

US-Based Transnational Corporations and Emerging Markets

Transnational corporations (TNCs)¹ are accounting for a larger share of global economic activity and their dependence on emerging markets is rapidly rising. For US-based TNCs, the attraction of emerging markets stems from superior economic growth, higher rates of return, but most importantly, from the prospect of expanding market share.

As the earnings of US-based TNCs become more dependent on emerging markets, US equities will offer a growing emerging market play. The consequence will be faster earnings growth, as well as higher volatility.

Foreign operations will likely boost US earning growth in the next decade . . .

Over the past half century, foreign earnings have become increasingly significant for US corporations, rising from less than 5% of the total in the 1950s, to about 25% currently (Chart 1 on page 12).

Until the mid 1980s, the behavior of domestic and foreign earnings were counter-cyclical. The main reason was petroleum. Energy-related profits weighed much more heavily outside than inside of the US, so while the oil crises of 1973-4 and 1979-80 undermined earnings for US parent companies, they boosted them for their foreign subsidiaries (bottom panel in Chart 1).

This inverse relationship now seems to have changed. First, energy prices have become far less volatile and, second, manufacturing and services now account for a larger share of TNC activity, both within and outside of the US. The result is that domestic and foreign earnings are now moving more or less in tandem.

Although US earnings should benefit from the prospects of a new long-wave upswing as argued by our sister publication *The Bank Credit Analyst*, their cyclical outlook seems more limited. Both in and outside the US, earning momentum is approaching historical peaks, so that the risk of deceleration is rising (bottom panel of Chart 1). For the next decade, however, there is a good chance that the domestic and foreign series will again diverge.

The reason is rooted in the different determinants of domestic as opposed to foreign earnings. In the US, profit growth depends on two components: (a) the overall growth of the economy, and (b) capital's

share of GDP. Given that the current recovery is already the longest on record, economic growth does not offer much *further* upside. The share of capital in national income is still very low by historical standards, and could continue to recover with further productivity improvements. However, given that this has already grown considerably over the past few years, the *political* risk of countervailing government action, particularly if the Democrats retain power, is also rising.²

Outside the US, the arithmetic is different. There, US-based TNCs operate alongside domestic companies as well as TNCs from other countries. As a consequence, their profits are affected not only by economic growth and the overall share of capital, but also by changes in their *own market share vis-à-vis other firms*.

This latter factor is important: in many parts of the world — and particularly in the developing countries — the market share of US-based TNCs is still relatively small and has ample room to grow.

US equities already offer a significant emerging-market play for investors . . .

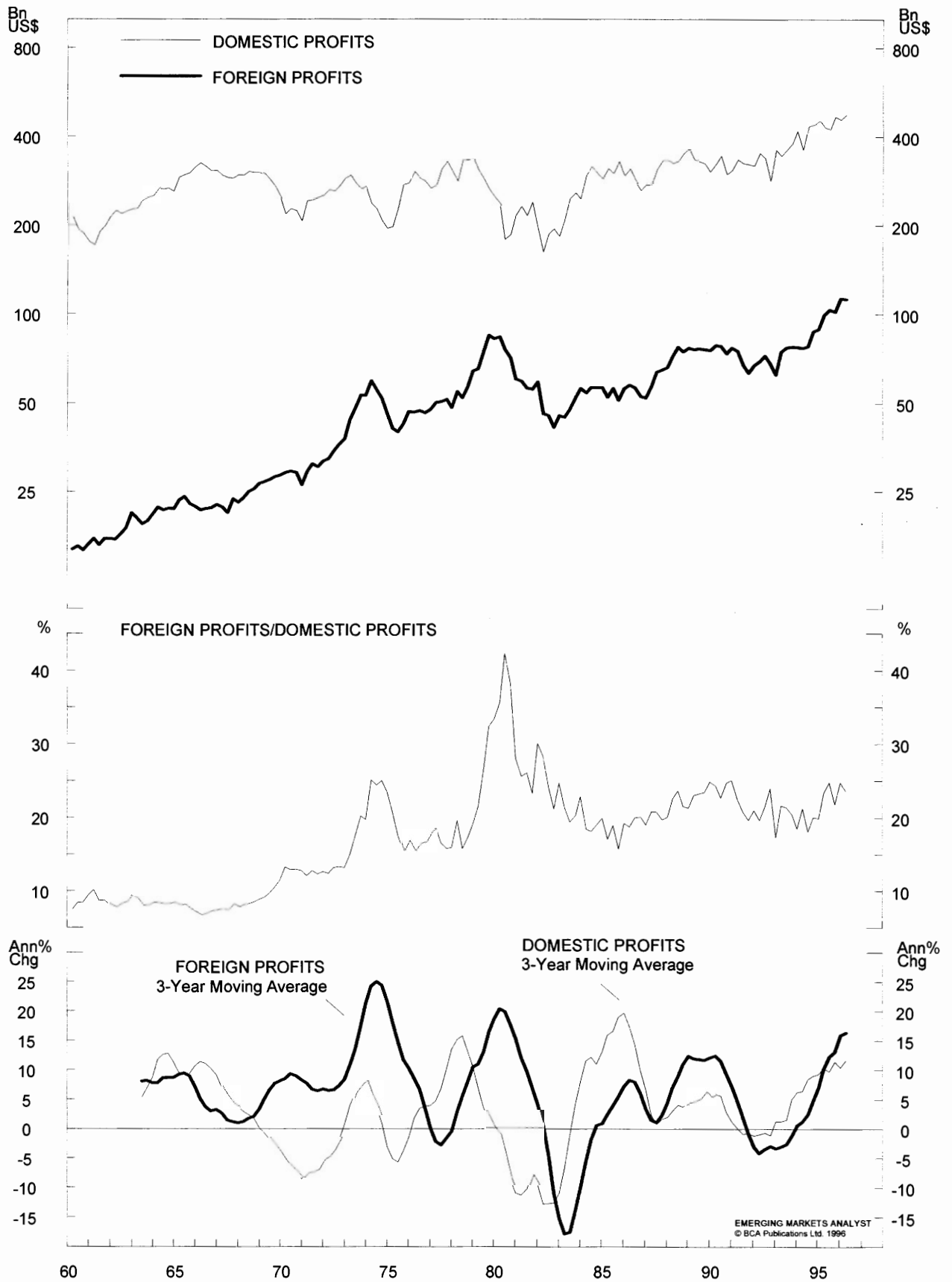
For US-based TNCs, the growing significance of affiliates based in emerging markets has become apparent since the late 1980s. As Chart 2 illustrates, between 1989 and 1993, affiliates based in 22 leading emerging markets³ have accounted for a full 15% of the *change* in sales — which is much larger than their 4.7% share in the aggregate *level* of sales. And the contribution of emerging-market affiliates to profit was even more pronounced (Chart 3). Although their share in overall profit remains limited at 9%, their profits have been *growing* while those of their parent companies and sister affiliates in the developed countries have been falling. (During the early 1990s, the net profits of US parent companies have been artificially reduced by one-time accounting changes, but even with these changes netted out, the significance of emerging-market profits remains disproportionate.)

¹ Transnational corporations are defined as companies who have more than a 10% stake in foreign affiliate(s).

² For analyses of distributive income shares in the US, see 'The Secular Revival in US Corporate Profitability: No Threat from a Worker Backlash,' *The Bank Credit Analyst*, April 1996, and 'The Populist Attack on Corporate America: A False Premise Based on Misleading Data,' *The Bank Credit Analyst*, June 1996.

³ In regional order, these comprise in **Europe**: Greece, Portugal and Turkey; in **Latin America**: Argentina, Brazil, Chile, Colombia, Mexico, Venezuela; in **Asia**: China, India, Indonesia, Hong Kong, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand; in the **Middle East**: Israel; and in **Africa**: Nigeria and South Africa.

CHART 1: NET PROFITS OF US-BASED CORPORATIONS



... and the share of emerging-market earnings is set to grow further

A somewhat broader picture, focusing on developing countries as a whole (rather than a subset of key emerging markets), shows a similar pattern (Charts 4 to 6). The data are broken down to separate between activities in developed and developing countries. US-based TNCs' operations in North America (including both US parents and Canadian subsidiaries), Western Europe and Japan are grouped together, and are contrasted with the aggregate activity of US-based TNCs in all other markets, which are roughly equivalent to the universe of developing countries. Current figures are available only for the 1982-93 period, but the trends are clearly apparent.

Chart 4 indicates that since the late 1980s, developing countries have accounted for a growing share of the aggregate net profit earned by US-based TNCs. Looking at the underlying determinants of this trend, it is clear that part of the reason is rooted in widening profit margin differentials, illustrated in Chart 5. (The divergence remains even if the accounting changes of the early 1990s are taken into account). Liberalization and the progressive opening of emerging markets to foreign investors will probably take time to reduce the superior markups currently enjoyed by subsidiaries in developing countries. For the foreseeable future, the implication is that positive differentials will be maintained. However, the fact that large differences in profitability already exist also suggests that this factor alone is unlikely to boost the earning share of developing countries much further.

The more crucial determinant is sales (Chart 6). Compared with 1982 (the first year of data), the distribution of sales revenues between developed and developing countries has tilted in favor of the former — but then 1982 is probably not the proper benchmark. FDI into emerging markets began to rise in earnest only during the late 1980s and the results in terms of growing sales are only now beginning to show up. Since 1986, sales by US-based TNCs in the developing countries rose by 46%, compared with a 12.5% for the developed countries (all figures are in real terms). If this trend were to continue, by 2000, the share of sales coming from affiliates in developing countries could reach 11%, up from 6.5% in 1986.

The crucial question is will this upward trend continue?

CHART 2: CHANGES IN SALES OF US-BASED TNCs (1989-93, US\$ MN)

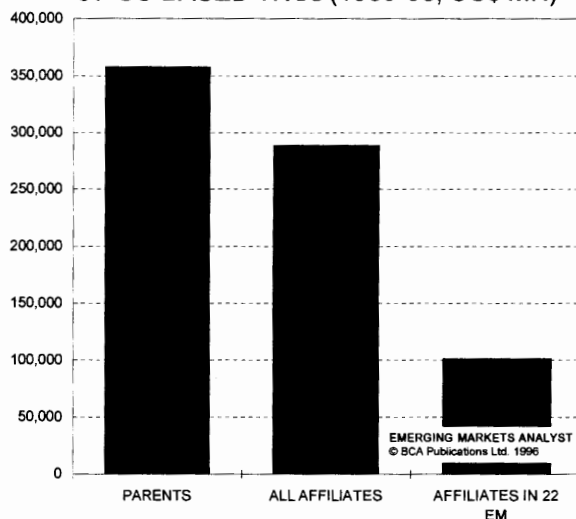


CHART 3: CHANGES IN NET INCOME OF US-BASED TNCs (1989-93, US\$ MN)

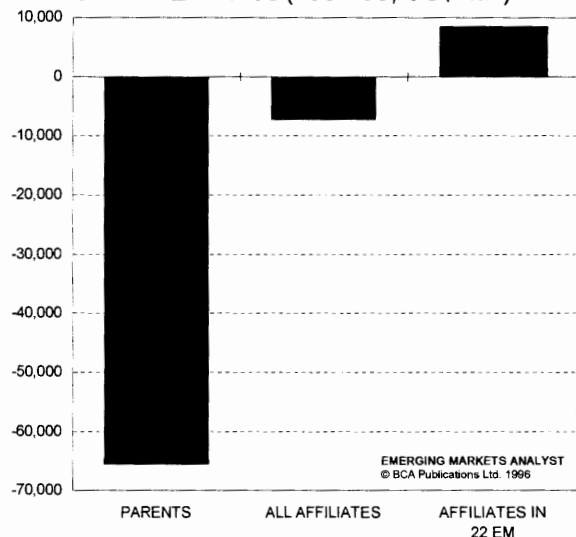


CHART 4: NET INCOME OF US-BASED TNCs

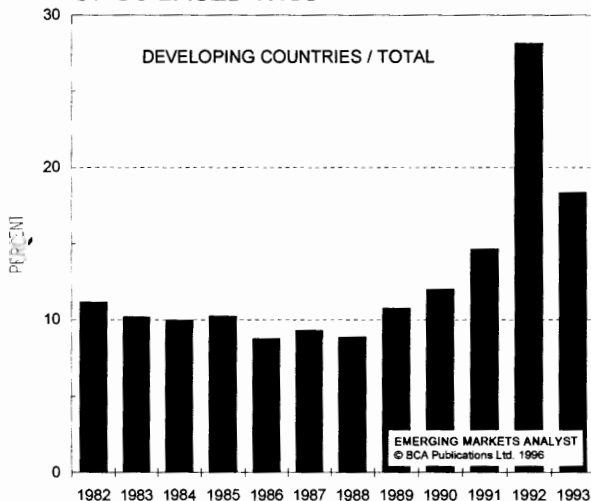


CHART 5: US-BASED TNCs: NET PROFIT MARKUP ON SALES (%)

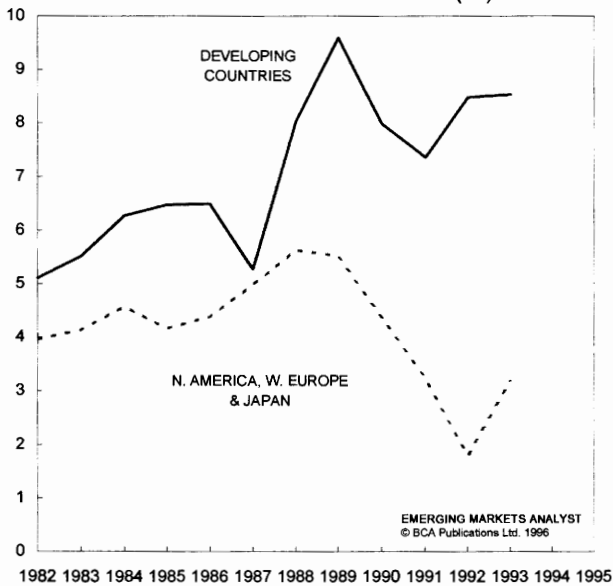
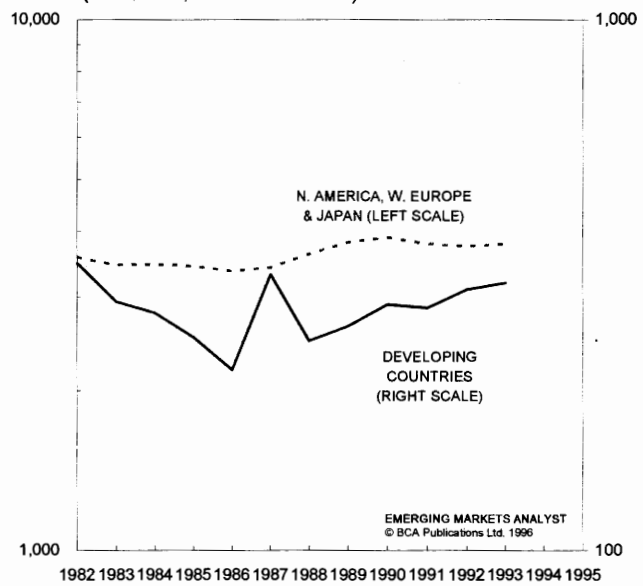


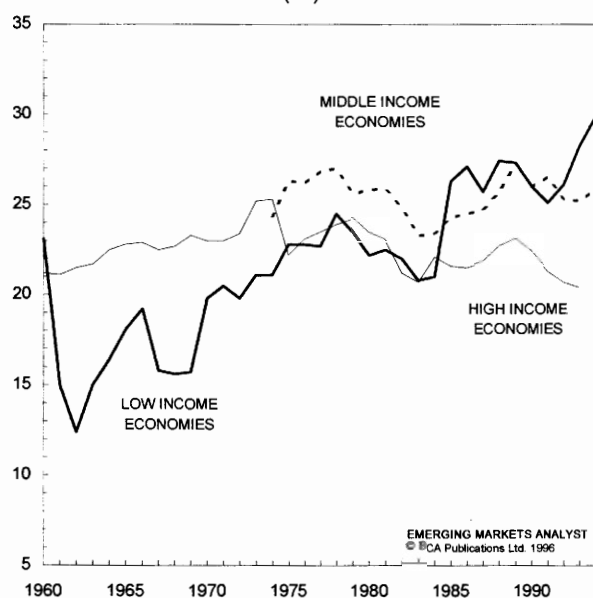
CHART 6: US-BASED TNCs: SALES (US\$ BN, 1987 PRICES)



The economic underpinnings of the emerging-market boom are intact . . .

On the face of it, emerging market growth does not seem ready to falter. The prime reason, illustrated in Chart 7, is real investment. Until the early 1970s, rapid growth in the high-income economies (primarily OECD), has been supported by a high investment/GDP ratio. Since then, however, this ratio has faltered in the industrial countries, while rising elsewhere, particularly in Asia. From the mid 1980s

CHART 7: GROSS DOMESTIC INVESTMENT/GDP (%)



onward, the superior growth performance of emerging markets has been at least partly explained by their surging investment in contrast to its protracted decline in the developed countries.

Some economists have recently claimed that this is precisely the problem.⁴ The growth of the Asian economies is almost wholly attributable to the growth of inputs: rising labor force participation, higher education and, most significantly, massive fixed investment in plant and equipment. According to this view, the absence of any discernible productivity growth in these economies is an extremely bearish sign. Since inputs growth carries diminishing returns and in any case cannot continue indefinitely, investment will eventually falter and growth will subside.

The validity of this conclusion rests on three presumptions — two of which are unsound and a third which is only partly correct.

First, in most developing countries, urbanization, improvements in education and health, and capital formation are only at their initial stage. Indeed, ongoing institutional changes such as better contract enforcement, growing asset markets and deregulation, could more than offset the effect of 'technically' diminishing return on capital. In any

⁴ For instance, Paul Krugman, 'The Myth of Asia's Miracle,' *Foreign Affairs*, November/December, 1994, and 'Dutch Tulips and Emerging Markets,' *Foreign Affairs*, July/August, 1995.

case, the growth of 'inputs' is still accelerating and that should feed economic growth for the foreseeable future.

The second shortcoming of this logic is that it is backward-looking. During its early stage of industrialization between the 1860s and 1880s, the US economy grew at a very fast rate, though almost all of that growth was due to a rapidly expanding population and massive infrastructure investment. Over that period, labor productivity in manufacturing grew at a rather sedate rate of 1% — and the figure would be even lower if we were to take the growth of capital into account. It was only from the 1890s onward, after population growth started to decelerate and the railway boom ended, that the country entered its second stage of development, and that productivity growth started picking up.⁵

There is nothing very surprising in that sequence. Clearly, when population and infrastructure grow in leaps and bounds, the business incentive for technological change is relatively limited. It is *after* these sources of growth begin to decelerate, that organizational and technological improvements become essential for business success. The US and other developed countries have followed this path and there is no *a priori* reason why developing economies cannot.

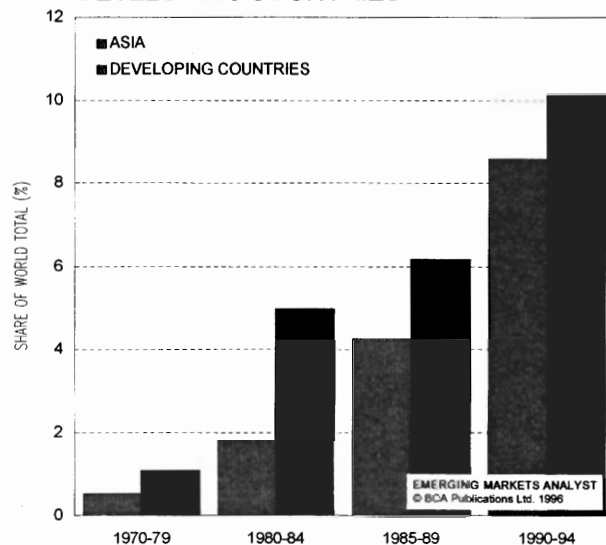
. . . but the political and institutional outlook remains uncertain

The third assumption underlying the bearish view on emerging market regards their politics. According to Paul Krugman of Stanford University, the neo-liberal policies of the "Washington Consensus" offered a huge *initial* payoff in the form of debt reduction and massive capital inflows.⁶ This incentive is now much reduced, particularly after the Mexican crisis demonstrated how capital flows could be a double-edged sword.

The argument is sound but incomplete. Although some of the *external* benefits may have worn out, the *internal* benefits have not. In many emerging markets, the local elites who previously supported the statist regime are now increasingly in favor of liberalization.⁷ Indeed, FDI *outflows* from emerging markets — particularly from Asia — have grown considerably over the past decade (Chart 8). And, as these benefits of liberalization continue to rise, so will the cost of policy reversal.

The principal political risks lie elsewhere. First, rapid industrialization is creating significant labor dislocation. Unlike during the industrial revolution of the 18th century, when labor surplus was offset by massive immigration into the colonies, this avenue is

CHART 8: FDI OUTFLOWS FROM DEVELOPING COUNTRIES



no longer available, and countries such as China have to deal with massive (unofficial) unemployment. The social costs of rapid reforms have already triggered political backlashes in countries like Mexico, Venezuela, Poland and India and this risk could intensify.

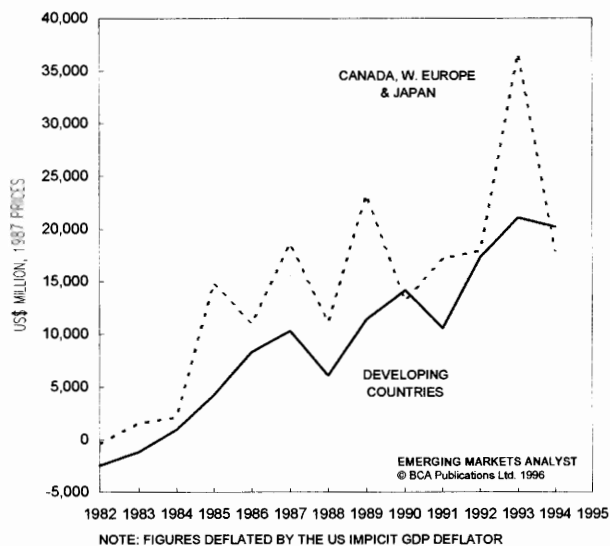
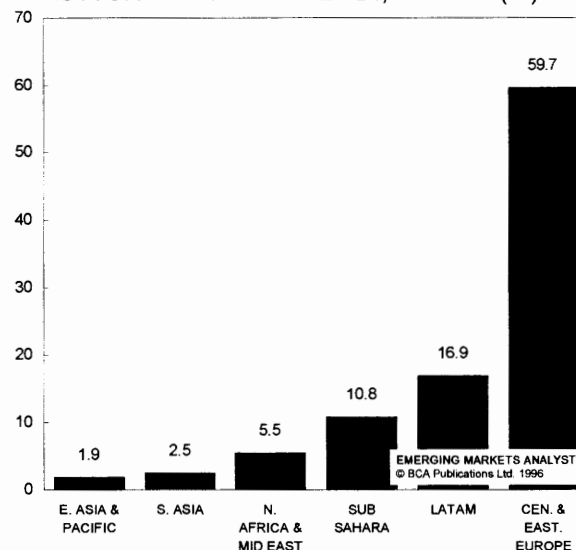
The second area of concern is the struggle over natural resources. Measured on per capita basis, mineral, food and water consumption in the emerging markets are only a fraction of their comparable western level. If the former are to succeed in raising their standards of living, conflict over natural resources is almost surely to heighten.

For US investors, the implication is that economics will boost TNC earnings, but politics will make them more volatile.

⁵ Computations are based on the Friky Index of manufacturing output and on the number of production workers in manufacturing, published in the *Historical Statistics of the United States, Colonial Times to 1970*.

⁶ See, 'Dutch Tulips and Emerging Markets,' *Foreign Affairs*, July/August, 1995. The term "Washington Consensus" was originally coined by John Williamson of the Institute for International Economics. In a nutshell, it denotes the belief that economic development is best served by free markets and sound finance.

⁷ Indeed, according to the *World Investment Report 1995*, published by the UN, during the 1991-94 period, 368 out of the 373 regulatory changes affecting FDI have been in the direction of greater liberalization (p. XX).

CHART 9: US FOREIGN DIRECT INVESTMENT**CHART 10: FDI FROM PRIVATIZATION AS A SHARE OF TOTAL FDI, 1989-93 (%)**

TNCs' sentiment toward emerging markets is rapidly rising . . .

The attractiveness of emerging markets has altered the distribution of US FDI, and developing countries currently account for about half of the US outflow, up from 30% only a decade ago (Charts 9 and 10).

In itself, foreign direct investment is a *financial* transaction, denoting a significant increase in foreign ownership (commonly accounting for 10% or more of the underlying company).

Broadly speaking, the important question is how much "real" investment (capital formation) is triggered — directly and indirectly — by FDI. This is not easy to answer, and here we take on the more limited task of identifying the *immediate* impact of FDI. This can be done by distinguishing between 'ownership switching' (the buying of *existing* businesses) and 'greenfield' capitalization of *new* productive capacity.

Liberalization and market reforms in many emerging markets have resulted in large privatization programs, in which the ownership of existing productive assets 'switches' from public to private ownership. However, UN data suggest that despite their publicity, the share of FDI flowing into emerging market privatizations has been fairly limited (Chart 10). Of the total FDI inflows into these economies over the 1989-93 period, only \$12.2 bn (7.6%) went into privatization, and even that was mostly concentrated in the transition economies of Europe and to a lesser extent in Latin America. The bulk of the FDI has flown to Asia and there privatization accounted for less than 2%.

Of course, direct foreign investors can 'switch' ownership by acquiring existing *private* companies, but that too has been relatively limited. Chart 11 provides data for the number of acquisitions as a share of the total number of new businesses created by majority-owned foreign affiliates (MOFAs) of US-based TNCs (value data are not available). The evidence is that 'ownership switching' FDI is marginally lower in the emerging markets (about 45% of the total), than in Canada and Europe

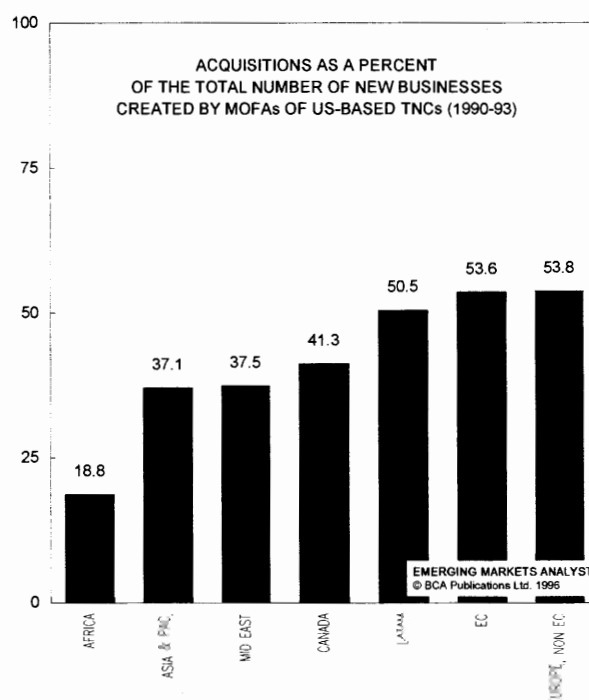
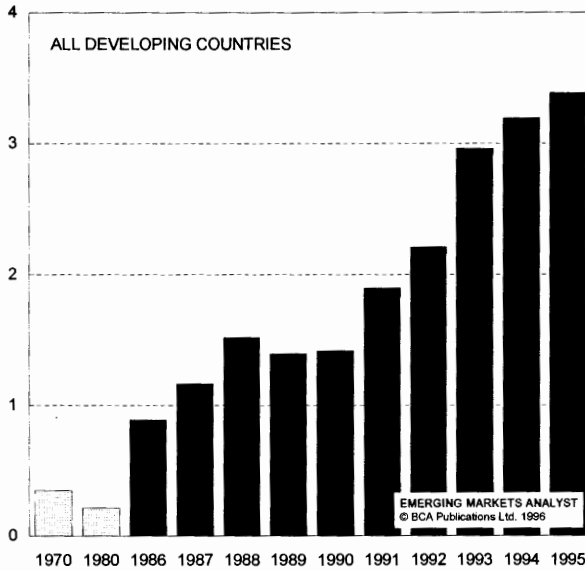
CHART 11: "OWNERSHIP SWITCHING" OR "GREENFIELD"?

CHART 12: RATIO OF FDI TO PROFIT REMITTANCES



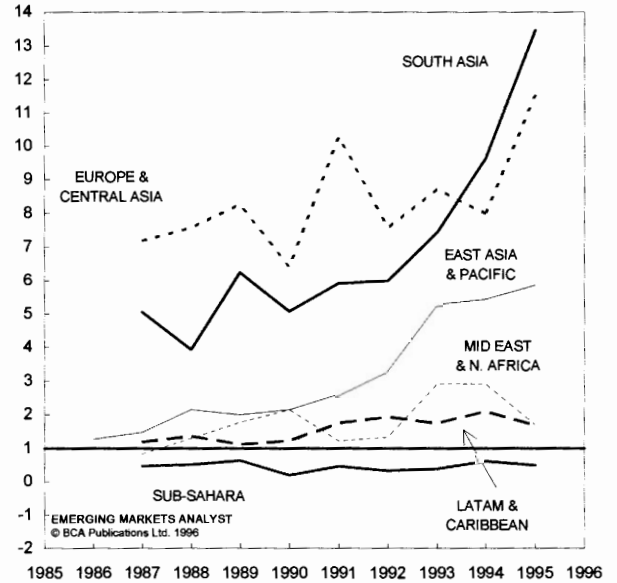
(around 53% of the total). For comparison, in the US roughly 1/2 of all FDI investments are earmarked for acquisitions, representing 70-90% of the total in terms of value.

On the face of it, the differences are insignificant and easily explainable: emerging markets are still in an early stage of development and their capital markets are nascent, so M&A opportunities are still relatively limited. However, further financial development will likely be accompanied by economic growth, so for the emerging markets, the ratio of 'ownership switching' to 'greenfield' FDI may end up falling from current levels.

A useful indicator for the long-term sentiment toward emerging markets is the ratio of FDI to profit remittances (Chart 12). This index has obvious limitations, for it is affected by capital controls and does not reflect other forms of income, such as royalties and fees. However, when broadly aggregated, it nevertheless provides a rough indication for the overall 'mood' of TNCs.

As the chart clearly corroborates, developing countries were in disrepute throughout much of the 1970s and 1980s. Until 1987, TNCs had better things to do with their money than plow it back into developing countries, and as a consequence, inflowing FDI fell short of outflowing profit remittances (index below one). But negative sentiment had slowly given way to a positive one, and since the late 1980s, and particularly from the early 1990s, optimism soared. Taken as a whole, developing countries now absorb more than three dollars of FDI for every dollar remitted in profit, and so far the uptrend remains intact.

CHART 13: RATIO OF FDI TO PROFIT REMITTANCES



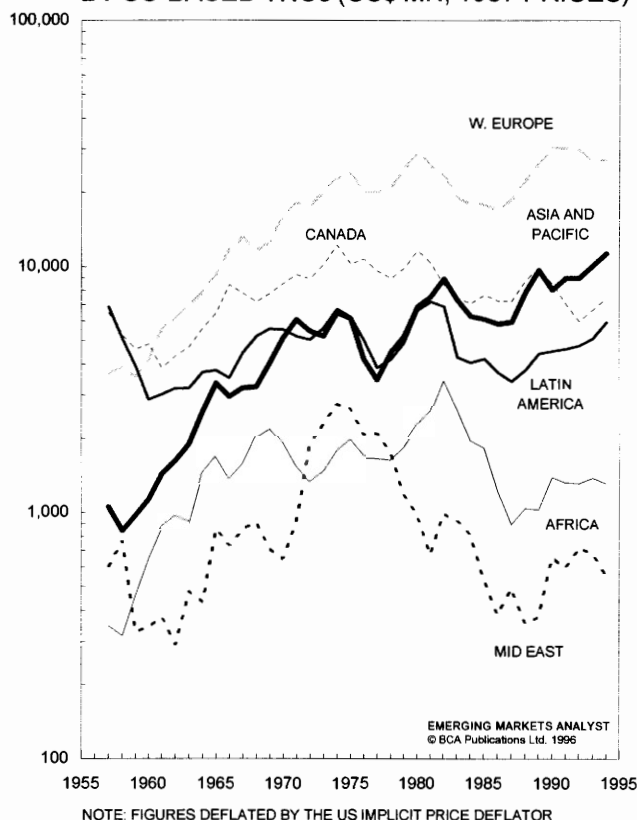
... but some regions are more promising than others

Not all developing countries were created equal, however, and a breakdown of the index reveals significant regional differences (Chart 13 and Table 1). The index is significant for its relative level as well as its direction. On both counts, the 'hottest' areas appear to be South Asia, the transition economies of Europe and East Asia and Pacific, in that order. In the first two regions, capital controls have until recently kept profit remittances artificially low, but as

TABLE 1

<i>FDI / Profit Remittances</i>	Rising	Stable
High	<ul style="list-style-type: none"> • South Asia • Europe & Central Asia • East Asia & Pacific 	
Low		<ul style="list-style-type: none"> • Middle East & North Africa • Latin America
Negative		<ul style="list-style-type: none"> • Sub Sahara

CHART 14: CAPITAL EXPENDITURE BY US-BASED TNCs (US\$ MN, 1987 PRICES)



these controls are gradually removed, the FDI/remittances ratio is actually *rising*, and more rapidly than anywhere else. Optimism regarding the East Asia and the Pacific is also strong and rising, although less so than in the previous two regions.

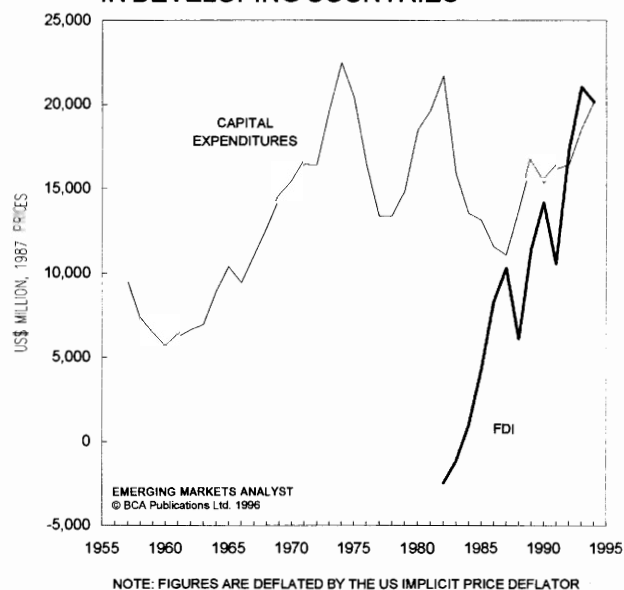
Latin America, a source of repeated disappointment to foreign investors, has so far failed to excite TNCs. Despite a wave of recent reforms in Mexico, Argentina and Brazil, FDI is still only marginally higher than profit remittances — a ratio comparable to that of the Middle East and North Africa. The pariah region remains that of the Sub Sahara, which despite being the source of some spectacular returns, continues to attract less FDI than it remits in profits.

Capital spending is recovering in most emerging markets, with Asia leading the pack . . .

From an accounting perspective, FDI is an entry on the liabilities side of the balance sheet, and in itself, tells us nothing about how the money is being utilized. And indeed, whereas the recent growth of FDI has been fairly widespread, the growth of capital spending has not.

Chart 14 provides a detailed breakdown of capital expenditure by majority-owned subsidiaries of US-

CHART 15: US-BASED TNCs IN DEVELOPING COUNTRIES



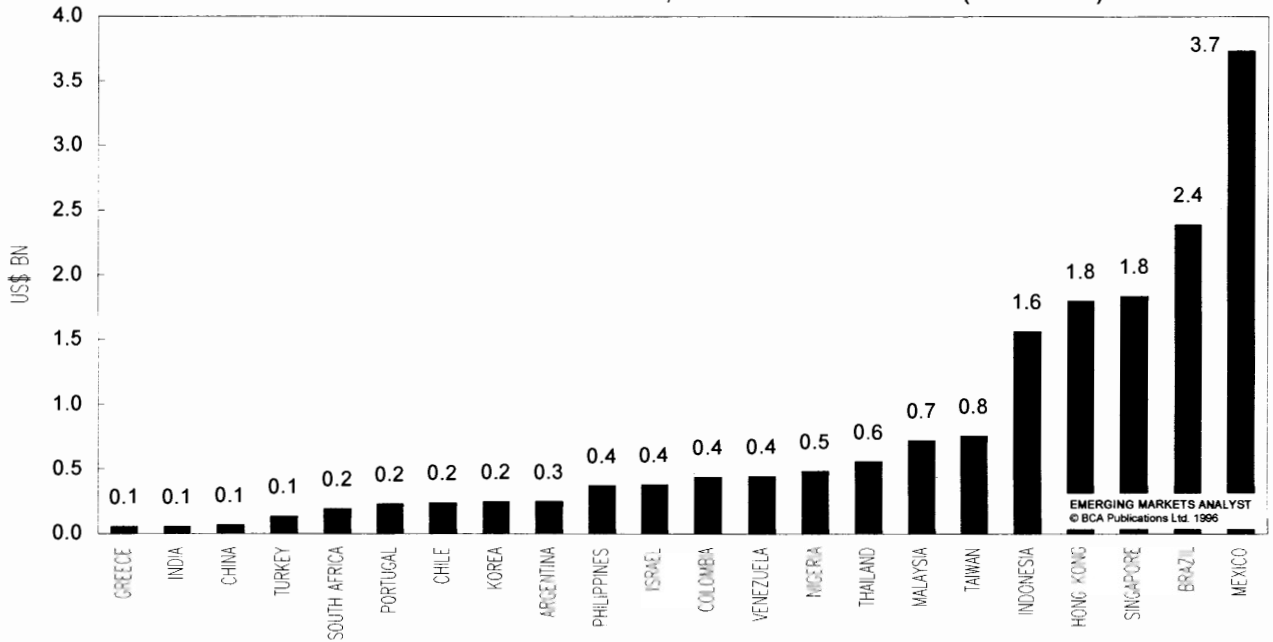
based TNCs. Although the recent spending boom has affected all regions (with the exception of Canada), the long-term trends point to a fairly differentiated pattern. The Middle East and Africa remain in the doldrums, after falling from their respective oil-driven peaks of the early 1970s and early 1980s. The situation is somewhat better in Latin America, where the recent spending recovery suggests a convergence to a mild upward trend, as US-based TNCs remain torn between the region's apparent potential and their memory of past disappointment.

The long-term trend in Western Europe remains positive, though there is a visible deceleration over the past twenty years. Much of the recent increase reflects US-based TNCs positioning themselves for an integrated EU. However, as the effect of this factor weakens in the coming decade, capital spending could slow — much like it did in Canada after its rapid integration with the US economy had been completed by the mid 1970s.

The only region showing a relentless increase is Asia and the Pacific. Capital spending by US-based TNCs there has risen from 5.3% of the total in 1957, to 11.3% in 1975, to 22.5% in 1994. Given that the long-term sentiment toward this region is the highest and fastest growing, its share in the capital expenditure of US-based TNCs' is likely to continue and rise in the coming years.

The rapidly growing significance of developing countries for US-based TNCs is also indicated by the way in which they finance their capital

CHART 16: AFFILIATES OF US-BASED TNCs, ANNUAL NET INCOME (1989-1993)



expenditure there (Chart 15). Although overlapping data are available only since the early 1980s, the changes of the recent period were rather remarkable. Until very recently, capital spending has far exceeded the value of incoming FDI, suggesting that real investment was externally financed via private and public borrowing, as well as international aid and domestic grants. The reason is straightforward: TNCs considered developing countries too risky for their own equity, and had to

be lured by various forms of capital subsidies. But from the mid 1980s onward, the gap has narrowed rapidly, and since 1992 US-based TNCs for the first time invest in developing countries more than they spend on capital equipment.

The relative growth of FDI inflows into emerging markets suggests that earnings from these countries will grow in significance. For US-based TNCs, the implication is that over the next decade, the cyclical impact of domestic earnings will tend to

CHART 17: AFFILIATES OF US-BASED TNCs, NET PROFIT MARKUP ON SALES (1989-1993)

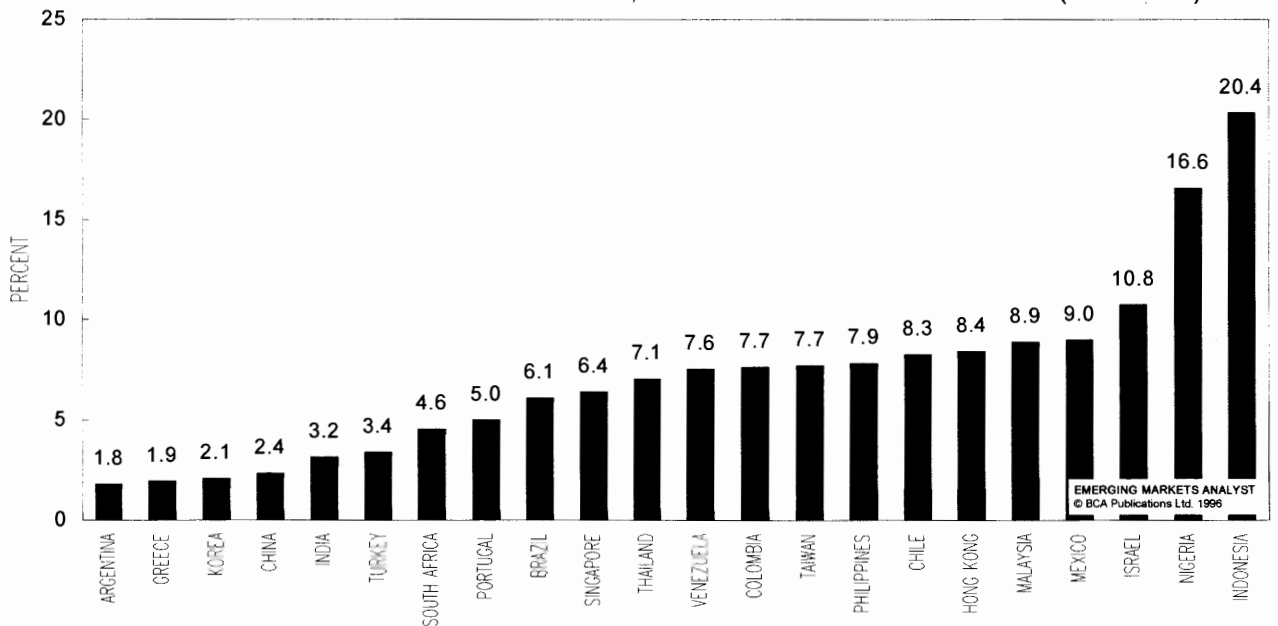
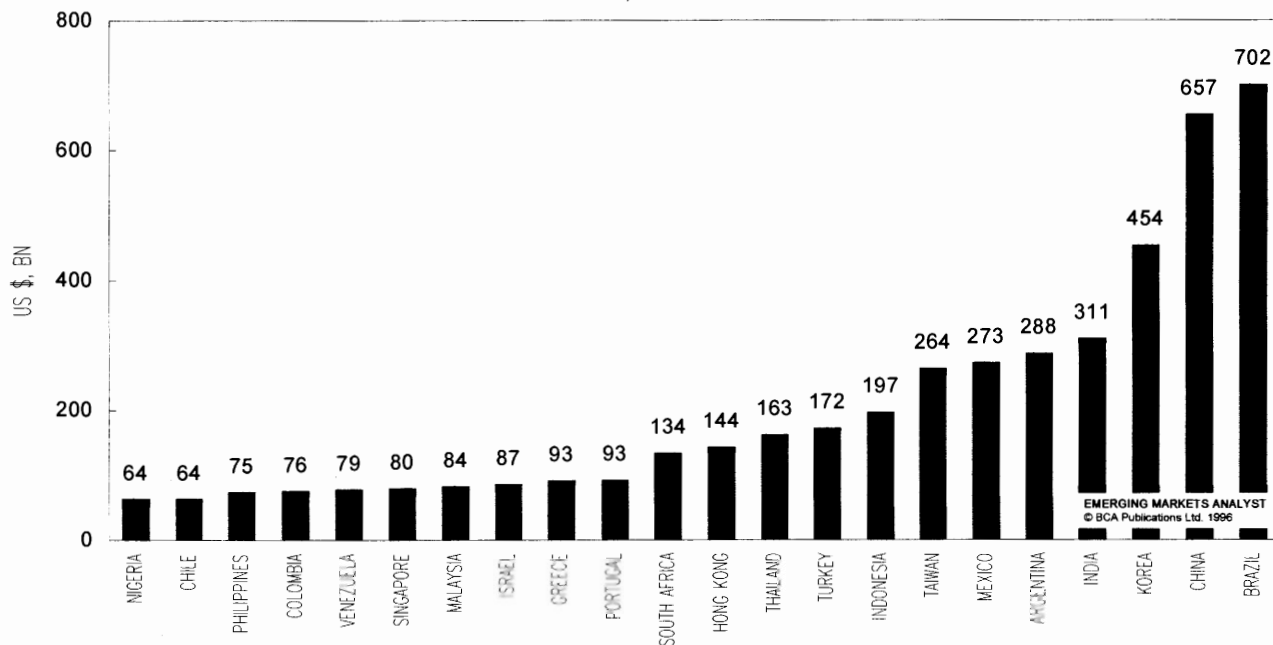


CHART 18: GROSS DOMESTIC PRODUCT, 1995



diminish and the secular impact of emerging-market earnings will rise.

Which Emerging Markets?

Some emerging markets will be much more prominent in this process than others, and their relative role will be affected by politics (domestic as well as global), no less than economics. In what follow, we focus only on the relative *potential* of the different markets for US-based TNCs. This potential

need not materialize, but it points to where US-based TNCs are most likely to concentrate their efforts.

Today's favorites may not be tomorrow's . . .

Chart 16 on page 20 ranks 22 key emerging markets according to their recent contributions to the net profits of US-based TNCs (1989-93). Five countries — **Mexico, Brazil, Singapore, Hong Kong and Indonesia** — have accounted for the lion's share of the total (67%). But this picture is likely to change dramatically in the future.

CHART 19: AFFILIATES OF US-BASED TNCs: SALES AS A SHARE OF LOCAL GDP (1989-1993)

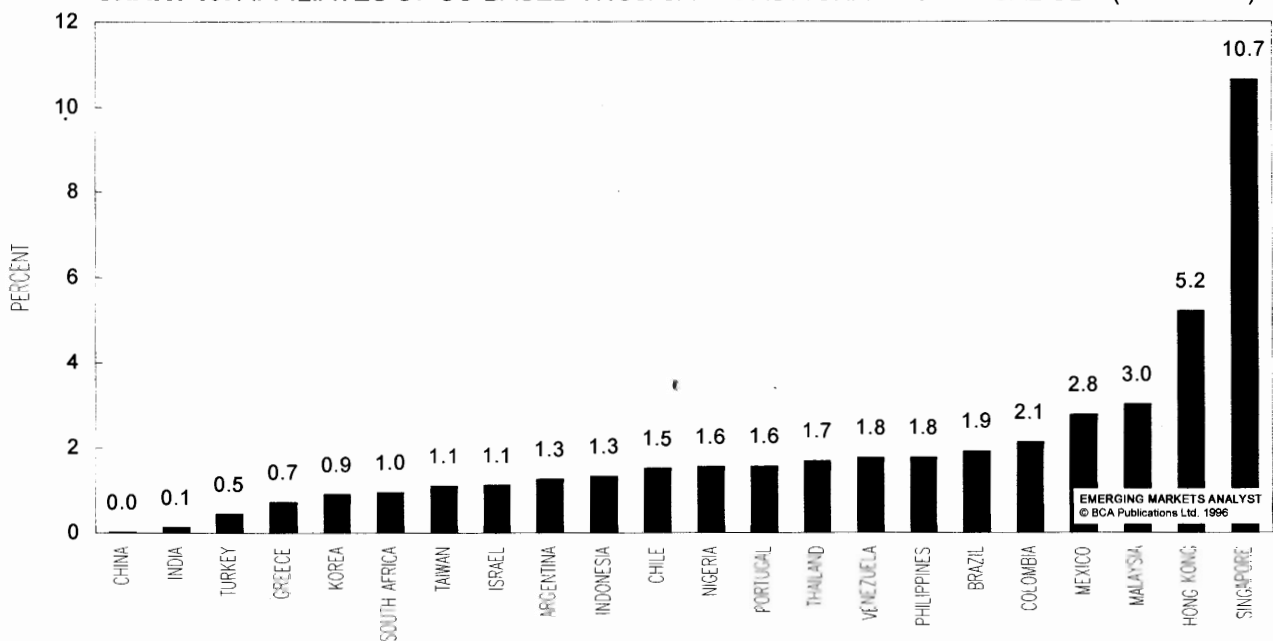
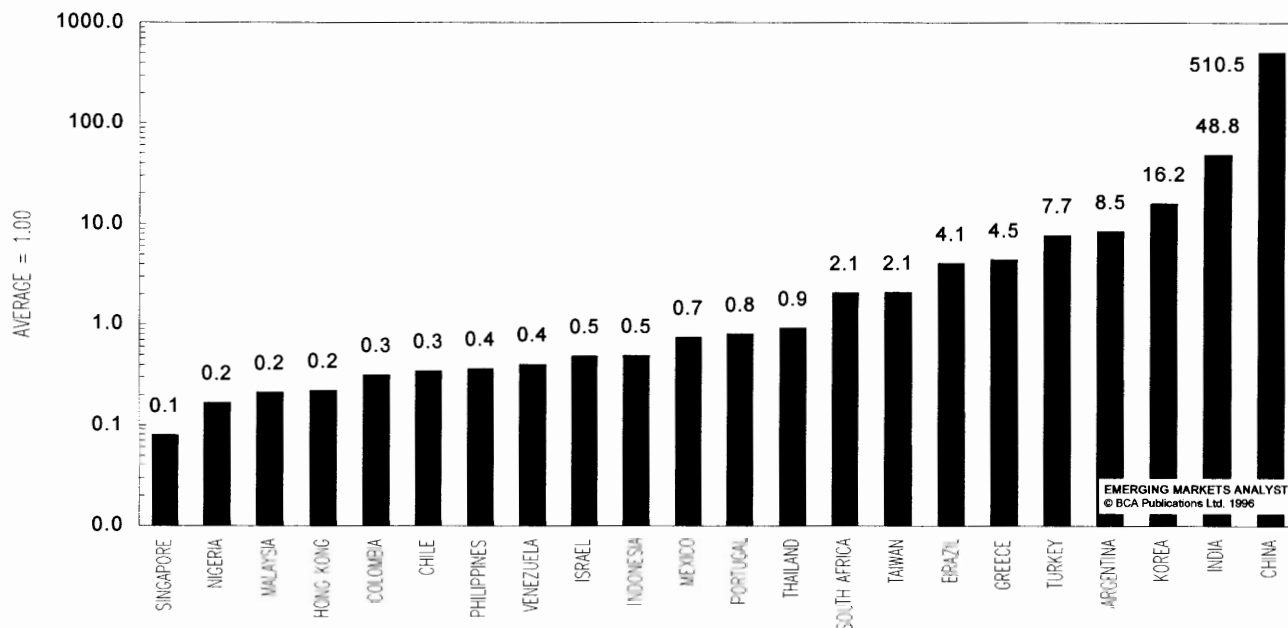


CHART 20: RELATIVE LONG-TERM PROFIT POTENTIAL FOR US-BASED TNCs (INDEX)



The new realignment will be affected by changes in three principal factors: (a) profit markup, (b) the size of the overall market, and (c) the market share of US-based TNCs in that country. Charts 17, 18 and 19 rank the above emerging markets according to these factors.

(a) Profit markups. Profit markups are highly sensitive to cyclical forces, but the course of FDI is more responsive to the structural underpinning of profitability which are largely secular in nature.

Economists often view profit *differentials* as a temporary phenomenon: if some industries earn higher rates of return than others, the flow of real investment from the less to the more profitable operations will cause the lower rates to rise and higher ones to fall. In reality, however, the process is far more complicated, and convergence often depends on changing institutional arrangements no less than capital flows.

In developing countries, the evolution of profit margins often follows a U-shape cycle: in the “pre-emergence” stage, margins are kept high by protectionism and investment barriers. In the second “emergence” stage, investment is rising fast, and the growing proportion of “young” nascent projects with relatively high fixed-costs pulls down the average markup. Moreover, lower entry barriers tend to undermine existing oligopolistic arrangements, making collusive pricing far more difficult. Eventually, however, markups tend to recover, although not necessarily to their earlier “pre-emergence” heights: as the economy approaches the third stage of

“maturity,” the falling burden of fixed cost and the progressive consolidation of new corporate coalitions cause profit markups on sales to rise once again.

This stylized pattern need not work in every case, of course, but given that US-based TNCs operate across the spectrum of developing countries, *over the long term*, their profit margins there are likely to converge to some extent. Based on this logic, Chart 17 on page 20 suggests that the markup in countries such as **Indonesia, Nigeria, Israel** and **Mexico** have little long-term upside. Markups in **Argentina, Greece, Korea, China, India, Turkey** and **South Africa**, on the other hand, are extremely low and should eventually rise from current levels.

(b) Overall market size. Chart 18 on page 21 ranks the countries according to their GDP measured in US dollars.⁸ Exchange rate fluctuations and vast differences in the size of the informal sectors of these economies make it difficult to project their future ranking. However, it seems likely that today’s leaders, notably **Brazil, China** and **Korea** (40% of the total), together with the second-tier countries of **India, Argentina, Mexico, Taiwan** and **Indonesia** (30% of the aggregate) will remain the most prized targets.

⁸ Measures based on purchasing power parity (PPP) are inadequate here because companies based in the US settle their accounts in US dollars.

(c) **Market Shares.** Of course, from the perspective of TNCs, GDP alone is only a partial indicator for market potential. The other factor is their market share within the local economy (Chart 19 on page 21). In countries such as **Singapore, Hong Kong, Malaysia and Mexico**, where sales by US-based TNC affiliates already account for a considerable share of GDP, further expansion will depend more on overall economic growth than on rising market share. On the other hand, US-based TNCs have only marginal presence in countries such as **China, India, Turkey, Greece, Korea and South Africa**, where their expansion prospects seem bright quite apart from the overall growth of the economy.

Chart 20 on page 22 provides a composite index of the long-term profit potential of each country from the perspective of US-based TNCs. The index is constructed based on the *relative* readings of the above three indicators (see box). It measures the future profit potential of each country relative to the average potential of all countries.

Based on this index, **China**, seems by far the most promising source of future profits. It currently accounts for less than one half of one percent of the total profits coming from the 22 emerging markets (Chart 16), but its future potential engulfs all other markets taken together. The second and third place are occupied by **India and Korea**, which much like China, are currently generating only minuscule profits for US-based TNCs. In all three countries, the potential derives from a very large economy, the prospects for higher profitability, and most importantly, the possibility of significant increases in market share.

On the other hand of the scale, **Singapore, Nigeria, Malaysia and Hong Kong**, which presently account for 29% of the total profit generated by the 22 emerging countries, offer the least long-term upside. In all four cases, the downside derives primarily from above-average profit markups and from the fact that US-based TNCs already have significant presence in their economies.

Investment Conclusions

- Developing countries account for roughly 20% of the profits of all US-based TNCs. The comparable proportion for the S&P400 (which is a subset of this universe) is even higher. **S&P400 equities therefore already offer a significant emerging market play.**
- The growing significance of emerging-market profits means that over the coming decade, domestic and foreign earnings of US-based TNCs will increasingly diverge. **The cyclical impact of domestic**

Relative Long-Term Profit Potential

The level of net profit (P) is given by the product of the net profit markup on sales (k), the level of GDP (Q) and the share of company sales in GDP (S):

$$P = k * Q * S$$

By making several simple assumption, this equation can be used to compare the *relative* long-term profit potential of different countries.

- **Net profit markup on sales (k).** Over the long-term, profit margins tend to equalize, falling in countries where they are currently high and rising when they are presently low. The relevant ratio to look at is between the average k across all countries and the country's own k . For instance, the potential upside in a country where the ratio is 1/2 will be four times higher than in a country where the ratio is 2.
- **GDP (Q).** Here, there is no convergence, and the growth prospects for different countries are largely independent and much more difficult to project. In addition, exchange rate fluctuations and changes in the relative share of the informal sector could alter the country's \$ GDP regardless of its real growth. In our computation we therefore assume that growth rates are equal across the board.
- **Market share (S).** The principle is the same as with profit markups. The relevant ratio is between the average S across all countries and the country's own S . For instance, the potential growth of market share in a country where the ratio is 1/3 will be six times higher than in a country where the ratio is already 2.

Thus, a composite index for the relative profit potential of any particular country will be:

$$index = \frac{avg.k}{k} * \frac{Q}{avg.Q} * \frac{avg.S}{S}$$

earnings will decline while the positive secular influence of foreign earnings will rise.

- **The economic fundamentals underlying the emerging-market boom are intact.** Input growth is still in its early stage, particularly in the emerging markets giants, and when this eventually decelerates, productivity growth will likely start rising.
- However, the social cost of market reforms domestically could rise and the struggle over resources

globally is likely to intensify. **US equities will therefore become increasingly susceptible to emerging market political risk.**

- Based on the ratio of FDI to profit remittances, the most promising regions for US-based TNCs are **Asia** and the **transitional European economies**. Attitudes toward the **Middle East** and **Latin America** are still hesitant and the **Sub Sahara** remains a pariah.
- Capital spending in emerging markets are now entirely financed by FDI, but regional experiences vary. "Greenfield" investment is strongest in **Asia**, where the long-term capital spending boom is intact. In other regions, "ownership switching" investment is large and capital spending hesitant.
- For US-based TNCs, the largest profit potential is in **China, India** and **Korea**, where GDP is large and profitability and market share are set to rise. In contrast, US affiliates in **Singapore, Nigeria, Malaysia** and **Hong Kong**, which generate significant earnings currently, already enjoy high markups and a relatively high market share, so their upside is limited.