, there are signs that the amount and strength of common shocks has decreased. I mentioned this earlier as an explanation for the global moderation of business cycles. As a result, the enhanced transmission channel for country-specific shocks has been compensated for by smaller and less frequent common international shocks. This explains why, on a global scale, co-movement of cycles has remained fairly stable.

Having discussed the global picture, I will return to the Netherlands now. As I said, the Dutch business cycle has become more volatile recently, as well as more synchronized with the US. Both observations are in contrast to the global picture of more moderate cycles with stable synchronization. In my opinion, these atypical features of the Dutch business cycle can be explained in the terms that I used to describe the global picture. First, the Dutch economy has been subject to some especially powerful country-specific shocks. An example is the exceptionally favourable housing market development in the nineteen-nineties, which had a positive effect on private consumption. Later on, consumption has been negatively affected by political developments, which reduced consumer confidence significantly.

Besides, the size of the external sector and the large FDI positions make the Dutch economy particularly sensitive to international developments, especially from the US. This is also reflected in the stock market - our own research indicates that the Dutch stock market is traditionally highly correlated with the US stock market, in comparison to other European countries. In terms of FDI, the US is by far the most important partner of the Netherlands. As a percentage of GDP, Dutch investments in the US are larger than those of any other European country. Hence it is no surprise that some international and US shocks have had a sizeable effect on the Dutch economy, like the sharp correction in international stock markets in 2000, as well as the geopolitical tensions of the recent years. As a consequence, the Dutch business cycle was more volatile and moved more closely together with the US economy than did business cycles in other countries.

It is challenging now to take a look ahead. What do these observations, that I have sketched here, imply for global business cycles in the near future? Will business cycles remain moderate and will co-movement remain stable? Let me try to discuss some implications from my remarks so far.

One implication to take note of, is related to the vulnerability of economies to international shocks. Several studies have concluded that business cycles have moderated, because the amount and size of shocks have diminished. However, this might not continue indefinitely - we may run out of luck. Major international shocks could occur again, significantly enhancing international business cycle volatility and co-movement. In fact, we have recently experienced that terrorism and geopolitical tensions may act as a shock to the economy, for example through global shocks in confidence levels or through disruptions of energy supply. An obvious result could be a disruptive shock to oil prices. In this respect, the results of a recent study on oil price shocks are striking. It found that an oil price shock that is related to political factors and supply side conditions has more severe implications than other types of oil price shocks, such as shocks related to demand conditions. Since 1984, an oil price shock of this type has not occurred, except in the past half year.

Were such a large international shock to materialize, one should be aware that the partial consequences for the exposed countries can be larger than in the past. This is because the transmission channels of shocks, such as FDI and trade flows, have increased over time and will probably continue to do so. However, this is not to say that we should aim at reducing these international linkages. Let me elaborate on this.

First, one should not forget that international trade and other linkages may transmit economic disturbances, but have beneficial effects as well. FDI has become an important mechanism for the transfer of technology, including management techniques. In this way, FDI supports a smooth adoption of technologies that can make an economy less vulnerable to cyclical factors. For example, scale economies may drive multinational firms to apply state-of-the-art ICT-technology or management models in different countries. I will not conceal that there also have been mistakes in this respect - there have been clear cases of overinvestment during the global boom in mergers and acquisitions. However, there is reliable empirical evidence that technology transfers through FDI have stimulated the rate of technological progress.

Second, the negative effect of international shocks may be kept in check by ongoing improvements in the resilience of the financial sector. This month, the IMF reported (in its WEO) that the global financial system is in its strongest shape over the past three years.

Finally, there are structural changes in the economy that indicate that firms are becoming more flexible and are less affected by cyclical developments. Let me illustrate this by focussing on the Dutch economy; however, similar developments have been found for the US economy.

A remarkable development can be observed in the sectoral pattern of employment changes. More than before, sectors or industries may be denoted as either structurally shrinking or structurally growing; independent of the state of the business cycle. Less than before, industries that shrink in a downturn can expect to grow again in the next upturn of the cycle. Consequently, employees are made redundant in sectors which are subject to structural shrinking, and must find new jobs in growth sectors. During the 1995-2002 cycle, these sectors accounted for 96% of employment, as compared to 71% during the 1987-1994 cycle. This changing pattern of sectoral employment indicates that labour and product markets have become more dynamic and flexible. A flexible labour market is conducive to labour productivity growth in the long term. Moreover, the ongoing changes in the sectoral composition of employment indicate that companies are forced to carry out ongoing restructuring, for example, as a result of increasing competition and innovation.

Let me conclude here. Every business cycle is unique. However, we may try to find patterns and take lessons from the past and from other countries. In summary, over the long run, business cycles tend to be more moderate and co-movement appears to be less strong than we would expect. Most of this can be explained by the absence of international shocks to the economy. However, since economies have increasingly become integrated, the risks of disturbances spilling over to other countries seem to be greater than ever. On the other hand, as I have indicated, modern economies are becoming more resilient at the same time. This may be viewed as a positive effect of increased economic linkages. It is my opinion that this effect should be encouraged; and I am convinced that the task of improving economic linkages is well dedicated to the AmCham. Looking at the current business cycle, I am convinced that the worst part is behind us now. Most indicators point to a sustained recovery of the US and the world economy. As we emerge from this downturn it will become clear that the Dutch economy has experienced a volatile business cycle and that strong linkages to the US economy can be a great advantage.