

# EE460: International Trade and Foreign Direct Investment

Bhanupong  
Lecture 19

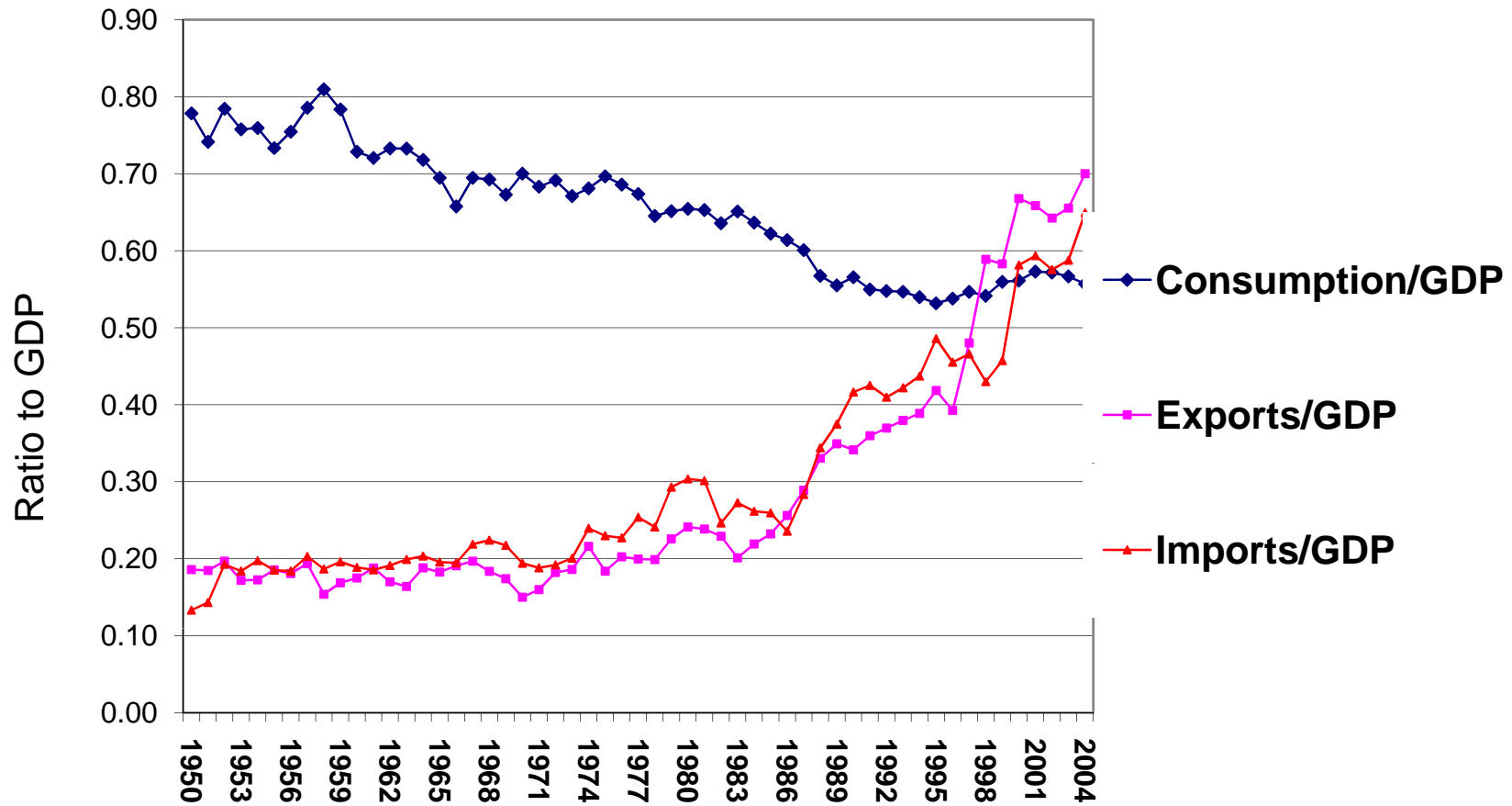
*“The propensity to truck, barter and exchange one thing for another is common to all men and to be found in no other race of animal” **Adam Smith.***

# Main themes

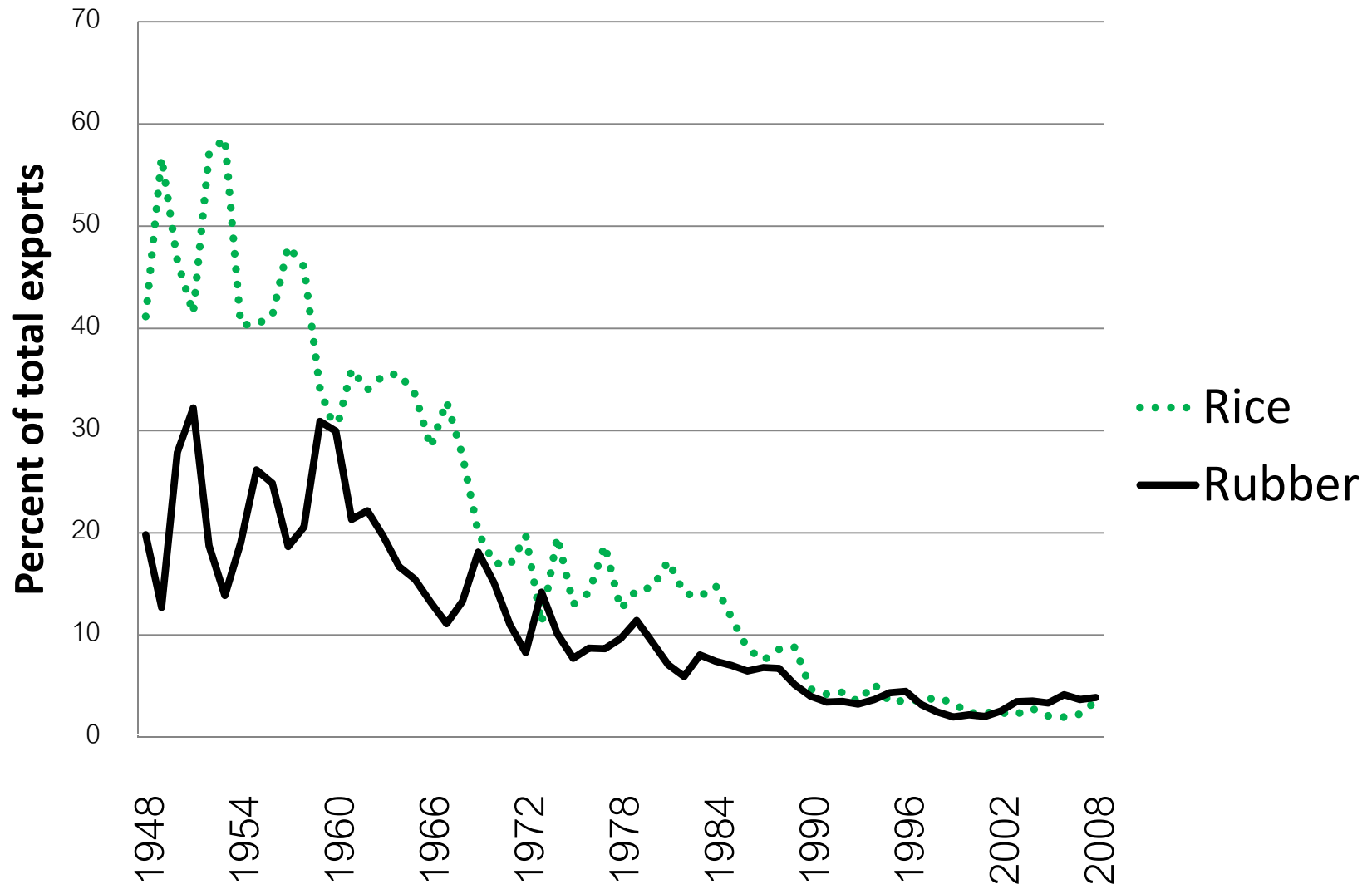
- Long-term trend
- Food crisis and trade
- Trade and growth
- FDI and network trade
- Trade structure
- The New Green Protectionism
- Japan Quake, The great deluge, and Thai exports

# Rising trade dependency

Protrade biased growth

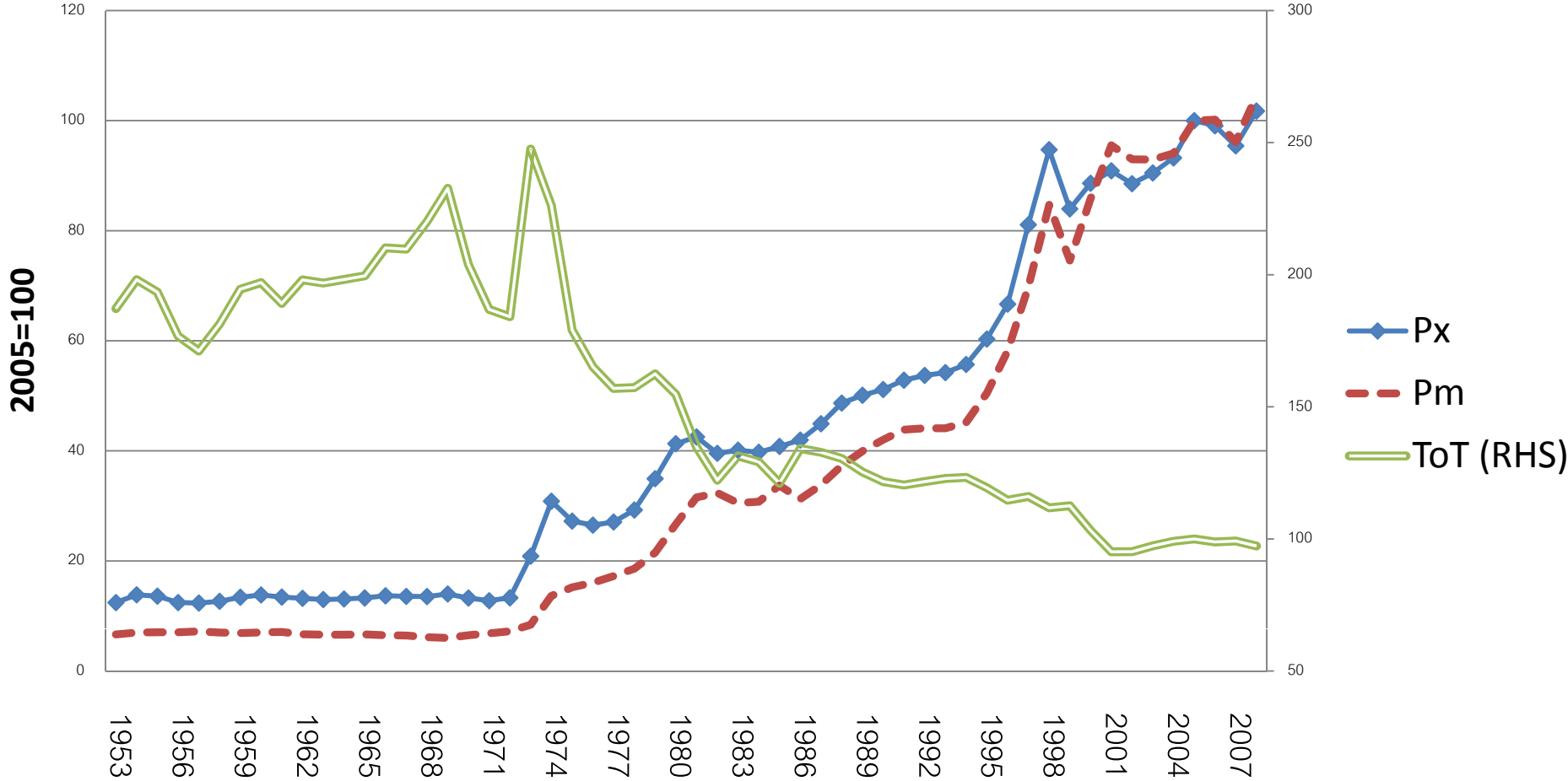


# Shares of traditional primary exports



# Declining terms of trade

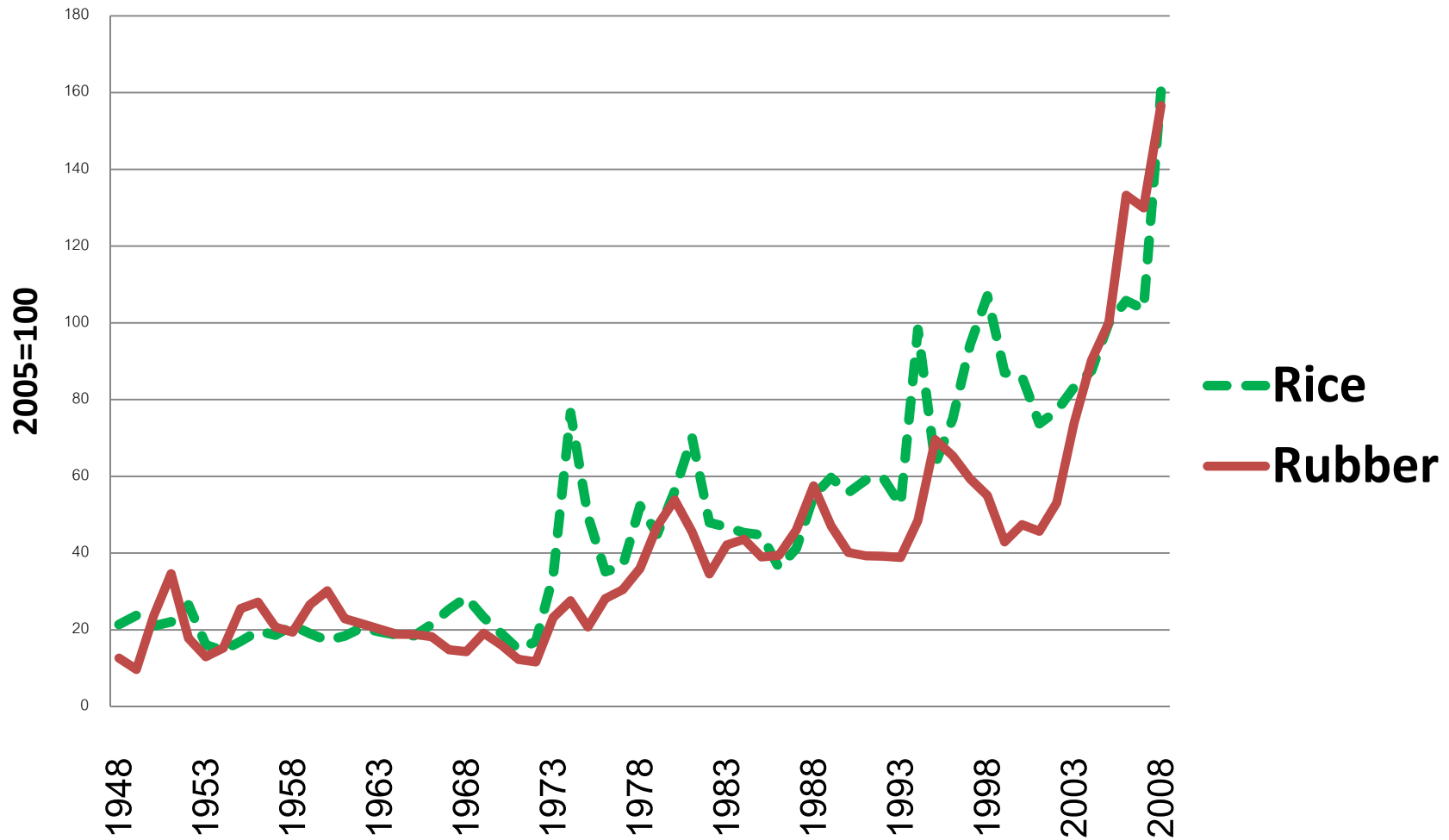
1953-2008



# Trade in primary products

- Primary goods are non-differentiated commodities whose prices are mainly set in commodity exchanges.
- Factor endowments are the main determinant of trade in mineral and agricultural commodities.
- With dissimilar production functions, ***technology gaps in agriculture***, along **with factor endowments**, are determinants of trade in agricultural goods such as rubber and rice.

# Rising commodity export prices



# One-billion hungry people

- The number of people who go to bed hungry every night somewhere in our world has reached 1 billion – one in six of the Earth's population, according to a new report by the United Nations' Food and Agriculture Organization.
- Should Thailand focus more on agricultural exports to exploit the rising trend of commodity prices?
- All countries are concerned with food security; FTAs usually exclude food items.

# Why did food prices soar?

- Things were triggered by the 2007 drought in Australia, the worst for a century, which halved its wheat harvest. But there were more fundamental background factors.
- As countries like China, India, Brazil and Russia have got richer they have begun eating more.
- Rich people don't just eat more than poor people, they eat *differently*.
- ***The demand for meat in developing countries has doubled since 1980;*** In India it is up 40 per cent, China 50 per cent.
- ***And because cattle and chickens are fed on corn – it takes 8kg of grain to produce 1kg of beef – the price of all cereals has been forced up.***

# Biofuels

- Added to that was George W Bush's love affair with American biofuels.
- (And what about the Thais' lunatic love of the gasohol?)
- Instead of buying plant ethanol from sunshine states like Brazil, the Americans have been trying to grow their own – with oil-based fertilizers and by subsidizing US farmers.
- A third of its maize crop goes to fuel cars, in a bid to lessen its dependency on oil from dodgy dictators in the Middle East.
- *The price of cereals has rocketed as a result.*

# Rice export bans

- Then, as food prices spiked between 2006 and 2008, speculators began hoarding food, and grain-producing governments slapped hefty export taxes on it.
- Some countries imposed export bans on rice.
- The prices have fallen a little in the past year but they are still 80 per cent higher than four years ago (see slide 7).
- And the coping margins for poor people have reduced; they have already sold off many of their meager assets.

# Agriculture productivity

- Investors switched their money from agriculture to more profitable areas.
- And so did financial aid. In 1980, 17 per cent of global aid went to agriculture; by 2006 that had fallen to 3.8 per cent.
- Aid was switched to debt reduction, health and education, and building up the capacity of Third World governments.

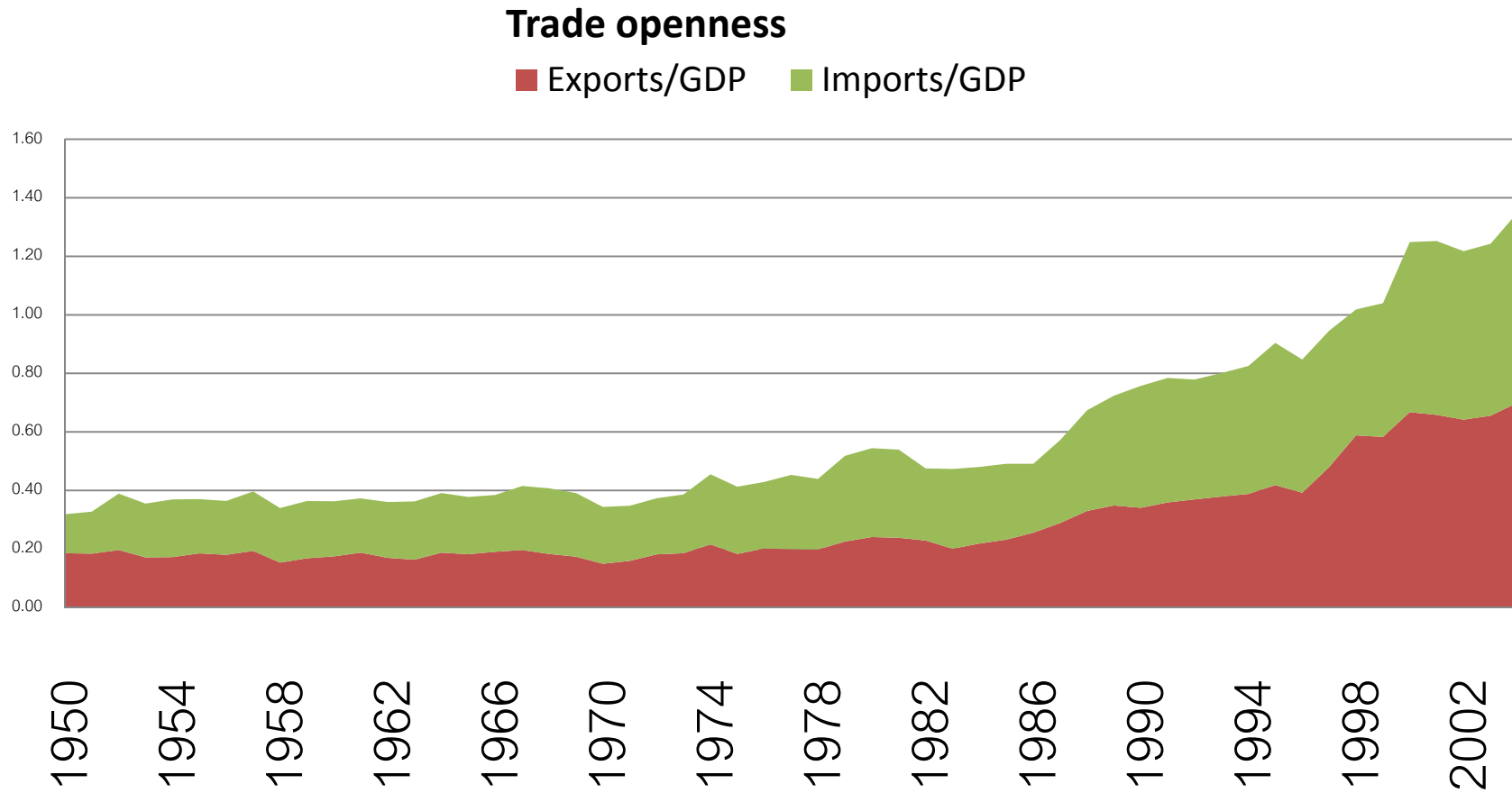
# FAO study

- A study week suggests that global warming will reduce farm production by 12 per cent in Africa by 2080 – with output falling by as much as 60 per cent in some countries (implication on long-term prices?)
- **Trade policy should be reformed to enable poor farmers to sell high-value products like special vegetables and flowers to the West without huge taxes and tariffs.**
- Rich countries should stop subsidizing farmers to produce too much which they then dump on the developing world, destroying the market for local crops.
- The OECD spent \$265bn on farm subsidy last year compared to a measly \$4bn on aid to Third World agriculture.

# Distributive issue

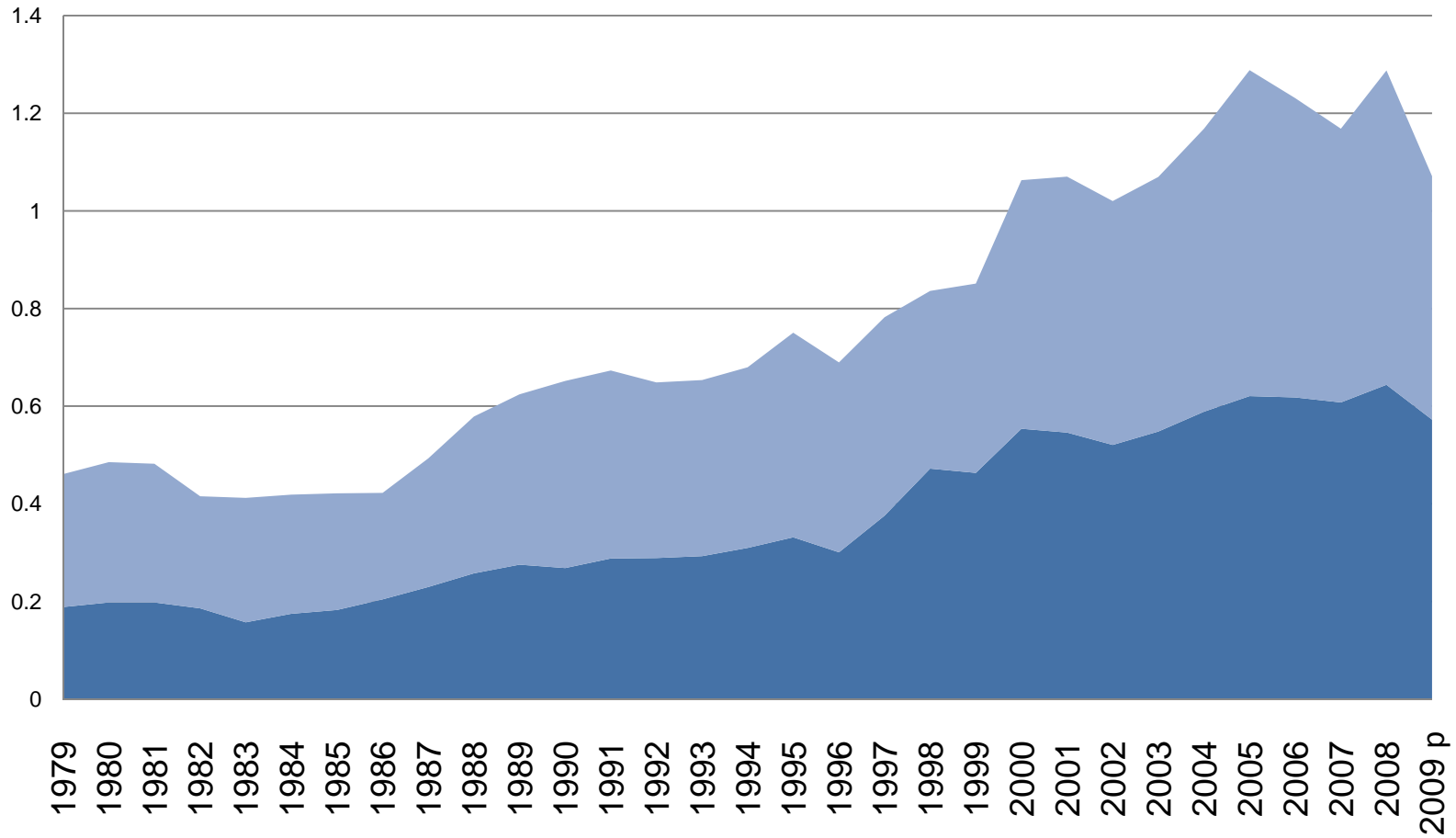
- The FAO predictions are that between 200,000 and 400,000 more children could die every year if the poor nations' food crisis goes unaddressed.
- The world produces enough grain to provide each one of its inhabitants with 2,500 calories a day.
- What is missing is the political will to ensure its fair distribution.

# Growing importance of trade



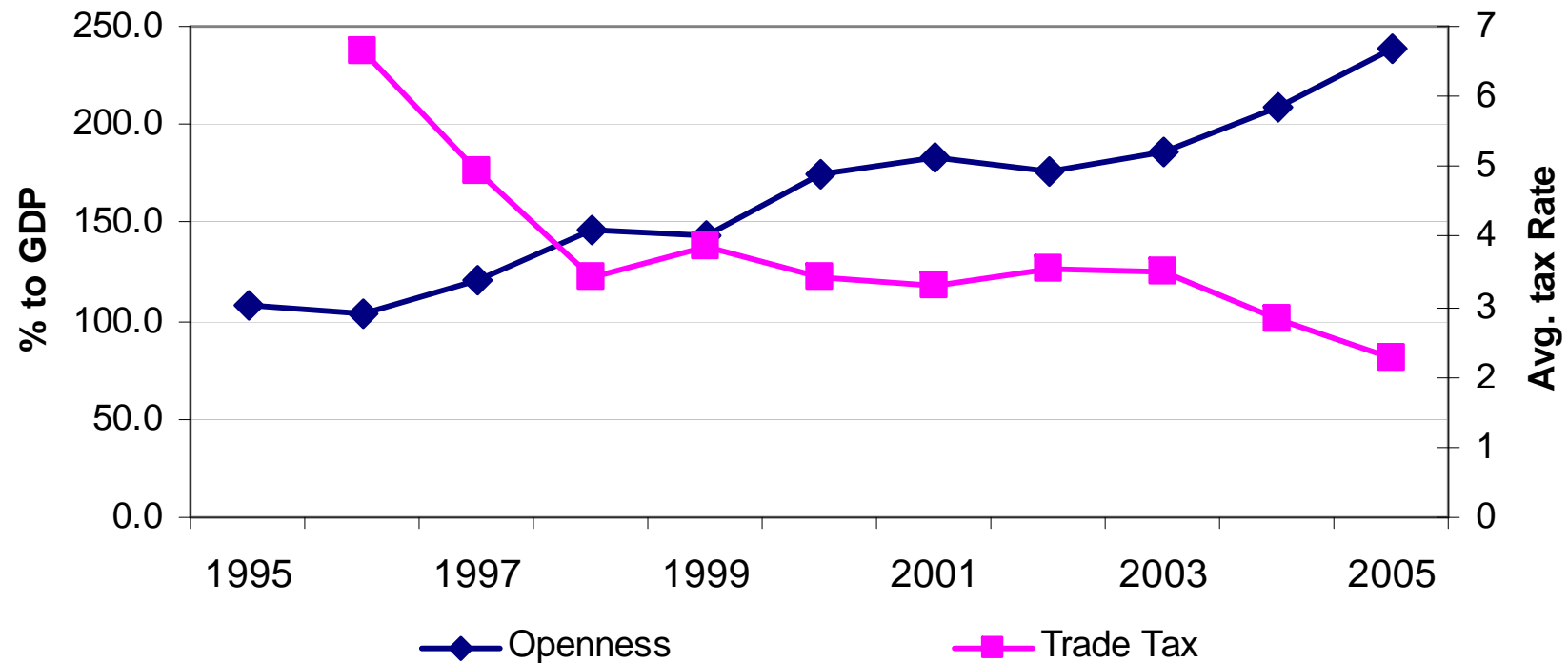
# Degree of Openness to trade

■ Exports/GDP ■ Imports/GDP



# Trade reform through tariff reduction

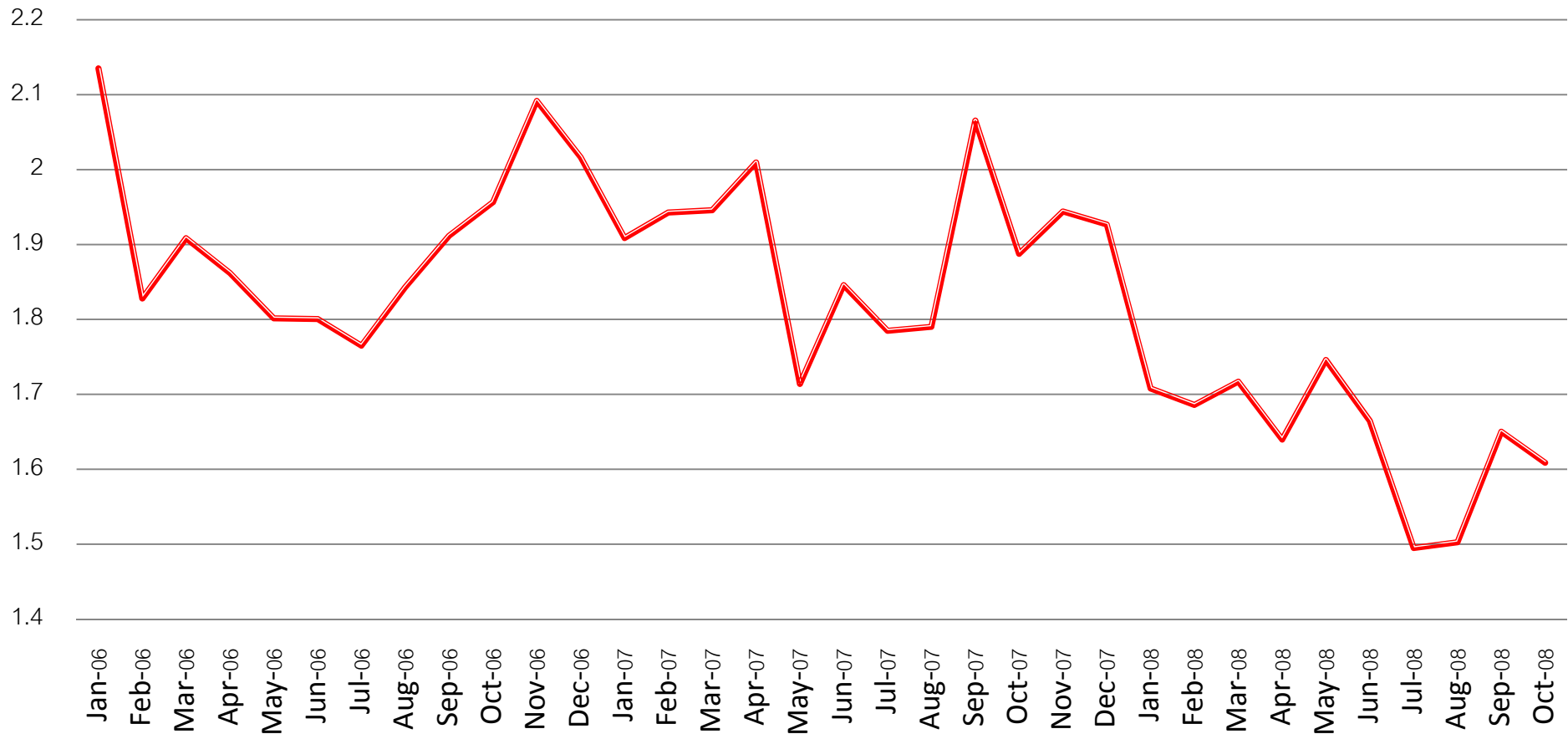
Figure 6.1: Degree of Trade Openness and Avg. Trade Tariff



Source: Bank of Thailand and Customs Department

# Thailand's implied tariff rate

*customs revenue to total imports(%)*



# Adverse impact of globalization

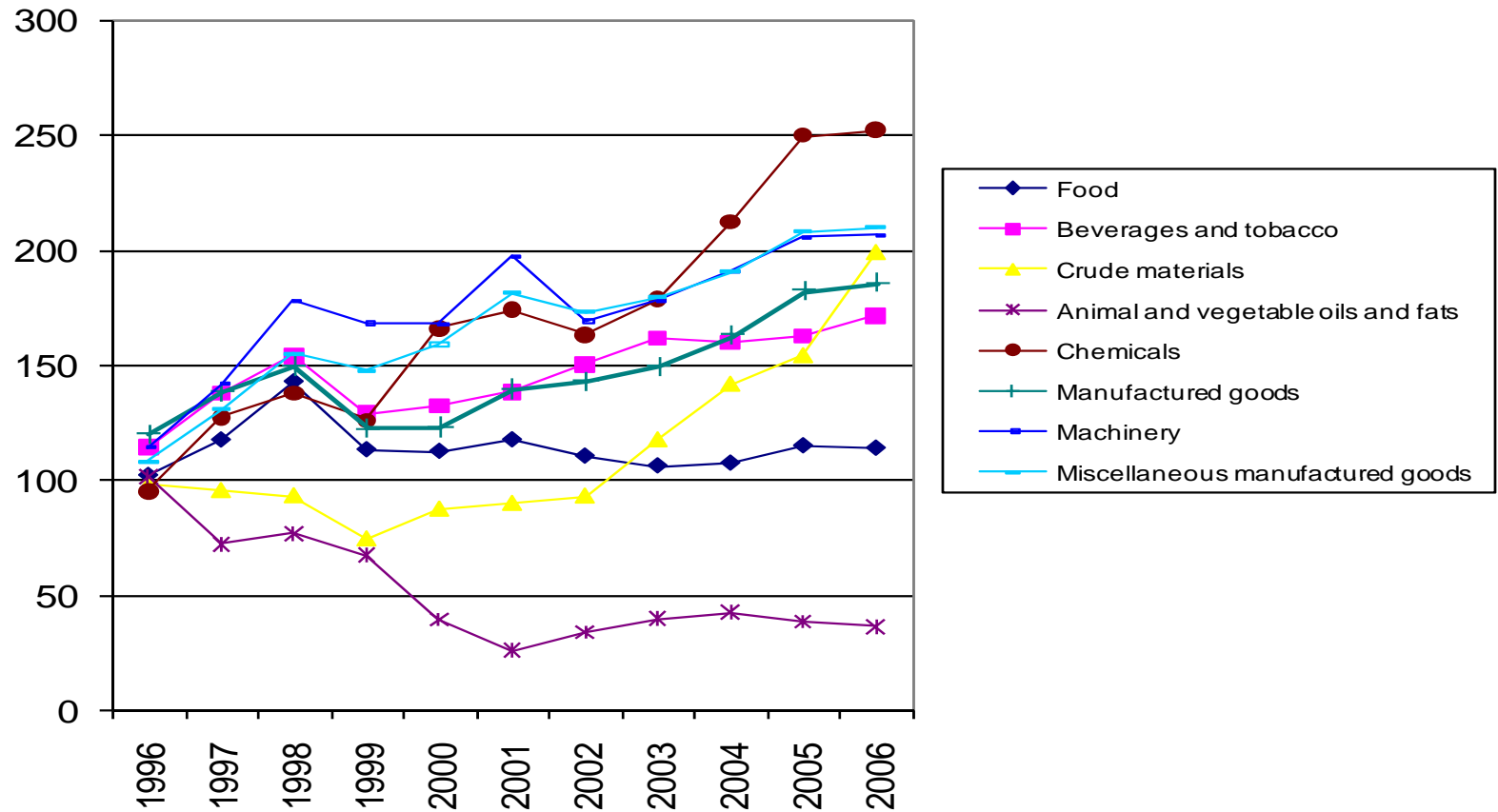
- Exposure to external shocks
- Export dependency
- Increase business synchronization
- Destroy traditional (uncompetitive) sectors

# What globalization can do

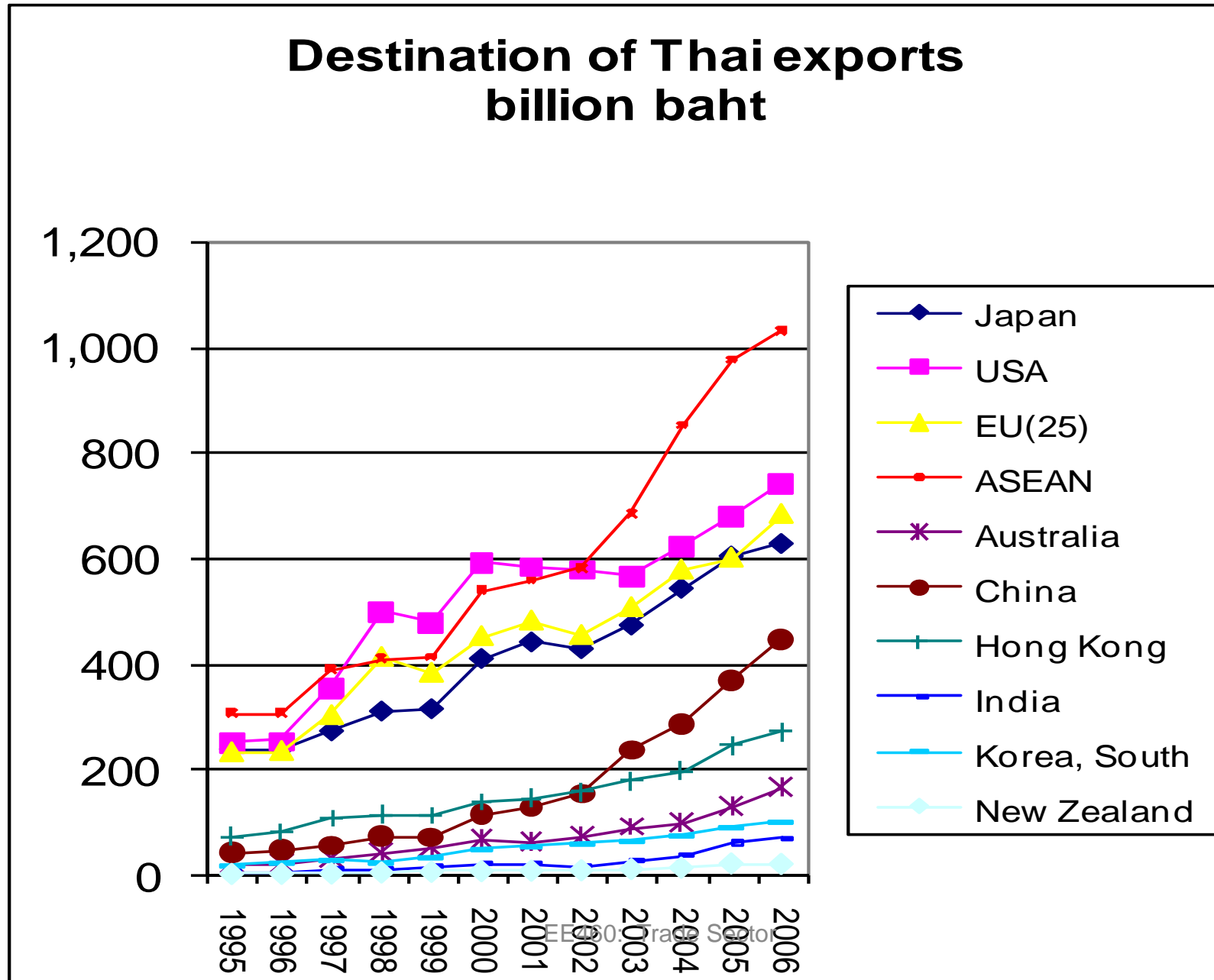
- High exports can sustain growth
- Imported capital goods raise productivity
- World competition exposure leads to efficiency improvement.
- Exploitation of economies of scale
- Outward oriented development strategy
- Improve resource allocation as production is dictated by comparative advantage.
- Encourage inflows and outflows of foreign direct investment

# Food and vegetable oils did not perform relatively well Manufacturing prices increased substantially

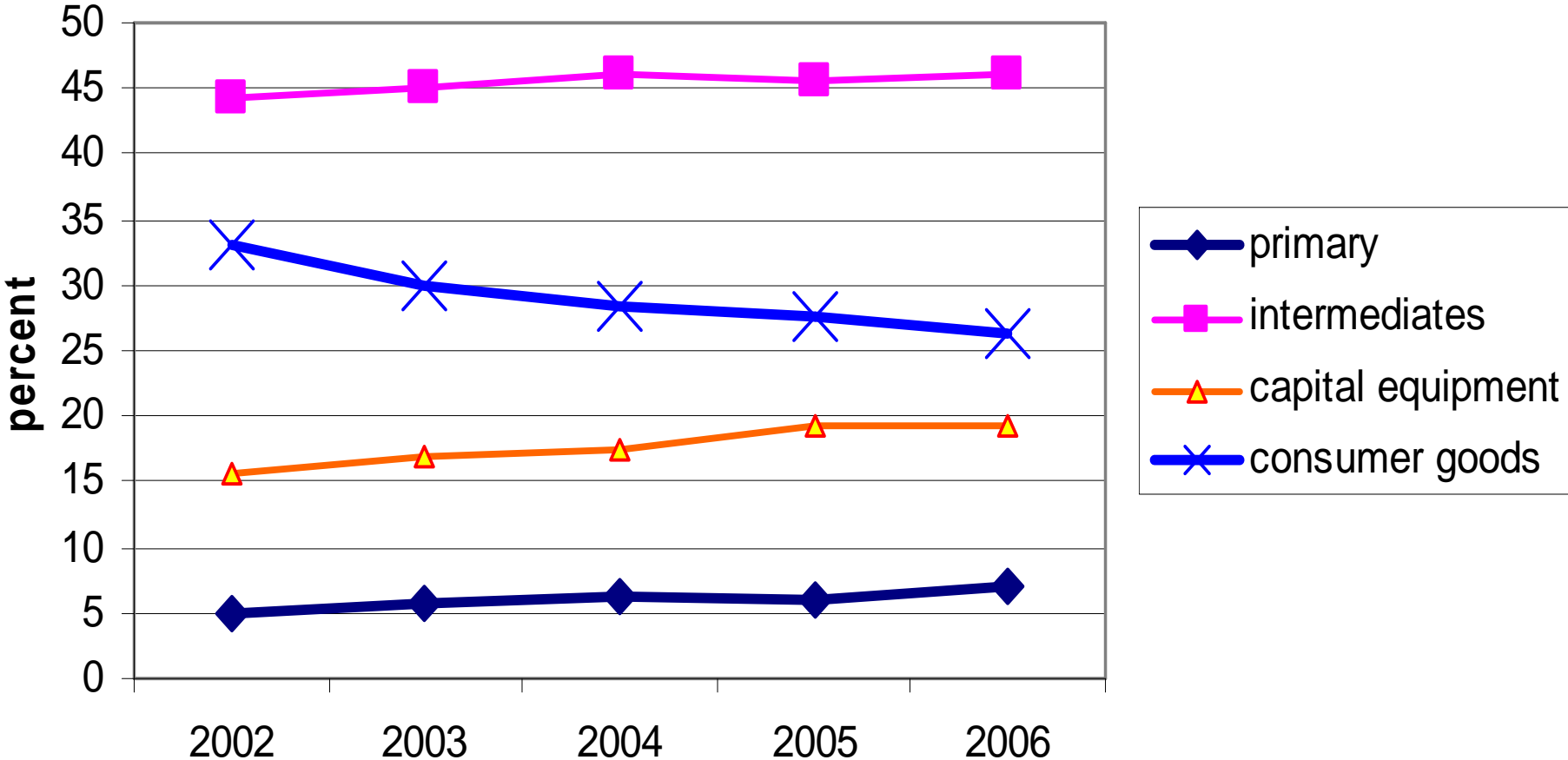
**Export Price Index: Manufacturing vs Agriculture  
1996-2006**



# Not just what but where you export matters



# Exports values by stage of procesing



# Growing network trade

- Network trade is expanding much faster compared to conventional product-based trade (24 % of total manufactured exports in 1993, 45.5% in 2007).
- There is a shift away from mature industrial economies towards developing countries .
- Developing countries' share in network exports rose from 25 % in 1993 to 41% in 2007.
- The degree and intensity of participation of East Asian Economies in network trade is much greater compared to countries in other parts of the world.
- China has become an integral part of global production networks—a premier center of final assembly.
- Clear evidence of trade complementarity rather than crowding out effect.

# Impact of global slowdown

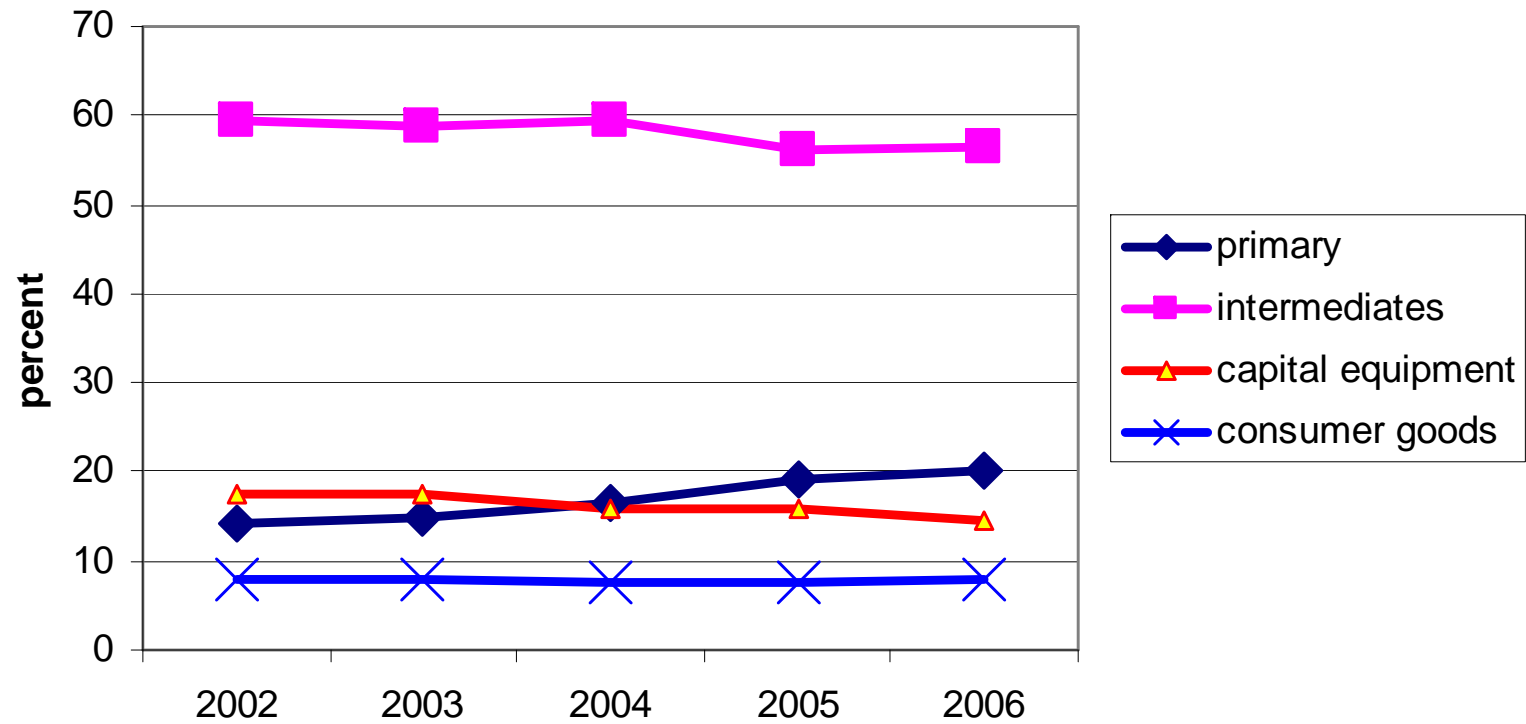
- A sharp contraction in world trade following the onset of the global financial crisis at a faster rate than in the Great Depression
- Trade contraction experienced by the East Asian countries has been even faster.
- Contraction of trade credit (global financial crisis)
- Greater share of consumer durables
- Parts and components trade have been more susceptible to the global economic slowdown compared to trade in final assembly and total trade.

# Destocking

- China's imports from countries in the region had contracted at a much faster rate compared to exports—an indication of destocking of imported parts and components by assembly firms in China.
- Taiwan, Korea, and Japan (major parts and component suppliers to China) suffered the highest rates of contraction in exports to China to other countries in the region.

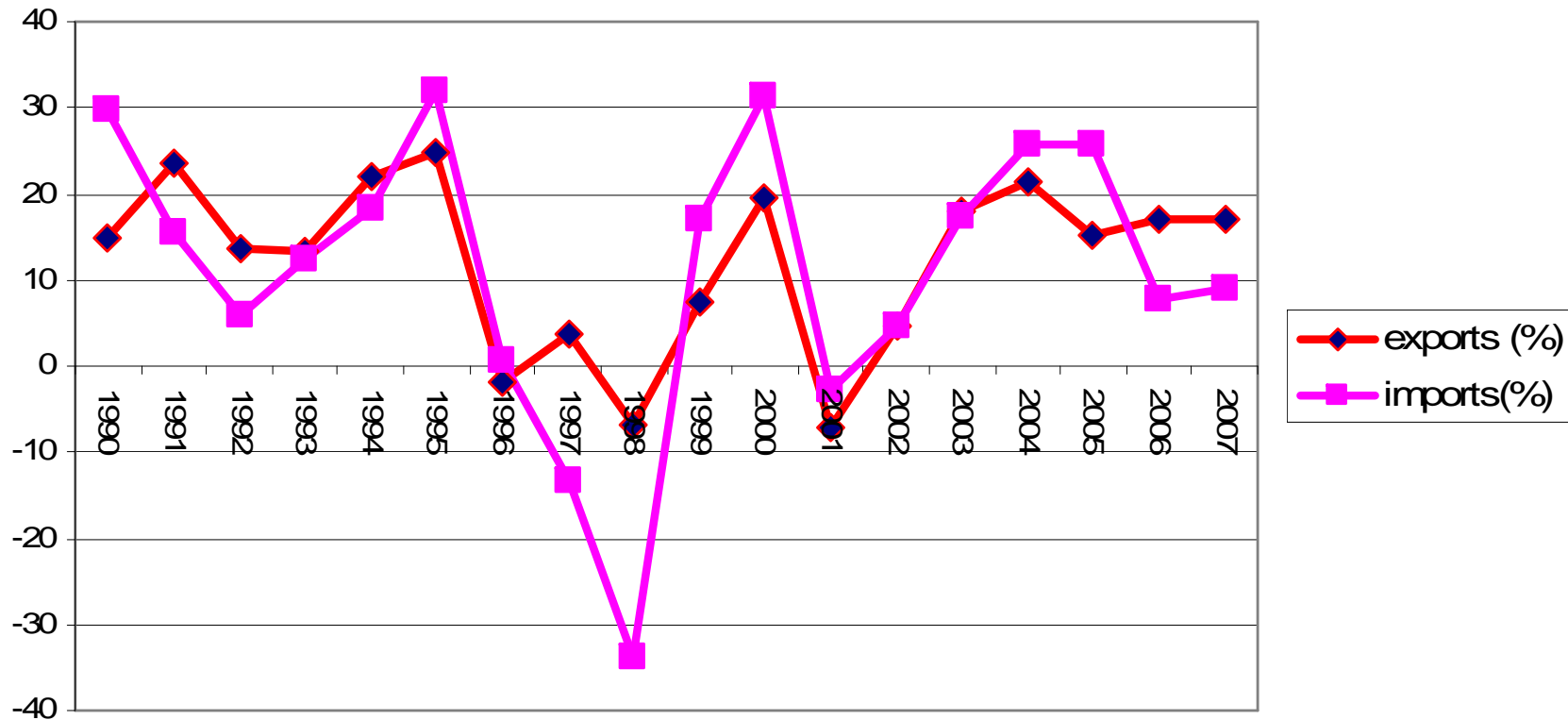
# Dependency on raw materials

Imports values by stage of processing



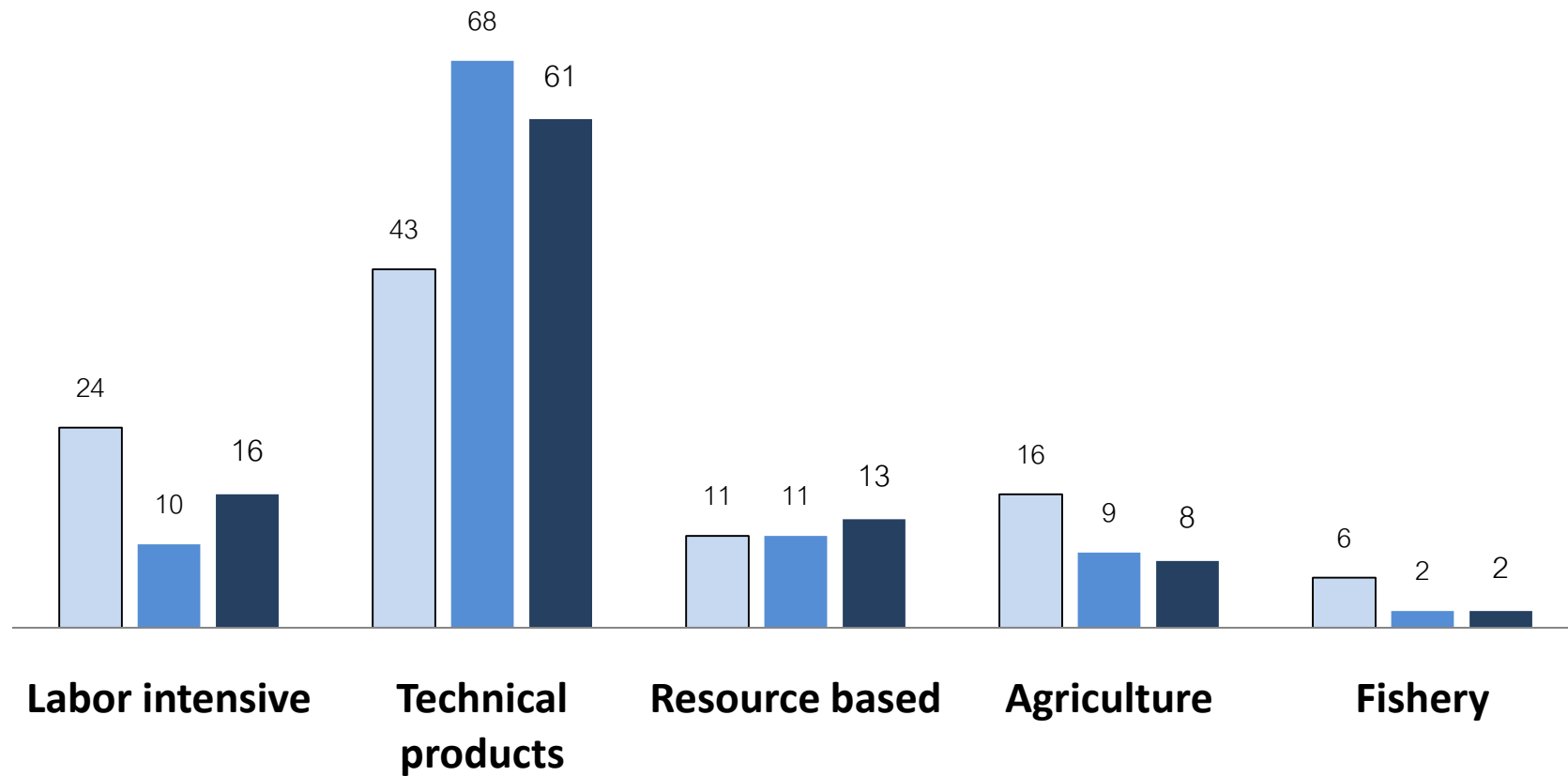
# Long-run causal relationship—non spurious

## Changes in exports and imports



## Export share by product group

1995 2005 2009

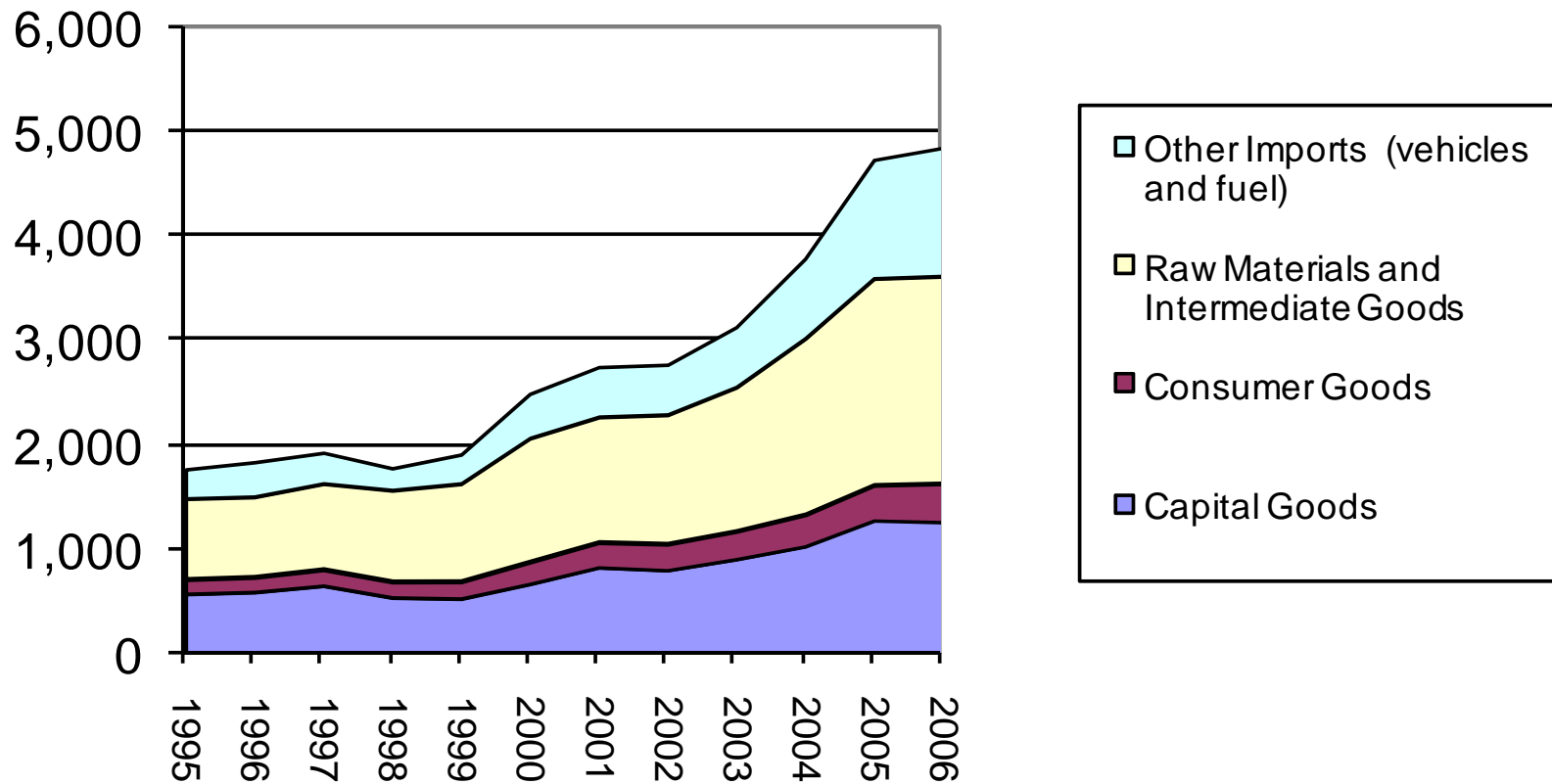


## Source of comparative advantage in manufactured goods: Their life cycles

- In the early phase, when the product is new, comparative advantage derives from **technology gaps**.
- In the middle phase, when imitators exist, **product differentiation**, accompanied by economies of scale, become principal explanation of comparative advantage.
- In the late phase, the product loses differentiation, **factor endowments and economies of scale** emerge as the dominant influences of comparative advantage.

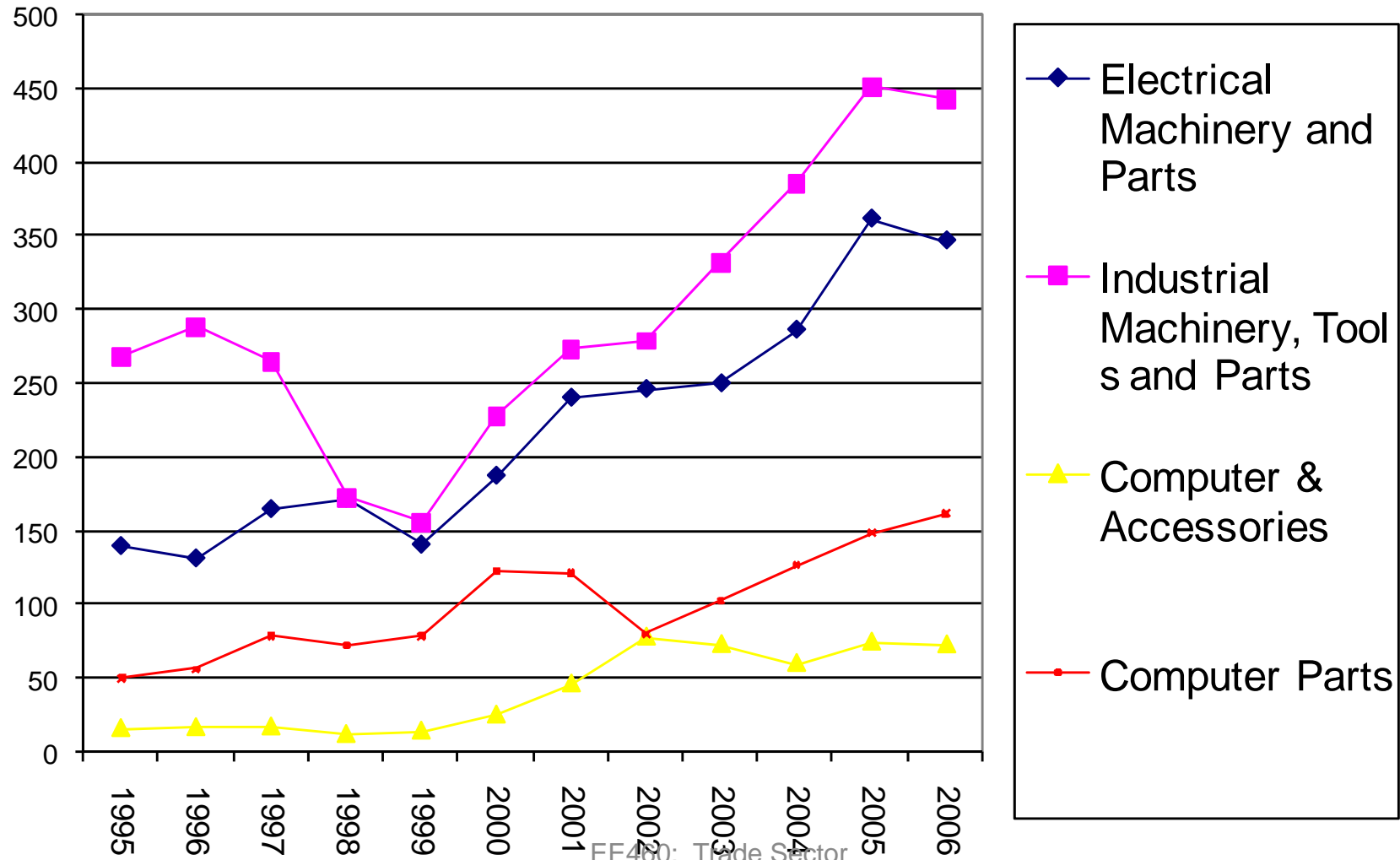
# Imports by economic classification

(billion baht)



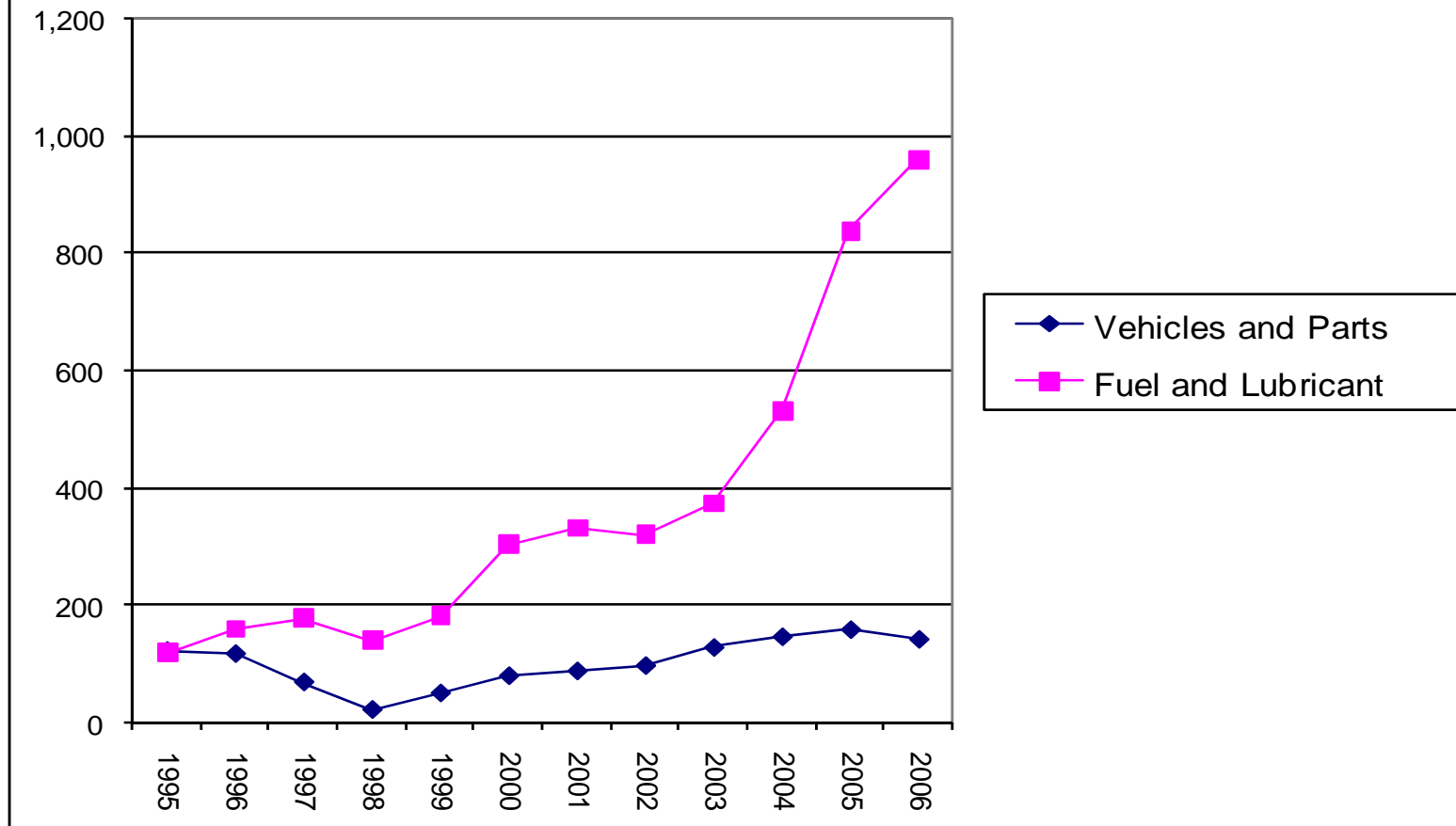
# Top four imported capital goods

1,000 million baht



# Imports of vehicles and fuel

1,000 million baht



# The role of MNCs

- Technology gaps, economies of scale, and product differentiation give to the individual firm some degree of market power.
- An explanation of trade in new and differentiated manufactured products must pay attention to the market behavior of Multinational Corporations.

# Benefits from FDI Inflows

- Infrastructure and technology transfer
- Increased productive efficiency due to competition from multinational subsidiaries.
- Improvement in quality of the factors of production
- Inflow in investment funds (benefits to the balance of payments)

# More FDI benefits

- Faster growth of output and employment
- Consumer benefits
- Increase in exports
- Increase in savings and investment (crowding-in vs. crowding-out effect on local investment)
- Reducing vulnerability to currency crisis

## Developing economies with biggest FDI inflows (USD billion)

|           | <b>1992-97<br/>average</b> | <b>2004</b> | <b>%GDP</b> stocks, end of<br>2004 |
|-----------|----------------------------|-------------|------------------------------------|
| China     | 32.8                       | 60.6        | 14.0                               |
| HK        | 7.8                        | 34.0        | <b>277.6</b>                       |
| Brazil    | 6.6                        | 18.2        | 25.2                               |
| Mexico    | 9.6                        | 16.6        | 27.0                               |
| Singapore | 8.3                        | 16.1        | <b>150.2</b>                       |
| S. Korea  | 1.3                        | 7.7         | 10.7                               |

## John Dunning (1981) *International production and the Multinational Enterprises*

- FDI implies that **location-specific** advantages favor a foreign host country.
- **Ownership-specific** advantages favor the investing firm.
- International production is attributable not only to firms' monopolistic advantage and its ability to internalize that advantage but also to the **presence of foreign country** in which production brings unique benefit to the firms.

# Determinants of FDI

- Ownership advantages arise from economies of scale with respect to **intangible assets** such as skilled management and know-how by investing abroad.
- Locational advantages in host countries
- Product cycle ( new technology produced and used in home country)
- Standardized technology permits shifting high cost plants abroad
- Low tax, low labor cost, and government policy

# Internalization

- Theory of internalization: MNCs invest abroad to capture market externalities: economies of scale in production and marketing, the ownership and public-goods character of knowledge, and government-imposed market constraints.
- Market imperfections are related to country-specific endowments, the benefits of internalization for the MNCs vary across countries.

# Eclectic theory of FDI

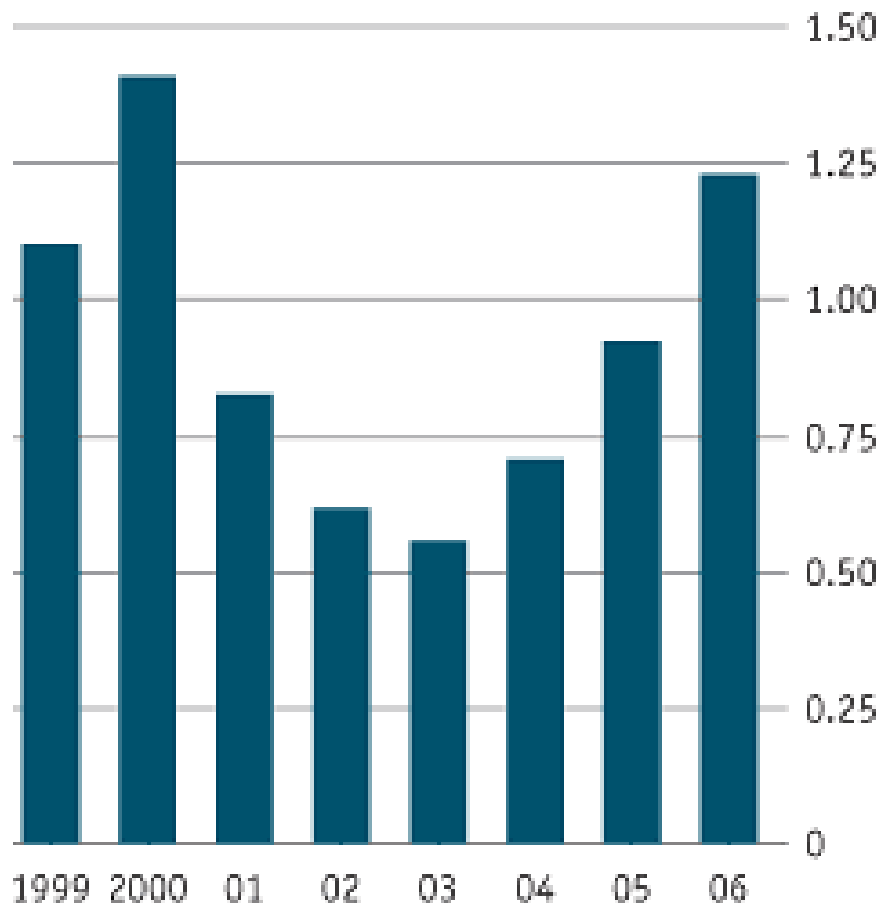
- The eclectic theory (Dunning, 1981) draws on the theories of comparative advantage and location and also on the theories of *monopolistic advantage* and *internalization*.
- MNC would invest only when it is most profitable for an MNC to internalize its monopolistic advantage in a foreign country
- Otherwise it exploits the country market through export or licensing.

# Factors affecting FDI

- Repatriation of profits
- Economy and market size
- *Risks and uncertainties*
- *Political stability*
- *Policy consistency*
- External debt discourages FDI
- Market potential and accessibility
- Product fragmentation

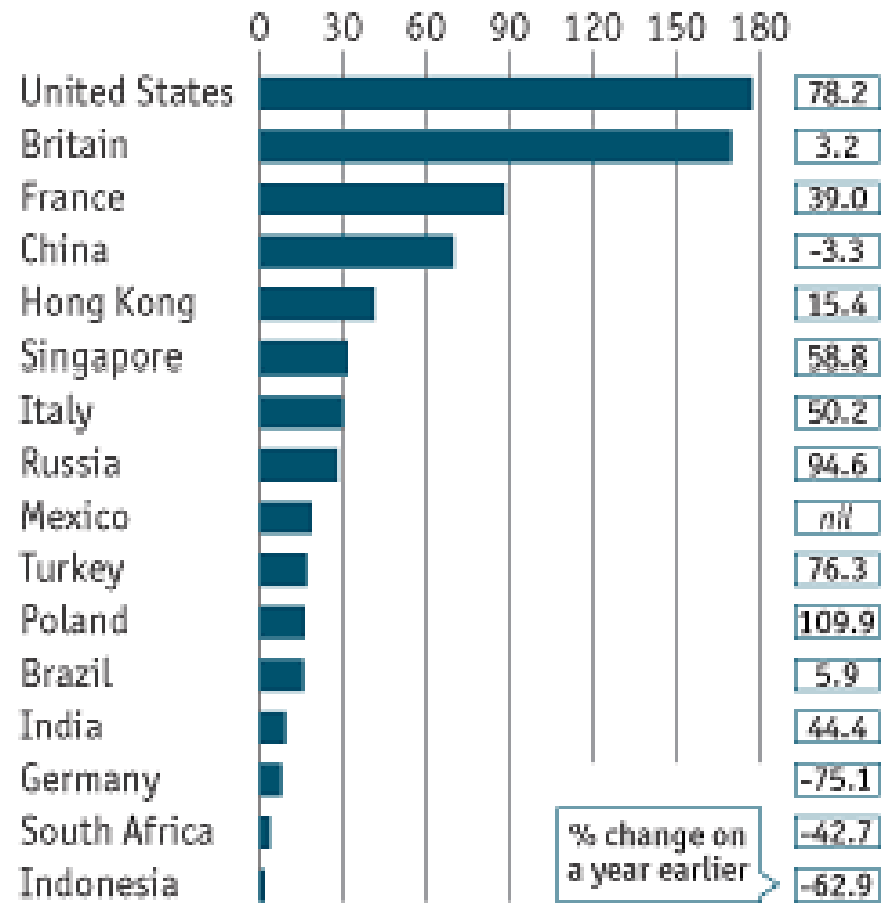
## Foreign direct investment

World FDI inflows\*, \$trn



Source: UNCTAD

FDI inflows\*, \$bn, 2006



\*Estimates

# Monopolistic and Oligopolistic Markets

- MNCs have some unique production knowledge or managerial skill that could easily and profitably be utilized abroad and over which the corporation wants to remain control.
- Horizontal integration: production of differentiated products that are also produced at home
- Vertical intergration: to obtain control of needed raw-materials by ensuring uninterrupted supply at the lowest cost

# Possible costs from FDI

- Negative effects on the balance of payments.
- Discourage development of technical know-how
- Detriment to growth of domestic producers
- Transfer pricing

# Social costs

- Environment and natural resource costs
- Damages to local culture and traditional exports
- Politico-Strategic Interests
- Facilitate hegemony by dominant Japanese and Western cultures.
- Country sovereignty is at stake.

## Corporate tax rates: average

|                                | 1998 | 2006 |
|--------------------------------|------|------|
| <b>Vietnam</b>                 | 32.5 | 28   |
| <b>US</b>                      | 40   | 40   |
| <b>Japan</b>                   | 51.6 | 40.7 |
| <b>China</b>                   | 33   | 33   |
| <b>HK</b>                      | 16.5 | 17.5 |
| <b>Thailand,<br/>Indonesia</b> | 30   | 30   |
| <b>Mexico</b>                  | 34   | 29   |
| <b>Singapore</b>               | 26   | 20   |
| <b>Malaysia</b>                | 28   | 28   |

# The New Green Protectionism

- Export-dependent jobs in Asia are under threat by vested interests including unions and industry in developed countries advocating for trade barriers disguised as environmentalism.
- Advocating trade barriers under the banner of environmentalism is nothing new. European countries support the introduction of carbon tariffs to offset the economic damage from their self-imposed climate change policies.

# The New Green Protectionism

- In the United States, political campaigns led by industry and unions have successfully introduced the Lacey Act that imposes extra regulation on imported wood and wood products to certify their origin and make them less competitive.
- And now the green protectionist disease appears to have been caught on in **Australia**.
- For years Australian green groups have claimed mass deforestation and illegal logging are occurring in the developing world.
- They've advocated for forestry products in the developing world to be certified against developed world standards of environmental management.
- And if they do not meet those standards their solution is to impose restrictions on imports.

# New protectionism

- Currently the campaigns are particularly focused on illegal wood and wood products from Asia, especially China and Indonesia. But these campaigns are based on false foundations.
- A recent report commissioned by the Australian government identified the insignificance of the problems with imports from Asia representing only 0.32% of illegally logged material.
- But that hasn't stopped Greenpeace coordinating other green groups and religious groups to campaign for trade barriers to eliminate "illegal forest products" from Asia.

- Trade unions representing forestry workers have backed these green campaigns.
- The Forestry Union has a history of working with green groups to push for self-interested public policy using green excuses.
- It has previously supported campaigns to encourage consumers to protest against supermarket chains selling tissue products supplied by Asia Pulp and Paper on environmental grounds.

# It is political economy

- But digging deeper the union was actually pushing for consumers to buy Australian-made paper products "[so] thousands of Australian workers [are] paid properly [and] more of your money stays in Australia."
- Before the last Australian election the union made donations of about 825,000 baht to political parties that committed to "greater policing and enforcement of an effective national ban on the sale of illegally logged timber imports".

# Conclusions

- Since the first oil shock, the terms of trade has been declining.
- Primary commodities have become less important.
- Comparative advantage is changing, reflected by changing capital intensity.
- Demand for biofuels will keep cereal prices high – making staples beyond the reach of the poorest .

# Conclusions

- Agriculture protection is on the rise for the sake of food security.
- FDI and trade are related through production fragmentation.
- The rise of production sharing is a major structural shift in world trade
- Thailand is benefiting from participation in network trade and the rapid recovery of exports in Japan and China in 2010.