CHAPTER 12

# ‘All Things in Prolific Abundance’

## THE INTERNATIONAL DIMENSION

## International Trade

*'Our Celestial Empire possesses all things in prolific abundance'*

In 1792, George III of Britain sent Earl Macartney to China as his special envoy. Macartney was to convince the Chinese emperor, Qianlong, to allow Britain to freely conduct trade in all of China, not just through Canton (Guangzhou), which was then the only port open to foreigners. At the time, Britain was running a large trade deficit with China (so, what's new?) in large part due to its new-found taste for tea. The British thought that they might be able to reduce the gap if they could engage in freer trade.

The mission completely failed. Qianlong sent Macartney back with a letter to George, telling him that the Celestial Empire saw no need to have more trade with Britain. He reminded the British king that China had allowed the European nations to trade in Canton only as a 'signal mark of favour', as 'the tea, silk and porcelain which the Celestial Empire produces, are absolute necessities to European nations'. Qianlong declared that 'our Celestial Empire possesses all things in prolific abundance and lacks no product within its own borders. There was therefore no need to import the manufactures of outside barbarians in exchange for our own produce.'[1]

As it was not even allowed to *try* to persuade the Chinese customers to buy more of its manufactured products, Britain resorted to stepping up its opium exports from India. The resulting spread of opium addiction alarmed the Chinese government into banning opium trade in 1799. That did not work, so in 1838 the Daoguang Emperor, Qianlong's grandson, appointed a new 'drug czar', Lin Zexu, to start a major crackdown on opium smuggling. In response, the British started the Opium War in 1840, in which China was pulped. Victorious Britain forced China into free trade, including of opium, with the Nanjing Treaty in 1842. A century of external invasions, civil war and national humiliation followed.

*David Ricardo challenges the Chinese Emperor – and Adam Smith: comparative vs. absolute advantages*

Given China's eventual and ignominious adoption of free trade, people have made fun of Qianlong's view on international trade; this backward despot simply didn't understand that international trade is good. However, Qianlong's view on international trade was actually in line with the mainstream view among European economists, including Adam Smith himself, at the time. His view of trade is known as the theory of **absolute advantage**; the idea that a country does not need to trade with another if it can produce everything more cheaply than can its potential trading partner. Indeed – our common sense tells us – why should it?

But it should – according to the theory of comparative advantage, invented by David Ricardo (see Chapter 4). According to this theory, a country can benefit from international trade with another country, even when it can produce *everything* more cheaply than the other, like China could, compared to Britain, in the late eighteenth century – at least according to Qianlong's view. All that is needed is that it specializes in something in which its superiority is *the greatest*. Likewise, even if a country is rubbish at producing everything, it can benefit from trade if it specializes in things which it is *least* rubbish at. International trade benefits every country involved.

*The logic behind the theory of comparative advantage is impeccable – given its assumptions*

Since Ricardo invented it in the early nineteenth century, the theory of comparative advantage has provided a powerful argument in favour of free trade and **trade liberalization**, that is, reduction in government restrictions on trade.

The logic is impeccable – that is, insofar as we accept its underlying assumptions. Once we question those assumptions, its validity becomes much more limited. Let me explain this, focusing on two key assumptions behind the Heckscher-Ohlin-Samuelson version of the theory of comparative advantage (henceforth HOS), which we first encountered in Chapter 4 as lying at the heart of the modern argument for free trade.[2]

*HOS structurally rules out the most important form of beneficial protectionism by assuming that all countries are equally capable*

The most important assumption underlying HOS is that all countries have equal productive capabilities – that is, they can use any technology they want.[3] According to this assumption, the only reason why a country might specialize in one product rather than another is because that product happens to be produced using a technology that is in line with its relative factor endowment – that is, how much capital and labour it has. There is no possibility that the technology might be too difficult for the country (recall the BMW and Guatemala example from Chapter 4).

This totally unrealistic assumption rules out a priori the most important form of beneficial protectionism, namely, infant industry protection, whose key role in the historical development of today's rich countries we discussed in detail throughout the book.

*HOS is overly positive about trade liberalization because it assumes that capital and labour can be remoulded for use in any sector at no cost*

In HOS, not only is free trade good for the country but moving towards it in countries that have not practised it produces no casualties. When tariffs on, say, steel are reduced, consumers of steel (e.g., car-makers who use steel plates and final consumers of cars) immediately benefit because they can import cheaper steel. This will damage the producers (capitalists and workers) in the domestic steel industry in the short run, as companies lose money due to cheaper imports and workers lose their jobs. But, soon, even they benefit. It is because activities that are more in line with the country's comparative advantage – say, the production of micro-chips or investment banking – will now be relatively more profitable and thus expand. The expanding industries would absorb the capital as well as the labour formerly employed in the steel industry and, thanks to their higher productivities, pay them higher profits and wages. Everyone wins in the end.

But the reality is that most capitalists and workers in the industry that has lost protection remain hurt. Factors of production – capital and labour – are often fixed in their physical qualities; there are few 'general-use' machines or workers with a 'general skill' that can be employed across industries. Blast furnaces from a bankrupt steel mill simply cannot be remoulded into a machine that makes micro-chips and thus may have to be sold as scrap metal. When it comes to the workers, how many steel workers do you know who have retrained to work in the semi-conductor industry or, even more unlikely, in investment banking? (Recall the examples of *Roger and Me* and *The Full Monty* from Chapter 10).

HOS can present such a positive view of trade liberalization because it assumes that all capital and labour are the same ('homogeneous' is the technical term) and thus can be readily redeployed in any activity (technically this is known as the assumption of **perfect factor mobility**).[4]

*Even the use of the compensation principle cannot quite hide the fact that a lot of people get hurt by trade liberalization*

Even when they acknowledge that trade liberalization may produce losers, free-trade economists justify trade liberalization by invoking the 'compensation principle' (see Chapter 4). They argue that, as trade liberalization makes the whole country better off, the losers from the process can be fully compensated and the winners still have additional income left.

As I mentioned earlier, the trouble with this argument is that the compensation is usually not made. In the rich countries, there is partial – but only partial – compensation through the welfare state, which provides unemployment insurance and access to basic social services, such as education and (except in the US) health care. But in most developing countries the welfare state is very weak and has patchy coverage, so the resulting compensation is minimal, if not non-existent.

If the compensation is not made, invoking the compensation principle to justify a policy that hurts some people, such as trade liberalization, is tantamount to demanding that some people make a sacrifice for the 'greater good' – a demand that used to be made of people by the government in socialist countries, which free-trade economists so heavily criticize.

*International trade is essential, especially for developing countries, but that is not to say that free trade is the best*

When they hear someone criticizing free trade, free-trade economists tend to accuse the critic of being 'anti-trade'. But criticizing free trade is *not* to oppose trade.

Apart from the benefits of specialization that the theory of comparative advantage extols, international trade can bring many benefits. By providing a bigger market, it allows producers to produce more cheaply, as producing a larger quantity usually lowers your costs (this is known as **economies of scale**). This aspect is especially important for smaller economies, as they will have to produce everything expensively, if they cannot trade and have a bigger market. By increasing competition, international trade can force producers to become more efficient – insofar as they are not developing-country firms that would get wiped out by vastly superior foreign firms. It might also produce innovation by exposing producers to new ideas (e.g., new technologies, new designs, new managerial practices).

International trade is particularly important for developing countries. In order to increase their productive capabilities and thus develop their economies, they need to acquire better technologies. They can in theory invent such technologies themselves, but how many new technologies can relatively backward economies really invent on their own? Perhaps one, such as North Korea's vinalon, which I mentioned in Chapter 7. Perhaps none. For these countries, therefore, it would be madness not to take advantage of all those technologies out there that they can import, whether in the form of machines or **technology licensing** (buying up the permit to use someone else's patented technology) or technical consultancy. But if a developing country wants to import technologies, it needs to export and earn 'hard currencies' (universally accepted currencies, such as the US dollar or the Euro), as no one will accept its money for payments. International trade is therefore essential for economic development.

The case for international trade is indisputable. However, this does *not* mean that free trade is the best form of trade, especially (but not exclusively) for developing countries. When they engage in free trade, developing countries have their chances of developing productive capabilities hampered, as I have pointed out in earlier chapters. The argument that international trade is essential should never be conflated with the argument that free trade is the best way to trade internationally.

## REAL-LIFE NUMBERS

*How important international trade is for different countries and how its importance has increased recently*

In the early 1960s, international trade, defined as the average of exports and imports, in goods and services used to be equivalent to around 12 per cent of world GDP (average for 1960–64). Thanks to the fact that international trade has grown much faster than has world GDP, the ratio now stands at 29 per cent (average for 2007–11).[5]

Even though the share of trade in a country's GDP has risen in almost all the countries during the last half century, there are considerable international differences in their levels.

Listening to the American media over the last three decades, you might have got the impression that the US is a country that is uniquely suffering from the negative impacts of international trade – first with Japan and now with China. But imports accounted for only 17 per cent of US GDP (2007–11 average), while exports accounted for 13 per cent. Averaging the export/GDP and the import/GDP figures, you get a **trade dependence ratio** of 15 per cent. This is way below the world average of 29 per cent, cited above. Indeed, the US is one of the least trade-dependent countries in the world.

The only other major economy with a lower trade dependence ratio than that of the US is Brazil (12 per cent). Interestingly, Japan, which in popular imagery is the quintessential trade-driven economy, has the same trade dependence as that of the US (15 per cent). Other things (like economic policy) being equal, larger economies tend to be less dependent on trade because they can afford to have a more diversified production structure thanks to their size, which allows them to attain economies of scale in more industries.

At the other extreme, we have small trade-oriented economies like Hong Kong (206 per cent) and Singapore (198 per cent). Such economies not only trade a lot for their own needs because they are small. They also specialize in international trading itself, thus importing certain things only to sell on to others – this is known as 're-exporting'.

*Many countries are far more trade-dependent than the 'world average', while only a handful of them are significantly less so*

Given that international trade is equivalent to 29 per cent of world GDP, you could say that countries with a trade dependence ratio close to it have 'average' trade dependence. These include some of the larger developed countries, such as France and Italy, and some very large developing countries, such as India, Indonesia and China.

Many countries have a trade dependence ratio that is well above average (say, above 60 per cent). This group includes some small rich countries (e.g., the Netherlands and Belgium), several oil-exporting countries (e.g., Angola and Saudi Arabia) and developing countries that have deliberately promoted manufactured exports through policy measures (e.g., Malaysia and Thailand).

*Changing structure of international trade: the (exaggerated) rise of services trade and the rise of manufacturing trade, especially that from developing countries*

Over the last half century, there have been a number of significant structural changes in international trade.

The first is the increase in the importance of services trade. Influenced by the recent media hype about new forms of trade in services – airline back offices, software, reading services for MRI results and what have you – most people have come to form the impression that services trade has been exploding in the recent period. However, the reality falls far short of this image. Services trade as a share of world trade

did go up from 17 per cent in the early 1980s (1980–82) to around 20 per cent in the early 1990s. However, since then, it has been fluctuating around that level.[6]

Another, more important, trend has been the rise in the importance of manufacturing trade. According to an unofficial UN report, the share of manufacturing in world merchandise trade used to be 40–45 per cent in the first half of the twentieth century.[7] According to the official UN data (ComTrade database), it rose to 57–60 per cent by the 1960s and then to 61–4 per cent in the 1970s.[8] The dataset from the WTO, starting from 1980, shows the continuation of the trend, even though the exact figures differ from the UN data. In the early 1980s (1980–82 average), manufacturing accounted for 57 per cent of world merchandise trade. The ratio then rose and peaked at 78 per cent in the late 1990s (1998–2000 average). It has fallen since then and currently stands at 69 per cent (2009–11 average).[9]

What this means is that the rise in the importance of manufacturing trade has been far more significant – or even dramatic – than that of services trade. This is yet another piece of evidence that we are not (at least yet) living in a post-industrial knowledge economy (see Chapter 7).

The third notable structural change in international trade is the fact that developing countries have increased their shares in international manufacturing trade significantly from around 9 per cent in the mid-1980s to around 28 per cent today.[10] This rise has been in large part propelled by the rapid development of export-oriented manufacturing industries in China. China used to account for only 0.8 per cent of world manufacturing export in 1980, but by 2012 the share had risen to 16.8 per cent.

## Balance of Payments

Balance of payments is a statement that shows how much a country is in debt or credit in which areas of its economic transactions with the rest of the world. As with any financial statement, it is boring stuff. But it is important that you know which items are in it, what they mean and what the numbers look like in reality, if you are to understand an economy's international position, so please bear with me for a few pages.

*Trade balance (or balance of trade)*

Trade involves not only the movements of goods and services but also the flows of money that go with them. When a country imports more goods and services than it exports, it is said to have a trade deficit, or a negative trade balance. When it exports more than it imports, it is said to have a trade surplus, or a positive trade balance.

*Current account and capital-financial account balances*

How do countries with trade deficits manage? Don't they have to find the money to pay for the import bills that are over and above their export earnings? Indeed they do. They can do this in two ways.

One is to earn money in ways other than through international trade (this is called 'income' in the technical language of balance of payments statistics) or to be given money by someone else (this is called 'current transfers').

Income includes compensation of employees and investment income. 'Compensation of employees' in this context is earnings of people working for foreign entities while being resident in the home country, such as Mexican workers commuting to their work in the US. 'Investment income' is income from

financial investment abroad, such as dividends from shares of foreign companies owned by a country's residents.

Current transfers include **workers' remittances**, that is, money sent from workers resident abroad (more on this later) and **foreign aid**, namely, grants given by foreign governments.

Balances in trade, income and current transfers make up the **current account balance**. See the box below to see how they add up.

BALANCE OF PAYMENTS
(SELECTED MAIN COMPONENTS)

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CURRENT ACCOUNT
- Trade
  - Goods
  - Services
- Income
  - Compensation of employees
  - Investment income
- Current transfers
  - Workers' remittances
  - Foreign aid

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CAPITAL AND FINANCIAL ACCOUNT
- Capital account
  - Capital transfers
  - Acquisition / disposal of non-financial assets
- Financial account
  - Portfolio investment
    - Equity
    - Debt (including bonds and derivatives)
  - (Foreign) direct investment
  - Other investments (including trade credits and bank loans)
  - Reserve assets

Even after adding up trade, income and current transfers, a country may still have a current account deficit. In this case, it has to either borrow money (that is, run debts) or sell assets it has. The activities on this front are captured in the 'capital and financial account' (CFA), which is more often known simply as **capital account**. CFA is – surprise, surprise – made up of two main components – capital account and financial account.

The capital account is divided into 'capital transfers' (mainly debt forgiveness by foreign countries or, conversely, your country forgiving debts of other countries) and the 'acquisition/disposal of non-financial assets', such as selling and buying patents.

The financial account is mainly made up of portfolio investment, (foreign) direct investment, other investments and reserve assets. **Portfolio investment** refers to the acquisition of financial assets, such as equity (company shares) and debt (including bonds and derivatives). **Foreign direct investment** involves

acquisition by a foreign entity of a significant (10 per cent is the convention) proportion of shares in a company, with a view to getting involved in its management.[11] 'Other investments' include trade credits (companies lending money to their buyers by letting them pay for their purchases later) and loans (especially bank loans). 'Reserve assets' include foreign currencies and gold that a country's central bank has. They are often referred to as **foreign exchange reserves**.

A country's current account balance and its capital and financial account balance, in theory, should add up to zero, but in practice there are always 'errors and omissions' that make the sum different from zero.

*Different items can drive the balance of payments dynamics in different situations*

Changes in the trade account often drive the rest of the balance of payments. A rapidly increasing trade deficit due, say, to a major crop failure or to a sudden and large-scale trade liberalization can make a country accumulate foreign debts and sell its assets. The generation of a large trade surplus due to, say, a surge in the demand of its major mineral export may allow a country to buy assets from abroad, thus creating a deficit on the capital account. But there are also situations in which non-trade components are driving changes in the other components of the balance of payments.

Sometimes the increase in current transfers can drive the balance of payments dynamics. Workers' remittances into a country may suddenly increase because, for example, it has joined the EU and lots of its workers have gone to Germany to work. Or the country may see a sudden increase in foreign aid because, say, it has suddenly become important in the War on Terror – think Pakistan or Djibouti. The increase in the resulting availability of foreign exchange will allow the country to import more goods and services, resulting in the deterioration of its trade balance (that is, its trade surplus will shrink or its trade deficit will widen), even though its current account balance may improve.

On some occasions, it can be the capital account that drives the dynamics. A country may get a sudden surge in the inflows of portfolio investment because it has suddenly become a 'hot' investment destination thanks to, say, the recent election of a pro-business president who is promising a lot of reforms. Or it may experience a big increase in foreign direct investment because, for example, a large oil deposit has been found. But when these happen the demand for the country's currency rises, as people need it in order to be able to buy the country's assets. This will lead to the rise in the value of the country's currency, making their exports uncompetitive and thus increasing trade deficit. In this case, the changes in the capital account have driven the change in the trade account.

## REAL-LIFE NUMBERS

*Trade deficits and surpluses in some countries are equivalent to around half of GDP*

In most rich countries and middle-income countries, trade balances are likely to be equivalent to a few percentage points of GDP, either positive or negative. For example, in 2010, trade surpluses as a proportion of GDP were 1.2 per cent in Japan, 2.6 per cent in Korea, 3.9 per cent in China, 5.6 per cent in Germany and 6.5 per cent in Hungary. Trade deficits as a proportion of GDP were 1 per cent in Brazil, 2.1 per cent in the UK, 3.5 per cent in the US, 4 per cent in Ecuador and 4.4 per cent in India.

But quite a number of countries have trade balances that are very large as a proportion of their GDPs. In 2010, Brunei had a trade surplus equivalent to 49 per cent of its GDP, while Kuwait had 34 per cent and Luxembourg 32 per cent. Some poor countries with few natural resources to export have very large trade deficits – in 2010, Lesotho had a trade deficit equivalent to 67 per cent of GDP. Trade deficit as a

proportion of GDP was also very large (over 40 per cent of GDP) in countries like Liberia, Haiti and Kosovo.[12]

*Current account deficits (surpluses) are usually smaller (bigger) than trade deficits (surpluses)*

A country's current account deficit (surplus) is usually smaller (larger) than its trade deficit (surplus), as other items in the current account are likely to reduce (magnify) it.

For the rich countries, investment incomes are typically the items that reduce the deficits (or swell the surpluses) created by the trade component of the current account. In 2010, trade deficit was 3.5 per cent of GDP in the US, but its current account deficit was 3.1 per cent. In France, the figures were, respectively, 2.3 per cent and 1.6 per cent. The German trade surplus in the same year was 5.6 per cent of GDP but its current account surplus was 6.3 per cent.

For the developing countries, the main items that close the gap between trade deficit and current account deficit are foreign aid and, increasingly more importantly, workers' remittances, which these days are around three times foreign aid. In 2010, Haiti had a trade deficit equivalent to 50 per cent of GDP, but its current account deficit was only equivalent to 3 per cent of GDP. This was possible because there was a large amount of current transfers, such as foreign aid (equivalent to 27 per cent of GDP) and remittances (equivalent to 20 per cent of GDP).

*Sudden surges in capital inflows and outflows can create serious problems*

Sudden surges in capital inflows can lead to a significant increase in deficits on the current account, especially the trade component of it, as I mentioned above. As long as capital keeps flowing in, current account deficits equivalent to, say, several percentage points of GDP, or even higher, might not be a problem.

The trouble is that capital inflow can suddenly fall dramatically or even turn negative; foreigners might, for example, sell assets they own and take the proceeds out. This sudden change can push countries into a financial crisis, as their economic actors suddenly find that the assets they have are worth a lot less than their liabilities.

In the case of developing countries, whose currencies are not accepted in the world market, such a situation will also lead to a foreign exchange crisis, as they now have insufficient means to pay for their imports. The shortage in the supply of foreign exchanges leads to **devaluation** of the local currency, which makes the financial crisis even worse, as the repayment burden for the country's foreign loans would skyrocket in local currency terms.

This is what happened, for example, in Thailand and Malaysia during the 1990s. Between 1991 and 1997, the annual capital account surplus averaged 6.6 per cent and 5.8 per cent of GDP in Thailand and Malaysia respectively. This allowed them to maintain high current account deficits, equivalent to 6.0 per cent and 6.1 per cent of GDP respectively. When the capital flows were reversed – the capital account deficit suddenly surged to 10.2 per cent and 17.4 per cent of their respective GDP in 1998 – they experienced combined financial and foreign exchange crises.

## Foreign Direct Investments and Transnational Corporations (TNCs)

*Foreign direct investment has become the most dynamic component in the balance of payments*

In the last three decades, foreign direct investment (FDI) has emerged as the most dynamic element in the balance of payments. It has grown faster than international trade, albeit with a much greater fluctuation.

Between 1970 and the mid-1980s, annual global FDI flows (measured in terms of inflows) were equivalent to around 0.5 per cent of world GDP.[13] Since then, its growth accelerated relative to world GDP growth, until it went up to the equivalent of 1.5 per cent of world GDP in 1997. Then there was another acceleration in FDI flow, with the ratio reaching around 2.7 per cent of world GDP on average between 1998 and 2012, although with big fluctuations.[14]

What makes FDI particularly important is the fact that it is not a simple financial flow. It can also directly affect the host (receiving) country's productive capabilities.

*FDI affects the productive capabilities of the recipient country*

FDI is different from other forms of capital inflows in that it is not a pure financial investment. It being an investment with a view to influencing how a company is run, FDI by definition brings in new management practices. It frequently, although not always, also brings in new technologies. As a result, FDI affects the productive capabilities of the company that is receiving it, whether it is **greenfield** FDI, that is, a foreign company setting up a new subsidiary (like the Intel subsidiary established in Costa Rica in 1997) or it is **brownfield** FDI, that is, a foreign company taking over an existing company (like Daewoo, the Korean carmaker bought by GM in 2002).

The impact of FDI is not confined to the enterprise receiving it. Especially when the gap in productive capabilities between the investing country and the recipient country is large, FDI might have particularly strong indirect influences on the productive capabilities of the rest of the economy. This might happen in a number of ways.

To begin with, there would be 'demonstration effects', in which local producers watch TNC subsidiaries and learn new practices and ideas. Then there is the influence through the supply chain. When they buy from local suppliers, TNC subsidiaries will demand higher standards in product quality and delivery management than do their local counterparts. Local suppliers will have to upgrade themselves if they want to keep the custom of TNC subsidiaries. Then there are effects from the employees of TNC subsidiaries leaving them to join other firms or even to set up their own enterprises. These workers can teach others how to use new technologies and how to manage the production process in a more efficient way. Collectively, these indirect positive effects of FDI are known as **spill-over effects**.

*The evidence for positive effects of FDI is rather weak*

Despite all these potentially positive (direct and indirect) effects of FDI, the evidence on whether FDI benefits the recipient economy is at best mixed.[15]

One reason for this is that the benefits I have discussed above are theoretical. Many TNC subsidiaries might actually buy very little from local producers and import most of their inputs – they are said to exist as **enclaves**. In these cases the benefits through supply chains will be non-existent. Workers can carry their knowledge from TNC subsidiaries to the rest of the economy only when there are already some local firms operating in relevant industries, whether as aspiring competitors or as suppliers. Frequently, this is not the case, especially when the TNC subsidiary in question has just come to exploit natural resources or cheap labour in your country rather than to establish a long-term production base.

But the more important reason why FDI has not unambiguously benefited the recipient economy is because it has negative, as well as positive, effects.

*Some of the biggest companies don't make any money – in the places they choose not to*

In 2012, a public outrage broke out when it was revealed that Starbucks, Google and other big international companies have paid very little in corporation tax in Britain, Germany, France and other European countries over the years. This was *not* because they have not paid the taxes that they owe. It was because they never made much money and thus owed very little in tax. But if these companies are so incompetent, how is it possible that they have become some of the world's biggest and best-known – if not necessarily the most liked – companies?*

These companies minimized their tax obligations in countries like Britain by inflating the costs for their British subsidiaries by having their subsidiaries in third countries 'over-charge' (that is, charge more than what they would have in open markets) the British subsidiaries for their services. These third countries were countries with a corporate tax rate that is lower than the UK rate (e.g., Ireland, Switzerland or the Netherlands) or even **tax havens**, namely, countries that attract foreign companies to set up 'paper companies' by charging very low, or even no, corporate taxes (e.g., Bermuda, the Bahamas).[16]

*The age-old trick of transfer pricing*

Taking advantage of the fact that they operate in countries with different tax rates, TNCs have their subsidiaries over-charge or under-charge each other – sometimes grossly – so that profits are highest in those subsidiaries operating in countries with the lowest corporate tax rates. In this way, their global post-tax profit is maximized.

A 2005 report by Christian Aid, the development charity, documents cases of under-priced exports like TV antennas from China at $0.40 apiece, rocket launchers from Bolivia at $40 and US bulldozers at $528 and over-priced imports such as German hacksaw blades at $5,485 each, Japanese tweezers at $4,896 and French wrenches at $1,089.[17] The Starbucks and Google cases were different from those examples only in that they mainly involved 'intangible assets', such as brand licensing fees, patent royalties, interest charges on loans and in-house consultancy (e.g., coffee quality testing, store design), but the principle involved was the same.

When TNCs evade taxes through transfer pricing, they use but do not pay for the collective productive inputs financed by tax revenue, such as infrastructure, education and R&D. This means that the host economy is effectively subsidizing TNCs.

*There are also other potentially negative effects of FDI for the host economy*

Transfer pricing is only one of the possible negative effects of FDI, especially when it comes to FDI into developing countries. Another one is that TNC subsidiaries may 'crowd out' local firms (in their own industry and in other industries) in the credit market. This might not necessarily be a bad thing if they are more attractive to lenders thanks to higher efficiency. But they might get easier access to credit, even when they are less efficient, because they are, well, TNC subsidiaries. They are seen, rightly, as being implicitly backed by their mother firms, which are far more creditworthy than any local firm in a developing country can aspire to be. If this is the case, TNC subsidiaries hogging the local credit market may mean loans going into less efficient uses.

Another reason is that TNC subsidiaries will be big firms in a monopolistic or oligopolistic position in the developing country market, even though they are small parts of the TNC that owns them. These subsidiaries can – and do – exploit such positions, which creates social costs, as discussed in Chapter 11.

Moreover, TNCs, having a lot of money and the political backing of their home countries, can change the policies of the host country in a way that is beneficial for them, rather than for the host economy. We are not simply talking about lobbying and bribing, as in the 2013 scandal involving GlaxoSmithKline and other global pharmaceutical TNCs in China. We are also talking about the **banana republic**.

The term is these days better known as a brand owned by Gap, the global clothing retail chain. But it has a dark origin. The term was coined during the time of the total economic and political domination of certain banana-growing countries in Latin America, such as Honduras, Guatemala and Colombia, by the United Fruit Company (UFC) in the early decades of the twentieth century. The most tragic episode in that history was the 1928 massacre of striking workers in a UFC banana plantation in Colombia; when it was threatened with an invasion by the US Marines to protect the interests of the UFC, the Colombian government sent in its army and killed possibly thousands of workers (the number has never been confirmed). The event was fictionalized in the masterpiece *One Hundred Years of Solitude* by the great Colombian writer Gabriel Garcia Márquez. American TNCs are said to have actively cooperated with right-wing military and the CIA to topple leftist regimes in Latin America in the 1960s and the 1970s.

In the long run, the most important negative effect of FDI is that it may make it more difficult for the host country to increase its own productive capabilities. Once you allow TNCs to establish themselves within your border, your local firms will struggle to survive. This is why many of today's rich countries – especially countries like Japan, Korea, Taiwan and Finland – strictly restricted FDI until their companies acquired the ability to compete in the world market. For example, had the Japanese government opened its automobile industry to FDI in the late 1950s, as was widely suggested following the debacle of Toyota's first car exports to the US,[18] Japanese car-makers would have been either wiped out or taken over by American or European TNCs, given the state of the industry at the time; back in 1955 General Motors alone produced 3.5 million cars whereas the whole of the Japanese automobile industry produced a mere 70,000.

*Benefits of FDI can be only fully realized under appropriate regulations*

FDI has complex effects that differ across industries and depending on country characteristics, making it difficult to generalize whether it is good or bad. Judgement on its desirability would also depend on the performance criteria (e.g., employment, export, productivity, long-term growth) and the time horizon you use, as their benefits tend to be more immediate while their costs may be of more long-term nature. Nevertheless, what seems certain is that countries, especially developing countries, can maximize the benefits from FDI only when they use appropriate regulations. And the list of regulations used for such a purpose is impressive.

Many countries have established rules on in which industries FDI may be made. They have demanded that TNCs have a local investment partner (known as **joint venture requirement**). They have had rules on how much of the joint venture a foreign investor can own; majority foreign ownership has typically been banned in important industries. Many governments have required that the TNC making the investment transfers their technologies to its local joint venture partner (**technology transfer requirement**) or that

they train local workers. Countries have also demanded that TNC subsidiaries buy certain proportions of inputs locally (known as the **local contents requirement**).[19]

Japan, Korea, Taiwan and China have been particularly successful with these regulatory measures – they allowed, or even welcomed in some sectors, FDI but put in all those measures to ensure that the benefits were maximized while the costs were minimized. However, using the WTO agreement (known as the TRIMS agreement, or the Trade-related Investment Measures agreement), bilateral free-trade agreements (FTAs) and bilateral investment treaties (BITs), the rich countries (including Japan, which used to regulate FDI most severely in the world) have made a number of these regulations, such as the local contents requirement, 'illegal'.[20]

The success with all those regulations in countries such as Japan and China does not mean that 'stick' is the only way to manage FDI. Some other countries, such as Singapore and Ireland, have used 'carrot' in order to attract FDI into areas that they think are important for their national economic development.[21] Their 'carrots' included subsidies for TNCs making investment in 'priority' sectors, provision of custom-made infrastructure and production of engineers and skilled workers needed in particular industries.

## REAL-LIFE NUMBERS

*Growth in FDI flows*

In the mid-1980s, when FDI started growing rapidly, total world FDI flow was around $75 billion per year (1983–7 average).[22] Today, at $1,519 billion (2008–12 average), it is over twenty times the mid-1980s figure, implying that it has grown at around 12.8 per cent per year. These figures look like huge sums and a very rapid growth rate, but they should be put into perspective.

In the mid-1980s, the world's total FDI was equivalent to 0.57 per cent of world GDP (1983–7 average of $13.5 trillion). The figure for the 2008–12 period, however large it may seem in absolute terms, is still equivalent only to 2.44 per cent of world GDP.

*Most FDI happens between rich countries, but developing countries have recently become 'over-represented' in global FDI, largely thanks to China*

Most FDI happens between the rich countries. In the mid-1980s (1983–7), 87 per cent of FDI went to the rich countries. Given that these countries accounted for 83 per cent of world GDP at the time, this meant that rich countries got slightly more than their 'fair' share of FDI. This ratio has fallen, although with ups and downs, to 66 per cent in the recent period (2008–12). Given that the rich countries still account for 70.8 per cent of world GDP in 2010, it is now the developing countries, rather than the rich countries, that are – once again, slightly – over-represented in global FDI.

The US has been by far the single largest recipient of FDI over the last three decades. Between 1980 and 2010, it received 18.7 per cent of world FDI inflows. It was followed by the UK, China, France and Germany.* Despite being by far the largest recipient of FDI in absolute terms, the US received much less than would have been expected from its weight in the world economy (it produced 26.9 per cent of world GDP during this period). In contrast, China and the UK received a lot more than would have been expected from their weight in the world economy.† Notable by its absence in this list is Japan. Despite producing 12 per cent of world GDP during this period, it received only 0.7 per cent of world FDI, thanks to its draconian regulation of FDI until recently.

Focusing on the more recent period, the top ten recipients of FDI (2007–11) are the US, China, the UK, Belgium, Hong Kong, Canada, France, Russia, Spain and Brazil. Of these, the US, France and Brazil got less than their 'fair' share, while all the others got more than their 'fair' share.[23]

The fact that developing countries as a group have become more important in the global FDI flows does not mean that all developing countries have been equally active participants in this game. Between 1980 and 2010, the top ten recipients of FDI flows into the developing world accounted for 75.7 per cent of total flows, despite accounting for only 71.4 per cent of developing world GDP.[24] In particular, China received 32.2 per cent of total FDI into the developing world during this period, despite accounting for only 22.8 per cent of developing world GDP.

*The recent period has seen an increase in the share of brownfield investment in total FDI, changing the global industrial landscape*

In the first seven years of the 1990s, brownfield FDI, that is, FDI in the form of cross-border M&A, was equivalent to 31.5 per cent of the world's FDI.[25] The number shot up to 57.7 per cent between 1998 and 2001 in the global cross-border M&A boom. After dipping back to 33.7 per cent for a few years between 2002 and 2004, it rose again to 44.7 per cent between 2005 and 2008. Even though the ratio has fallen to the lowest level in two decades (25.3 per cent between 2009 and 2012), following the 2008 global financial crisis, the general trend has been that brownfield FDI has risen relative to greenfield FDI.

This rise in brownfield investment is closely linked with what the Cambridge economist Peter Nolan calls the **global business revolution**.[26] In the last couple of decades, through an intense process of cross-border M&As, virtually all industries have become dominated by a small number of global players. The global aircraft industry is dominated by two firms, Boeing and Airbus, while industry observers are debating whether more than the top six mass-market automobile firms (Toyota, GM, Volkswagen, Renault-Nissan, Hyundai-Kia and Ford) can survive in the long run, which means that they are not even sure about such major companies as Peugeot-Citroën, Fiat-Chrysler and Honda.

Moreover, through what Nolan calls the 'cascade effect', even many of the supplier industries have become concentrated. For example, the global aircraft engine industry is now dominated by three firms (Rolls-Royce, Pratt & Whitney and Fairfield, a GE (General Electric) subsidiary).

## Immigration and Remittances

*Open borders – except for people?*

Free-market economists wax lyrical about the benefits of open borders. They argue that open borders have allowed companies to source the cheapest things from across the globe and offer the best deals to consumers. Open borders, they point out, have increased competition among producers (of material goods and services), forcing them to cut their costs and/or improve their technologies. Any restriction on the cross-border movement of any potential object of economic transaction – goods, services, capital, you name it – would be harmful, they say.

But there is an economic transaction that they don't talk about in the same way – **immigration**, or cross-border movement of people. There are very few free-market economists who advocate free immigration in the way they advocate free trade.[27] Many free-market economists do not even seem to realize that they are being inconsistent when they advocate free movement of everything except for people. Others seem to

instinctively keep away from the topic, deep down knowing that free immigration would be economically unfeasible and politically unacceptable.

*Immigration reveals the political and the ethical nature of markets*

What makes immigration – namely, the cross-border movement of people as providers of labour services – different from cross-border movements of other things (goods, financial services or capital) is that labour services cannot be imported without bringing their providers physically into the country as well.

When you buy an iPad from China or investment banking service from Britain, you don't need to have the Chinese assembly worker or the British banker come and live in your country. There are some cases in which workers commute across borders (say, between the US and Mexico), thus earning 'compensation of employees' in the income element of the current account (see above). In general, however, when people come to work in your country, they have to stay, at least for a while.

And when people stay and work within your borders, they have to be given certain minimum rights, at least in democratic countries.[28] You cannot say that a worker who has moved from, say, India to Sweden should still be paid an Indian wage and have only an Indian level of workplace rights because – well – he is an Indian.

But what rights should be given to the immigrants? Should they get the same freedom of choosing occupations, once admitted, or should they be tied to a particular industry or even a particular employer, as is the practice in many immigrant-receiving countries? Should immigrants be made to pay for certain social services that are free at point of access to citizens, such as basic education and healthcare?* Should we even make them conform to the cultural norms of the receiving country (say, a ban on the hijab)? These are all questions that have no easy answers – especially ones that standard Neoclassical economics can give. Answers to these questions require explicit political and ethical judgements, once again showing that economics cannot be a 'value-free science'.

*Immigration usually benefits the recipient countries*

There is a general agreement that immigrants themselves benefit from immigration – often greatly, especially if they are moving from a poor to a rich country. The opinion is more divided on whether the recipient countries benefit, but the evidence suggests that they do, albeit to a limited extent.[29]

Immigrants usually come to fill labour shortages (though defining labour shortage is actually not a straightforward matter).[30] It could be general shortages that they are filling, like the Turkish workers did in West Germany in the 1960s and the 1970s, when the *Wirtschaftswunder* (economic miracle) created all-round labour shortages. But more often they come to fill shortages in particular segments of the labour market – whether for '3D' jobs (not jobs in 3D cinemas, but dirty, dangerous and demeaning jobs) or for highly skilled jobs in Silicon Valley. In short, immigrants come because they are needed.

In some rich countries, especially in the UK (which actually doesn't have a particularly generous welfare state by European standards) there is a fear of 'welfare tourism' – immigrants from poor countries coming to live off the welfare state of the recipient country. But in most of these countries immigrants pay on average more taxes than they claim from the welfare state. This is because they tend to be younger (and thus don't use health care and other social services very much) and, thanks to immigration policy favouring skilled workers, tend to be more skilled (and thus earning more) than the average local person.[31]

Immigrants add to cultural diversity, which may stimulate both the natives and the immigrants into being more creative by bringing new ideas, new sensitivities and new ways of doing things. This is true or not just immigration-based countries, such as the US, but also the less immigration-driven countries of Europe.

*Some native workers lose out but not by much and their woes are mostly created by 'wrong' corporate strategies and economic policies, not migrants*

The fact that immigration benefits the recipient country does not mean that all citizens in that country benefit equally. Those at the lower end of the labour market with few prized skills, who have to fight for jobs with immigrants, can lose out by being made to accept lower wages, poorer working conditions and higher chances of unemployment. But studies show that the extent of their losses is small.[32]

Especially in difficult economic times, such as the 1930s or today, disaffected native workers, manipulated by right-wing populist politicians, come to believe that their woes have largely been caused by immigrants. But much bigger causes of stagnant wages and declining working conditions are in the realm of corporate strategy and government economic policy: shareholder value maximization by corporations, which requires squeezing workers, poor macroeconomic policies that create unnecessary amounts of unemployment, inadequate systems for skills training that make local workers uncompetitive and so on. Unfortunately, the inability and the unwillingness of mainstream politicians to tackle those underlying structural issues have created the space for anti-immigrant parties in many rich countries.

*'Brain drain' and 'brain gain': impacts on the sending countries*

The immigrant-sending countries lose workers. This may be a good thing, if the country has high unemployment and it is unemployed unskilled workers who emigrate. However, those workers usually find it difficult to emigrate because immigrant-receiving countries want people with skills and because emigration costs money, which these workers don't have (e.g., search costs, application fees, air tickets). So very often it is the 'wrong' people who emigrate – skilled workers. This is known as **brain drain**.

Some of those skilled workers may learn even more skills in their destination countries and eventually come back home, teaching others new skills. This is known as **brain gain**, but the evidence for it is limited.

*Remittances are the main channel through which the immigrant-sending country is affected*

The main channel through which the immigrant-sending country is affected is remittances. Remittances have complex impacts on the receiving country.[33]

A high proportion (60–85 per cent) of remittances is used for daily household expenses. This certainly improves the material living standards of the recipients. What is not consumed may be ploughed into small businesses run by families receiving remittances, generating further income. In countries like Mexico, remittances have also been channelled into public investments at the local level through the so-called 'hometown associations' (e.g., clinics, schools, irrigation).[34]

Having higher incomes, the members of recipient families do not have to work as much as before. This often means reduction in child labour. It also reduces infant mortality, as mothers with young children are given priority by the rest of the family to reduce outside work.

Last but not least, there are negative human costs to pay to get the remittances. Emigration often breaks up families and puts children in the care of others, often for the mothers to work as babysitters and

housemaids elsewhere. The incalculable costs from such suffering may not be fully made up by remittances.

## REAL-LIFE NUMBERS

*Immigration into the rich countries has increased in the last two decades but not as much as people think*

Reading the popular press in the rich countries and observing the recent success of anti-immigrant parties in some European countries (especially France, the Netherlands, Sweden and Finland), you might get the impression that those countries have seen huge influxes of immigrants in the recent periods.

But immigration into the rich countries has not increased so dramatically. Between 1990 and 2010, the number of immigrants living in these countries increased from 88 million to 145 million. In proportional terms, this meant that the stock of immigrants in the rich countries rose from 7.8 per cent of the population in 1990 to 11.4 per cent in 2010.[35] This is a substantial rise, but hardly the seismic shift that it is sometimes made out to be.

*One-third of immigrants live in developing countries*

Immigration is not exclusively from developing countries into rich countries. There is a big flow of immigration between developing countries – usually from poorer to richer ones, but also between neighbouring countries due to natural disasters or armed conflicts.

As of 2010, there were 214 million immigrants worldwide; 145 million of them lived in the rich countries and the rest (69 million people) in developing countries, which means around a third of the world's immigrants live in developing countries.

*Global immigrant stock as a share of world population has risen very little in the last two decades*

The share of immigrants in the population of the developing world has actually experienced a *fall* in the last two decades. It fell from 1.6 per cent of its population in 1990 to 1.2 per cent in 2010.

Since the population of the developing world is nearly 4.5 times that of the rich world (5.60 billion vs. 1.29 billion), this has nearly offset the rise in the immigrant stock of the rich world that I have discussed above. On the worldwide scale, immigrant stock has been basically stagnant – rising from 3.0 per cent in 1990 to 3.1 per cent in 2010.

*Remittances have risen rather dramatically in the last decade*

Remittances have dramatically increased since the early 2000s. As I mentioned earlier, it is, at over $300 billion, now around three times larger than foreign aid given to developing countries by rich countries (around $100 billion).

In absolute terms, the biggest recipient of remittances in 2010 was India ($54.0 billion).[36] It was closely followed by China ($52.3 billion). Mexico ($22.1 billion) and the Philippines ($21.4 billion) were distant third and fourth. Other developing countries with large remittances included Nigeria, Egypt and Bangladesh. Some developed countries – France, Germany, Spain and Belgium – also had high remittances.

The importance of remittances is seen more clearly when we see them in proportion to the country's GDP, rather than as absolute amounts. Even though they are the largest in the world in absolute terms, India's remittances are only about 3.2 per cent of its GDP. In some countries, remittances as a share of GDP could be gigantic as a proportion of GDP. In 2010, Tajikistan topped the world league table on this

account, by having remittances equivalent to 41 per cent of GDP. Lesotho, with 28 per cent, came in a distant second. Kyrgyz Republic, Moldova, Lebanon and a few others had remittances equal to or bigger than 20 per cent of GDP.

*High remittances can affect the recipient country seriously, both positively and negatively*

When remittances are this high, they can affect the recipient countries seriously, both positively and negatively.

On the positive side, an addition of financial resources equivalent to 20 per cent of GDP would raise a country's consumption and investment hugely. Large-scale remittances have also functioned as a shock absorber in many countries. After natural disasters (e.g., earthquake in Haiti), financial crises (e.g., South-east Asian countries in 1997) or civil wars (e.g., Sierra Leone, Lebanon), remittances are known to increase, partly because more people emigrate but also because existing workers send more money to help their families and friends in times of greater need.

On the negative side, however, high remittances have fed financial bubbles, as in the notorious case of the 1995–6 pyramid scheme of Albania, which collapsed in 1997. A sudden large inflow of foreign currencies in the form of remittances can also weaken the recipient country's export competitiveness by abruptly raising the value of its currency, thus making its exports relatively more expensive in terms of foreign currencies.

## Concluding Remarks: Best of All Possible Worlds?

The rapidly changing international environment in the last three decades has significantly affected national economies in many ways. Greatly increased cross-border flows of goods, services, capital and technologies have changed the way in which countries organize their production, earn foreign currencies to import what they need and make and receive financial and physical investments. The increase in the cross-border movement of people has been far less than increases in other areas, but it has also significantly affected a large number of countries – by causing tensions between the immigrants and the 'natives' (in recipient countries) or by bringing in huge remittance flows that have significantly changed patterns of consumption, investment and production (in sending countries).

These changes, often summed up as the process of globalization, have been the defining feature of our time. In the last couple of decades, triumphant business elites, fashionable management gurus, politicians running powerful rich countries and clever economists who support them have declared the process to be an inevitable and unstoppable one. Claiming the process to be driven by technological progress, they have criticized anyone who is trying to reverse or modify any aspect of it as backward-looking. The 2008 global financial crisis has somewhat dented the confidence with which these people make their case, but the thinking behind it still dominates our world: protectionism is always bad; free capital flows will ensure that the best managed companies and countries get money; you have to welcome TNCs with open arms; and so on.

However, globalization is not an inevitable consequence of technological progress. During the Golden Age of capitalism (1945–73), the world economy was much *less* globalized than its counterpart in the Liberal Golden Age (1870–1913). And this was despite having much more advanced technologies of transportation and communications than the steamships and wired (not even wireless) telegraphy of the

earlier period. The world has become globalized in the way it has in the last three decades only because the powerful governments and the business elite in the rich world decided that they wanted it that way.

Nor has globalization created 'the best of all possible worlds', to borrow a famous expression from the French writer and philosopher Voltaire's novella *Candide*, as its proponents have claimed. In the last three decades of hyper-globalization, economic growth has slowed down, inequality has increased, and financial crises have become far more frequent in most countries.

All of this is not to say that international economic integration is harmful in any form nor that countries should minimize their interaction with the outside world. On the contrary, they need to actively participate in the world economy, if they are to maintain a decent standard of living. When it comes to developing countries, interaction with the international economy is essential for their long-term development. Our prosperity absolutely depends on a serious degree of international economic integration.

However, this does not mean that all forms and degrees of international economic integration are desirable. Where and how much a country should be open, and thus how much overall international integration we should have in which areas and to what degrees, depends on its long-term goals and capabilities: protectionism may be good if it is done in the right way for the right industry; the same regulation of FDI may be good for some countries but harmful for others; some cross-border financial flows are essential while too many of them may be harmful; immigration may or may not benefit both the sending and the receiving countries, depending on how it is organized. Unless we recognize this critical point, we will not be able to reap the full benefits that international economic integration can bring us.

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