

Trade and Foreign Direct Investment

Bhanupong

Lecture 18

*“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.***

International Reserve Management

- Holding large amount of international reserves have high opportunity cost in the form of forgone income
- With more flexible exchange rate, there is no need to hold large buffer stock (similar to banks that have low risk of large deposit withdrawals)
- Inventory approach to real money balance can be applied to central banks' international reserve management.

BOT to invest part of global reserves in foreign equities

THE NATION March 23, 2016

- THE BANK OF THAILAND may start investing 3-4 per cent of the country's international reserves in foreign equities in an effort to manage currency risk due to global economic volatility.
- The Cabinet yesterday approved an amendment to the [Bank of Thailand](#) Act that would allow the central bank to invest more in capital markets.

BOT Governor Dr Veerathai Santiprabhob said the objective of the amendment was to help the central bank reduce the risk from currency volatility in the global market.

Greenback in retreat

Dollar broad trade-weighted index

January 1997=100



Source: Federal Reserve

About turn: the depreciating dollar

- In mid-December, fund managers polled by Bank of America Merrill Lynch thought that being bullish on the dollar was the most overcrowded trade around.
- Simultaneously, they thought the greenback was overvalued.
- But because they also expected the Federal Reserve to push interest rates up three times this year, they may have felt they had little choice but to buy the buck; none of the other big central banks was likely to raise rates.

Hawk vs Dove

- However, the Fed has turned more doveish since; this month's statement suggested no increase was likely before September.

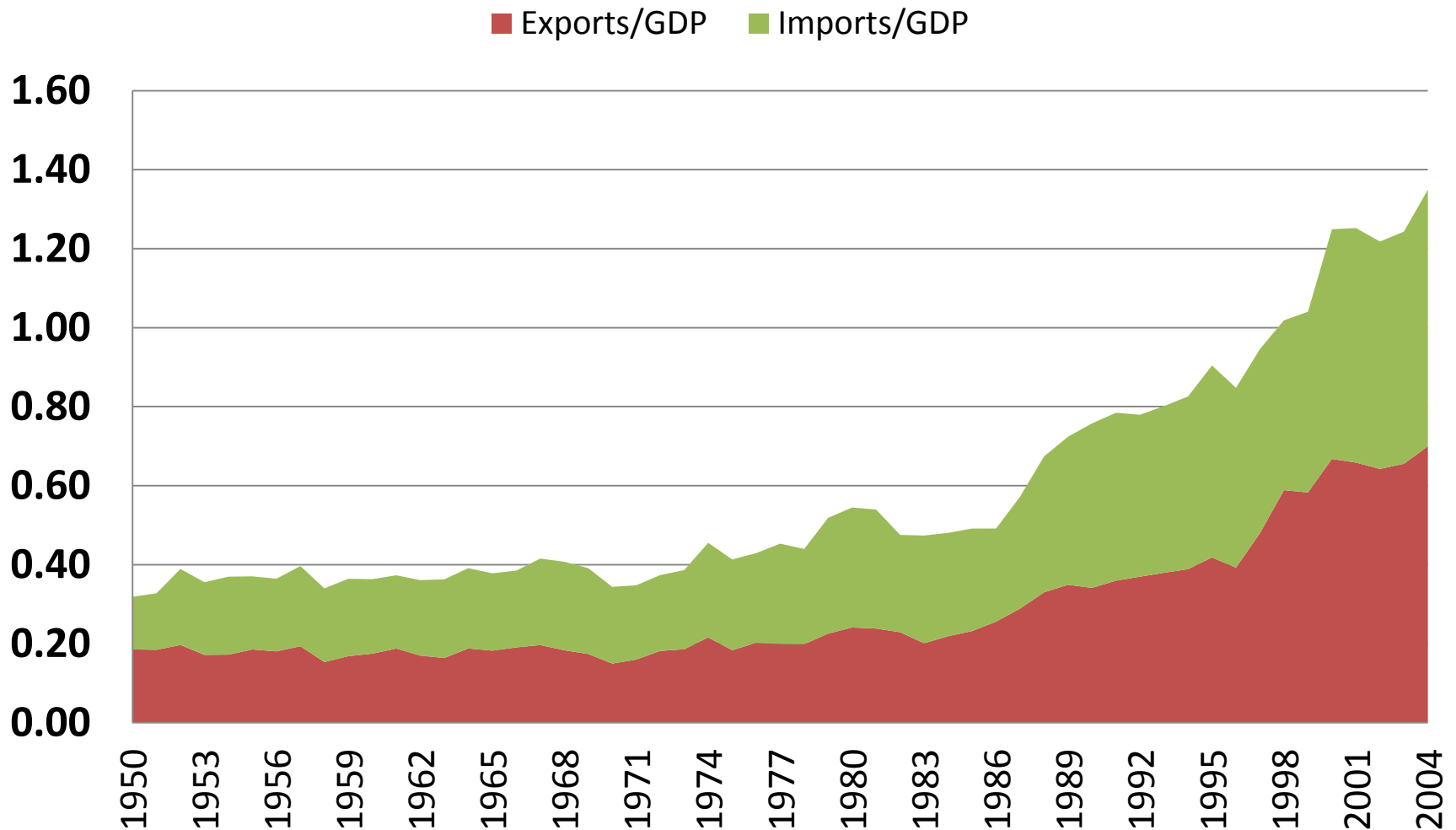
The depreciating dollar

- The dollar has fallen about 3% in trade-weighted terms from its peak on January 20th. That's a relief for emerging-market debtors who have borrowed in dollars and for American multinationals due to report foreign profits.
- The dollar's fall may also be prompted by a rebound in commodity prices, which has lessened the gloom over emerging markets.

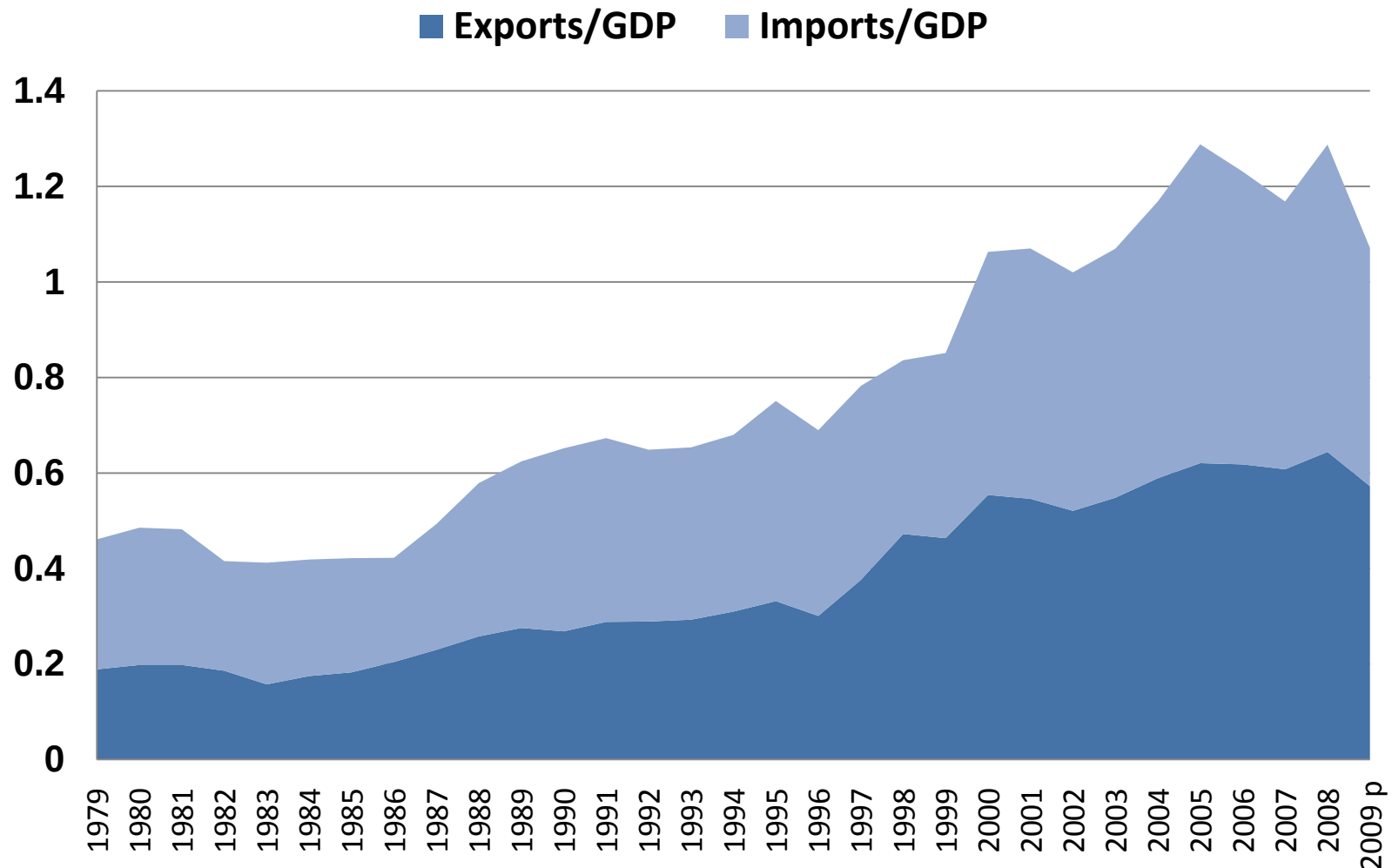
Lecture focus

- Long-term trend
- Food crisis and trade
- Trade and growth
- FDI and network trade
- Trade structure
- GFC and trade

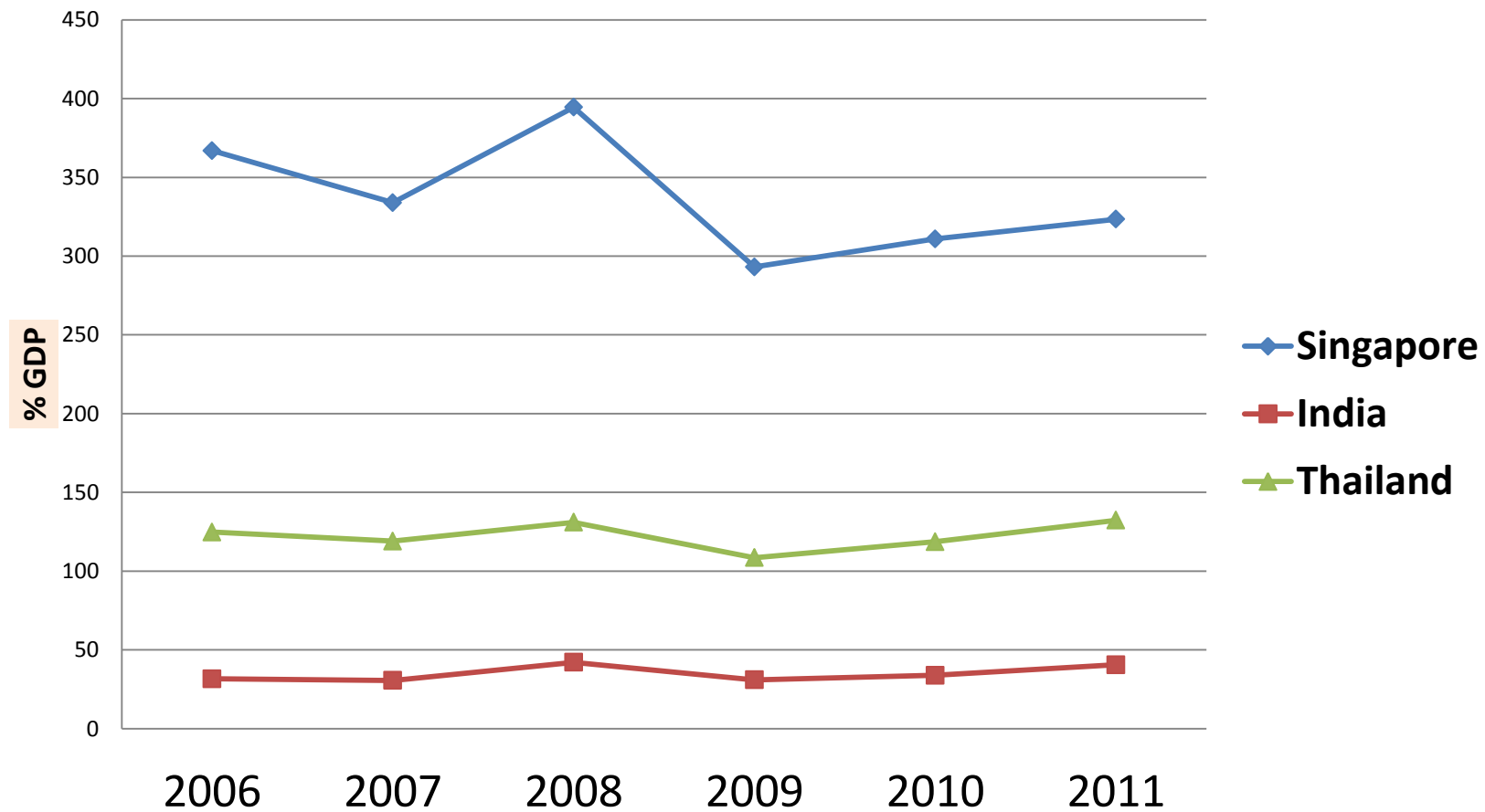
Importance of trade sector since 1950



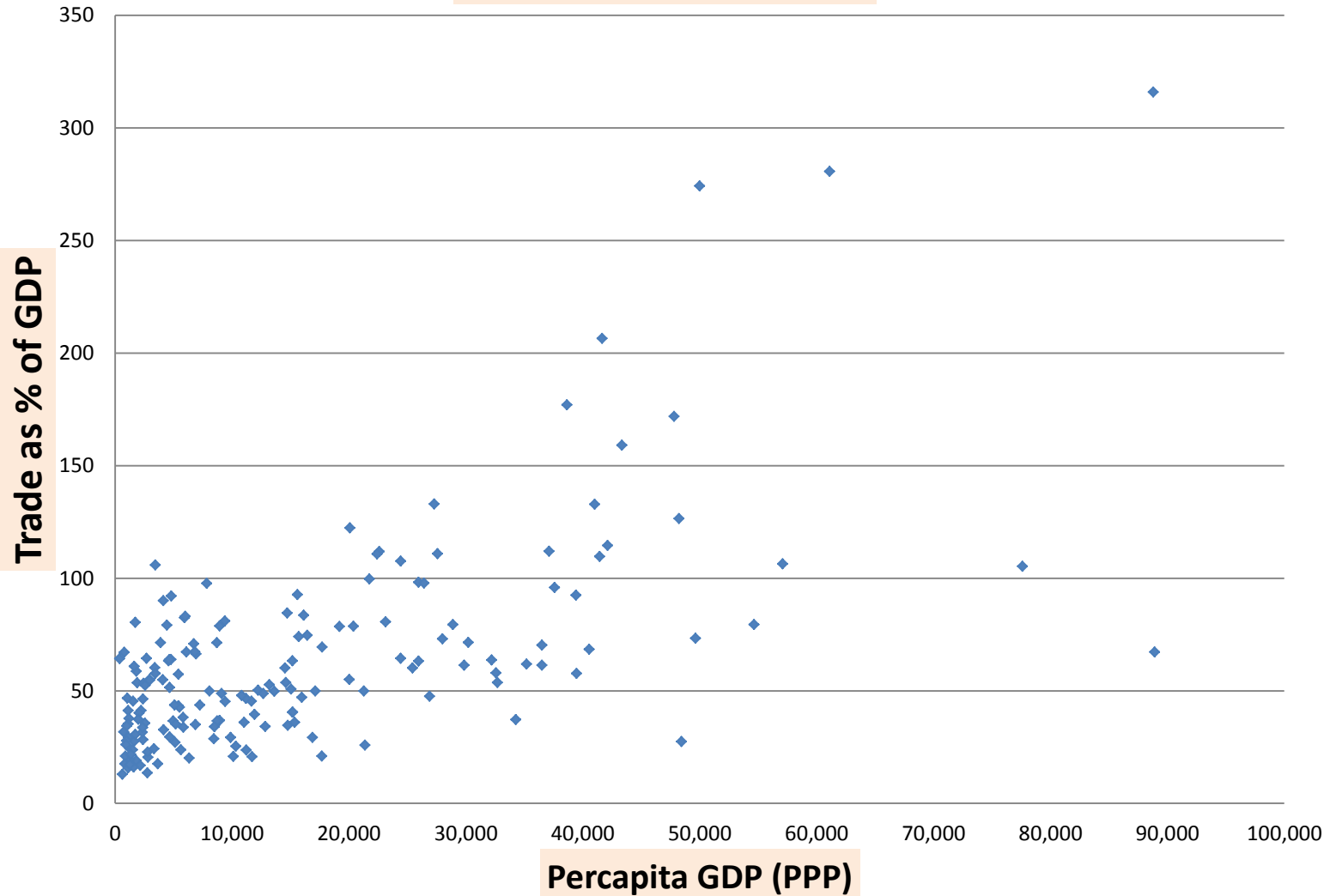
Degree of Openness to trade since 1979



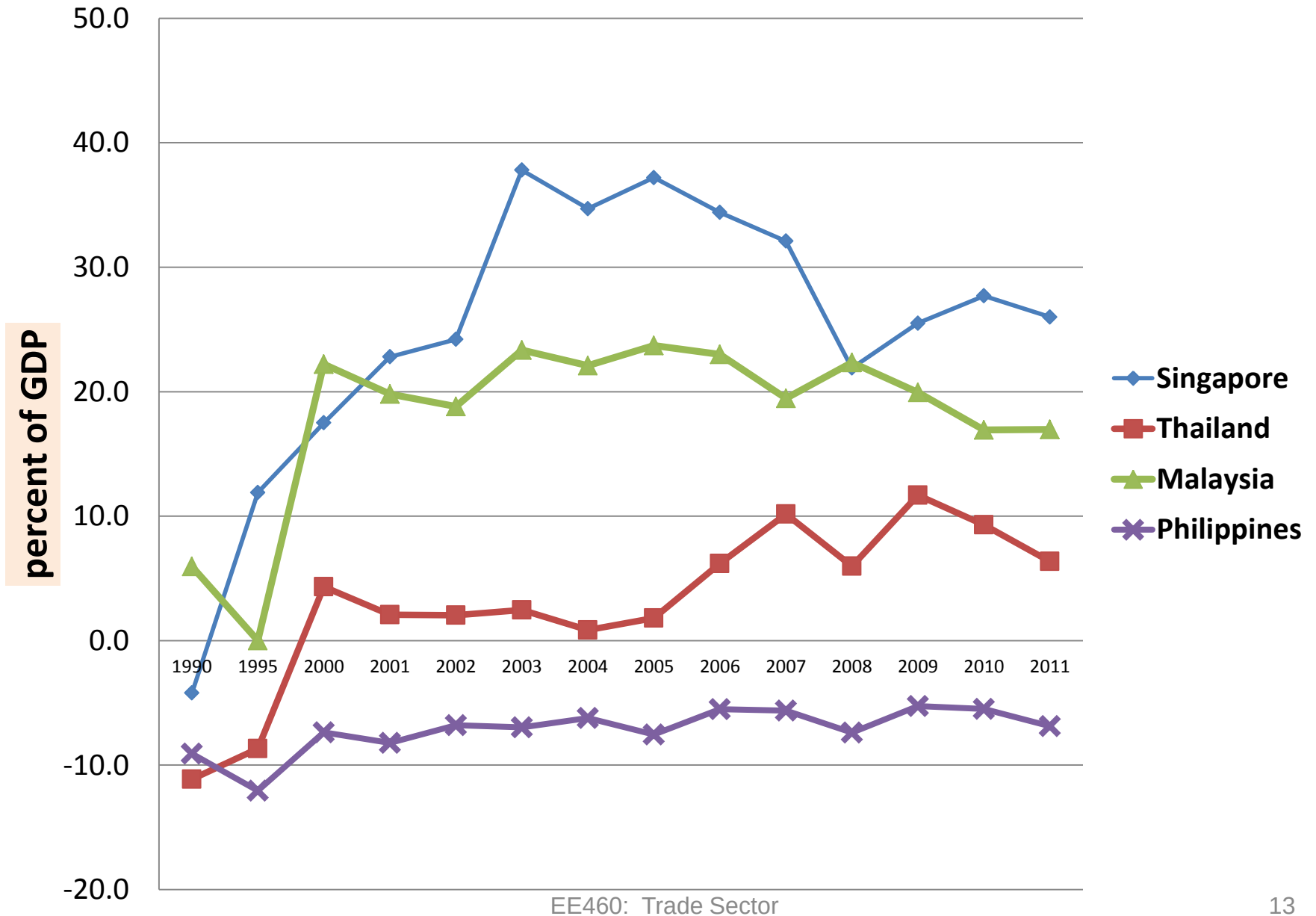
Trade Openness (Exposure): A comparison



Trade and Development 2009-2011

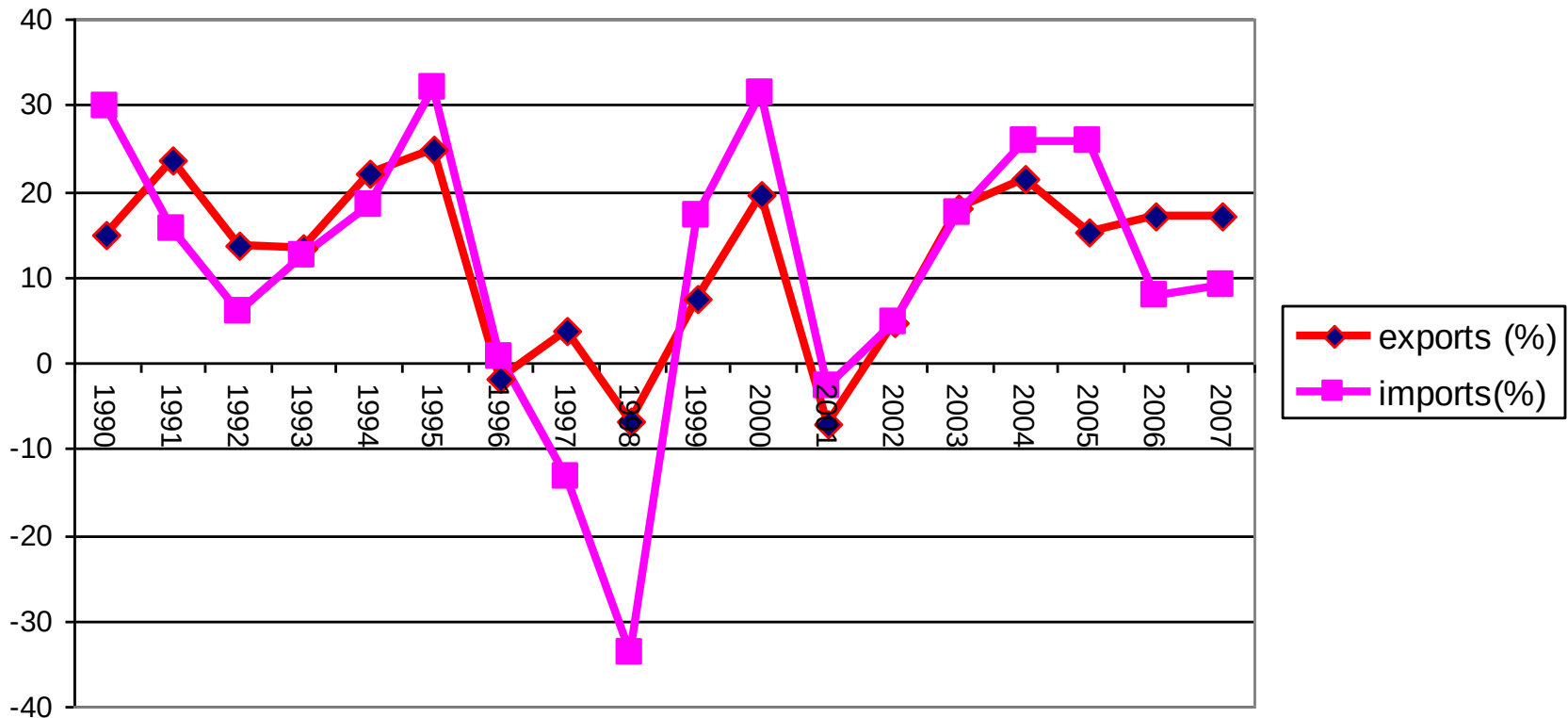


Balance of Trade

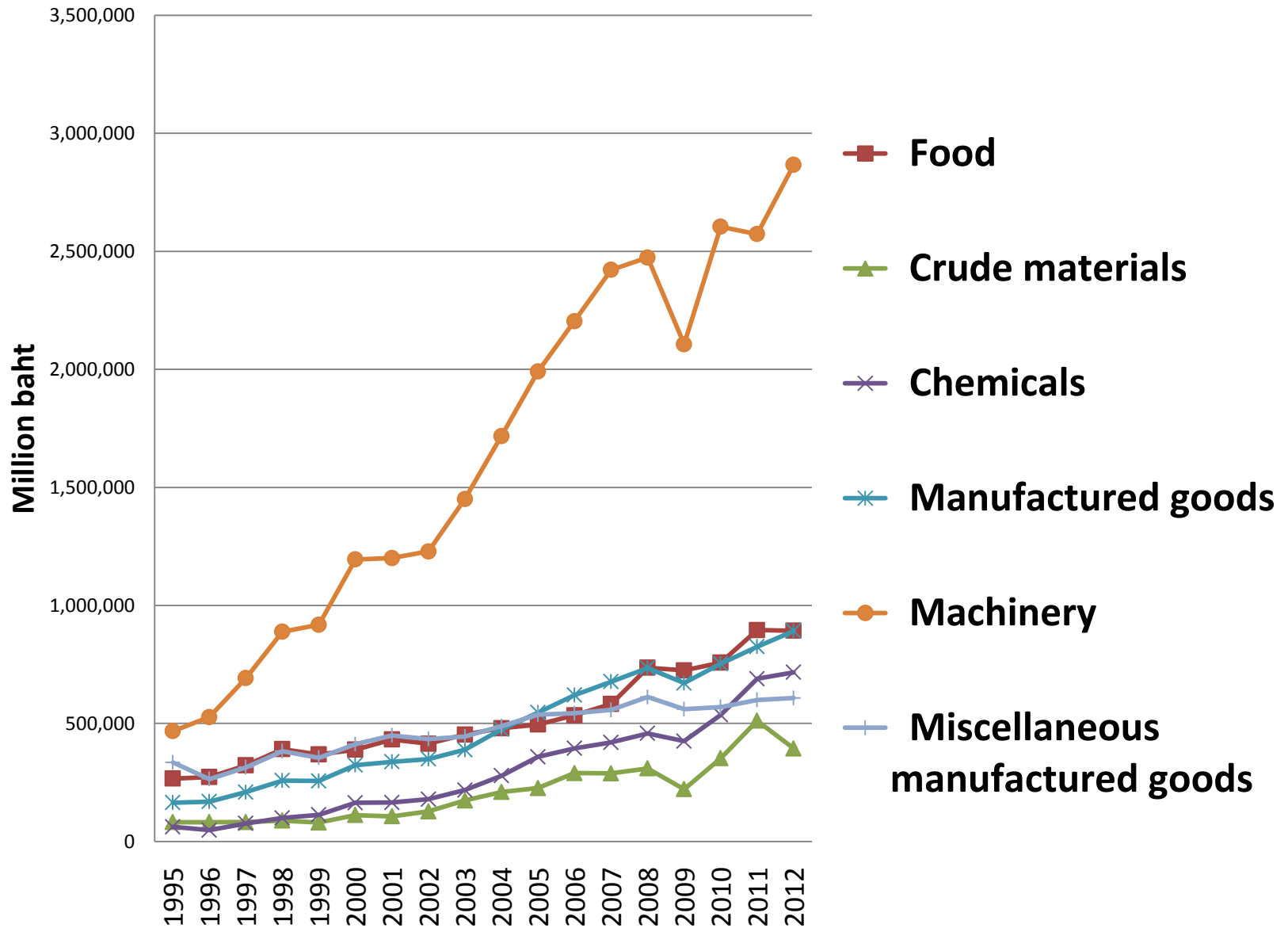


Long-run causal relationship—non spurious

Changes in exports and imports

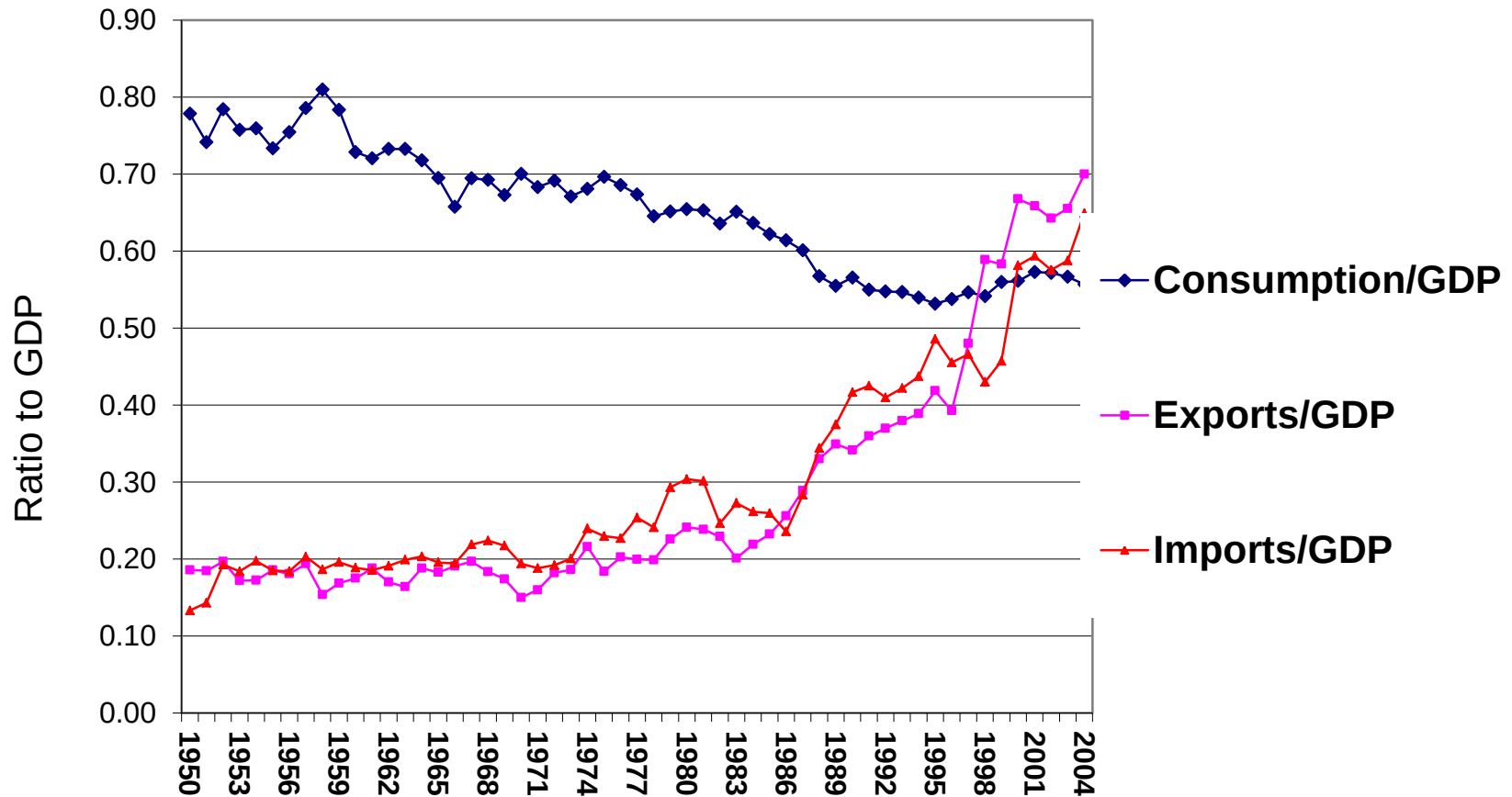


Exports by commodity group

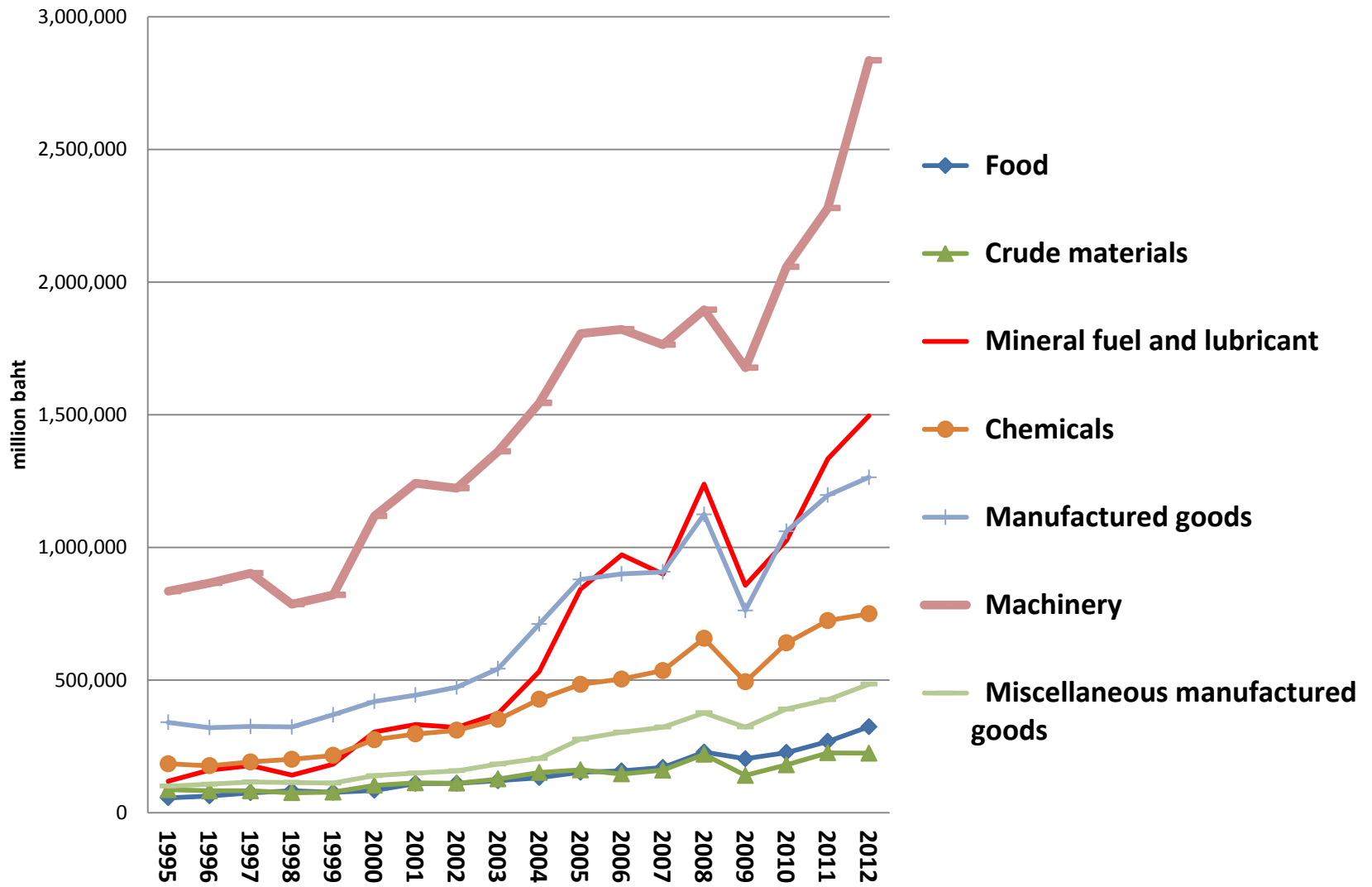


Rising trade dependency

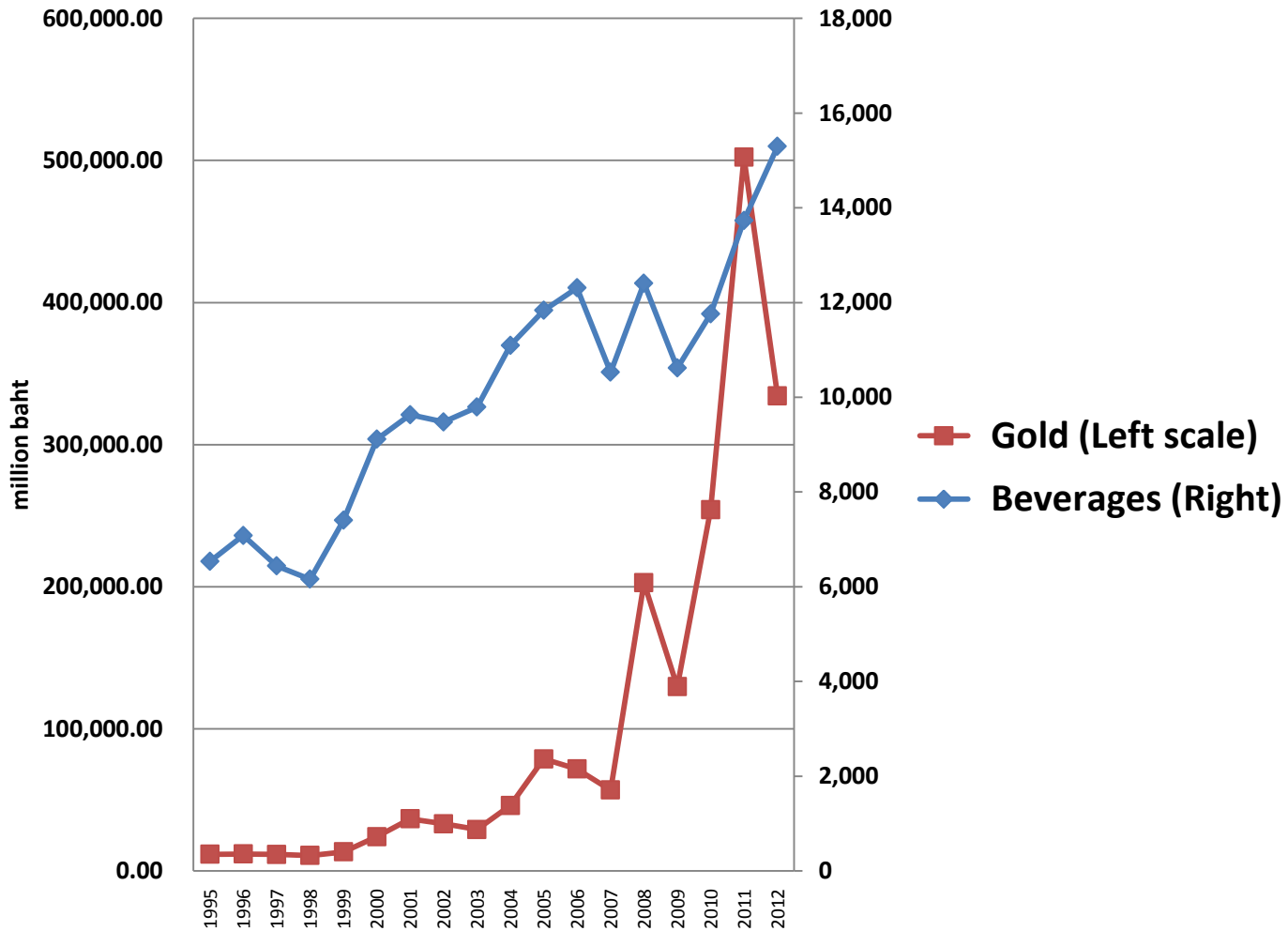
Protrade biased growth



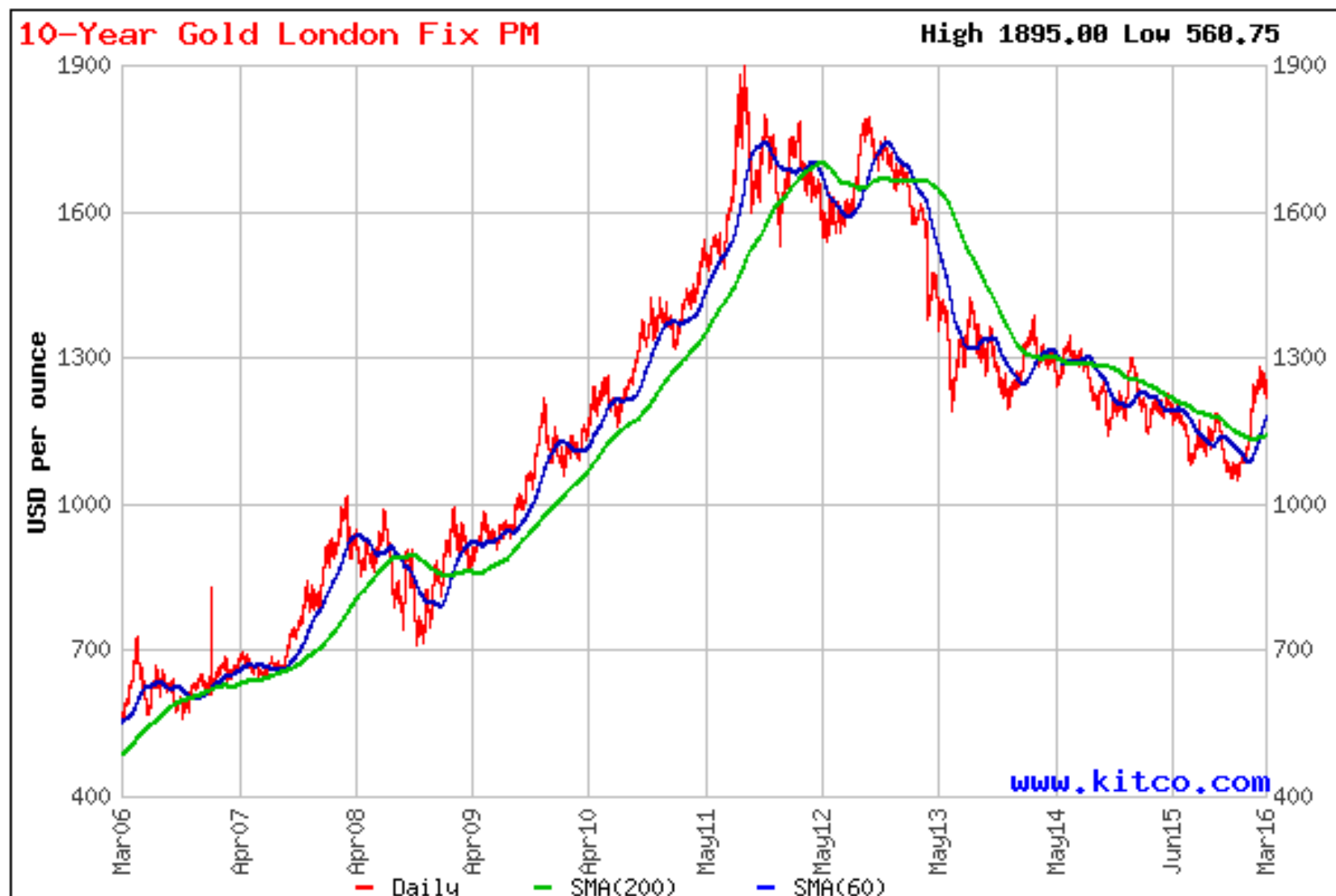
Imports by commodity group



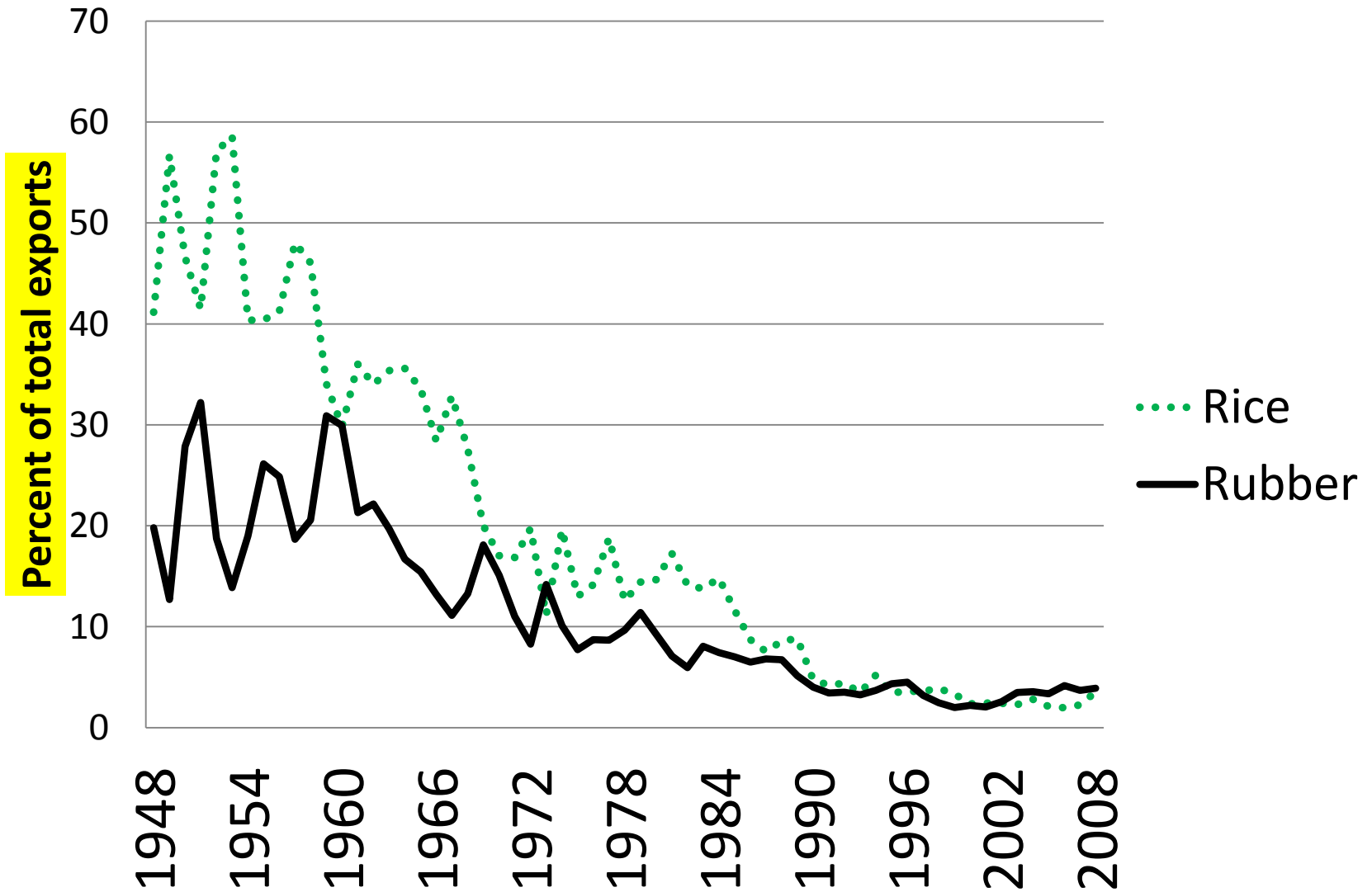
Imports of essential items



10 Year Gold London Fix PM Daily with 60 and 200-day moving averages

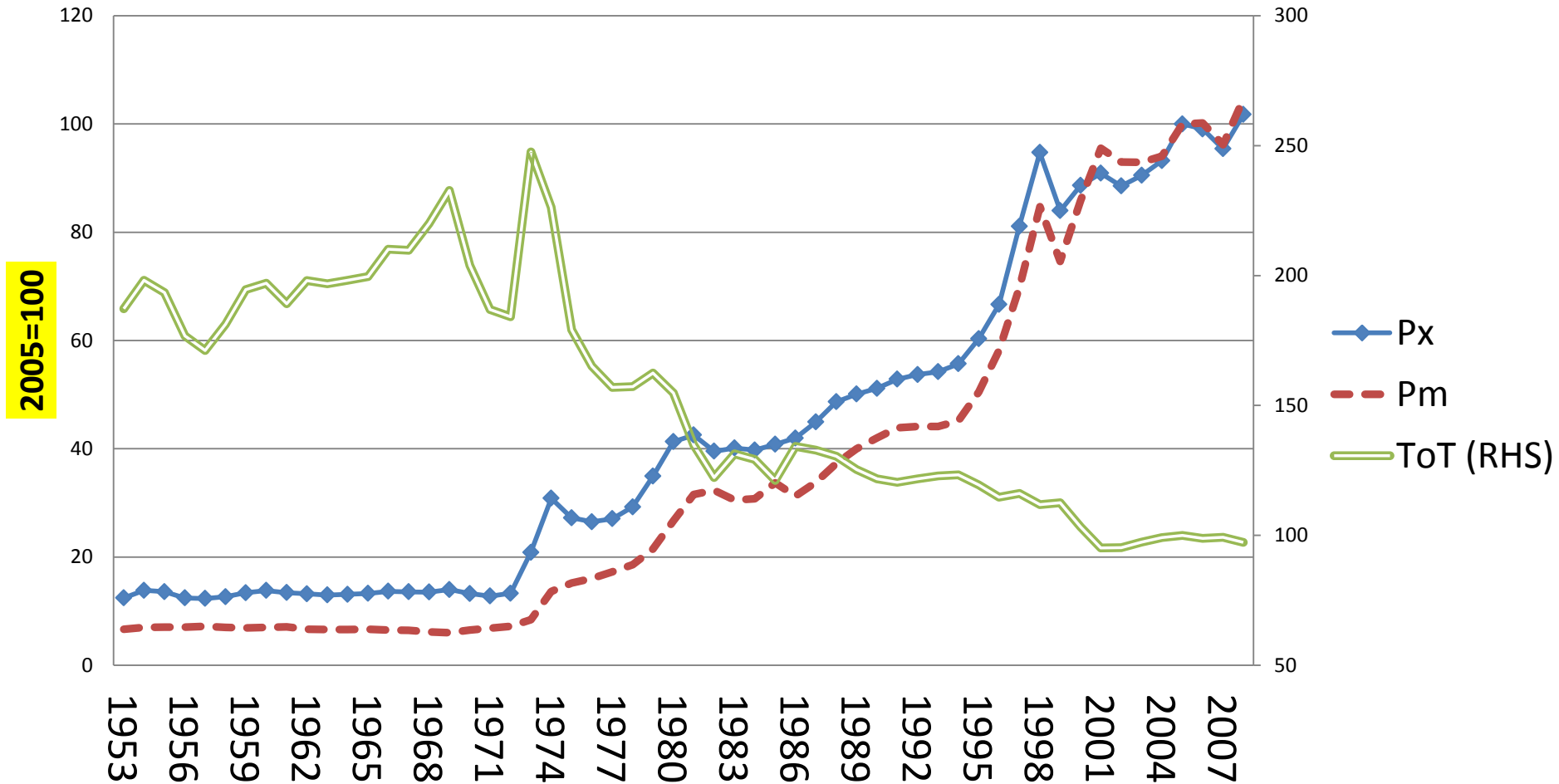


Shares of traditional primary exports



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.

Price in US cents per kilogram: 151.5

As of: Tuesday, March 22, 2016

Source: Singapore Commodity Exchange (SICOM)

Rubber Monthly Price - US cents per Pound

Range

Feb 1986 - Feb 2016: 21.130 (58.84 %)



Description: Singapore Commodity Exchange, No. 3 Rubber Smoked Sheets, 1st contract, US cents per

Rice Monthly Price - US Dollars per Metric Ton

Range

Feb 1986 - Feb 2016: 143.330 (62.32 %)



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.

Malthusian vs. Senian view

- Demand is outpacing supply.
(Thomas Malthus)
- Enough supply but access to food is denied for hungry people. (A.K. Sen)

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.***

Maize (corn) Daily Price

160.63

Maize (corn), U.S. No. 2 Yellow, FOB Gulf of Mexico, U.S. price, US\$ per metric ton

Price in US\$ per bushel: 4.08

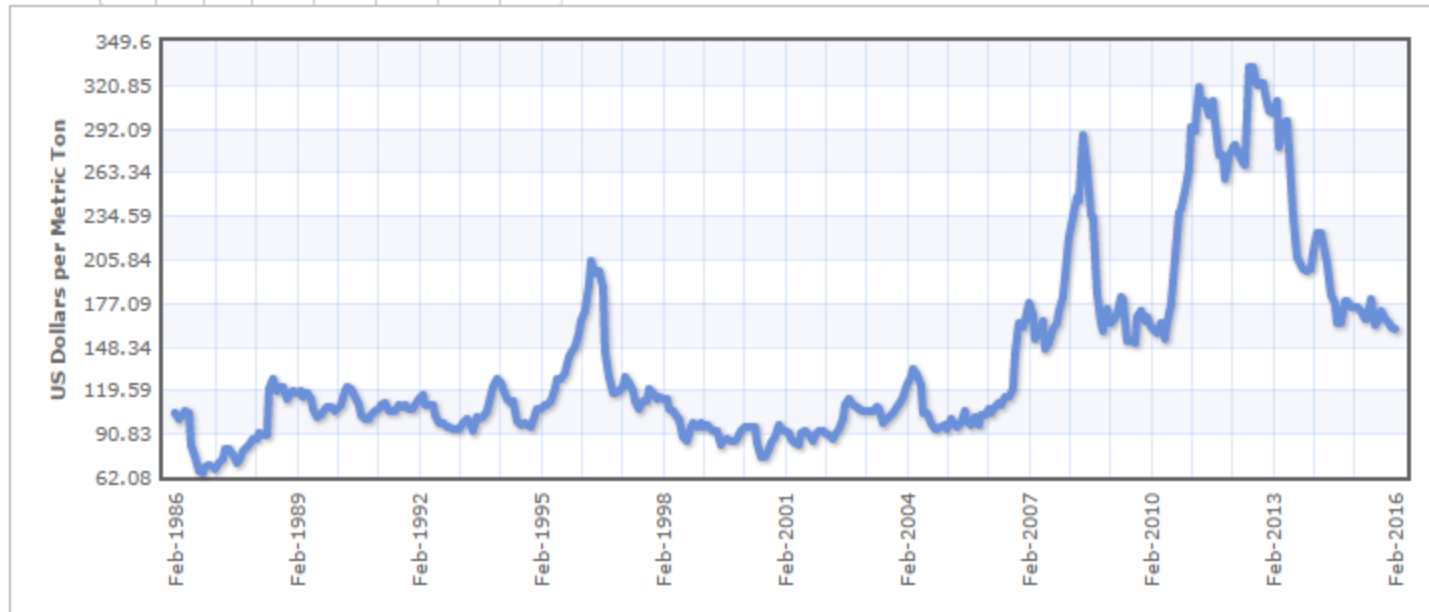
As of: Tuesday, March 22, 2016

Source: USDA Market News

Maize (corn) Monthly Price - US Dollars per Metric Ton

Range

Feb 1986 - Feb 2016: 55.350 (53.05 %)

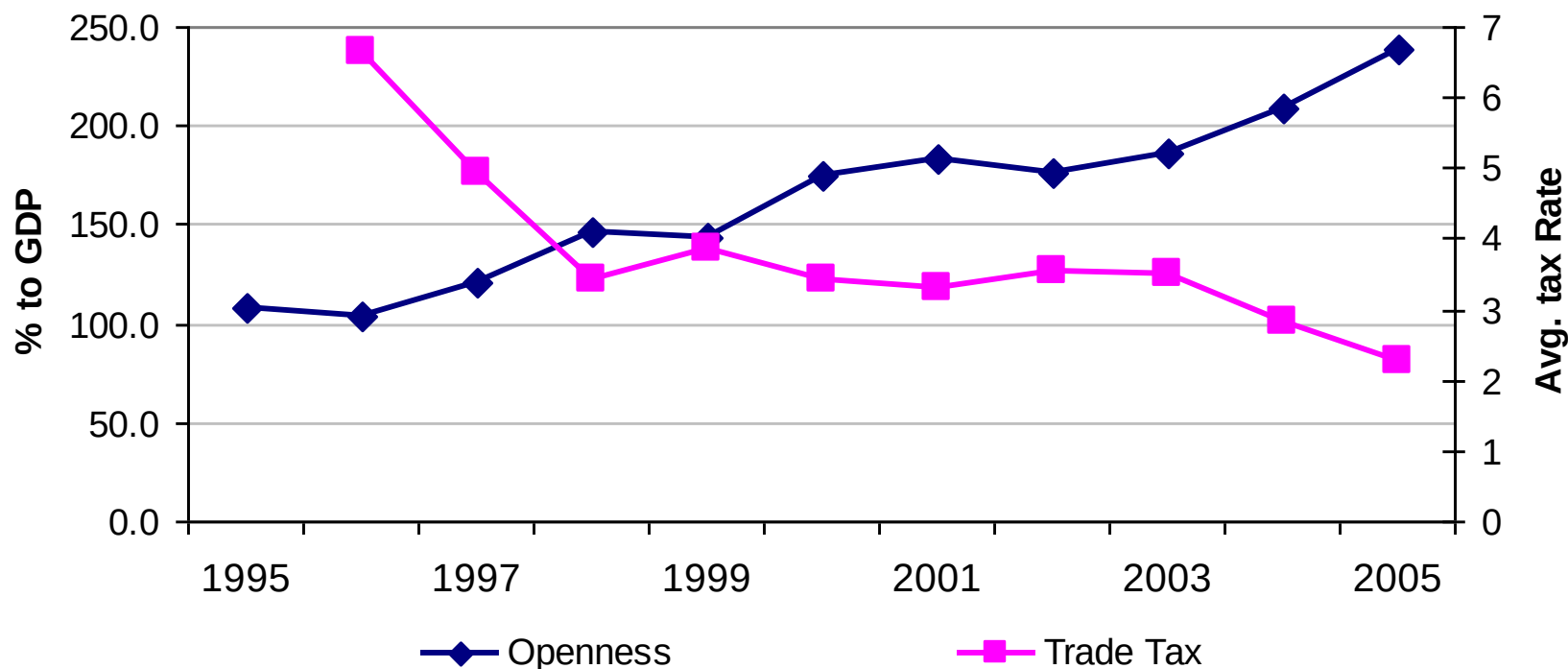


Biofuels

- Added to that was George W Bush's love affair with American biofuels.
- (And what about the Thais' 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.***

Trade reform through tariff reduction

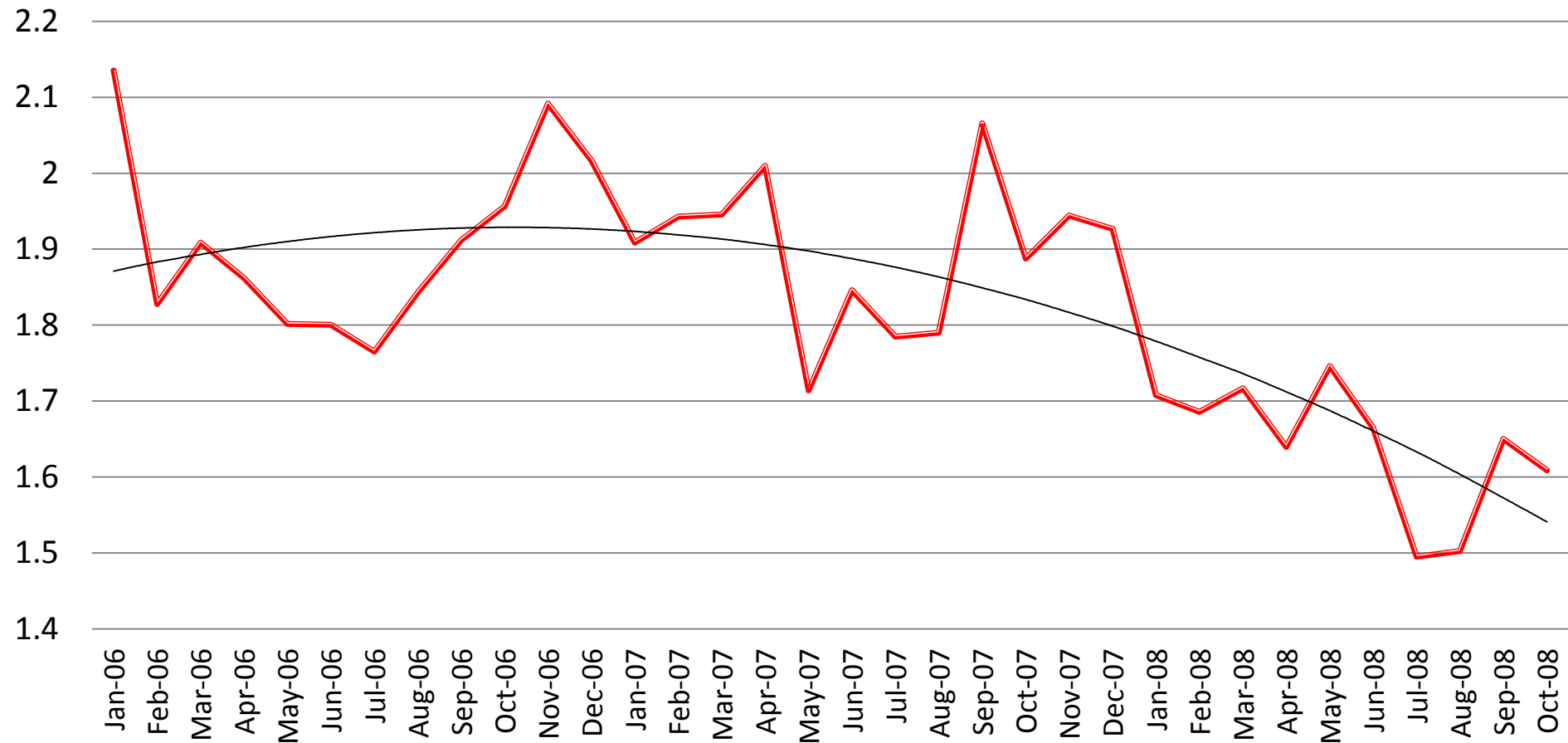
Figure 6.1: Degree of Trade Openness and Avg. Trade Tariff



Source: Bank of Thailand and Customs Department

Thailand's implied tariff rate

customs revenue to total imports(%)



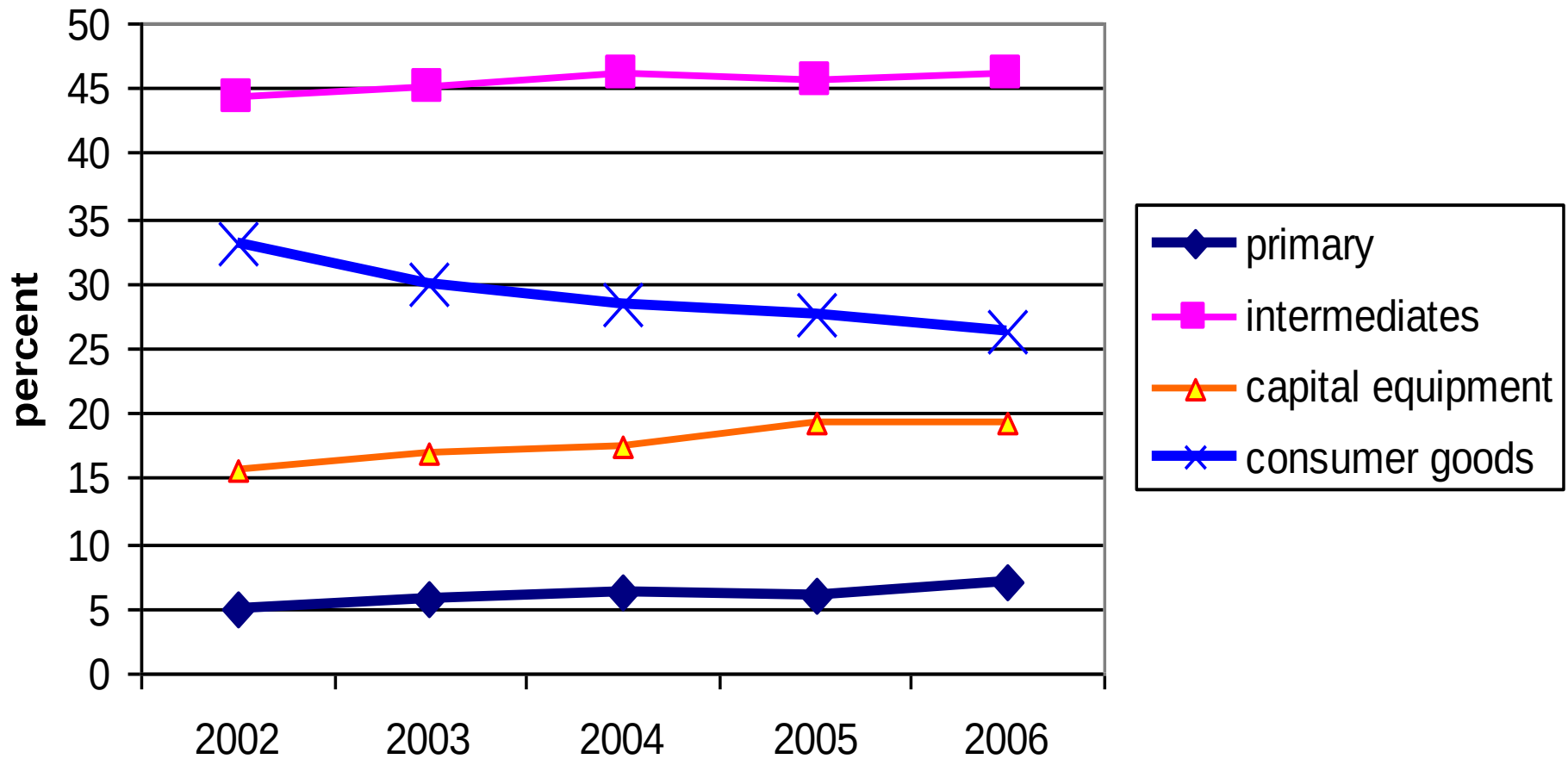
Adverse impact of globalization

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

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

Exports values by stage of procesing



Does the picture change in 2015?

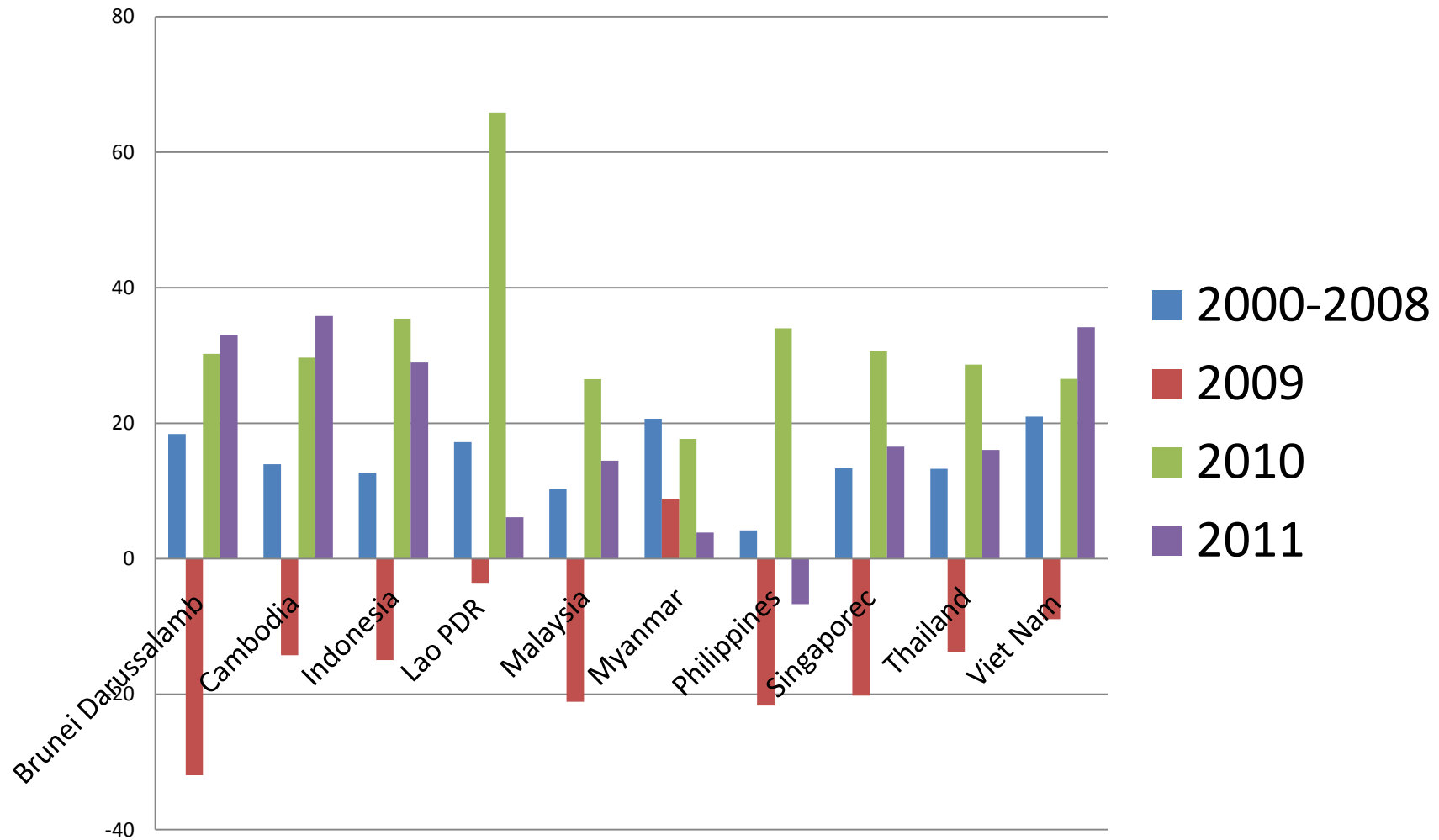
Growing *network trade*

- 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.

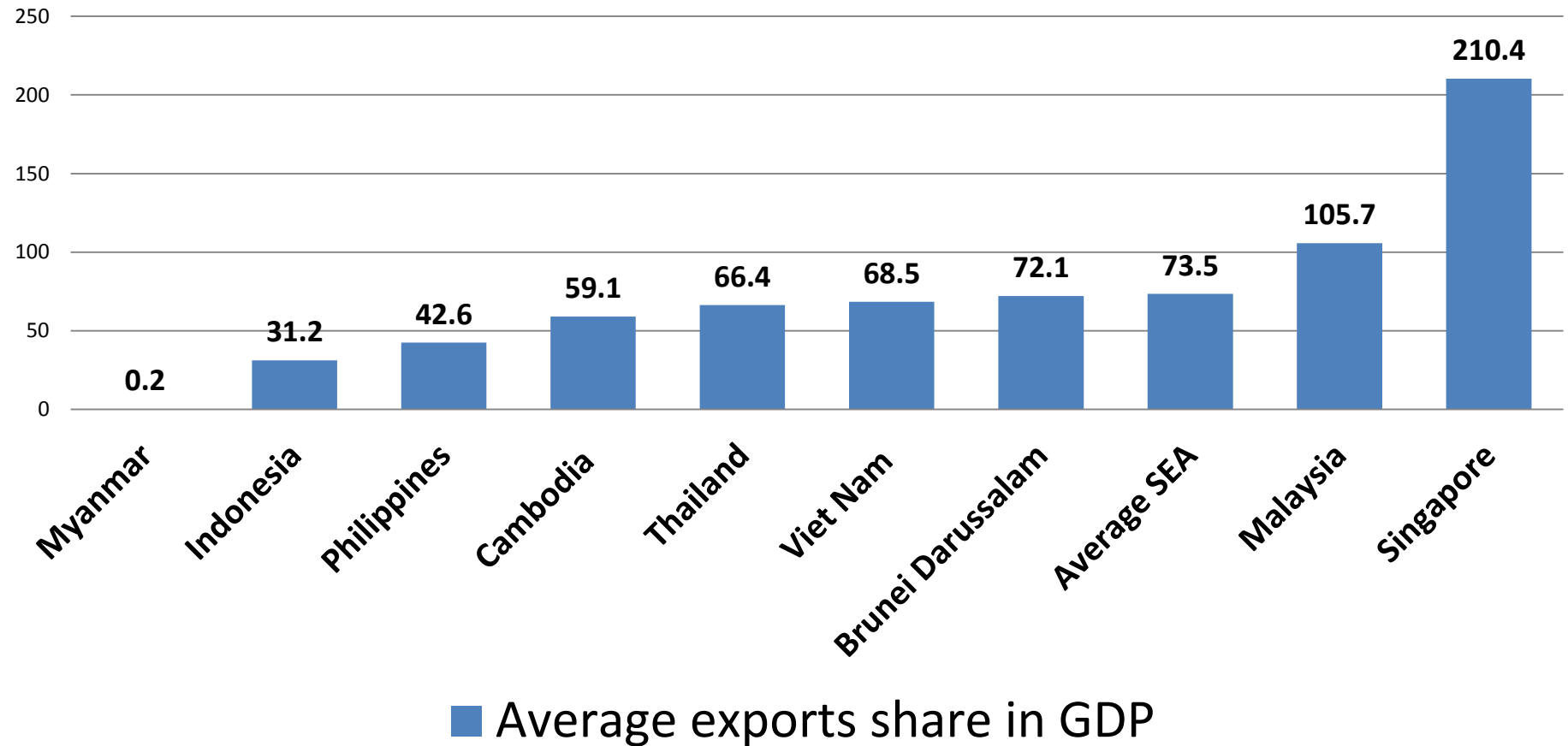
Impact of global slowdown: The Great Deceleration

- 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.

Impact of GFC on Exports (% growth)

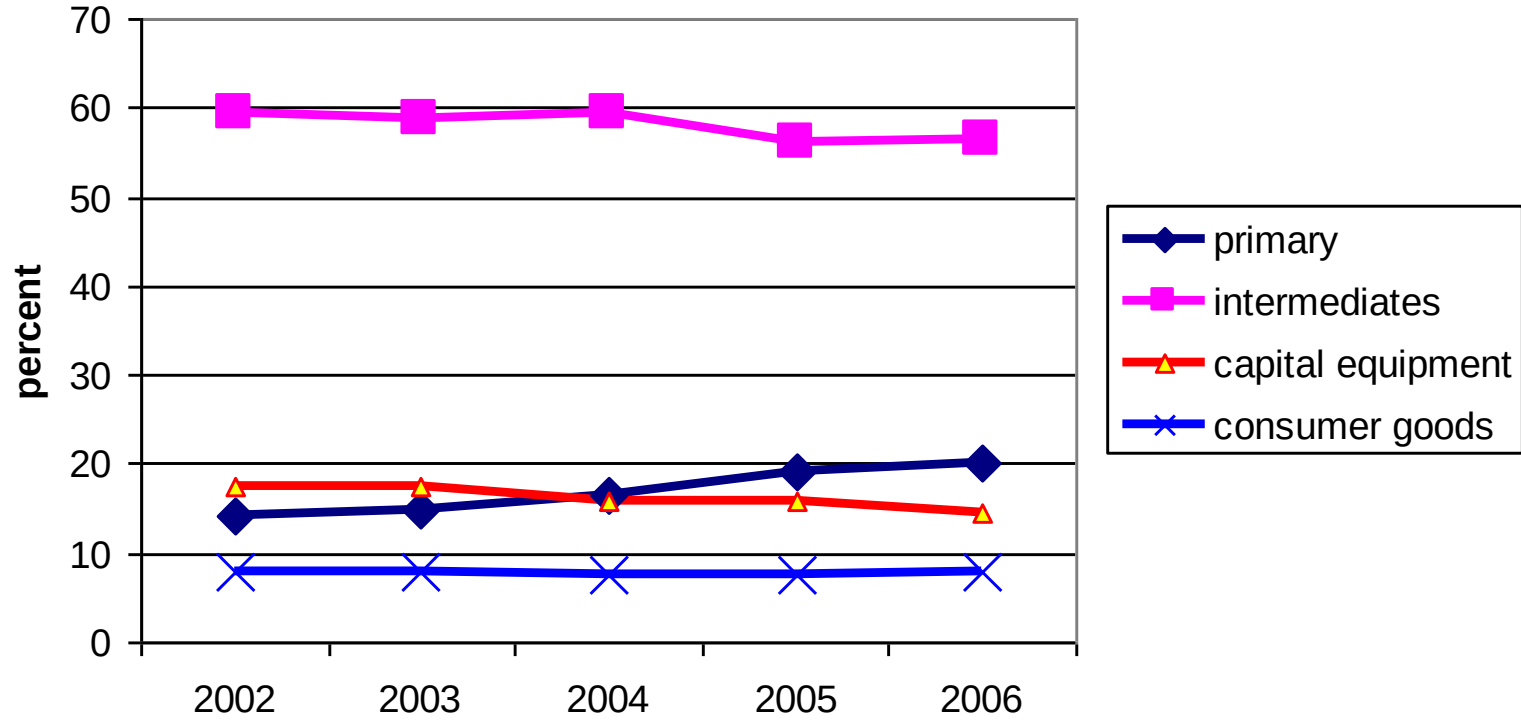


Outward vs. inward oriented Southeast Asian economies: 2000-2011



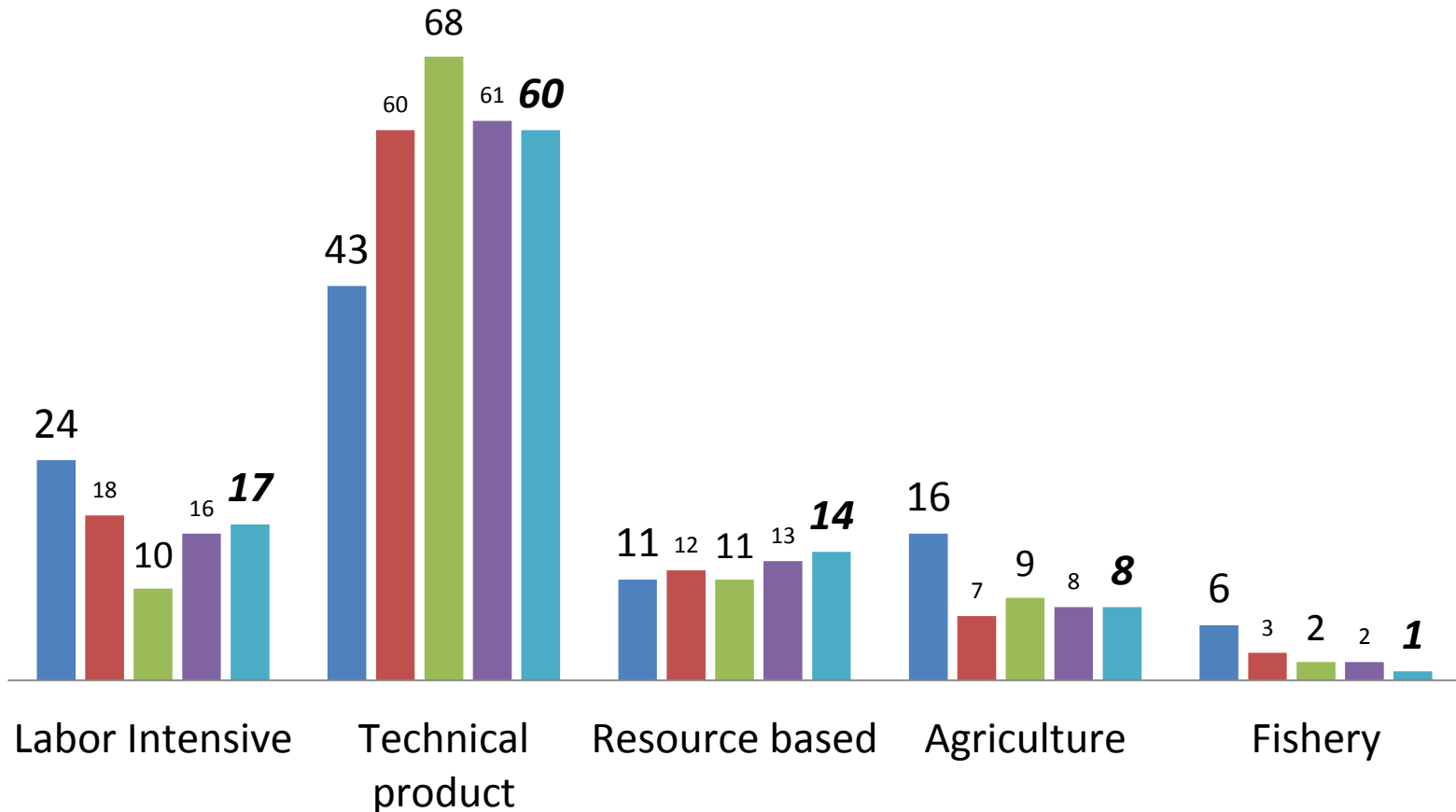
Dependency on raw materials

Imports values by stage of processing



Export share classified by product group

■ 1995 ■ 2000 ■ 2005 ■ 2009 ■ 2012



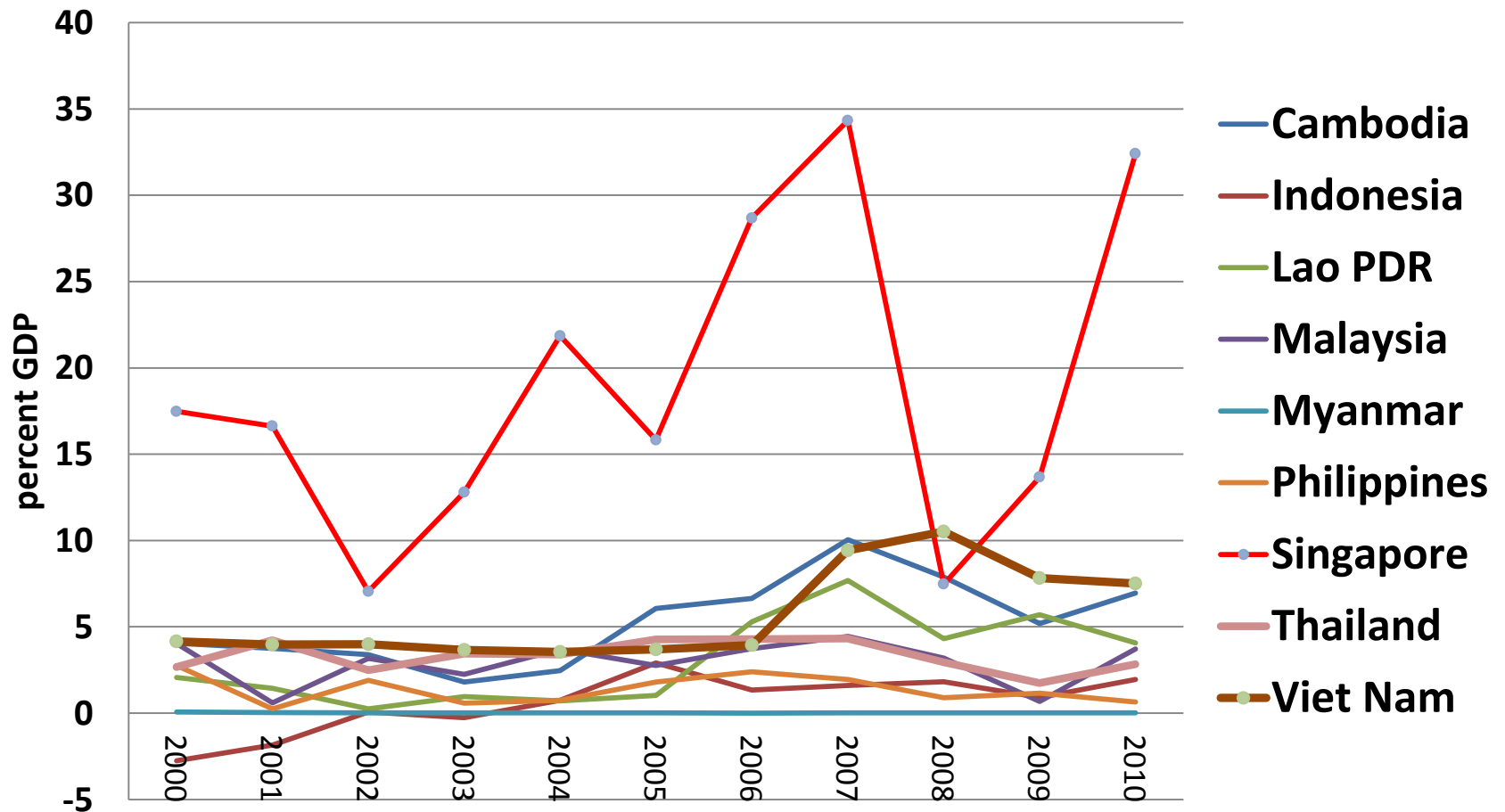
Source of comparative advantage in manufactured goods: Their life cycles

- 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.

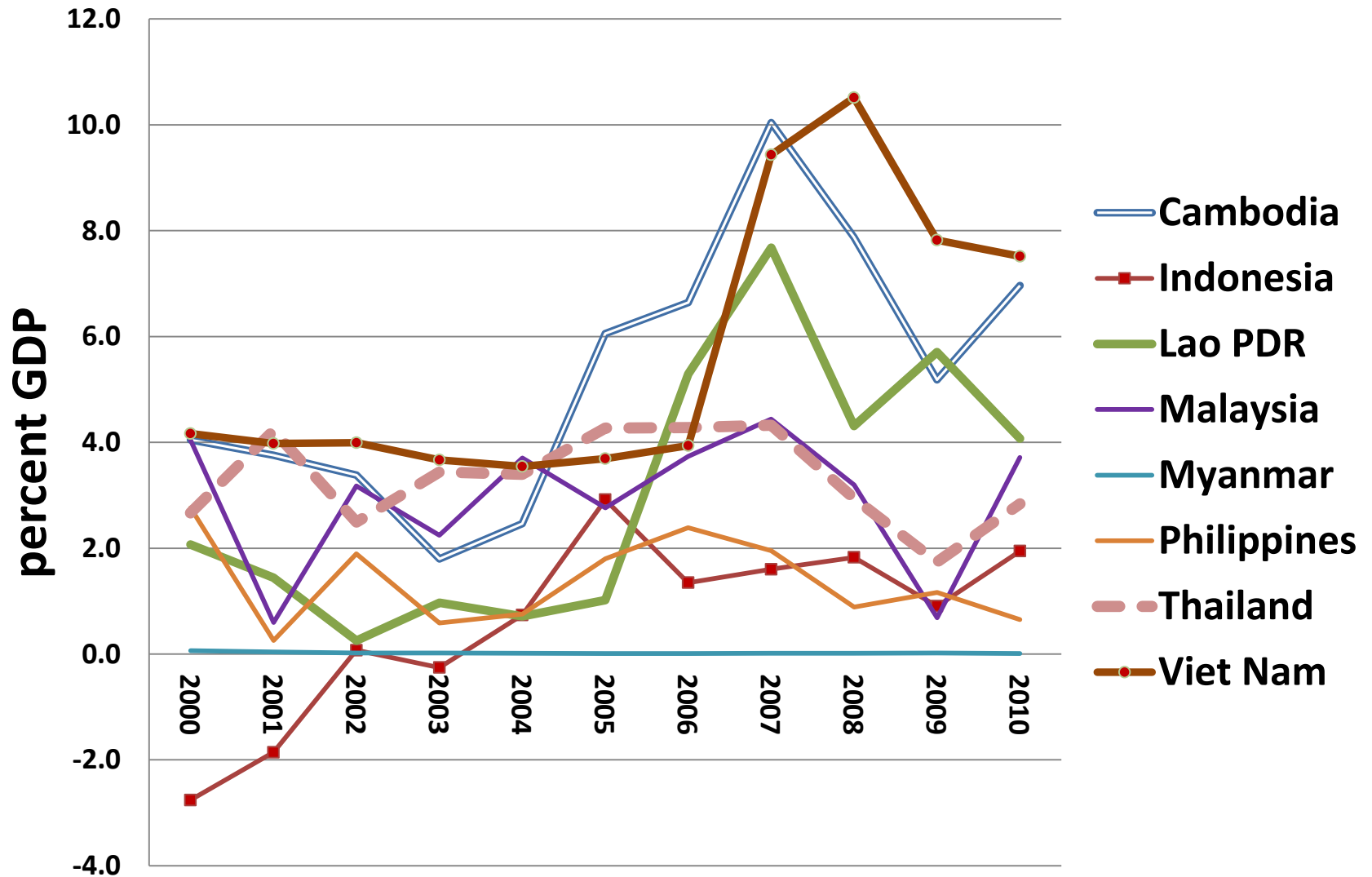
The role of MNCs

- 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 (MNCs).

FDI Inflows



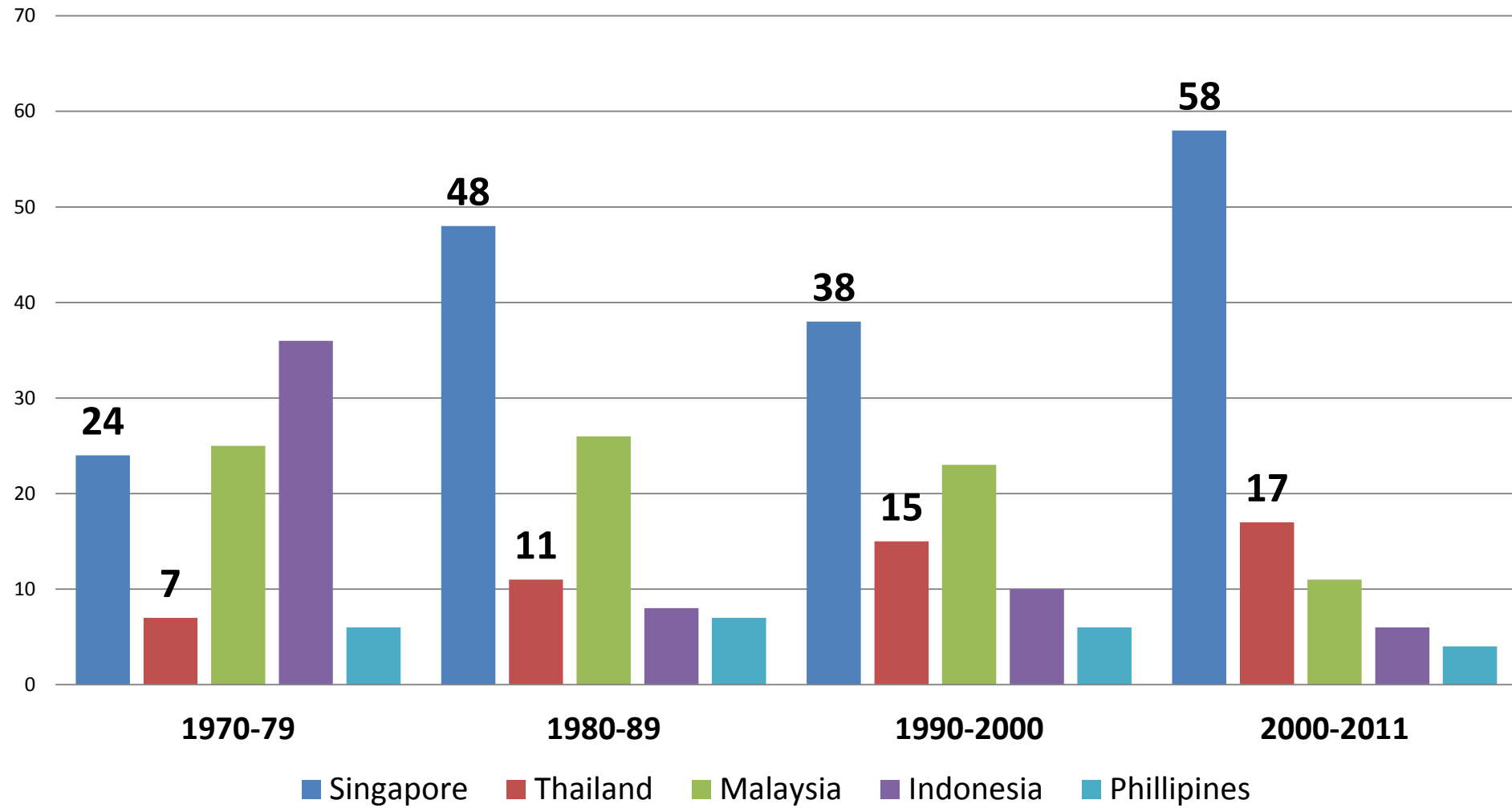
Foreign Direct Investment Inflows



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)

Share of FDI inflows to Southeast Asia



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)

	1992-97 average	2004	%GDP stocks, end of 2004
China	32.8	60.6	14.0
HK	7.8	34.0	277.6
Brazil	6.6	18.2	25.2
Mexico	9.6	16.6	27.0
Singapore	8.3	16.1	150.2
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

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

Ranking of business climate In Southeast Asia: 2012

Singapore	1
Malaysia	12
Thailand	18
Brunei	80
Vietnam	99
Indonesia	128
Cambodia	133
Philippines	138
Laos	163

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 integration:** 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

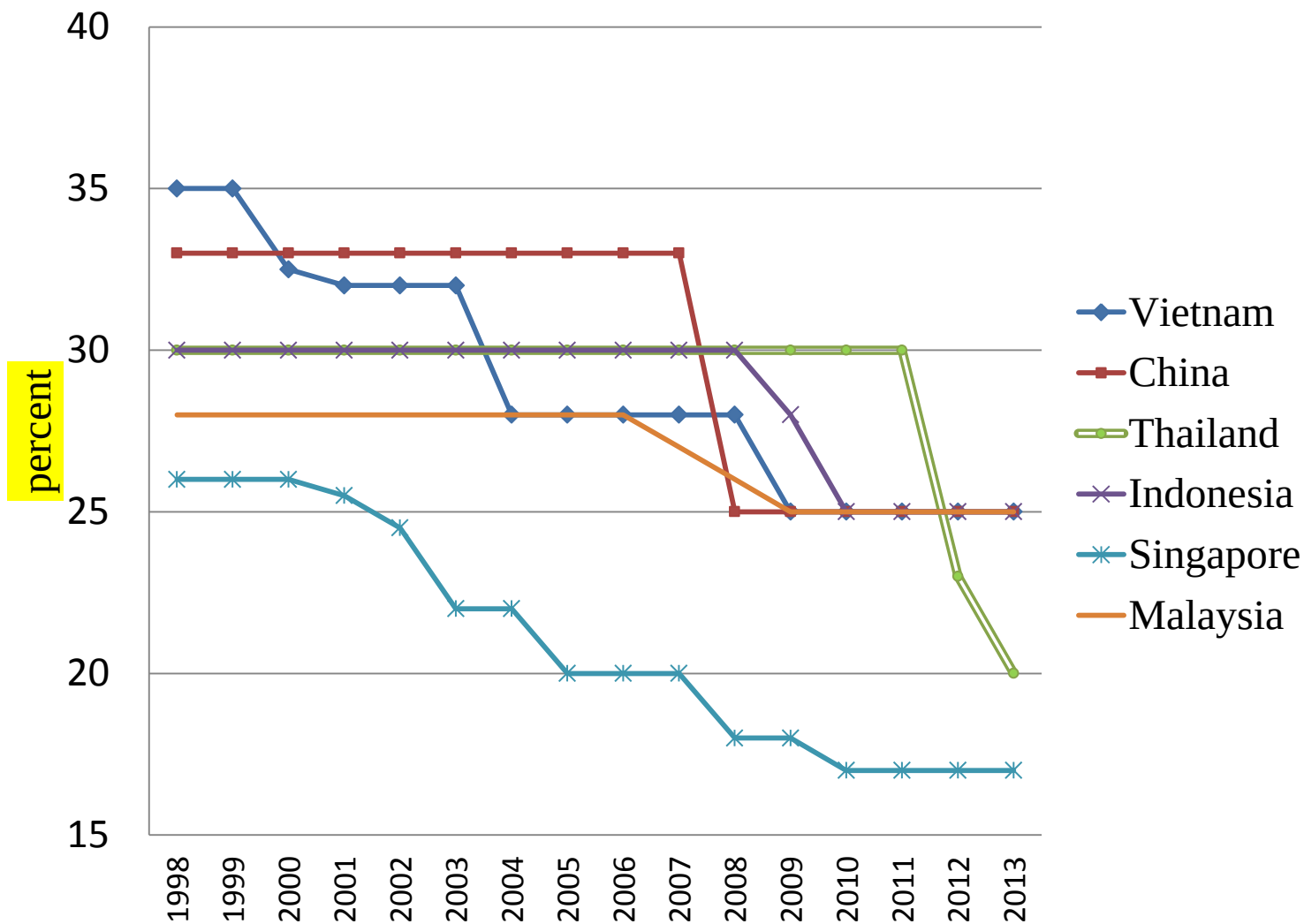
Social costs

- 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 rate: average

	1998	2006
Vietnam	32.5	28
US	40	40
Japan	51.6	40.7
China	33	33
HK	16.5	17.5
Thailand, Indonesia	30	30
Mexico	34	29
Singapore	26	20
Malaysia	28	28

Corporate Income Tax Rates



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 lack of FDI implies low rate of technological adoption and hence lower standard of living.
- The rise of production sharing is a major structural shift in the world trade.

Conclusions

- Thailand is befitting from participation in network trade and the rapid recovery of exports in Japan and China in 2010.
- Impact of GFC on Southeast Asian economies depend on export dependency of each country and trade intensity among them.

Further questions

- What would be the impacts of the war on corporate income tax cut?
- What will be the impact of the Great Deceleration in 2016?
- Explain why network trade can lead to business cycle synchronization in Asia?