STRATEGIC DEVELOPMENTS IN INTERNATIONAL TRADE

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Summary

Developments in world international trade have become more important due to the increased volume of international trade, or globalization as it is more popularly designated. The growth in foreign direct investment and multinational enterprises has been an important feature of this growth although the effects of freer mobility in international capital markets has had serious unintended consequences, such as its impact on the Asian crisis in 1997–1998. This capital mobility has forced a certain discipline on the domestic and other policies (including the foreign exchange rate regime) of some developing economies. This discipline may not be conducive to rapid growth and development. In addition, developing economy policies are subject to pressure from major industrial powers and multilateral institutions, while part of the cost of membership of international organizations like the Organization for Economic Cooperation and Development and North American Free Trade Agreement is that a number of discretionary policy instruments are no longer available.

This growth in world trade has been accompanied by a growth in regional trade agreements, which has reduced the transaction cost of the countries that are signatories to the agreements. These agreements may include such features as monetary and financial cooperation, exchange rate arrangements, macroeconomic policy coordination, and regional mechanism for the provision of international liquidity which, in addition to being more easily attainable, may also lead to greater stability and guard against systemic instability and contagion. It remains to be seen whether this expansion in regional trade agreements leads ultimately to freer multilateral trade worldwide. What is required is the coordination of a range of policies and issues, which can only be effectively resolved in a multilateral system. Globalization has also had an impact on the environment and international labor standards. International institutions such as the International Monetary Fund, the World Bank, and the World Trade Organization are well aware of these issues and attempts (although perhaps not overly successful) have been made to reduce environmental damage and improve labor standards. A proposal for a World Environmental Organization has been a welcome input into the debate. Concerning the future of labor standards, the consensus of international institutions like the World Trade Organization and the International Labor Organization is that labor standards should not be used for protectionist purposes, nor should they compromise the comparative advantage of countries.

1. Introduction

Considerable expansion occurred in the second half of the twentieth century in domestic regulations to do with health, safety, consumer protection, the environment, and labor markets. As the world economies continue to liberalize trade in goods and services, these domestic regulatory measures could be interpreted as a form of non-tariff barrier (NTB) to trade. The advocates of free trade, be they firms, countries, or international organizations, wish to limit these regulations as barriers to trade while environmentalists, consumer advocates, and non-government organizations (NGO) want to limit trade agreements insofar as they provide a barrier to regulations. This conflict between domestic or national sovereignty and international agreements is ever present and is a constant source of friction and a barrier to reforms and harmonization of policies.

Another aspect of this increased trade or globalization is the expectation that growth and development based on global market forces will be more sustainable and more widely shared than in the past. In some cases this expectation has not been realized and there is still a substantial gap between developed and developing countries. What is required, is sound domestic policies supported by an enabling global environment and economic cooperation at the international level. In order to share the benefits of globalization, international organizations may have to intervene rather than relying purely on market forces.

Historically, the international monetary system has passed through three phases. First, the 1947–1958/60 phase when the United States ran the international monetary system and funded other countries' continued balance of payments deficits with a mixture of publicly controlled capital and foreign direct investment (FDI). Second, the 1960–1975 phase when other countries ran trade surpluses but the USA still acted as a source of global liquidity. Third, the post-1975 phase when the U.S. became a deficit/debtor country and international institutions played a more active role in emerging corporations. In part, these developments resembled the asset-based exchange system of the nineteenth century.

A feature of the 1990s in international trade was the episodes of currency crises, most notably the near breakdown of the European exchange rate mechanism in 1992/93, the Latin American Tequila crisis following Mexico's peso devaluation in 1994/45, the Asian crisis in 1997–1998, and the Russian economic crisis of 1998.

Globalization has led to an increase in international capital flows. This increase has been particularly evident in banks and other private firms lending to emerging market economies both in the form of direct and portfolio investment. The mechanism of the direct investment is to create both employment opportunities and demand for capital, plant, and equipment. This demand for capital equipment facilitates the transfer of technology and encourages higher growth rates.

Freer international trade in both goods and services has also accelerated the integration of the world economy as well as increasing national competition and cooperation. This increased integration is evident at the microeconomic levels as firms expand across national borders through equity investment or through non-equity linkages that integrate independent firms. At the macroeconomic level, international economic integration is increasing as barriers to trade are reduced through regional trade agreements such as the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO).

2. Foreign Direct Investment and Multinational Enterprises

Foreign direct investment generally consists of: 1) new equity capital such as a new plant or joint venture; 2) reinvested corporate earnings; and 3) net borrowing through the parent company or affiliates and under ownership and control of a business or part of a business in another country. Portfolio investment, on the other hand, involves the purchase of securities in a domestic firm solely to earn a financial return rather than ownership and/or control. There has been phenomenal growth in FDI and in the last decade of the twentieth century its growth was twice that of fixed capital investment, indicating increasing internationalization of production systems. As well, there was a shift between 1980 and 2000 in the pattern of FDI by multinational enterprises (MNE). There are three reasons why these shifts occurred. First, changes in the competitiveness of MNE; second, changes in what these MNE sought from the countries in which they invested; and third, a transformation in the way production and the local markets were linked. Table 1 sets out the changing distribution of the flows of FDI by region and country of destination between two periods (1975–1980) and (1990–1996). An inspection of the table will show that there have been quite significant shifts over those 20 years. South Asia, East Asia, and Southeast Asia and Central and Eastern Europe increased their share of investment while Japan and the European Union (E.U.) had smaller gains.

	1975–1980		1990–1996		Index of FDI growth 1975–1980 = 100
	Annual Average	%	Annual Average	%	
Total inflows	32 183	100.0	234 724	100.0	729.3
Developed economies	24 642	76.6	153 381	65.3	622.4
Western Europe	13 874	43.1	92 295	39.3	665.2
of which: European Union[a]	13 190	41.0	83 947	35.8	636.4
North America	8 757	27.2	50 942	21.7	581.7
of which: U.S.	7 895	24.5	44 757	19.1	566.9
Japan	152	0.5	1 013	0.4	666.7
Other developed economies	1 859	5.7	9 169	3.9	493.2
of which: Australia	1 271	3.9	5 805	2.5	456.7
Developing economies	7 539	23.4	74 778	31.9	991.9
Africa	810	2.5	3 498	1.5	431.9
Latin America and Caribbean	4 014	12.5	22 536	9.6	561.4
of which: South America	2 377	7.4	12 824	5.5	539.5
Asia	2 489	7.7	48 075	20.5	931.5
of which: South, East, and Southeast Asia	1 971	6.1	45 857	19.5	2326.6
West and Central Asia[b]	518	1.6	2 217	0.9	428.1
Other developing economies[c]	226	0.7	668	0.3	295.8
Central and Eastern Europe	3	Neg.	6 565	2.8	218 847.6

Notes:
[a] Includes the 12 member countries of the EU in 1994
[b] Including the Middle Eastern countries
[c] The Pacific and developing Europe
Neg. = negligible

Source: J.H. Dunning, The new geography of foreign direct investment, *The Political Economy of Globalization*, ed. N. Woods (London: Macmillan, 2000), 20–53, citing UNCTC, *Transnational Corporations and World Development* (New York: United

Nations, 1988) and UNCTAD, *World Investment Report 1995* (Geneva and New York: United Nations, 1998).

Table 1. The distribution of foreign direct investment inflows by host region and country, 1975–1980 and 1990–1996 (US$ millions)

Table 2 provides the details divided into developed and developing economies. On balance, there was a slight trend towards a more even geographical distribution of FDI over this period, with the MNE responding to globalization by integrating their sourcing, value-added, and marketing activities and treating the world as a whole as a source for their resources.

Developed Countries

	1975–1980	**%[b]**		**1990–1996**	**%**
USA	7 894.0	32.0	USA	44 757.1	29.2
U.K.	5 795.4	21.1	UK	19 613.4	12.8
France	2 127.3	8.6	France	19 080.1	12.4
Netherlands	1 276.6	5.2	Belgium	10 012.1	6.5
Australia	1 271.4	5.2	Spain	8 579.3	35.6
Belgium[d]	1 203.1	4.9	Netherlands	7 770.9	5.1
Germany	1 052.6	4.3	Canada	6 185.3	4.0
Spain	970.5	3.9	Australia	6 118.9	4.0
Top 8	20 991.6	85.2	Top 8	12 2117.1	79.6
All	4 642.0	100.0	All	153 380.9	100.0

Developing Countries[a]

	1975–1980	**%[c]**		**1990–1996**	**%[c]**
Brazil	1 835.8	24.4	China	22 424.7	30.0
Mexico	1 023.5	13.5	Singapore	7 081.7	9.5
Malaysia	524.3	7.0	Mexico	5 622.1	7.5
Singapore	502.0	36.7	Malaysia	34 289.0	35.7
Egypt	376.1	5.0	Argentina	3 690.3	34.9
Iran	315.5	4.2	Brazil	3 222.7	4.3
Indonesia	289.9	3.8	Indonesia	2 842.6	3.8
Hong Kong	241.1	3.2	Thailand	2 179.9	2.9
Top 8	5 108.2	67.8	Top 8	51 353.0	68.7
All	7 539.1	100.0	All	74 777.6	100.0

Notes:

[a] Bermuda was, in fact, ranked higher (sixth), but we have excluded the tax haven from our rankings
[b] Of all developed country investment
[c] Of all developing country investment
[d] And Luxembourg

Table 2. The largest recipients of inward FDI, 1975–1980 and 1990–1996 (annual averages) (US$ millions)
(J.H. Dunning, The new geography of foreign direct investment, *The Political Economy of Globalization*, ed. N. Woods (London: Macmillan, 2000), 20–53, citing UNCTC, *Transnational Corporations and World Development* (New York: United Nations, 1988); UNCTAD, *World Investment Report 1995: Transnational Corporations and Competitiveness* (New York and Geneva: United Nations, 1995); and UNCTAD, *World Investment Report 1998* (Geneva and New York: United Nations, 1998))

In the years 1975–1980, the ten largest recipients of FDI identified in Table 2 accounted for 74.1% of all FDI inflows, and in 1990–1994 they accounted for 68.8%. In the former period, Japan accounted for only 0.6% of all inflows into developing countries, and in the latter for 1.0%.

The expansion in FDI for developing economies has caused problems when the country's financial sector has been underdeveloped or nonexistent. The Asian crisis of 1997–1998 was partly caused by such a view of the financial sector as well as by a perception of corruption**.** As well, debate has taken place over the manner in which FDI is directed, the better to benefit the economic development of the host country.

There is convincing historical evidence that short-term capital movements contribute to volatility in financial markets, which in turn leads to macroeconomic instability. This is further aggravated when the exchange rate is fixed or pegged because it provides short-term lenders and borrowers with a guarantee against adverse exchange rate movements. On the other hand, if the exchange rate is flexible, then it adjusts with the inflow and outflow of capital so that international lenders have to factor the exchange rate risk into their calculations and may moderate excessive short-term capital movements.

In addition to capital movements, the health and stability of the banking and financial sectors are important in determining the country's vulnerability to a currency crisis. The financial sector played an important role in the Asian crisis of 1997–1998 since the crisis was more liquidity-driven than solvency-driven, as was more usual. The issue of contagion, whereby several countries with important trade links to the country that first experienced the crisis were similarly affected by a common shock, also played a role. Thus both trade linkages and financial interdependence contributed to the transmission of the crisis via spillover effects. Nevertheless, despite these problems, the growth potential for the Asian developing economies remains high. This is due partly to 1) high domestic savings rates, 2) improving literacy levels or human capital resources, and 3) catch-up and market development.

Historically, the shortage of human capital such as skilled labor and managerial talent has been a crucial reason in limiting foreign investor interest and hence restricting growth rates in developing economies. When FDI has occurred, it has been a source of foreign exchange and tax revenue in addition to its role in modernizing industry. Also, the standard of living has generally increased in these economies although issues of equity and the distribution of income remain.

In the four decades from 1945 to 1985, global economic expansion was mainly confined to the Organization for Economic Cooperation and Development (OECD) countries. In the aftermath of the 1980s debt crisis, a large number of developing countries began to liberalize their economies, dismantling trade barriers as well as domestic production subsidies. Their trade expanded with OECD countries but also with other developing countries. In the 1990s the former soviet bloc countries had emerged seeking new markets and trade partners and this saw an unprecedented expansion in FDI, with a four-fold increase between 1985 and 1995. These large FDI flows were facilitated by governments privatizing state-owned enterprises.

From a development perspective, FDI should help in the transfer of technology and expertise from developed to developing countries. This transfer would thus hasten economic development as well as the integration of such economies into the world markets. Unfortunately, there is no guarantee that this inflow of investment will perform this role. For example, there are still regional imbalances in development despite the free mobility of capital (and usually labor) in the region. Governments have responded by trying to direct investment to certain industries or regions through incentives in the form of tax breaks and other subsidies and in turn requiring specific export performances to aid development and growth.

The environmental impact of FDI depends on two factors. First, the system of managing the environment and, second, the transfer of environmentally sound technology. In practice, environmental damage tends to be greatest in low-productivity operations working with obsolete technology, outdated work methods, poor human resource development, and inefficient capital and energy use. MNE can be seen as a repository of clean technologies, which can be transferred to developing economies. Alternatively, they can be seen as relocating pollution production and inferior technologies to their subsidiaries in developing economies, thus exploiting the technology gap and adding to overall pollution.

The role of foreign banks complements the MNE presence in both developing and developed economies. Foreign bank participation has a number of points in its favor. These include increasing the funds available for domestic projects by facilitating capital inflow and improving the quality of financial services and system infrastructure such as accounting, transparency, and financial documentation. A counter view is that foreign banks decrease financial stability by facilitating capital flight or enabling capital to move more quickly out of a country in a crisis. What is clear is that, like MNE, the presence of foreign banks is increasing as part of the globalization process.

There have been some attempts at the international level to set out the best practices for prudential supervision of banks, particularly in emerging markets. The Basel Committee on Banking Supervision (BCBS) set out some core principles in 1997 that should be applied if the supervisory system is to be effective. These principles relate to:

- preconditions for effective banking supervision,
- licensing and structure,
- prudential regulations and methods of banking supervision,
- information requirements,
- formal powers of supervision,
- cross-border banking principles,

and are minimum requirements that should be supplemented by other measures as appropriate.

These concerns have also led to a proposal for setting up a World Financial Authority to provide and supervise financial regulations (Box 1) although it is not clear why such an organization would be more successful than the International Monetary Fund (IMF) in achieving stability.

The increasingly global character of financial markets and growing links between different categories of financial business have given rise to proposals for the creation of a global mega-agency for financial regulation and supervision or World Financial Authority (WFA). These proposals would appear to be motivated by two arguments. On one argument, since financial businesses are becoming increasingly interrelated and cross-border, their regulation and supervision should also be carried out on a unified and global basis. The other argument focuses on the stability of capital movements under the present patchwork of regimes which only more globally uniform regulation could be expected to control. Various models for a WFA can be envisaged, spanning the spectrum from an institution built on (and thus involved in a limited departure from) existing arrangements to one with more comprehensive responsibilities. The more ambitious variant would involve a body with responsibility for setting regulatory standards for all financial enterprises, off-shore as well as on-shore entities. National regulators would remain responsible for implementing standards promulgated by such a WFA, but the new institution could contribute to ensuring their observance through its surveillance since unfavorable public assessments issued by it could be expected to act as a brake on a country's capital inflows. A less ambitious variant for the WFA might serve simply as an umbrella organization into which existing bodies (in some cases with appropriately expanded mandates) would be brought.

Source: Y. Akyüz and A. Cornford, *Capital Flows to Developing Countries and the Reform of the International Financial System*, United Nations Conference on Trade and Development (UNCTAD) Discussion Paper No. 143 (Geneva: UNCTAD, 1999).

Box 1. A World Financial Authority (WFA)
(Y. Akyüz and A. Cornford, *Capital Flows to Developing Countries and the Reform of the International Financial System,* United Nations Conference on Trade and Development (UNCTAD) Discussion Paper No. 143 (Geneva: UNCTAD, 1999))

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Biographical Sketch

Pasquale M. Sgro is Professor of Economics at Deakin University, Melbourne, Australia. He has held numerous teaching and research positions at universities and research institutions in Australia and overseas. His research interests are in the areas of international trade and economic development where he has published a number of books and numerous journal articles. He is founding co-editor of the *Journal of International Trade and Economic Development*, published by Routledge (U.K.).