

EE460: Trade and Foreign Direct Investment

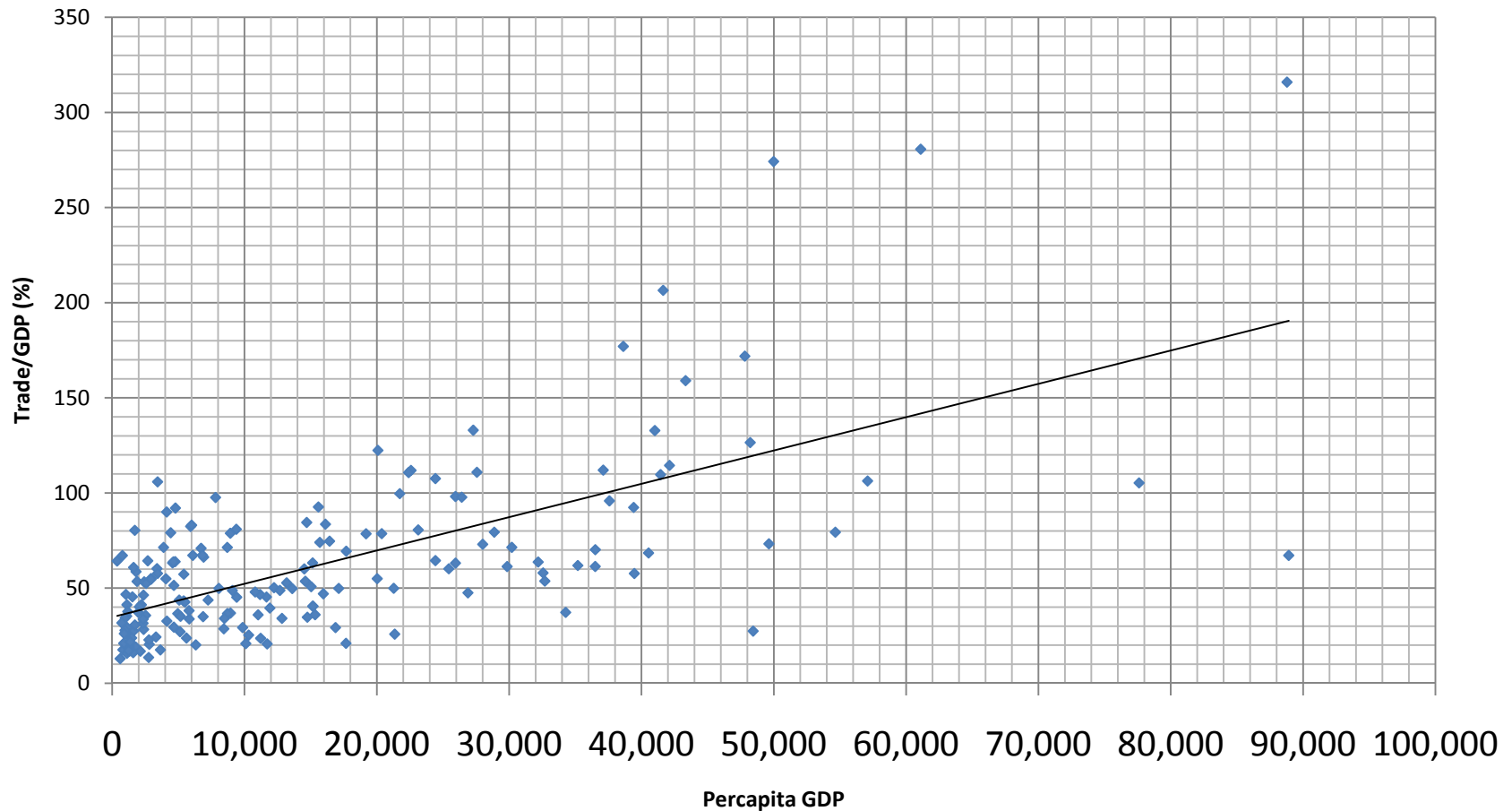
Bhanupong
Lecture 18

*“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.***

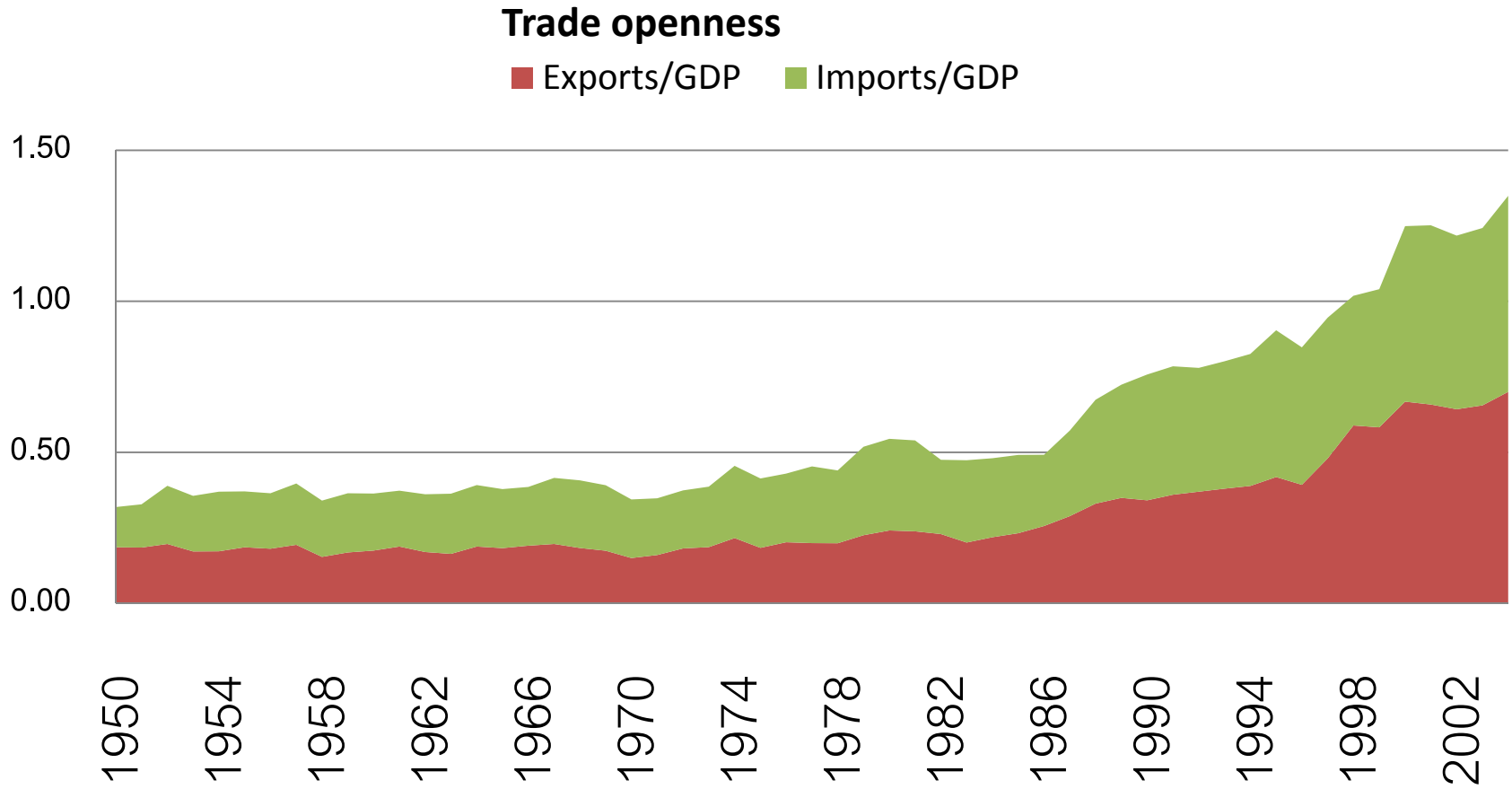
Main themes

- Trade and development
- Trade liberalization
- Food crisis and trade
- Theories explaining FDI Trade structure
- GFC and world trade

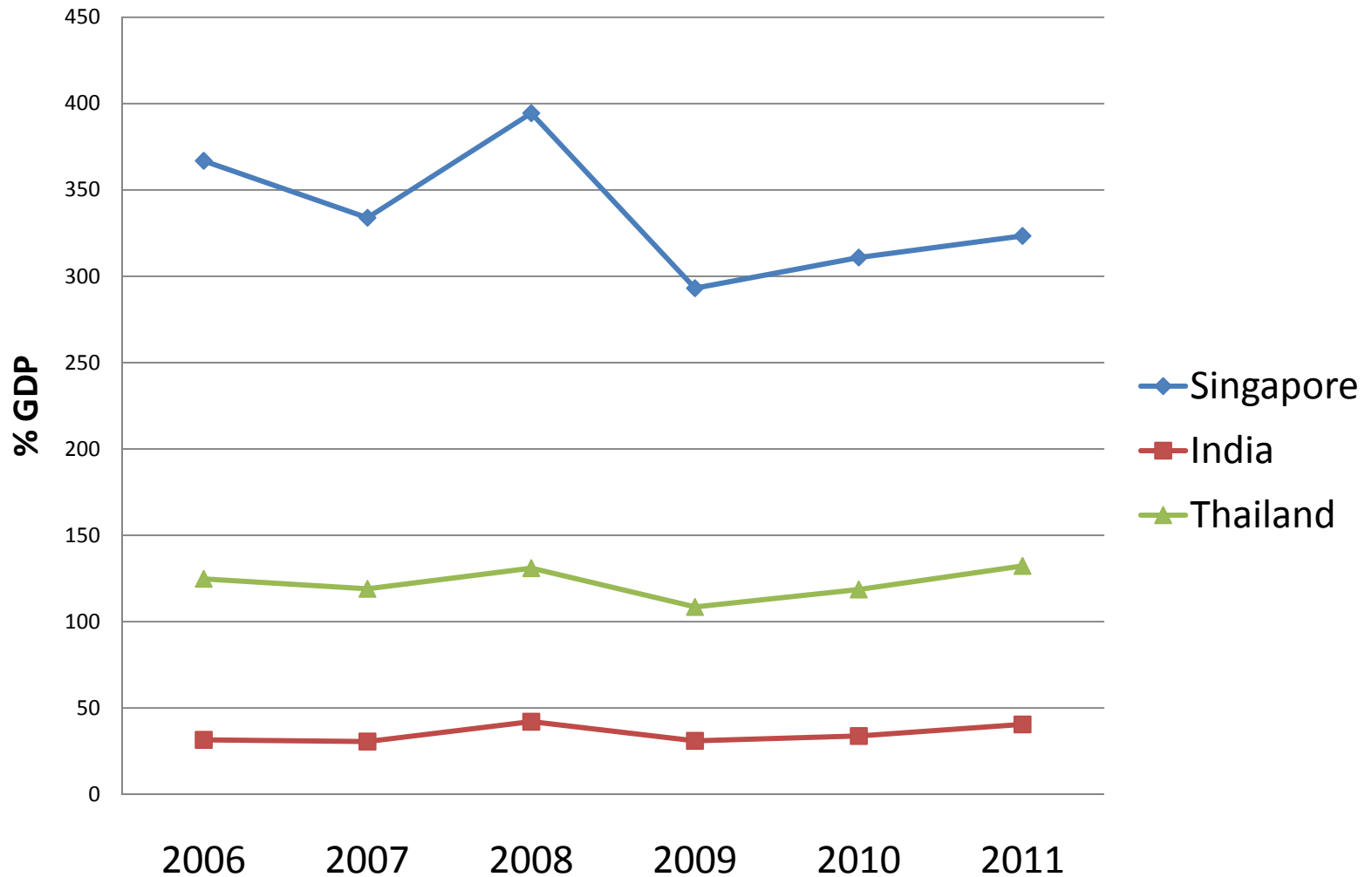
Trade and Development: Average values from 2009 to 2011



Rising importance of trade sector 1950-2000

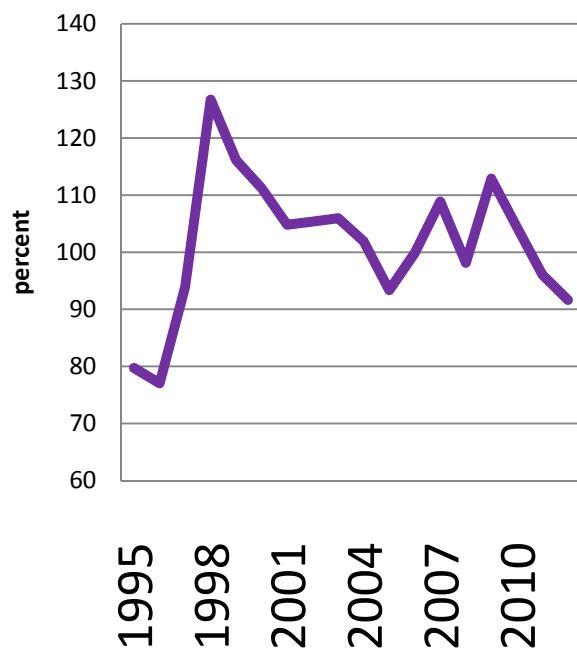


Trade Openness: Giant economy and city state

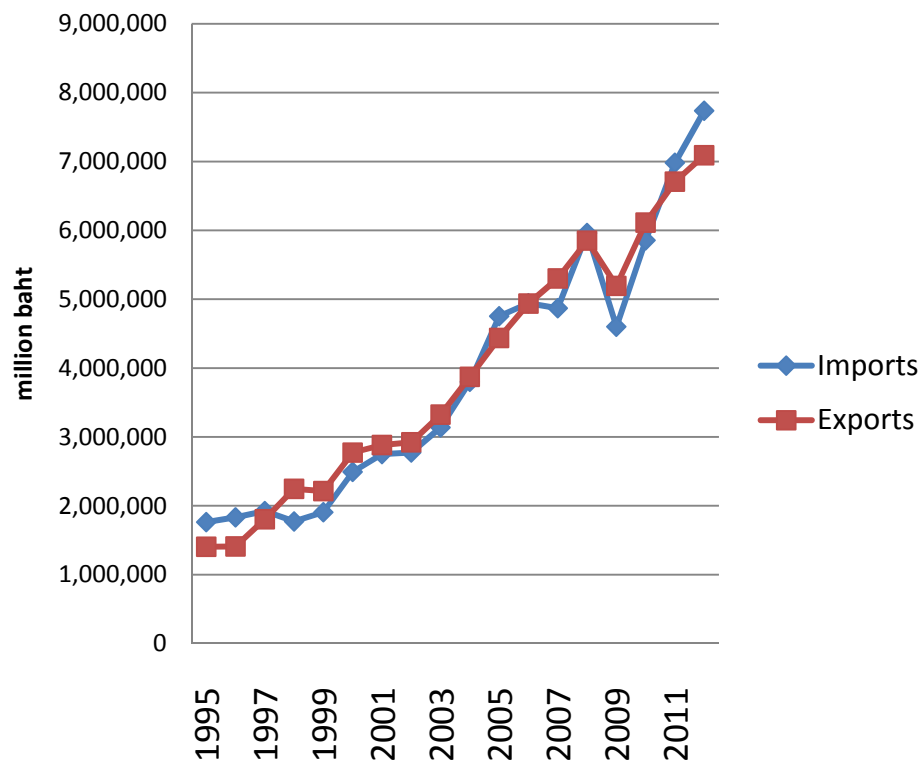


Thailand's external trade

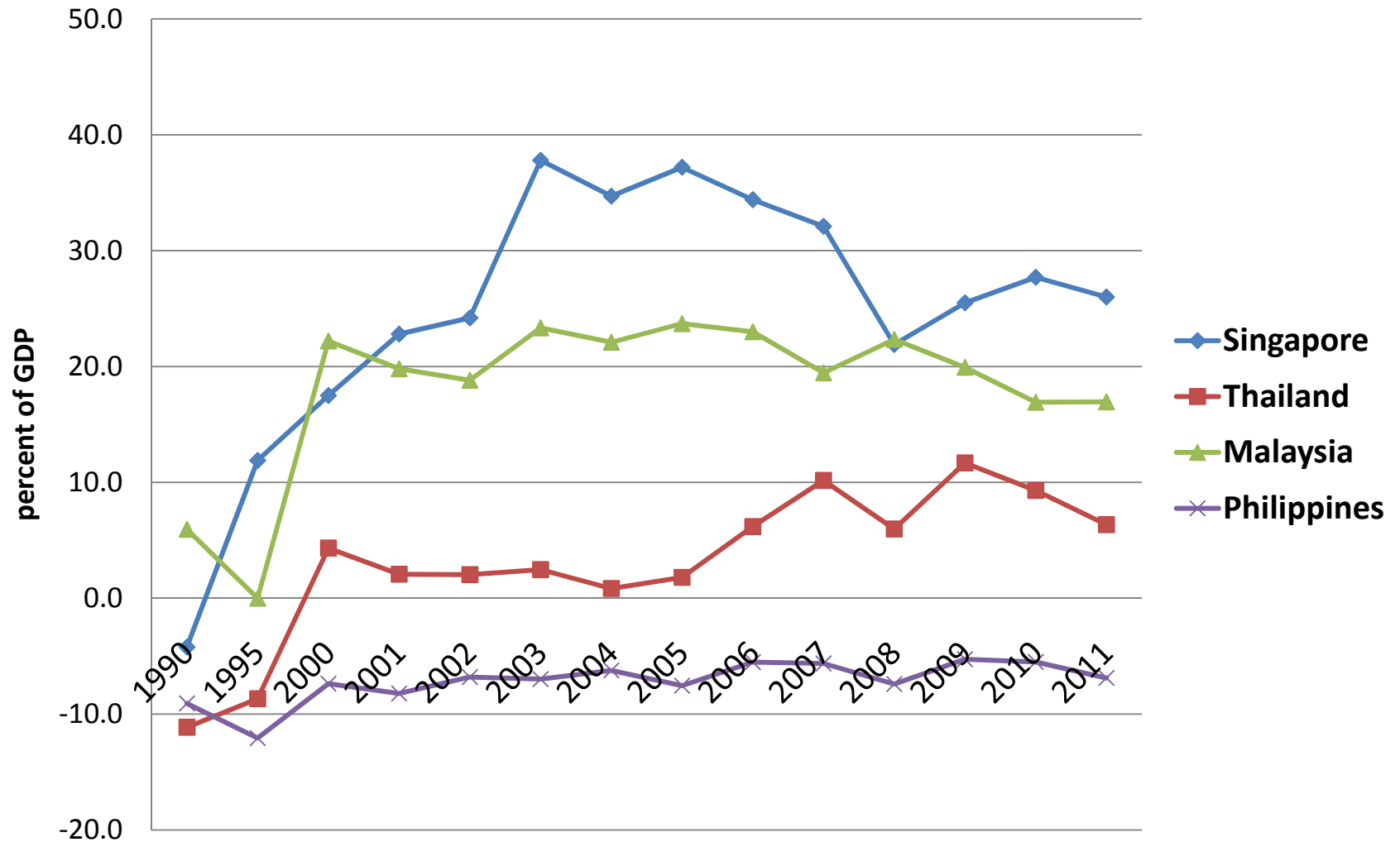
Export-import ratio



Exports and Imports

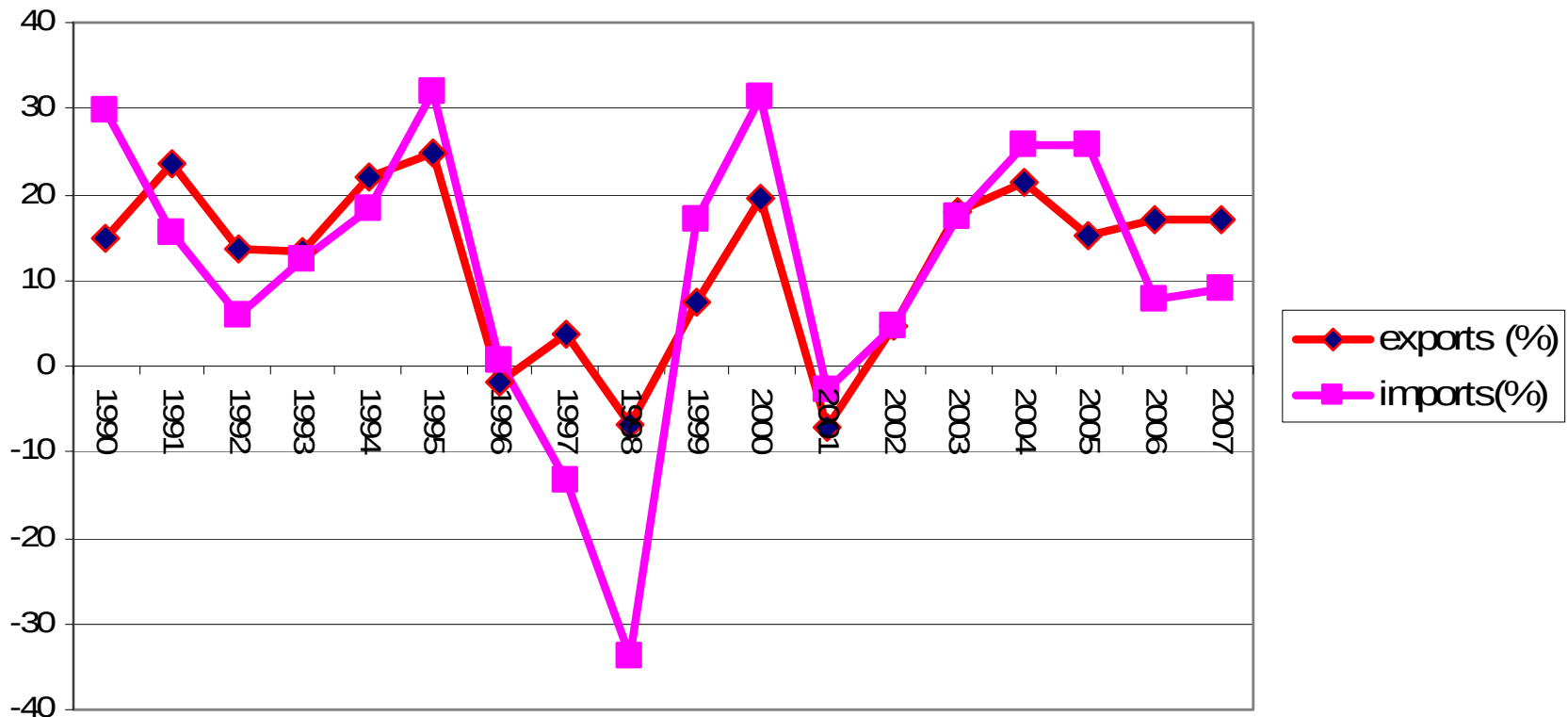


Balance of Trade

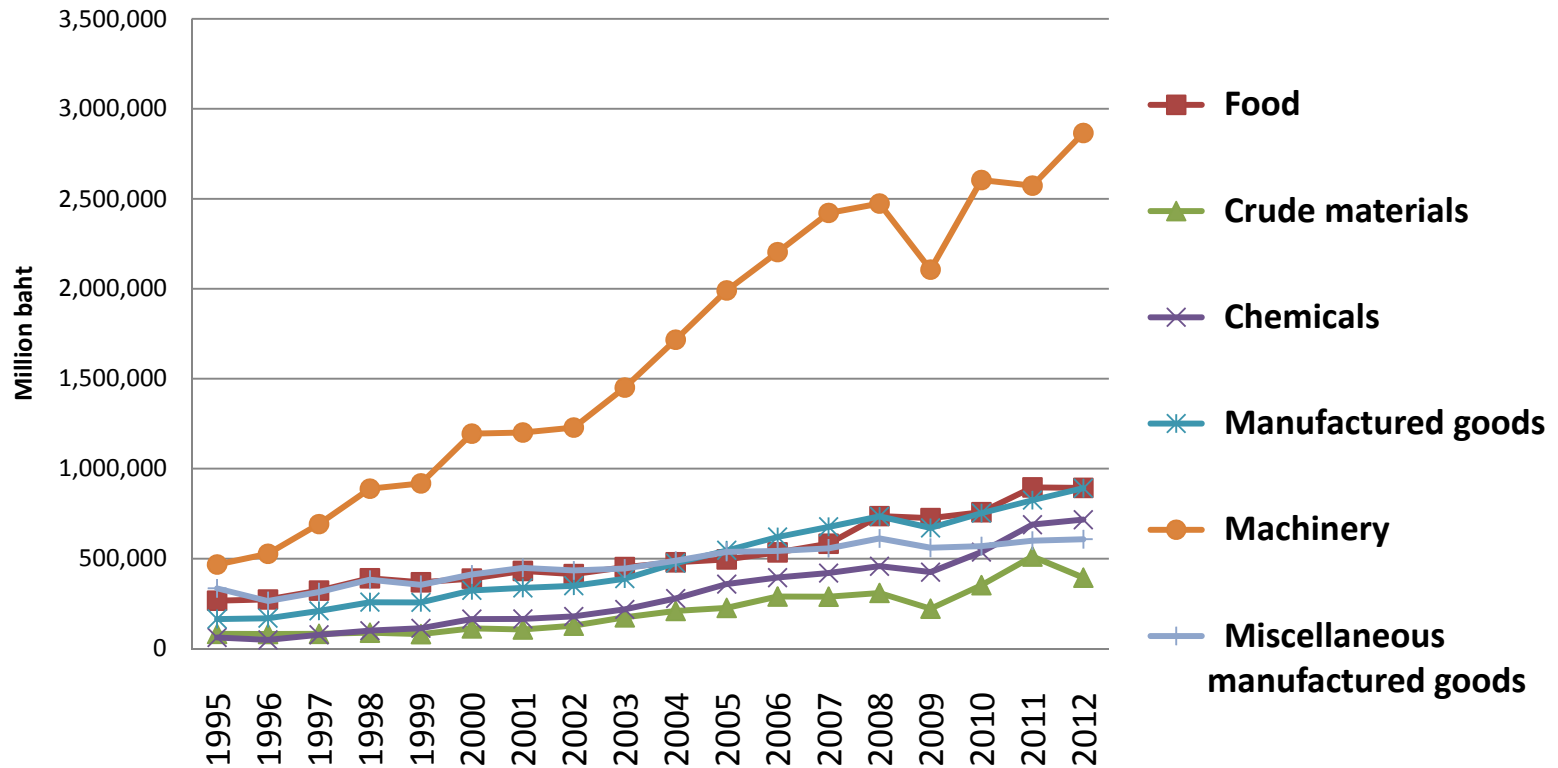


Long-run causal relationship—non spurious

Changes in exports and imports

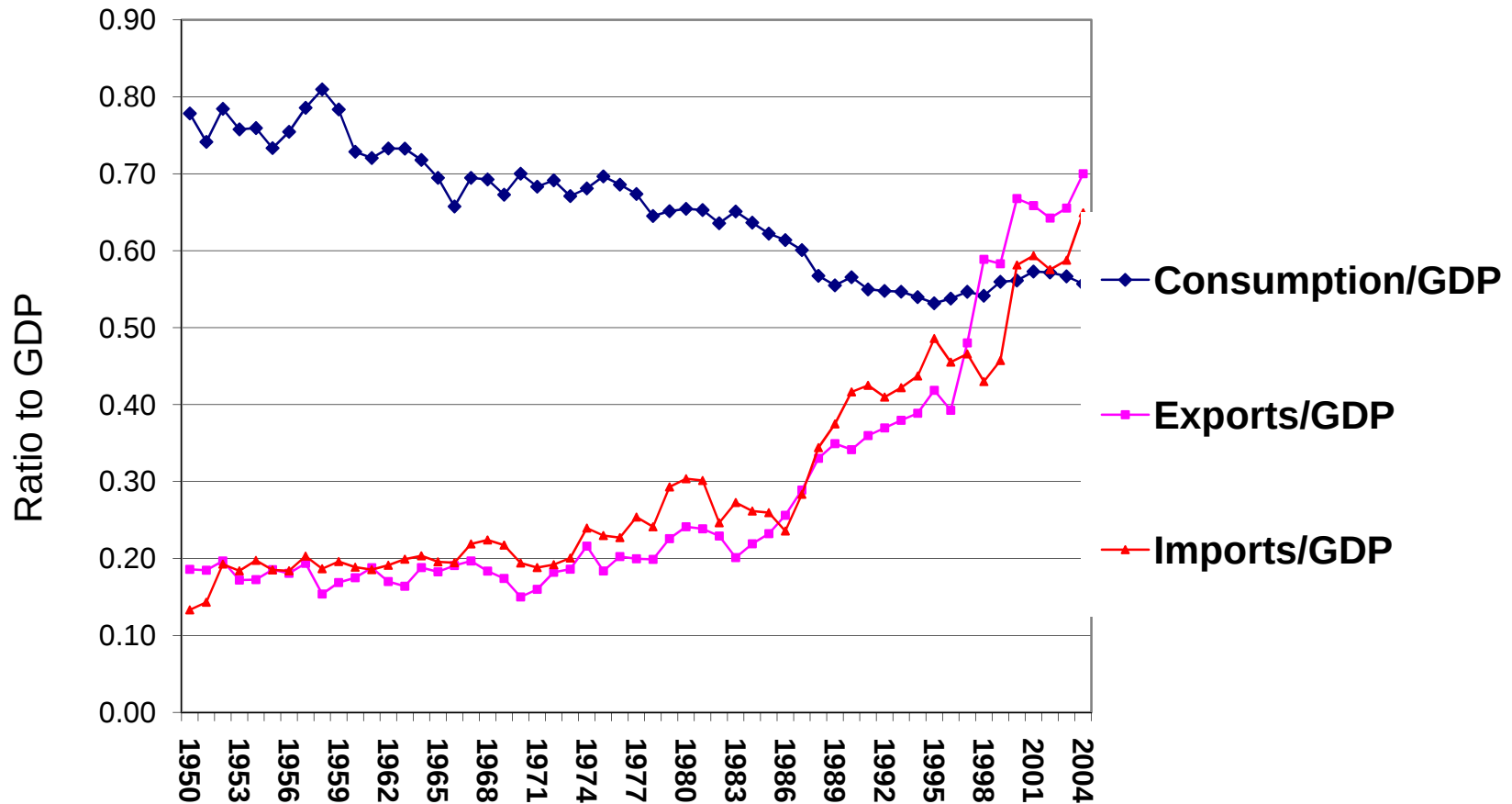


Exports by commodity group

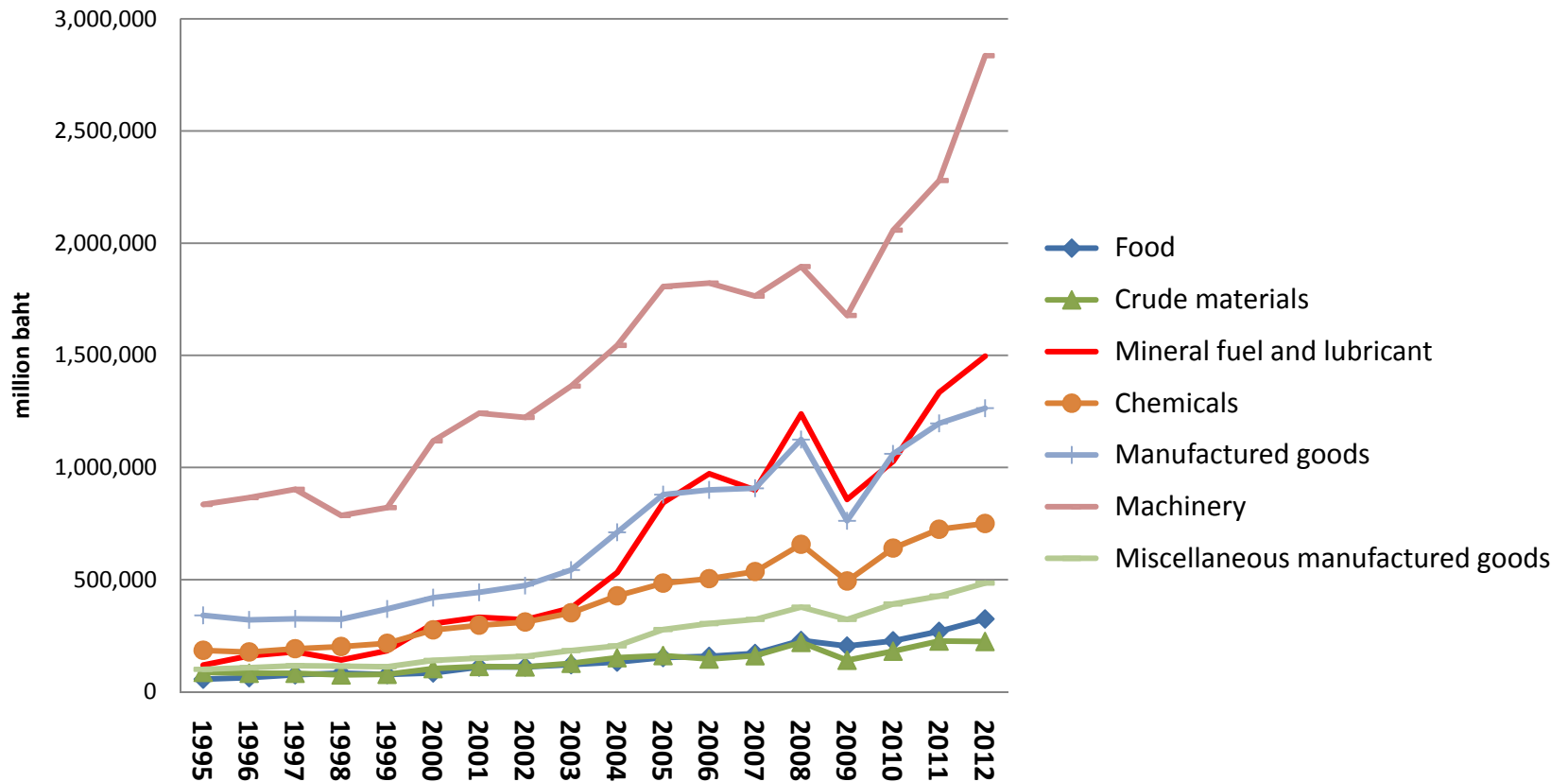


Rising trade dependency

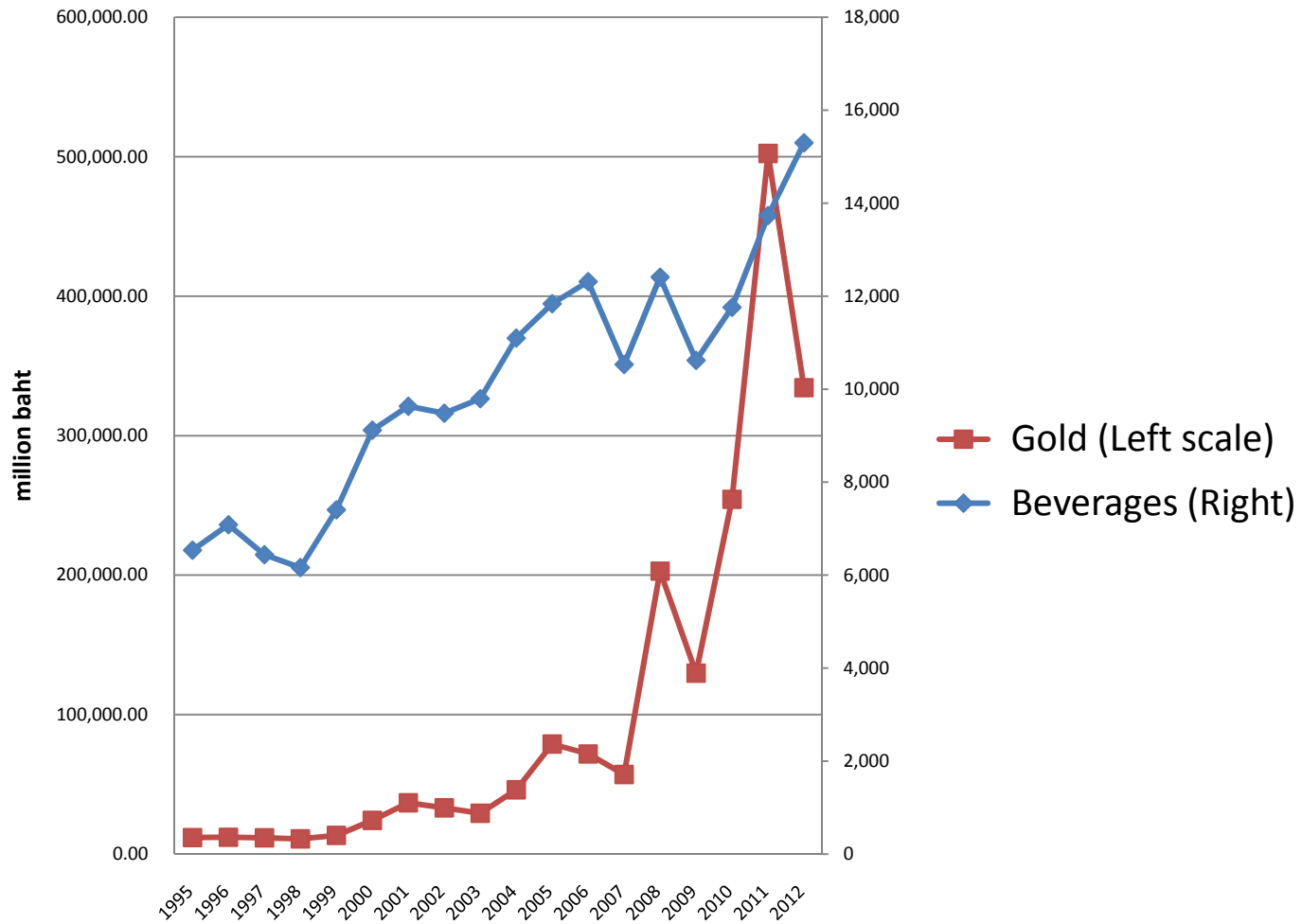
Protrade biased growth



Imports by commodity group

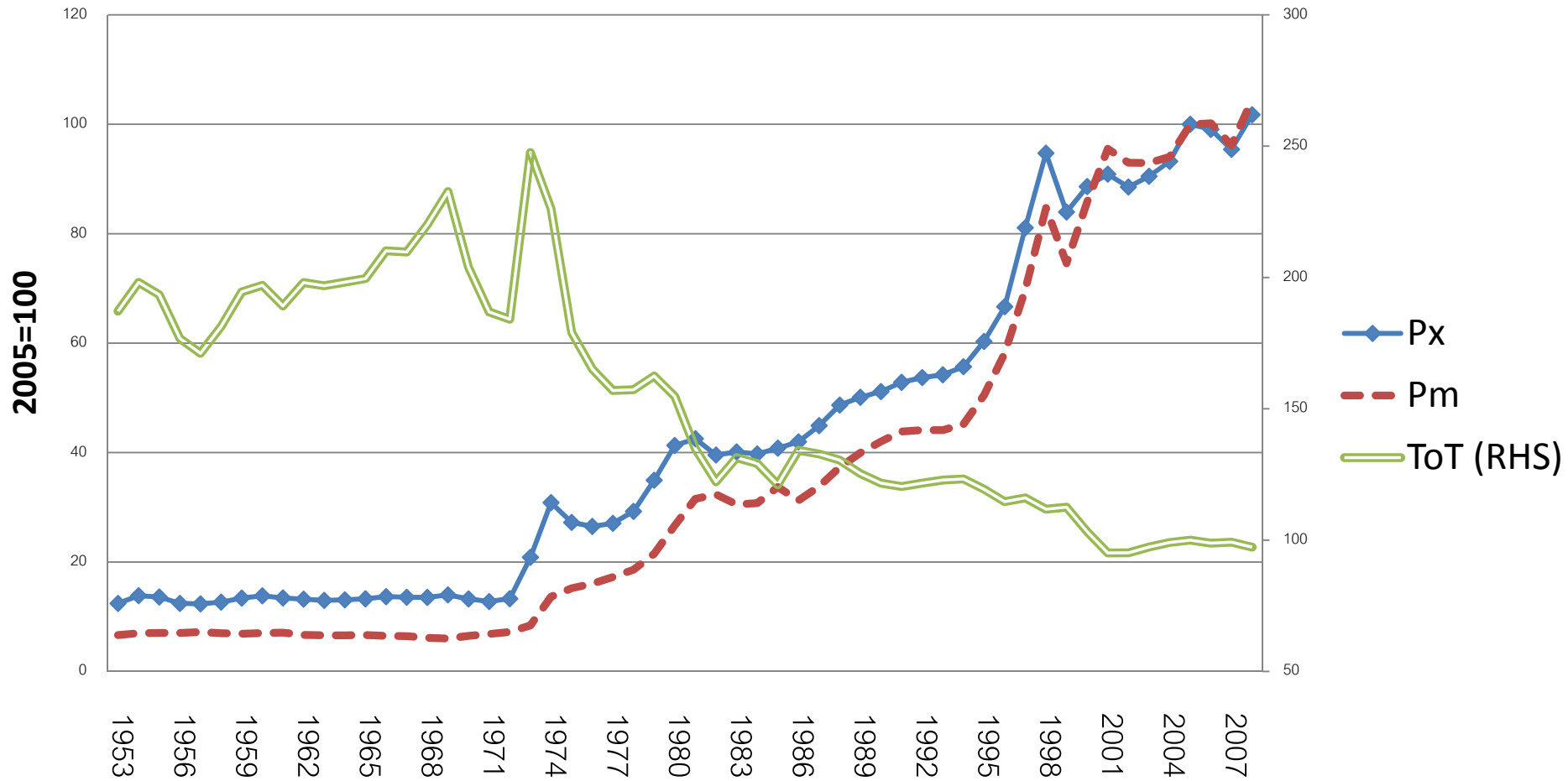


Imports of essential items



Declining terms of trade

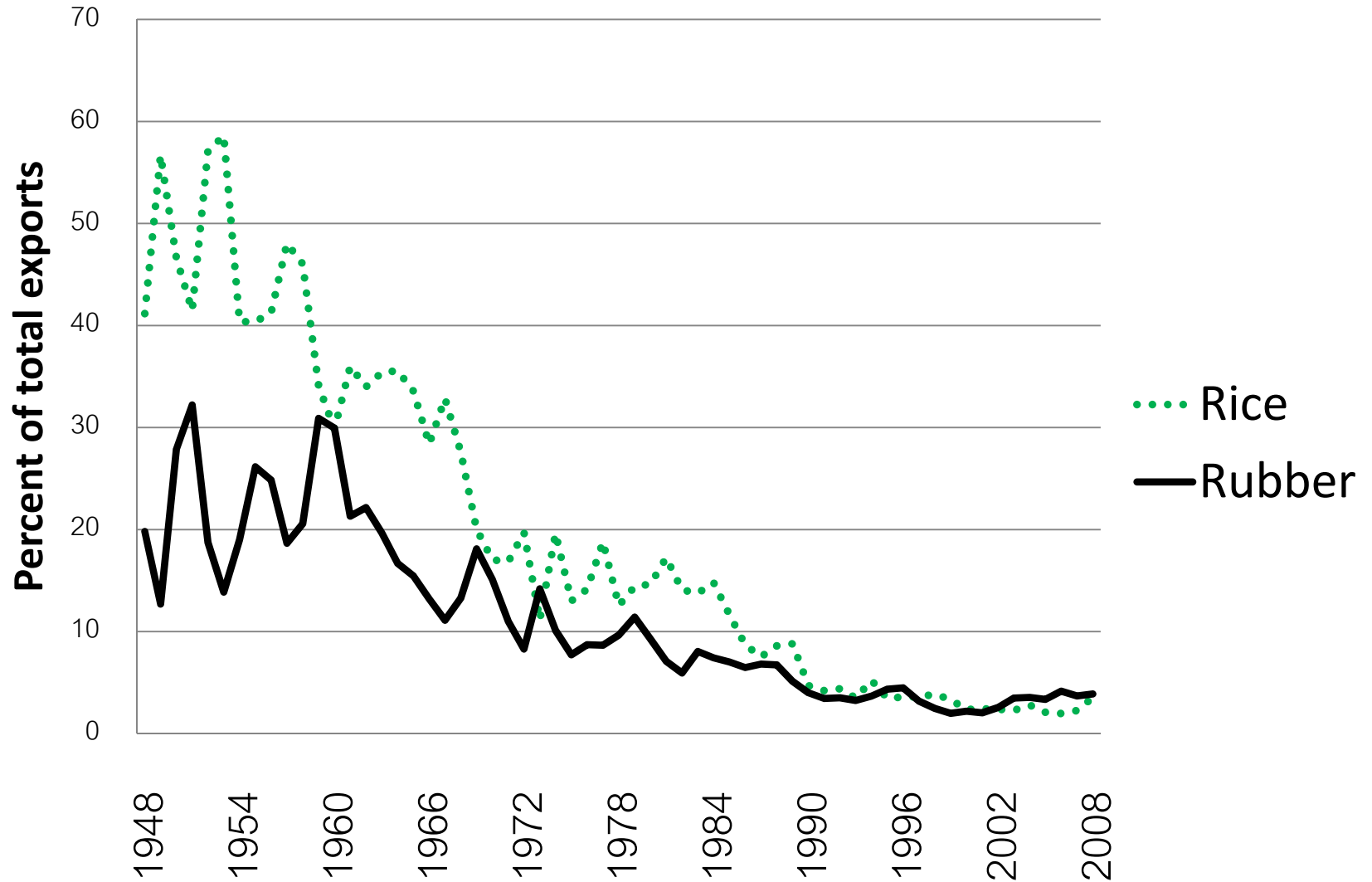
1953-2008



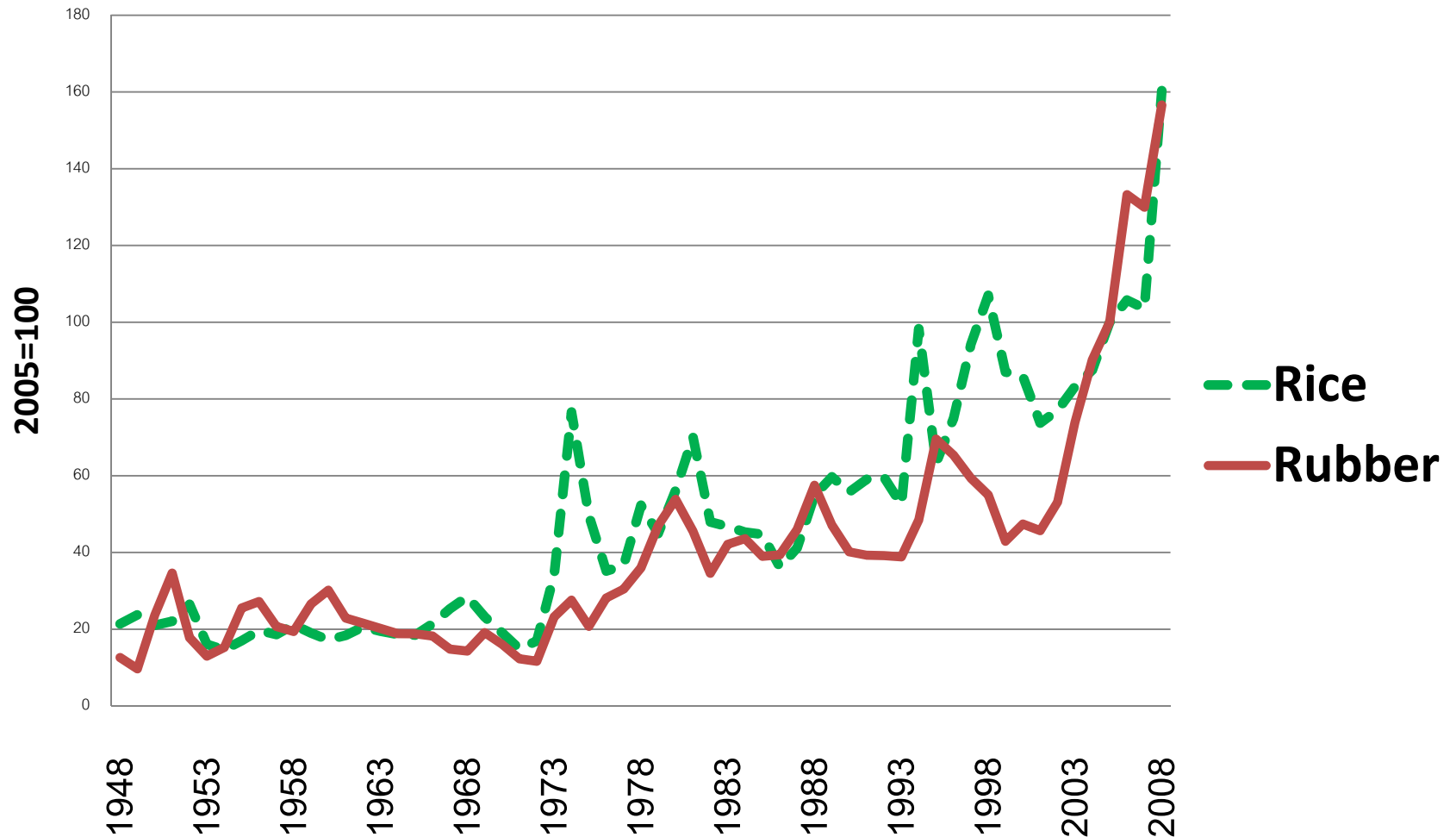
Trade in primary products

- 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.

Shares of traditional primary exports



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.

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?

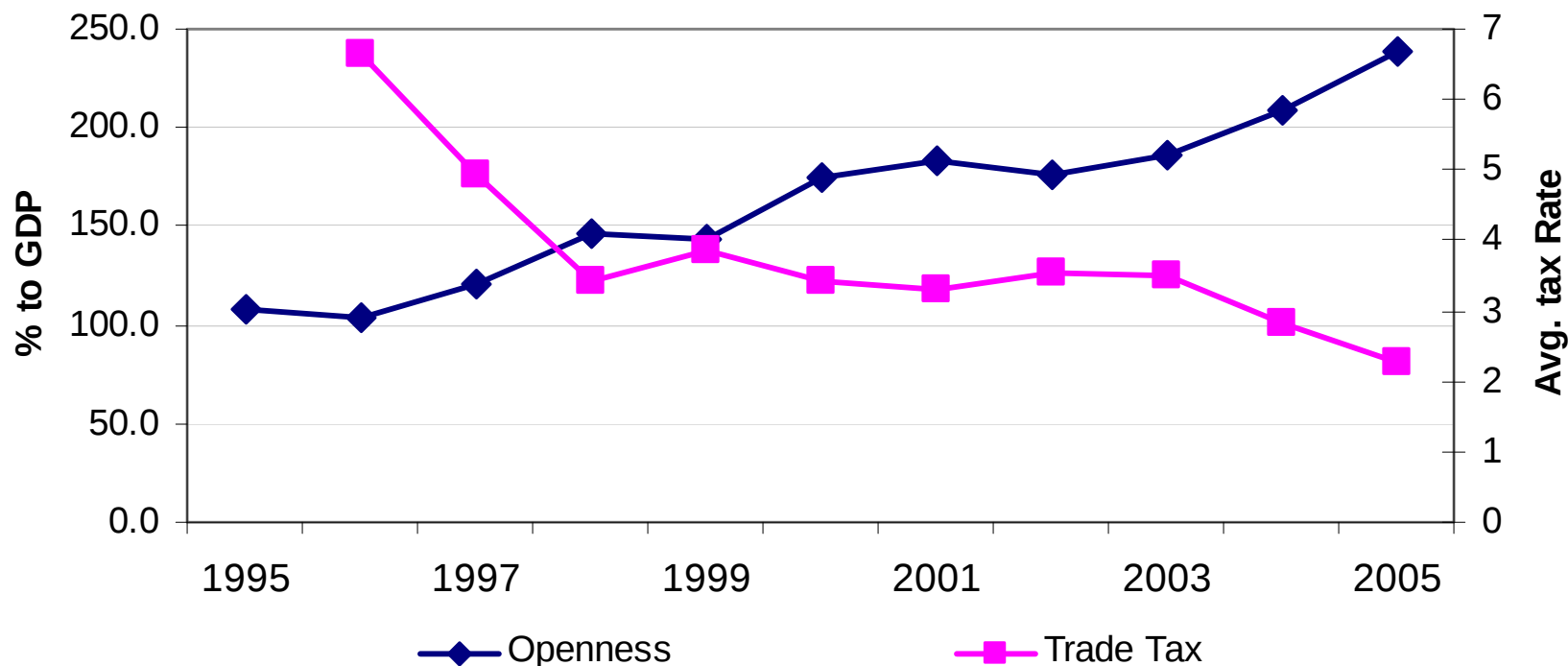
- Things were triggered by the 2007 drought in Australia, the worst for a century, which halved its wheat harvest. But there were more fundamental background factors.
- As countries like China, India, Brazil and Russia have got richer they have begun eating more.
- Rich people don't just eat more than 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.***

Biofuels

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

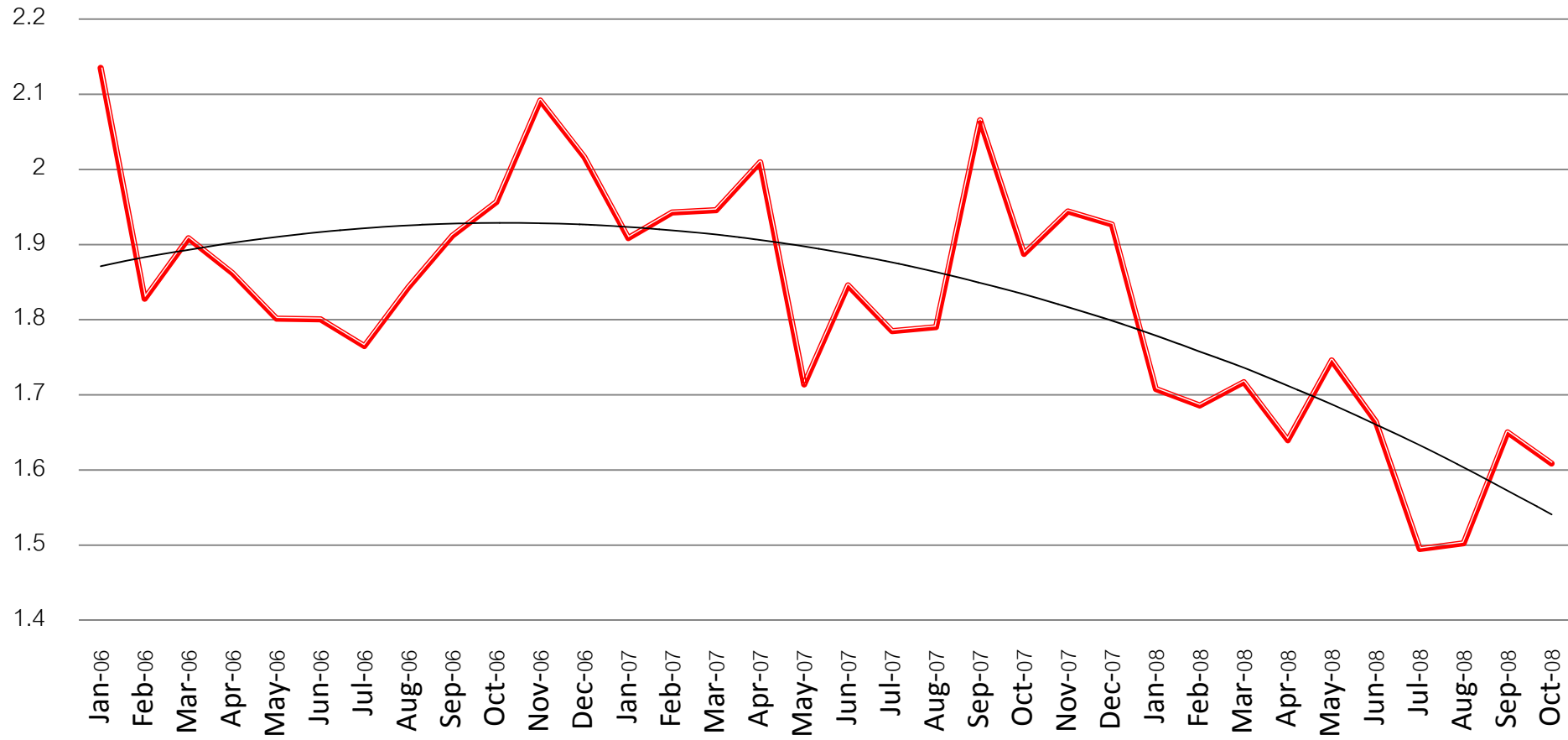
Figure 6.1: Degree of Trade Openness and Avg. Trade Tariff



Source: Bank of Thailand and Customs Department

Thailand's implied tariff rate

customs revenue to total imports(%)



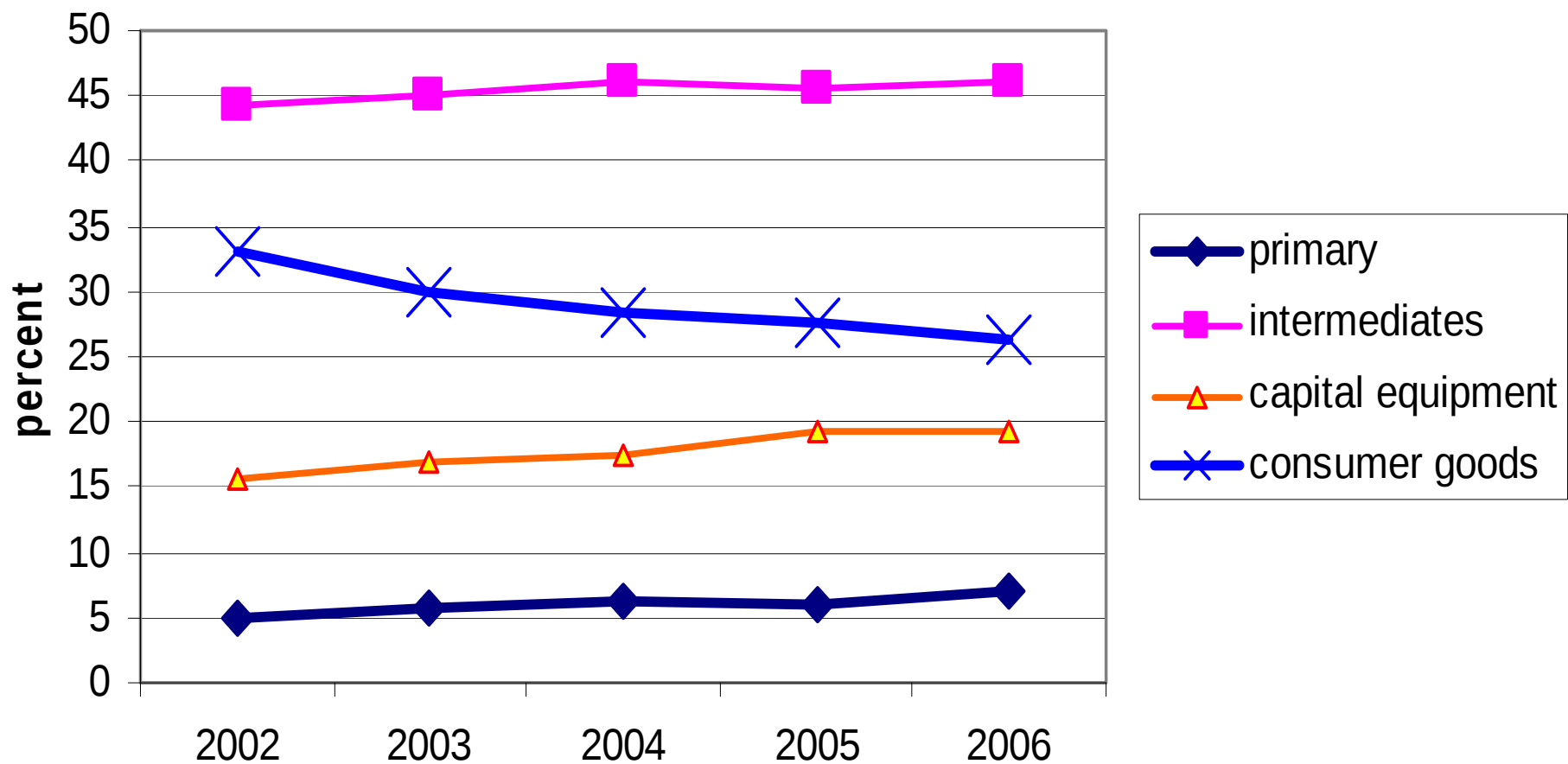
Adverse impact of globalization

- 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 processing



Growing network trade

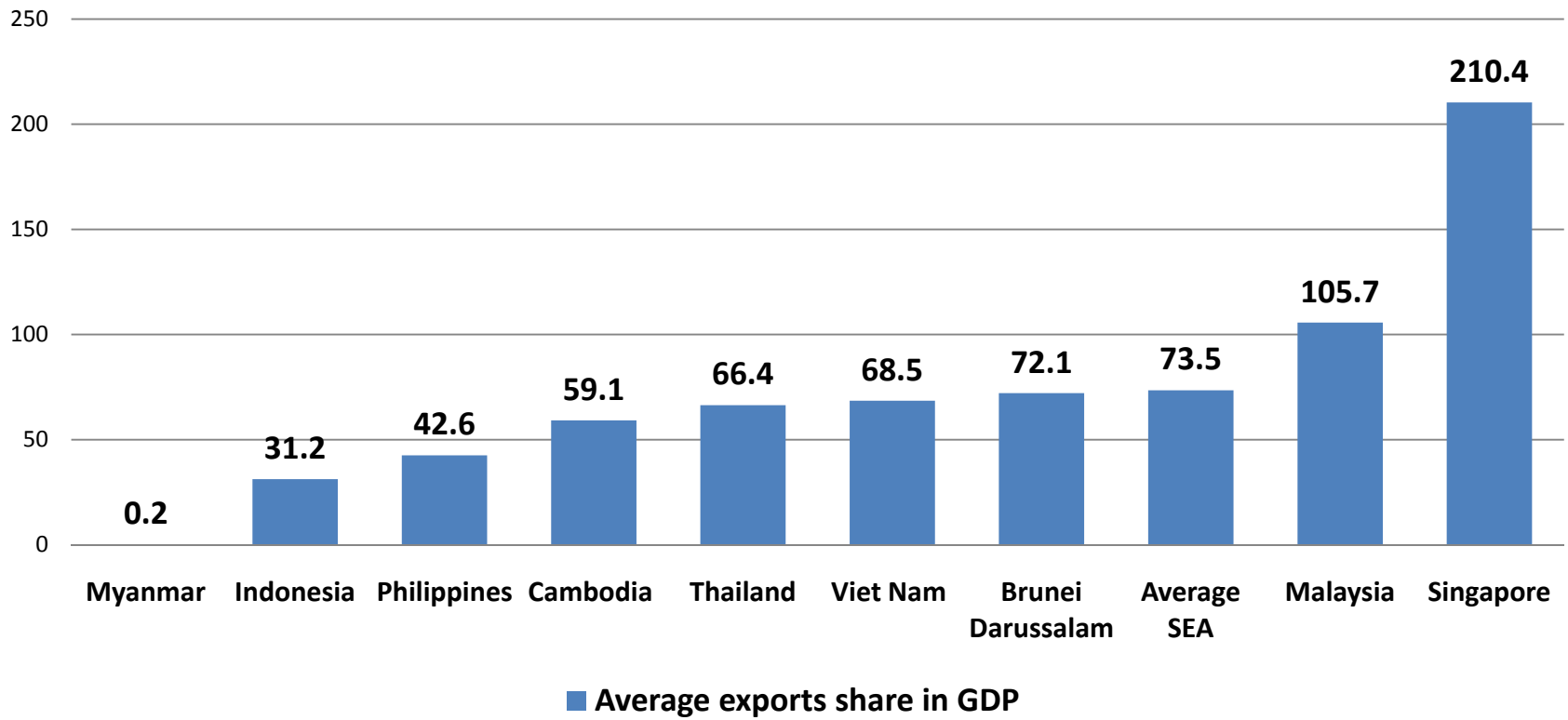
- Network trade is expanding much faster compared to conventional product-based trade (24 % of total manufactured exports in 1993, 45.5% in 2007).
- There is a shift away from mature industrial economies towards developing countries .
- Developing countries' share in network exports rose from 25 % in 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

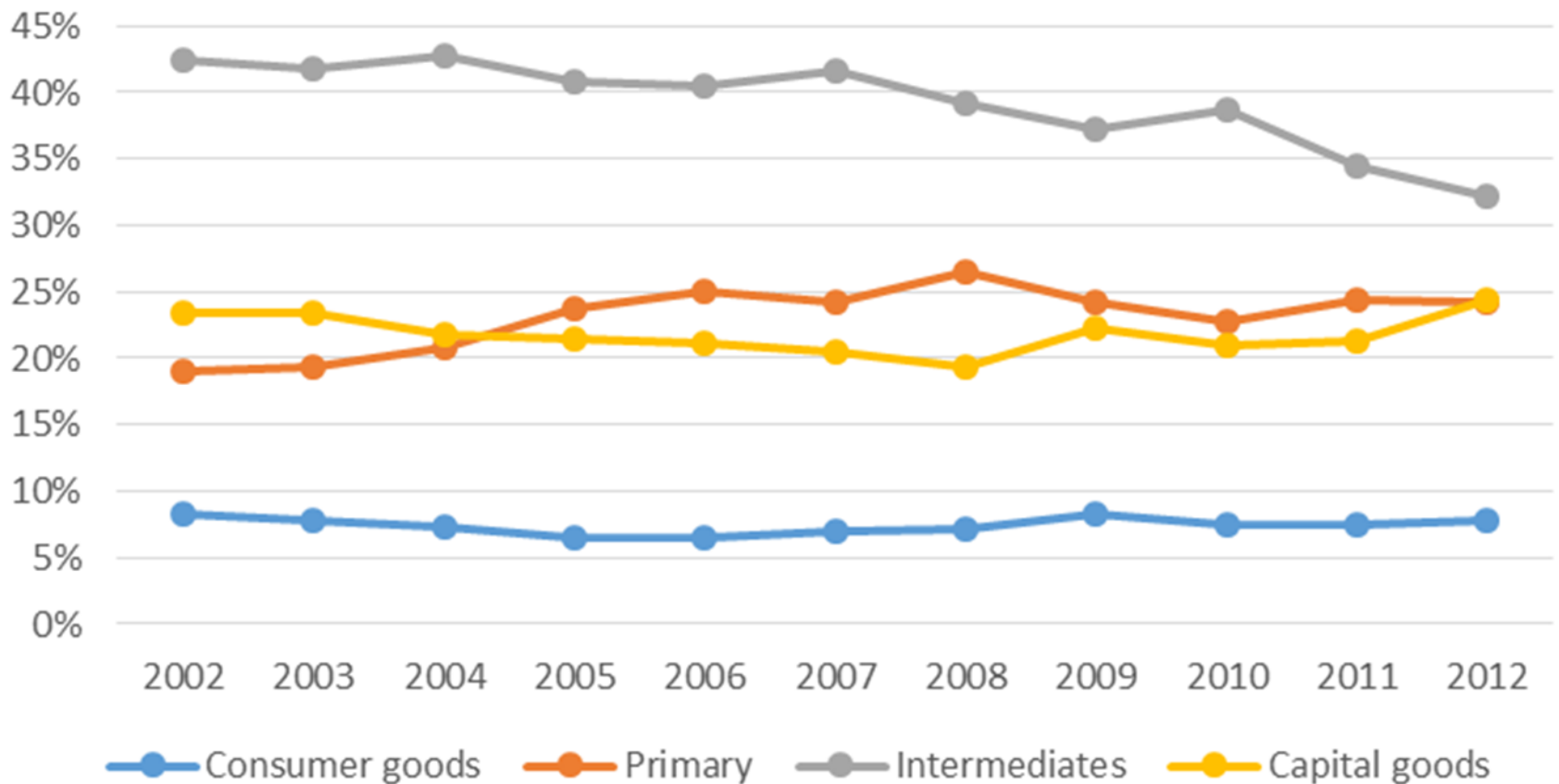
- A sharp contraction in world trade following the onset of the global financial crisis at a faster rate than in the Great Depression
- Trade contraction experienced by the East Asian countries has been even faster.
- Contraction of trade credit (global financial crisis)
- Greater share of consumer durables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

Exposure to Trade Shocks

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

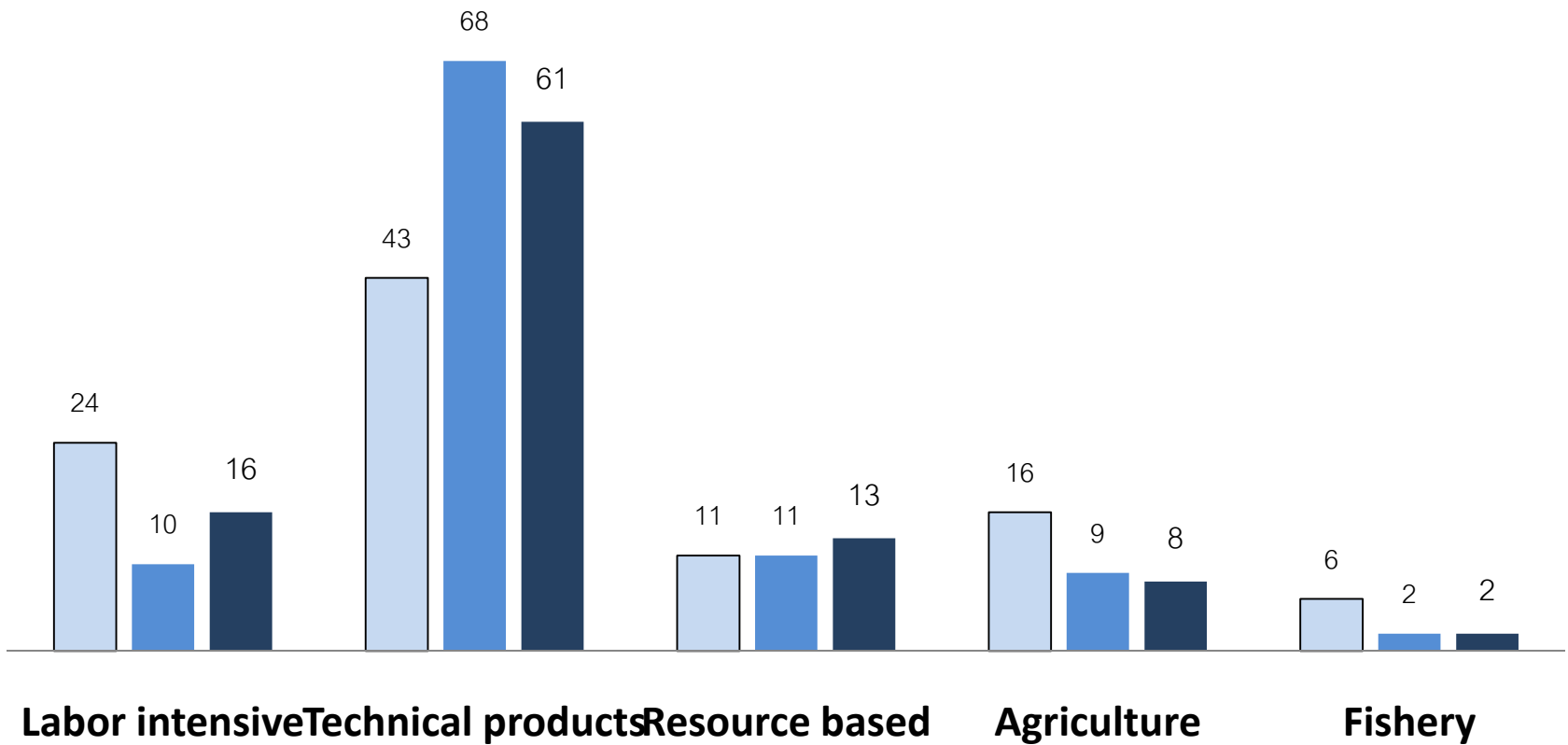


Imports value by stage of processing



Export share by product group

1995 2005 2009



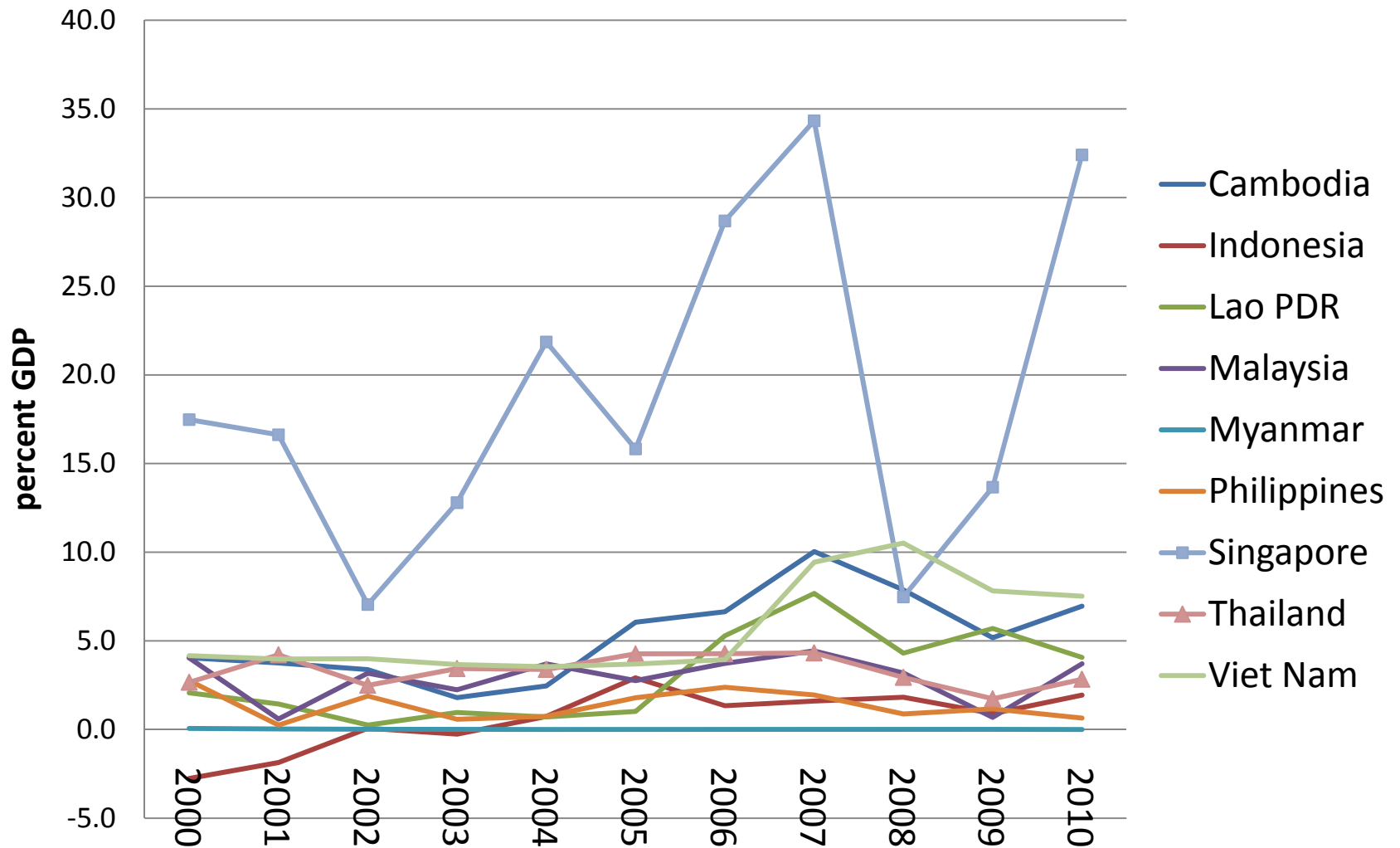
Source of comparative advantage in manufactured goods: Their life cycles

- 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.

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.

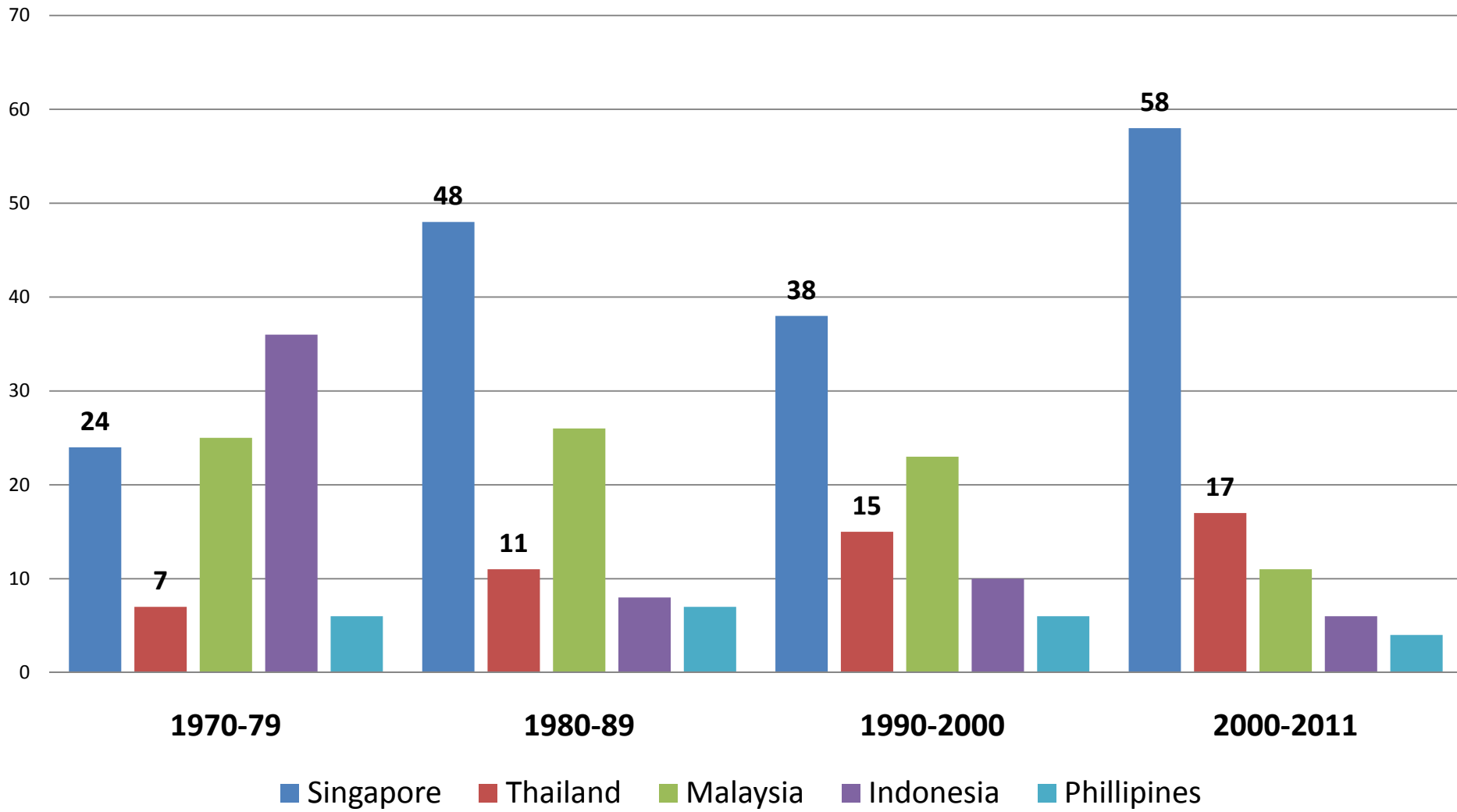
Foreign Direct Investment Inflows



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

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

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

FDI: Internalization Theory

- 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.

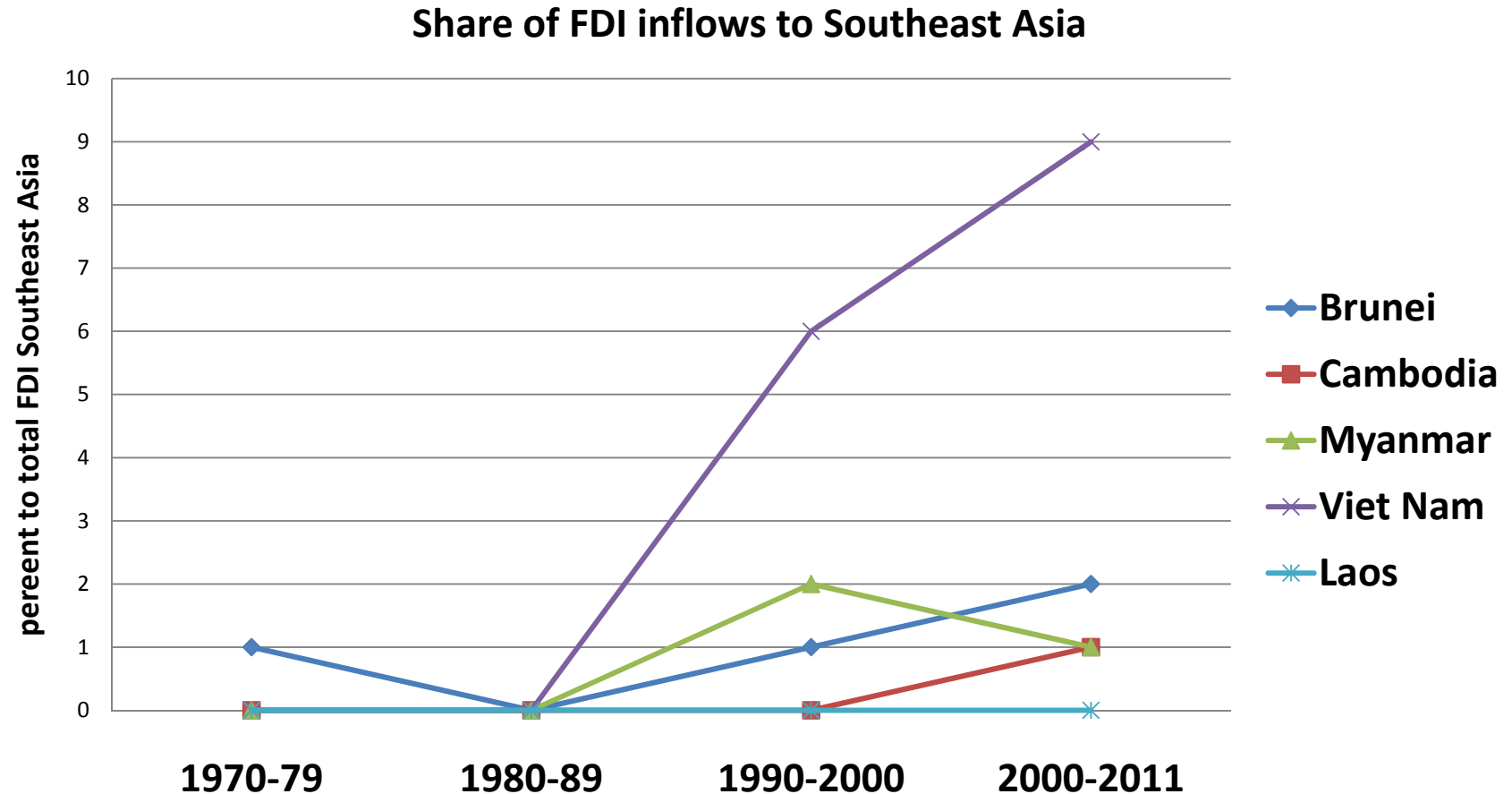
FDI: Eclectic theory

- 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.

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

Watch out for Viet Nam



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

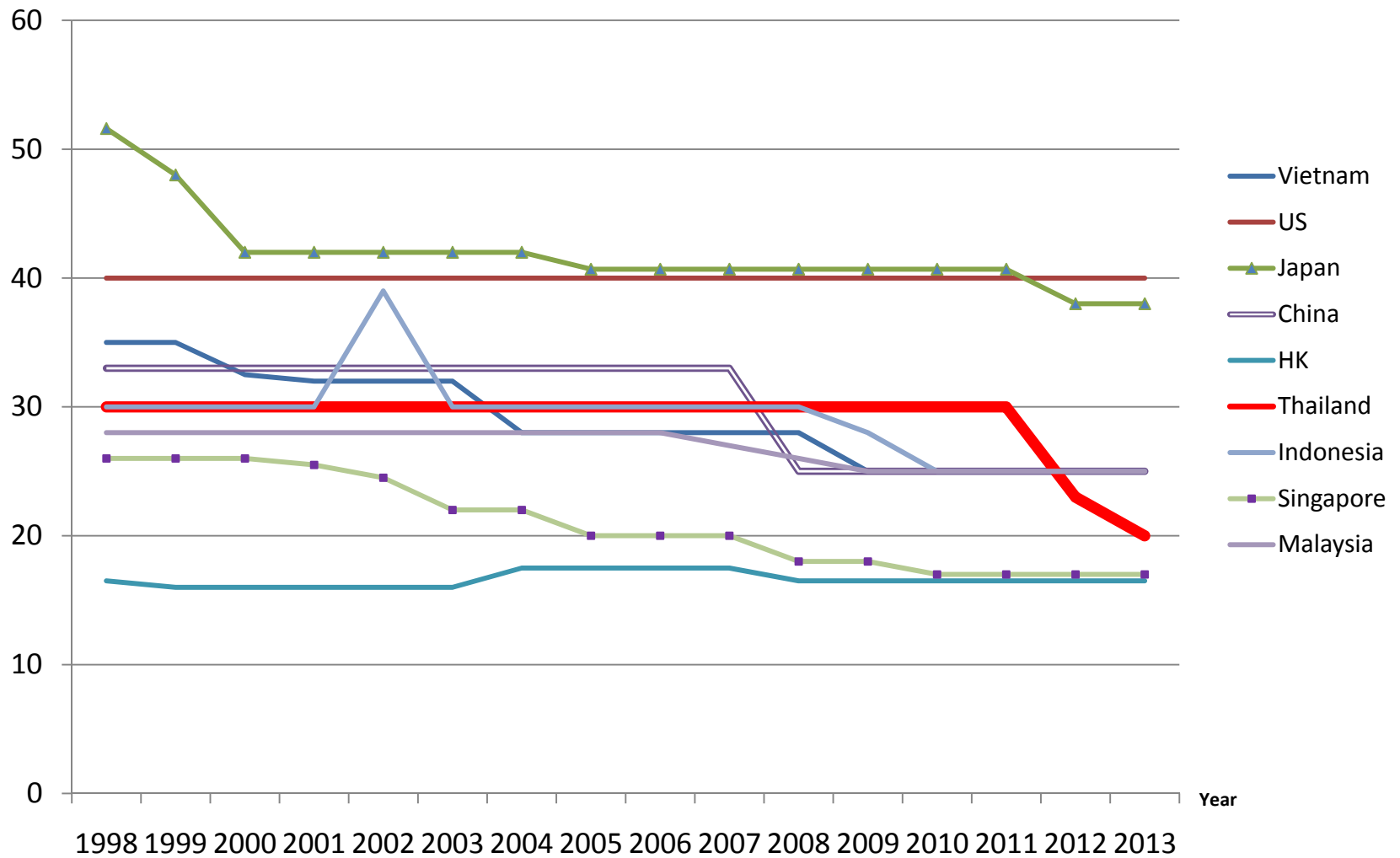
Social costs

- 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
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

Average Corporate 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 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 GDC on Southeast Asian economies depend on export dependency of each country.