Recap

- Globalization 1.0 (1800 to 1914)
  - Dynamic force was countries globalizing for resources and imperial conquest
- Globalization 2.0 (1945 to 1989)
  - Dynamic force was companies globalizing for markets and labor
- Globalization 3.0 (1989 to 2008)
  - Dynamic force is individuals and small groups globalizing
- Globalization 4.0 (2009 to)

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Recap

- Understand theories of why and how countries trade
- Familiar with factors affecting countries' trade patterns
- Discern why the production factors of labor and capital move internationally
- Grasp the relationship between foreign trade and industry competitiveness
- Current World Trading System
  - How has the current world trading system emerged?
  - Regional economic integration – Europe, America, Asia

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Recap

- **Why do Certain Patterns of Trade Exist?**
- Some patterns of trade are fairly easy to explain
  - It is obvious why Saudi Arabia exports oil, Ghana exports cocoa, and Brazil exports coffee
- But, why does Switzerland export chemicals, pharmaceuticals, watches, and jewelry?
- Why does Japan export automobiles, consumer electronics, and machine tools?

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Agenda

Foreign Investment Environment

1. Government Intervention
2. Foreign Direct Investment
3. The Foreign Exchange Market
4. The International Monetary System
5. The Global Capital Market

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Why is Free Trade Beneficial?

- Free trade - a situation where a government does not attempt to influence through quotas or duties what its citizens can buy from another country or what they can produce and sell to another country
- Trade theory shows why it is **beneficial** for a country to engage in international trade even for products it is able to produce for itself

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Why is Free Trade Beneficial?

- International trade allows a country
  - to specialize in the manufacture and export of products and services that it can produce efficiently
  - to import products and services that can be produced more efficiently in other countries
- Limits on imports may be beneficial to producers, but not beneficial for consumers

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What Role does Government have in Trade?

- The **mercantilist** philosophy makes a crude case for government involvement in promoting exports and limiting imports
- Smith, Ricardo, and Heckscher-Ohlin promote unrestricted **free trade**
- **New trade theory** and Porter's theory of national competitive advantage justify limited and selective government intervention to support the development of certain export-oriented industries

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Government Intervention

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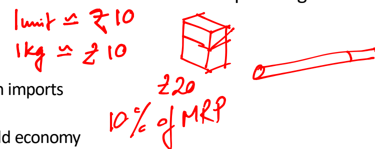
How do Governments Intervene in Markets?

- Governments use various methods to intervene in markets including

1. **Tariffs** - taxes levied on imports that effectively raise the cost of imported products relative to domestic products
   - **Specific tariffs** - levied as a fixed charge for each unit of a good imported
   - **Ad valorem tariffs** - levied as a proportion of the value of the imported good

   - Pros & Cons of Tariffs
     - increase government revenues
     - force consumers to pay more for certain imports
     - are pro-producer and anti-consumer
     - reduce the overall efficiency of the world economy



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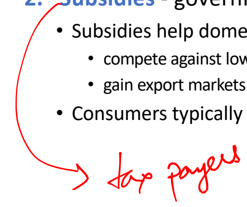
How do Governments Intervene in Markets?

2. **Subsidies** - government payments to domestic producers
   - Subsidies help domestic producers
     - compete against low-cost foreign imports
     - gain export markets
   - Consumers typically absorb the costs of subsidies



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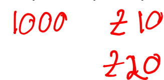
How do Governments Intervene in Markets?

3. **Import Quotas** - restrict the quantity of some good that may be imported into a country
   - **Tariff rate quotas** - a hybrid of a quota and a tariff where a lower tariff is applied to imports within the quota than to those over the quota
   - A **quota rent** - the extra profit that producers make when supply is artificially limited by an import quota



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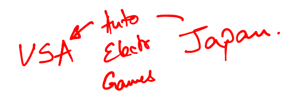
How do Governments Intervene in Markets?



4. **Voluntary Export Restraints** - quotas on trade imposed by the exporting country, typically at the request of the importing country's government
   - Import quotas and voluntary export restraints
     - benefit domestic producers
     - raise the prices of imported goods

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How do Governments Intervene in Markets?

5. **Local Content Requirements** - demand that some specific fraction of a good be produced domestically
   - benefit domestic producers
   - consumers face higher prices

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How do Governments Intervene in Markets?

5. **Administrative Policies** - bureaucratic rules designed to make it difficult for imports to enter a country
   - **Investment restrictions**: restrict foreign firms to invest in some industry sector
   - **Currency control**: restrictions on the outflow of hard currency from a country

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How do Governments Intervene in Markets?

7. **Antidumping Policies**–also called **countervailing duties**–punish foreign firms that engage in dumping and protect domestic producers from "unfair" foreign competition
   - **dumping** - selling goods in a foreign market below their costs of production, or selling goods in a foreign market below their "fair" market value
     - enables firms to unload excess production in foreign markets
     - may be predatory behavior - producers use profits from their home markets to subsidize prices in a foreign market to drive competitors out of that market, and then later raise prices

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Why do Governments Intervene in Markets?

- There are two main arguments for government intervention in the market

1. **Political arguments** - concerned with protecting the interests of certain groups within a nation (normally producers), often at the expense of other groups (normally consumers)

2. **Economic arguments** - concerned with boosting the overall wealth of a nation - benefits both producers and consumers

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What are the Political Arguments for Government Intervention?

1. **Protecting jobs** - the most common political reason for trade restrictions
   - results from political pressures by unions or industries that are "threatened" by more efficient foreign producers and have more political clout than consumers
2. **Protecting industries deemed important for national security** - industries are often protected because they are deemed important for national security
   - aerospace or semiconductors

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What are the Political Arguments for Government Intervention?

3. **Retaliation for unfair foreign competition** - when governments take, or threaten to take, specific actions, other countries may remove trade barriers
   - if threatened governments do not back down, tensions can escalate, and new trade barriers may be enacted
   - risky strategy
4. **Protecting consumers from "dangerous" products** - limit "unsafe" products

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What are the Political Arguments for Government Intervention?

5. **Furthering the goals of foreign policy** - preferential trade terms can be granted to countries that a government wants to build strong relations with
   - trade policy can also be used to punish rogue states
6. **Protecting the human rights of individuals in exporting countries** - through trade policy actions
7. **Protecting the environment** - international trade is associated with a decline in environmental quality
   - concern over global warming
   - enforcement of environmental regulations

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What are the Economic Arguments for Government Intervention?

1. **The infant industry argument** - an industry should be protected until it can develop and be viable and competitive internationally
   - accepted as a justification for temporary trade restrictions under the WTO

- **Question**: When is an industry "grown up"?
- Critics argue that if a country has the potential to develop a viable competitive position, its firms should be capable of raising necessary funds without additional support from the government

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What are the Economic Arguments for Government Intervention?

2. **Strategic trade policy** – first-mover advantages can be important to success
   - governments can help firms from their countries attain these advantages
   - governments can help firms overcome barriers to entry into industries where foreign firms have an initial advantage

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Is Unrestricted Free Trade Always Beneficial?

- Unrestricted free trade is beneficial, but the gains may not be as great as the simple model of comparative advantage would suggest
  - immobile resources
  - diminishing returns
  - dynamic effects and economic growth
  - the Samuelson critique
- But, opening a country to trade could increase
  - a country's stock of resources as increased supplies become available from abroad
  - the efficiency of resource utilization and so free up resources for other uses
  - economic growth

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Could a Rich Country be Worse off with Free Trade?

- **Paul Samuelson** - the dynamic gains from trade may not always be beneficial
  - Free trade may ultimately result in lower wages in the rich country
- The ability to offshore services jobs that were traditionally not internationally mobile may have the effect of a mass **inward migration** into the United States, where wages would then fall
  - But protectionist measures could create a more harmful situation than free trade

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When Should Governments Avoid Using Trade Barriers?

- **Paul Krugman** argues that strategic trade policies aimed at establishing domestic firms in a dominant position in a global industry are beggar-thy-neighbor policies that **boost national income at the expense of other countries**
  - countries that attempt to use such policies will probably provoke retaliation
- Krugman argues that since **special interest groups** can influence governments, strategic trade policy is almost certain to be captured by such groups who will distort it to their own ends

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Foreign Direct Investment

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What is FDI?

- **Foreign direct investment** (FDI) occurs when a firm invests directly in new facilities to produce and/or market in a foreign country
  - the firm becomes a **multinational enterprise**
- FDI can be in the form of
  - **greenfield investments** - the establishment of a wholly new operation in a foreign country
  - acquisitions or mergers with existing firms in the foreign country

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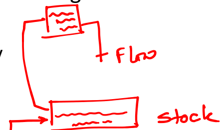
What is FDI?

- The **flow of FDI** - the amount of FDI undertaken over a given time period
  - **Outflows of FDI** are the flows of FDI out of a country
  - **Inflows of FDI** are the flows of FDI into a country



- The **stock of FDI** - the total accumulated value of foreign-owned assets at a given time
- Both the flow and stock of FDI have increased over the last 35 years
  - Most FDI is still targeted towards developed nations

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What are the Patterns of FDI?

- The growth of FDI is a result of
  1. a fear of protectionism
     - want to circumvent trade barriers
  2. political and economic changes
     - deregulation, privatization, fewer restrictions on FDI
  3. new bilateral investment treaties
     - designed to facilitate investment
  4. the globalization of the world economy
     - many companies now view the world as their market
     - need to be closer to their customers

Unilever. L HUL

1991 – LPG.

MFN

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What are the Patterns of FDI?

- **Gross fixed capital formation** - the total amount of capital invested in factories, stores, office buildings, and the like
  - the greater the capital investment in an economy, the more favorable its future prospects are likely to be
- So, FDI is an important source of capital investment and a determinant of the future growth rate of an economy
  - Since World War II, the U.S. has been the largest source country for FDI
  - the United Kingdom, the Netherlands, France, Germany, and Japan are other important source countries China.
  - together, these countries account for 60% of all FDI outflows from 1998-2011

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What are the Theoretical Approaches to FDI?

Left.

- The **radical view** - the multinational enterprise (MNE) is an instrument of imperialist domination and a tool for exploiting host countries to the exclusive benefit of their capitalist-imperialist home countries
  - in retreat almost everywhere

Capitalist.

- The **free market view** - international production should be distributed among countries according to the theory of comparative advantage
  - embraced by advanced and developing nations including the United States and Britain, but no country has adopted it in its purest form

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What are the Theoretical Approaches to FDI?

- **Pragmatic nationalism** - FDI has both benefits (inflows of capital, technology, skills, and jobs) and costs (repatriation of profits to the home country and a negative balance of payments effect)
  - FDI should be allowed only if the benefits outweigh the costs

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How does FDI Benefit the Host Country?

Destination.

- There are four main benefits of inward FDI for a host country
  1. **Resource transfer effects** - FDI brings capital, technology, and management resources
  2. **Employment effects** - FDI can bring jobs
  3. **Balance of payments effects** - FDI can help a country to achieve a current account surplus
  4. **Effects on competition and economic growth** - greenfield investments increase the level of competition in a market, driving down prices and improving the welfare of consumers
     - can lead to increased productivity growth, product and process innovation, and greater economic growth

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What are the Costs of FDI to the Host Country?

Destination.

- Inward FDI has three main costs:
  1. Adverse effects of FDI on **competition** within the host nation
     - subsidiaries of foreign MNEs may have greater economic power than indigenous competitors because they may be part of a larger international organization
  2. Adverse effects on the **balance of payments**
     - when a foreign subsidiary imports a substantial number of its inputs from abroad, there is a debit on the current account of the host country's balance of payments
  3. Perceived loss of national sovereignty and **autonomy**
     - decisions that affect the host country will be made by a foreign parent that has no real commitment to the host country, and over which the host country's government has no real control

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How does FDI Benefit the Home Country?

Origin.

- The benefits of FDI for the home country include
  1. The effect on the capital account of the home country's **balance of payments** from the inward flow of foreign earnings tax.
  2. The **employment** effects that arise from outward FDI
  3. The gains from learning valuable **skills** from foreign markets that can subsequently be transferred back to the home country

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What are the Costs of FDI to the Home Country?

Origin.

1. The home-country's balance of payments can suffer
   - from the initial capital outflow required to finance the FDI
   - if the purpose of the FDI is to serve the home market from a low-cost labor location
   - if the FDI is a substitute for direct exports
2. Employment may also be negatively affected
   - if the FDI is a substitute for domestic production
3. International trade theory suggests that home-country concerns about the negative economic effects of **offshore production** (FDI undertaken to serve the home market) may not be valid
   - may stimulate economic growth and employment in the home country by freeing resources to specialize in activities where the home country has a comparative advantage

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How does Government Influence FDI?

- Governments can encourage outward FDI
  - government-backed insurance programs to cover major types of foreign investment risk
  - offer incentives to foreign firms to invest in their countries
    - gain from the resource-transfer and employment effects of FDI, and capture FDI away from other potential host countries
- Governments can restrict outward FDI
  - limit capital outflows, manipulate tax rules, or outright prohibit FDI
  - use ownership restraints and performance requirements

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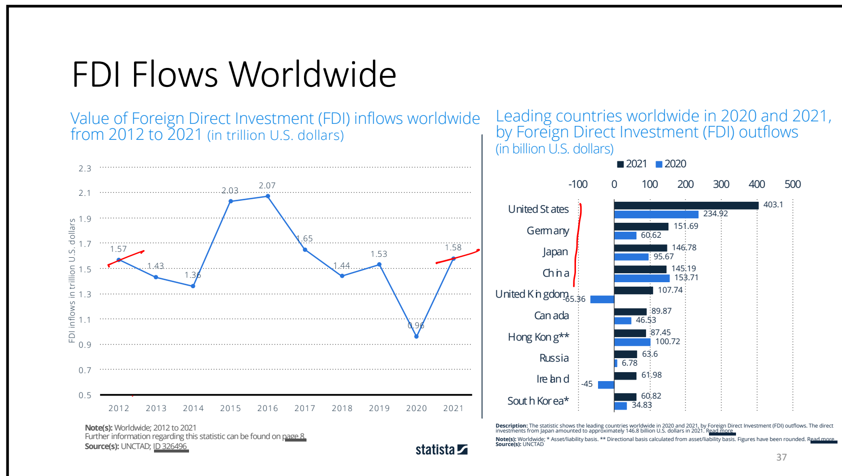

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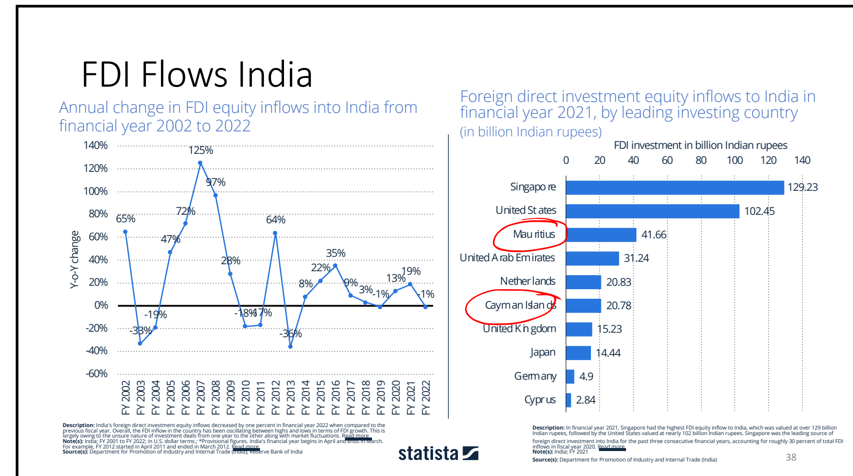

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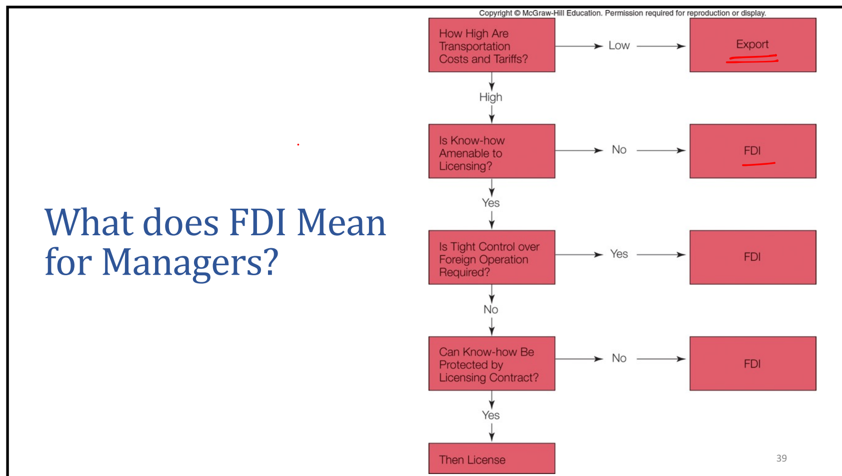

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Why Is The Foreign Exchange Market Important?

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- The **foreign exchange market**
  1. is used to convert the currency of one country into the currency of another
  2. provides some insurance against **foreign exchange risk** - the adverse consequences of unpredictable changes in exchange rates
- The **exchange rate** is the rate at which one currency is converted into another
  - events in the foreign exchange market affect firm sales, profits, and strategy

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Pros & Cons of FX Market

ADVANTAGES

- There are **fewer rules** than in other markets. Investors aren't held to strict standards or regulations.
- There are **no clearing houses** and no central bodies that oversee the forex market.
- Most investors **won't have to pay the traditional fees or commissions** that they would on another market.
- Because the market is **open 24 hours** a day, you can trade at any time of day.
- You can **get in and out** whenever you want, and you can buy as much currency as you.

DISADVANTAGES

- The market being unregulated creates risks, as there is **no significant oversight** that can ensure risk-free transactions.
- **Leverage** can help magnify profits but can also lead to high losses.
- Unlike stocks that provide returns through dividends and bonds through interest payments, **FX transactions solely rely on appreciation**.
- **Lack of transparency** in the FX market can harm a trader as they do not have full control over how their trades are filled, may not get the best price, and may have a limited view of information, such as quotes.

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When Do Firms Use The Foreign Exchange Market?

- International companies use the foreign exchange market when
  - the payments they receive for exports, the income they receive from foreign investments, or the income they receive from licensing agreements with foreign firms are in foreign currencies
  - they must pay a foreign company for its products or services in its country's currency
  - they have spare cash that they wish to invest for short terms in money markets
  - they are involved in **currency speculation** - the short-term movement of funds from one currency to another in the hopes of profiting from shifts in exchange rates

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How Can Firms Hedge Against Foreign Exchange Risk?

- The foreign exchange market provides insurance to protect against **foreign exchange risk**
  - the possibility that unpredicted changes in future exchange rates will have adverse consequences for the firm
- A firm that insures itself against foreign exchange risk is **hedging**

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What Is The Difference Between Spot Rates And Forward Rates?

- The **spot exchange rate** is the rate at which a foreign exchange dealer converts one currency into another currency on a particular day
  - spot rates change continually depending on the supply and demand for that currency and other currencies
- Spot exchange rates can be quoted as the amount of foreign currency one U.S. dollar can buy, or as the value of a dollar for one unit of foreign currency

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What Is The Difference Between Spot Rates And Forward Rates?

- To insure or hedge against a possible adverse foreign exchange rate movement, firms engage in **forward exchanges**
  - two parties agree to exchange currency and execute the deal at some specific date in the future
- A **forward exchange rate** is the rate used for these transactions
  - rates for currency exchange are typically quoted for 30, 90, or 180 days into the future

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What Is A Currency Swap?

1st Transaction buyer Seller.
2nd Transaction seller buyer.

- A **currency swap** is the simultaneous purchase and sale of a given amount of foreign exchange for two different value dates
- Swaps are transacted
  - between international businesses and their banks
  - between banks
  - between governments when it is desirable to move out of one currency into another for a limited period without incurring foreign exchange rate risk

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Recap

Foreign Investment Environment

1. Government Intervention
   - Why and how governments interfere in free trade?
2. Current World Trading System
   - How has the current world trading system emerged?
   - Regional economic integration – Europe, America, Asia
3. Foreign Direct Investment
   - Patterns of FDI
   - Cost & benefits of FDI

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