Global Trade and Investment

Module 4

Evolution of Trade

The Age of Mercantilism (16th to 18th Century)

- Accumulation of wealth through a positive balance of trade.
- Emphasis on protecting domestic industries and acquiring precious metals.

Classical Trade Theory (18th to 19th Century)

- Developed by economists like Adam Smith and David Ricardo.
- Focus on comparative advantage for global economic efficiency.

Factor Proportions Trade Theory (Early to Mid-20th Century)

- Developed by economists Eli Heckscher and Bertil Ohlin.
- Introduced the role of factor endowments in determining trade patterns.
- Advocated for countries to export goods using their abundant factors of production.

International Investment and Product Cycle Theory (1960s)

- Proposed by economist Raymond Vernon.
- Introduced the temporal dimension to trade dynamics.
- Argued that a product's life cycle influences international trade and investment patterns.

Evolution of Trade

The New Trade Theory: Strategic Trade (Late 20th Century):

- Developed by economists like Paul Krugman.
- Explores the impact of government intervention and strategic policies on global competitiveness.
- Suggests that governments can strategically support certain industries to enhance national positions.

Theory of International Investment (Contemporary Perspective):

- Acknowledges the interconnectedness of trade and investment.
- Recognizes the role of multinational corporations.
- Emphasizes understanding the dynamics between foreign direct investment and international trade.

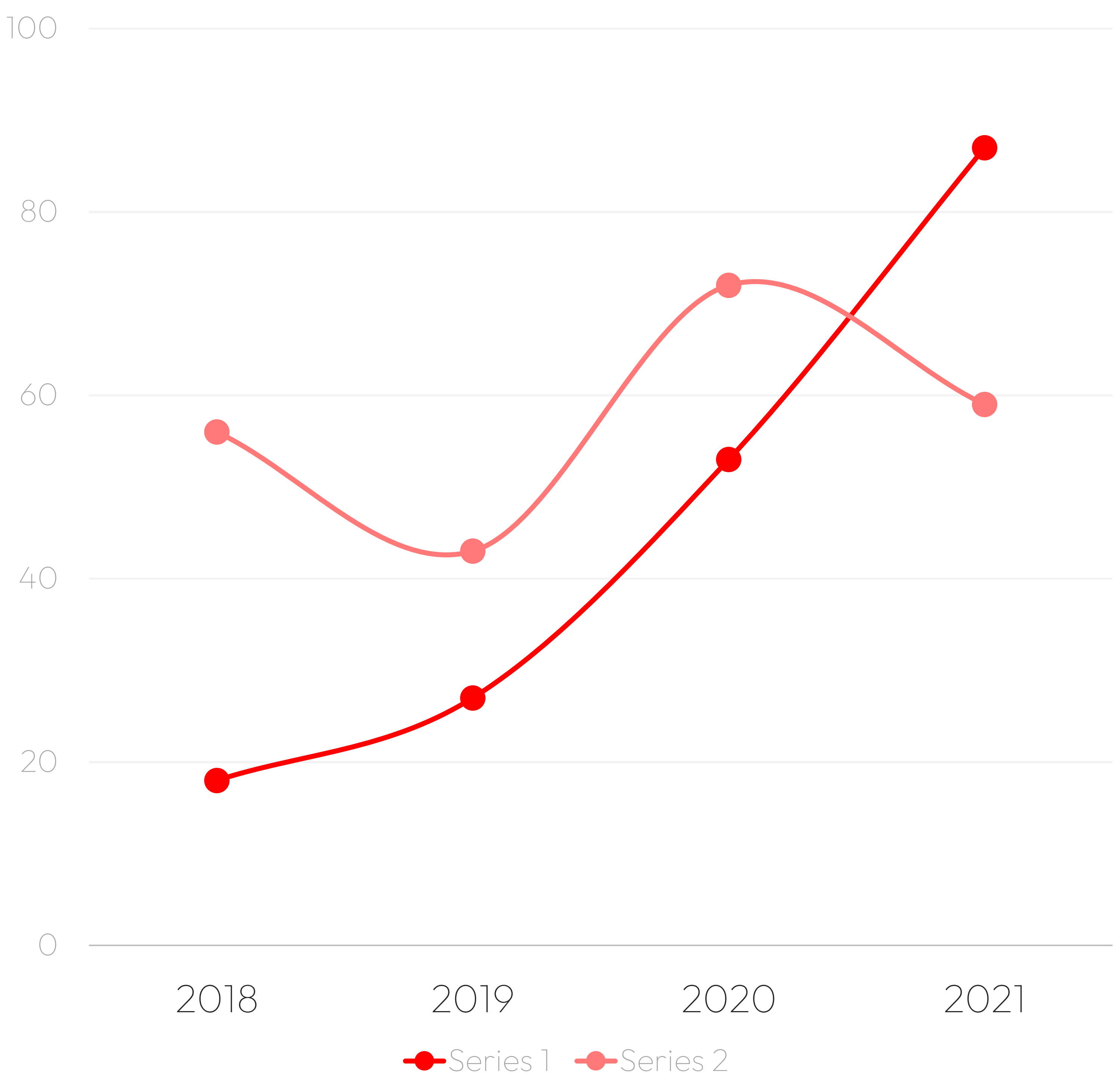
The Leontief Paradox

01 Proposed by economist Wassily Leontief in 1953.

02 The paradox arises when the United States, a capital-abundant country according to the Heckscher-Ohlin model, was observed to export more labor-intensive goods and import more capital-intensive goods.

03 The Leontief Paradox challenged the widespread acceptance of the Heckscher-Ohlin model as the sole explanation for international trade patterns.

04 The Leontief Paradox highlights a discrepancy between the predictions of the Heckscher-Ohlin model and the actual trade patterns observed in the United States. The paradox sparked debates and led to further refinements in trade theory, encouraging economists to consider dynamic factors, technological differences, and productivity in understanding international trade dynamics.



Theory of Absolute Advantage

The Theory of Absolute Advantage is an economic concept attributed to the Scottish economist Adam Smith. It is one of the earliest theories explaining why and how countries engage in international trade

Absolute advantage refers to a situation where a country can produce a good more efficiently (using fewer resources) than another country. In other words, it is the ability of a country to produce a good or service at a lower opportunity cost than another country.

Key Principles

Focus on Efficiency:

The theory emphasizes efficiency in production. A country has an absolute advantage if it can produce a certain good with fewer resources (or in less time) than another country.

Opportunity Cost:

The concept of opportunity cost is central to absolute advantage. The country with the lower opportunity cost of producing a particular good has an absolute advantage in that good.

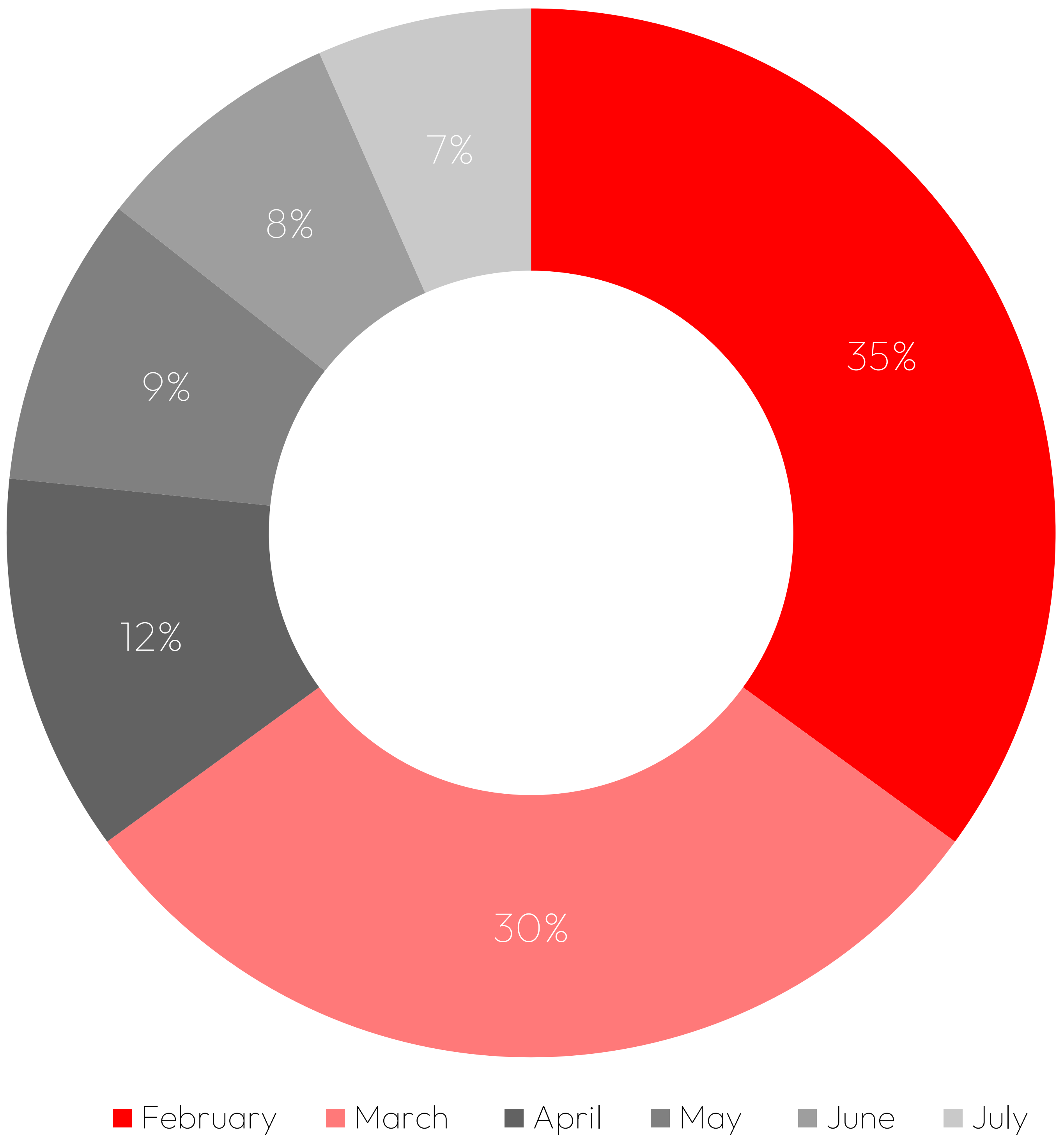
Specialization and Trade:

Smith argued that countries should specialize in the production of goods in which they have an absolute advantage. By specializing and then trading with each other, countries can maximize overall production and consumption.

Theory of Comparative Advantage

The Theory of Comparative Advantage is an economic principle developed by David Ricardo in the early 19th century. It provides a framework for understanding the benefits of international trade based on differences in opportunity costs

Comparative advantage refers to a situation in which one country can produce a good or service at a lower opportunity cost than another country. Unlike absolute advantage, which focuses on the ability to produce more efficiently, comparative advantage emphasizes the relative efficiency in terms of opportunity cost.



Key Principles

Opportunity Cost:

The central concept is the opportunity cost of producing a particular good. Opportunity cost is the value of the next best alternative foregone when resources are used to produce a certain good.

Comparative Advantage is Relative:

A country does not need to have an absolute advantage in the production of any good to benefit from trade. It only needs to have a lower opportunity cost compared to its trading partners.

Specialization and Mutual Gains:

Countries should specialize in the production of goods in which they have a comparative advantage. By doing so and engaging in trade, both countries can achieve higher levels of consumption than if they tried to produce everything domestically.

Overlapping Product Ranges Theory

Proposed by Staffan Burenstam Linder challenges traditional notions in international trade by suggesting that trade in manufactured goods is not solely dictated by cost considerations

According to Burenstam Linder, trade in manufactured goods is influenced by similarities in the preferences and incomes of trading nations rather than just production cost differences.

Burenstam Linder argues that nations with similar consumer preferences and income levels are more likely to trade with each other, leading to an overlap in the types of manufactured goods they produce and exchange.

Product Life Cycle Theory

The Product Cycle Theory, also known as the Vernon's International Product Life Cycle Theory, was proposed by economist Raymond Vernon in the 1960s. This theory attempts to explain how the location of production and the pattern of international trade evolve over time for a particular product

The theory primarily focuses on the lifecycle of products and how their production and trade patterns change over time.

The theory was introduced by economist Raymond Vernon in his work titled "International Investment and International Trade in the Product Cycle."

Stages of Product Life Cycle Theory

a. The New Product
b. The Maturing Product
c. The Standardized Product

Stage 1 - Introduction (Innovator Country):

Innovator Country: The product is initially developed and introduced in an innovator country with advanced technological capabilities.

High Production Costs: Production costs are high due to the initial stages of innovation and development.

Export by Innovator Country: The innovator country exports the product to other nations.

Stage 2 - Growth (Maturing Product):

Maturing Product: The product becomes more established, and demand starts growing.

Standardization and Cost Reduction: Production processes become more standardized, and costs decrease.

Emergence of Competitors: Other countries begin to imitate and produce the product, leading to the emergence of competitors

Stage 3 - Maturity (Competitor Countries):

Shift to Low-Cost Production Countries: As the product reaches maturity, production shifts to countries with lower production costs.

Establishment of Production Facilities: Competitor countries become major producers, and the original innovator country may reduce production.

Export by Competitor Countries: The now-mature product is exported by the lower-cost producer countries .

The New Trade Theory

The New Trade Theory, particularly the contributions of Paul Krugman and Michael Porter, highlights the importance of considering imperfectly competitive markets and industry-specific factors in understanding and shaping international trade. This approach recognizes the dynamic and strategic nature of global competitiveness.

The New Trade Theory, particularly the concept of Strategic Trade, introduced innovative perspectives on international trade

Paul Krugman's Contribution:

Focus on Imperfectly Competitive Markets

Paul Krugman's contribution to the New Trade Theory centers on how trade dynamics are altered when markets are not perfectly competitive.

Economies of Scale and Monopolistic Competition

Krugman emphasized the role of economies of scale and monopolistic competition in shaping international trade patterns. In imperfectly competitive markets, firms can achieve cost advantages through economies of scale, leading to strategic behavior.

Strategic Trade Policy

Krugman argued that governments can strategically intervene in the market to enhance national competitiveness. This might involve policies such as subsidies, tariffs, or technology support to promote domestic industries in strategic sectors.

Michael Porter's Contribution:

Global Competitiveness of Industries

Michael Porter's contribution to the New Trade Theory involves examining the competitiveness of industries on a global basis.

Diamond Model of National Advantage

Porter introduced the "Diamond Model of National Advantage," which identifies four factors influencing the competitive advantage of industries: factor conditions, demand conditions, related and supporting industries, and firm strategy, structure, and rivalry.

Clusters and Competitiveness

Porter emphasized the significance of industry clusters, where interconnected industries in a specific location mutually reinforce each other's competitiveness. This concept highlights the role of regional specialization and cooperation.

Strategic Trade and Imperfect Competition

Price Competition:

In imperfectly competitive markets, firms have the ability to influence prices rather than being price takers, as assumed in perfect competition.

Repetition

Product Differentiation: In imperfectly competitive markets, products may be differentiated, allowing firms to create unique features or branding.

Cost Competition:

Imperfect Cost Structures: In imperfectly competitive markets, firms may not have identical cost structures. Some industries or firms may have cost advantages due to factors such as economies of scale or technological superiority.

Externalities

Spillover Effects: Imperfect competition may lead to positive externalities, where the actions of one firm positively impact others or the industry as a whole.

Strategic Trade and Porter's Diamond of National Advantage:

Innovation as a Driver of Competitiveness:

According to strategic trade principles, innovation plays a pivotal role in driving and sustaining competitiveness. Nations that foster a culture of innovation are better positioned in the global market.

Michael Porter's Competitive Clusters:

Competitive clusters, as described by Michael Porter, refer to geographical concentrations of interconnected companies and institutions in a particular field. These clusters exhibit unusual competitive success, fostering innovation and efficiency.

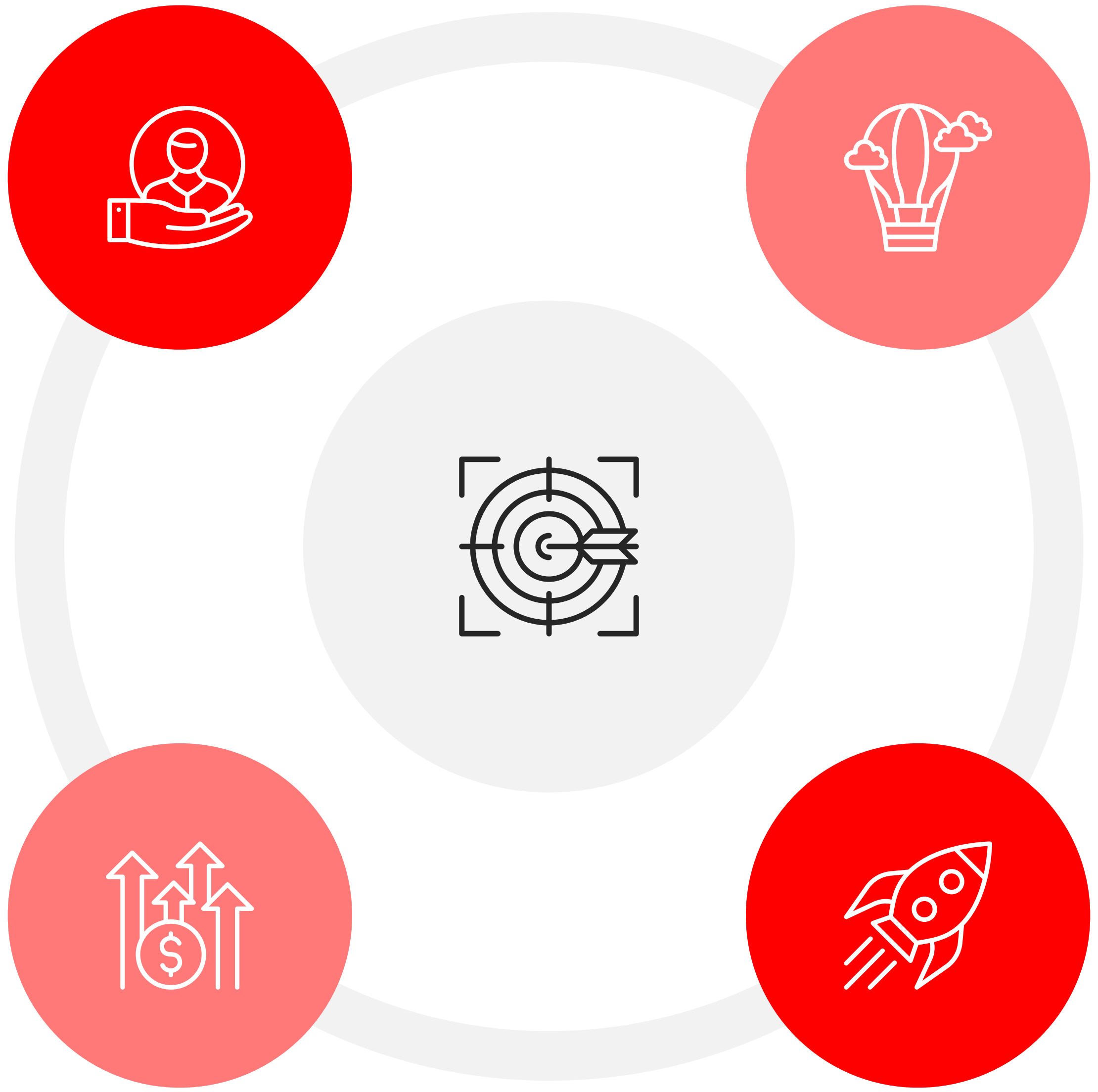
Located in One Place

The significance of clusters lies in their geographic proximity, allowing for easy collaboration, knowledge sharing, and specialization. This geographic concentration creates a synergy that enhances the competitiveness of the entire industry.

Four Components of Competition - Porter’s Diamond:

Factor Conditions:

Refers to a nation's endowments in terms of resources, skills, and infrastructure. These factor conditions provide the basic building blocks for competitive industries..



Related and Supporting Industries:

The presence of strong and competitive industries that are either suppliers or in related fields can enhance the overall competitiveness of an industry.

Demand Conditions:

Relates to the nature and size of the domestic market. Strong and sophisticated domestic demand can act as a driver for innovation and competitiveness.

Firm Strategy, Structure, and Rivalry:

Encompasses the strategies and management practices of firms within a nation. The nature of domestic rivalry and the strategies adopted by firms contribute to overall competitiveness.

Theory of International Investment

The theory of international investment acknowledges the global movement of capital, facilitating foreign direct investments across borders. This phenomenon has become a prominent feature of the contemporary global economy.

Firms as Seekers:

Seeking Resources:

Firms engage in international investment to access essential resources, such as raw materials, that may not be readily available in their home country.

Seeking Factor Advantages:

International investments are often driven by the pursuit of factor advantages, like cheaper labor or specialized skills, present in foreign markets.

Seeking Knowledge:

Companies invest internationally to tap into knowledge and expertise that may be concentrated in specific regions, fostering innovation and competitiveness.

Seeking Security:

Seeking a secure business environment, companies may invest in politically stable and economically viable foreign markets to diversify risks.

Seeking Markets:

Companies invest internationally to access new markets, expanding their customer base and increasing market share.

Firm as Exploiters of Imperfections

Imperfections in Access:

Firms exploit imperfections in market access, investing in regions where barriers to entry are relatively low, allowing them to establish a presence.

Imperfections in Factor Mobility:

International investments address imperfections in factor mobility, allowing firms to capitalize on factors such as labor or technology that may not be easily transferable.

Imperfections in Management:

Firms may invest internationally to exploit differences in management practices, leveraging expertise that is not readily available in their home country.

Firms as Internalizers:

Establishing Multinational Operations:

Companies internalize production processes by establishing their own multinational operations rather than relying solely on external suppliers or partners.

Competitive Advantage due to Confidentiality:

Internalizing production can provide a competitive advantage, especially when confidentiality and control over proprietary processes are critical to a firm's success.

Conclusion of International Investment

The theory of international investment is multifaceted, encompassing firms as seekers of various advantages and as exploiters of imperfections in the global market. Companies strategically invest abroad to secure resources, factor advantages, knowledge, security, and access to new markets. Additionally, firms internalize operations to gain a competitive edge, particularly when confidentiality and control are paramount. The theory reflects the dynamic nature of global business operations in the pursuit of strategic advantages.

Types of FDIs

1. Foreign Portfolio Investment
2. Foreign Institutional Investors
3. Offshore Funds
4. American Depositary Receipts (ADRs) / Global Depositary Receipts (GDRs):

Foreign Portfolio Investment (FPI)

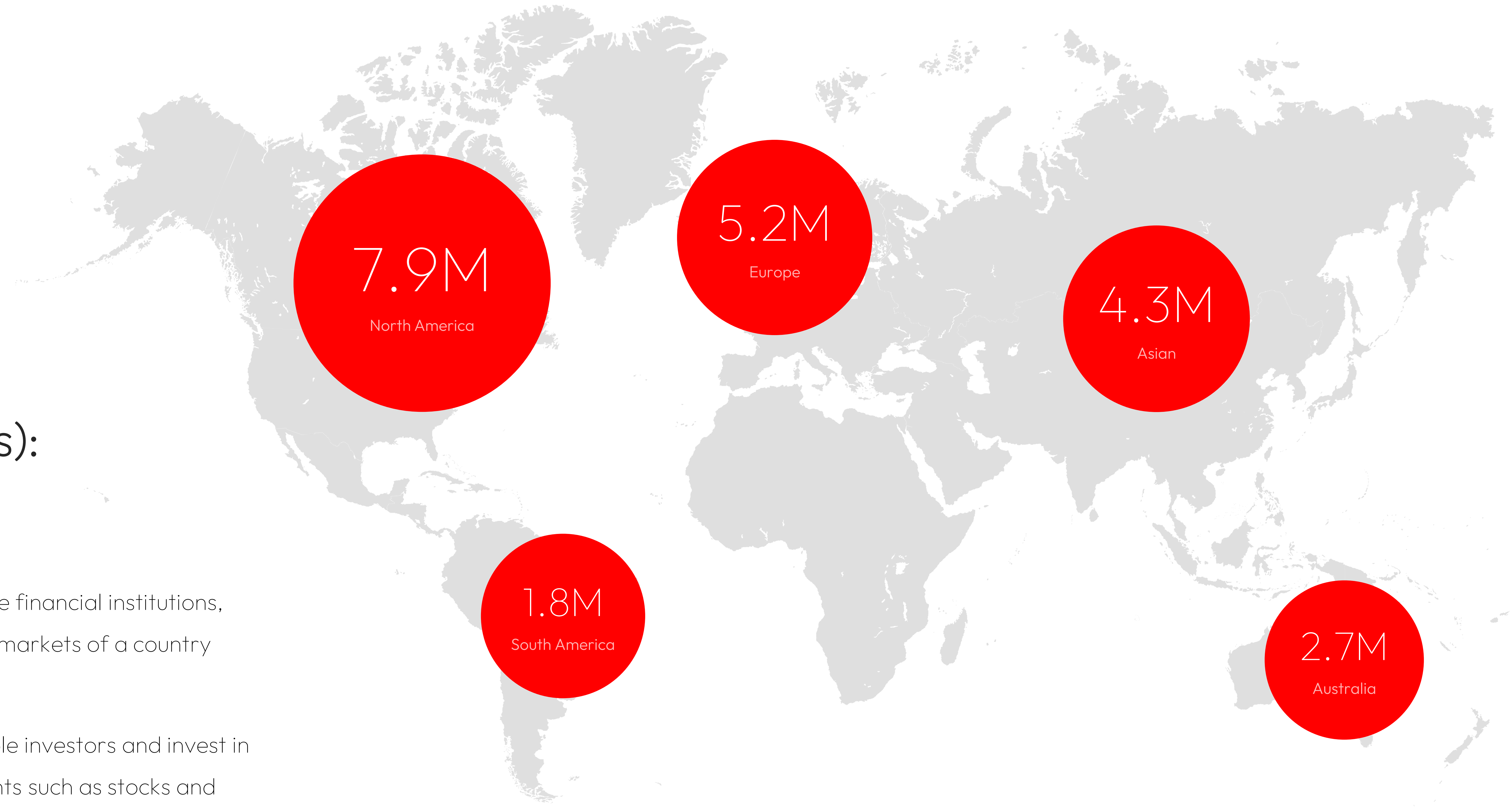
FPI involves buying financial assets such as stocks and bonds in a foreign country without taking an active role in the management of the invested enterprise.

Investors, often institutional, invest in a portfolio of financial assets in foreign markets with the goal of earning returns. FPI typically does not result in a significant degree of control or influence over the companies in which investments are made.

2. Foreign Institutional Investors (FIIs):

FIIs are entities, often large financial institutions, that invest in the financial markets of a country different from their own.

FIIs pool funds from multiple investors and invest in various financial instruments such as stocks and bonds in foreign markets. They play a crucial role in capital flows between countries, influencing global financial markets.



3. Offshore Funds:

Offshore funds are investment funds located in a jurisdiction with favorable tax regulations, providing international investors with tax advantages.

These funds attract investors by offering tax benefits and are often established in offshore financial centers. Investors benefit from potentially reduced tax liabilities, making offshore funds an attractive option for international investment.

4. American Depositary Receipts (ADRs) / Global Depositary Receipts (GDRs):

Definition

ADRs and GDRs are financial instruments representing ownership in a foreign company and are traded on a stock exchange in a country other than the company's home country.

ADRs

ADRs: Issued in the U.S., ADRs allow U.S. investors to invest in foreign companies without trading the actual foreign shares. They simplify the process for American investors.

GDRs

GDRs: Issued globally, GDRs are similar to ADRs but can be traded on multiple international exchanges. They provide a way for companies to raise capital in multiple markets.

FDI?

FDI is defined as an investment that establishes a long-term relationship and reflects a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate).

FDI can take various forms, including acquiring a stake in an existing enterprise in the foreign country or establishing a subsidiary to expand the operations of an existing enterprise.

FDI implies a long-term commitment and involvement, indicating a lasting interest by the foreign investor in the enterprise in the host country.

Why FDI ?

One of the key characteristics of FDI is that the investor exerts a significant degree of influence on the management of the enterprise located in the other economy. This influence can manifest in decision-making processes, strategic planning, and overall operational control.

The primary purpose of FDI is to establish a physical presence in a foreign market. This can involve setting up production facilities, establishing marketing operations, or both. The aim is to enhance the firm's global reach and competitiveness.

FDI involves a commitment to a long-term relationship between the foreign investor and the enterprise in the host country. This contrasts with more temporary forms of investment, such as portfolio investment.

FPI?

FPI involves investing in foreign financial assets, such as stocks, bonds, commodities, etc. The focus is on financial instruments rather than direct ownership or control of companies.

Unlike Foreign Direct Investment (FDI), FPI is not made with the intention of acquiring a controlling interest in the issuing company. Investors in FPI are more interested in the financial returns generated by the assets.

FPI is typically short-term in nature. Investors engage in FPI to take advantage of short-term opportunities, such as favorable changes in exchange rates or to earn profits from interest rate differentials.

Why FPI?

- Investors in FPI are motivated by the prospect of making short-term profits. This could involve capitalizing on currency movements or exploiting changes in interest rates to generate financial gains.
- FPI provides investors with an opportunity to diversify their portfolios. By spreading investments across various foreign financial assets, investors aim to reduce risk and enhance the overall stability of their investment portfolios.
- Investors engaging in FPI often adopt a global investment strategy, seeking opportunities in different markets to capitalize on specific conditions or trends that may present short-term advantages.

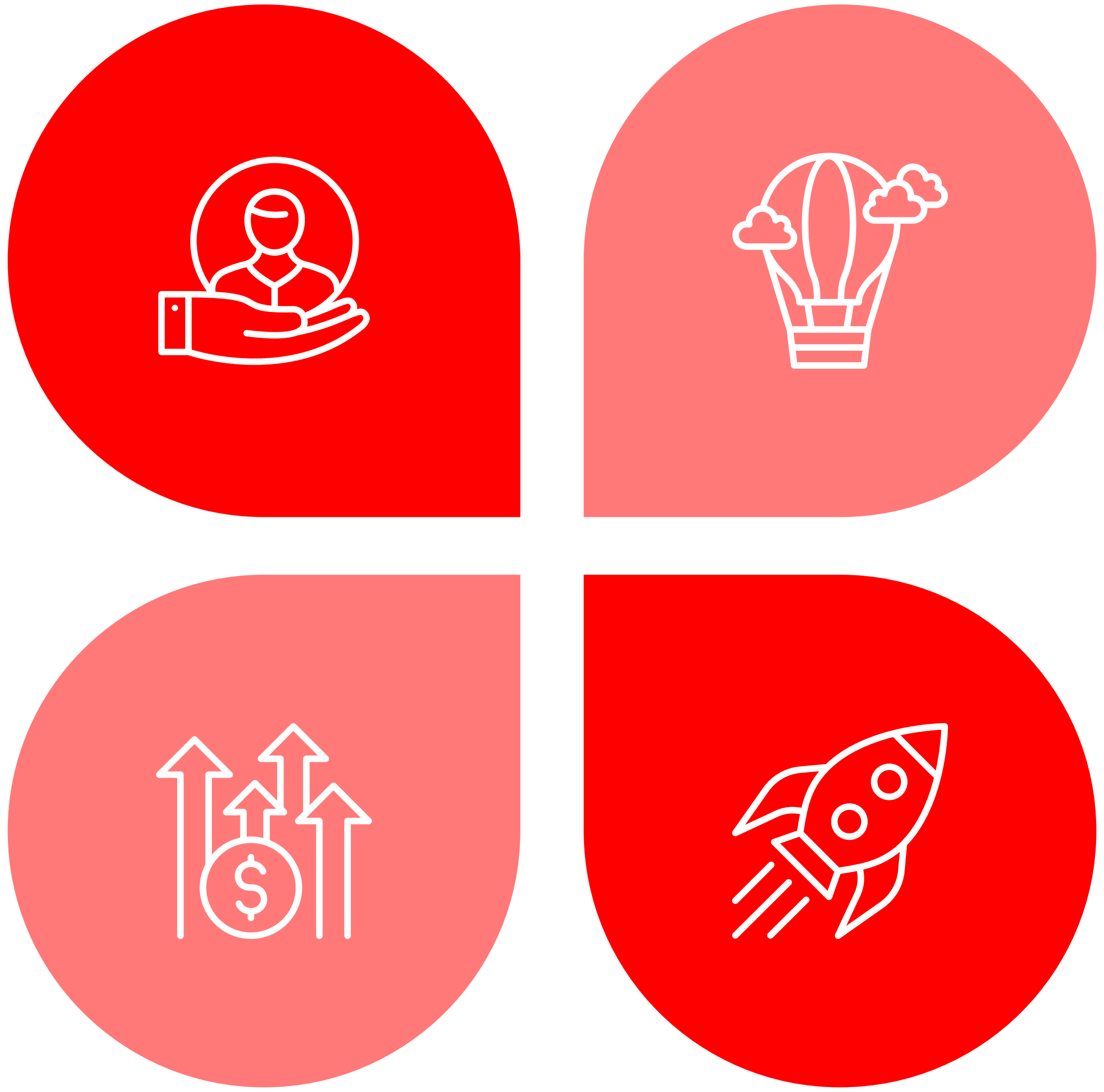
FDI V/s FPI

Basis	FDI	FPI
Motive	Made for the purpose of productive capacity	Motivated by the pursuit of profit
Participation in Management	Intention of managerial control	No say in the management
Assets	Involves physical assets and infrastructure	Involves financial assets such as stocks, bonds, etc.
Duration	Long-term	Short-term
Stability	More stable	Less stable (volatile)
Impact on Growth	Critical driver of economic growth	Gives impetus to financial markets
Entry and Exit	Entry and exit can be difficult and complex	Entry and exit are relatively easy and quick

Classification of Foreign Direct Investment (FDI)

Based on Direction of Flow of Funds

FDI is classified by the flow of funds. Inward FDI sees foreign capital invested locally, while Outward FDI involves local capital invested abroad.



Based on Strategic objective

FDI objectives guide its classification. Resource-Seeking aims to utilize natural resources; Market-Seeking serves markets with local production; Efficiency-Seeking focuses on cost-effective global production; and Strategic Asset-Seeking acquires assets for competitiveness.

Based on Nature of investment

FDI types include Greenfield (establishing new facilities), Mergers and Acquisitions (combining entities), and Brownfield (infusing capital into existing ventures).

Based on Operation

Operations-based FDI includes Horizontal (same industry), Vertical (upstream or downstream operations), highlighting varied integration in the economy.

1. Based on Direction of Flow of Funds:

Inward FDI:

Inward Foreign Direct Investment (FDI) occurs when foreign capital is directed towards investing in local resources within a host country. This involves the establishment of operations or significant investments by a foreign entity in the local market.

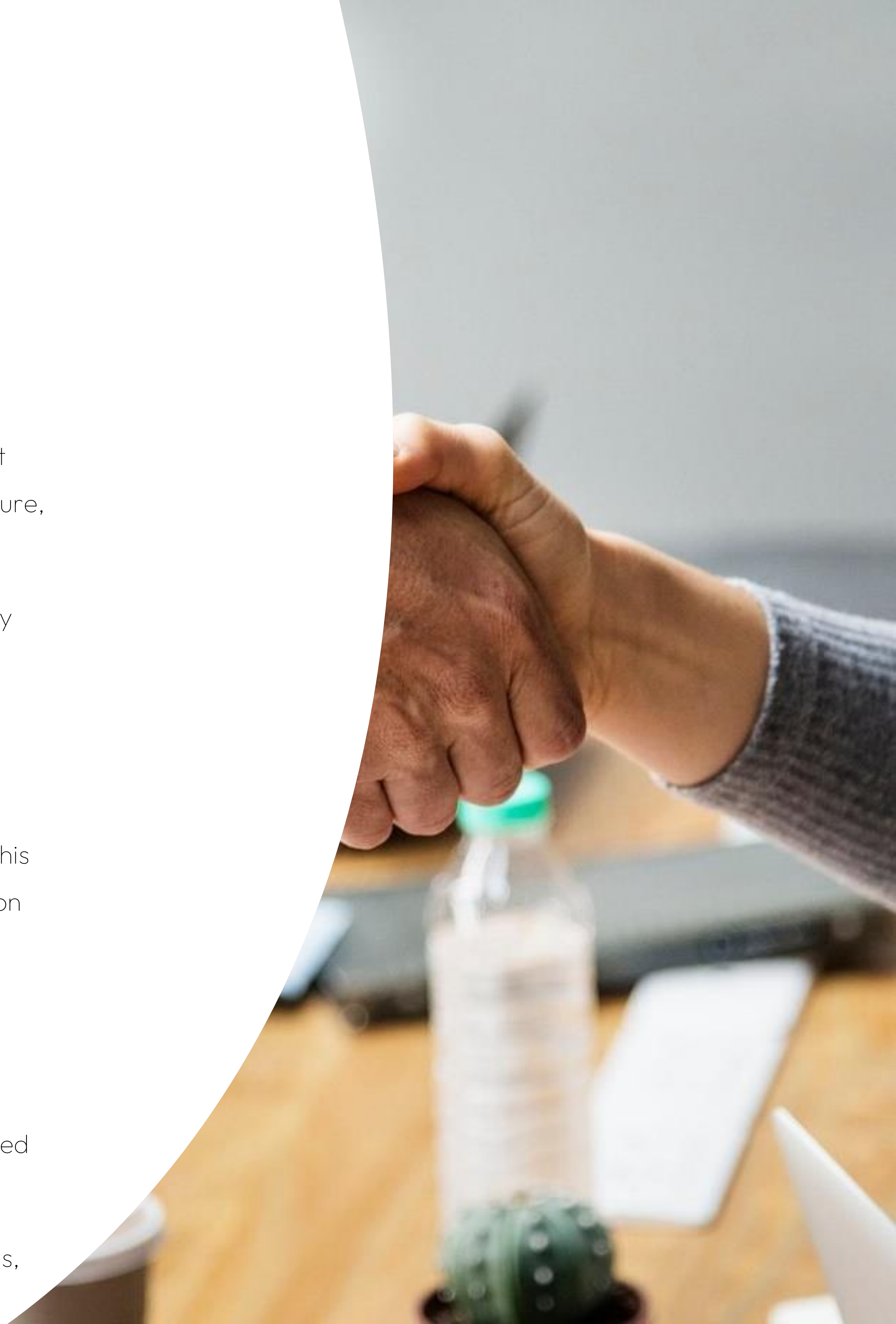
An illustration of Inward FDI is when a multinational corporation headquartered in a foreign country decides to expand its business operations by establishing manufacturing plants, offices, or service centers within the host country. This type of investment often brings in new technologies, skills, and employment opportunities, contributing to the host country's economic development.

Inward FDI:

Outward Foreign Direct Investment (FDI) takes place when local capital is strategically invested in foreign resources. In this scenario, a local company expands its operations beyond national borders by investing in and establishing business ventures in foreign countries.

An example of Outward FDI is when a successful local company decides to invest in overseas markets to tap into new consumer bases, access resources, or benefit from favorable business environments. This form of investment allows the local company to diversify its operations, gain global market exposure, and potentially achieve economies of scale.

2. Based on the Nature of Investment:



Greenfield Investment:

Greenfield Investment entails the establishment of entirely new operational facilities from the ground up in the host country. This form of investment represents a profound commitment, involving the construction of new infrastructure, facilities, or business units.

Greenfield investments are marked by a dedication to a lasting presence in the host country, fostering sustainability and local integration.

Mergers and Acquisitions (M&As):

Mergers and Acquisitions involve the collaboration of two or more independent entities from different countries. This collaboration results in either the formation of a new legal entity or one entity acquiring the other. M&As can take on various dynamics, ranging from friendly to hostile.

Characteristics:

- Hostile or Friendly: M&As can occur through cooperative agreements or more competitive, hostile takeovers.
- Purchase of an Existing Venture: M&As often involve the acquisition of an existing business, leveraging established market presence.
- Combination of Investments: M&As may encompass both greenfield investments (new ventures) and acquisitions, providing a comprehensive strategic approach.

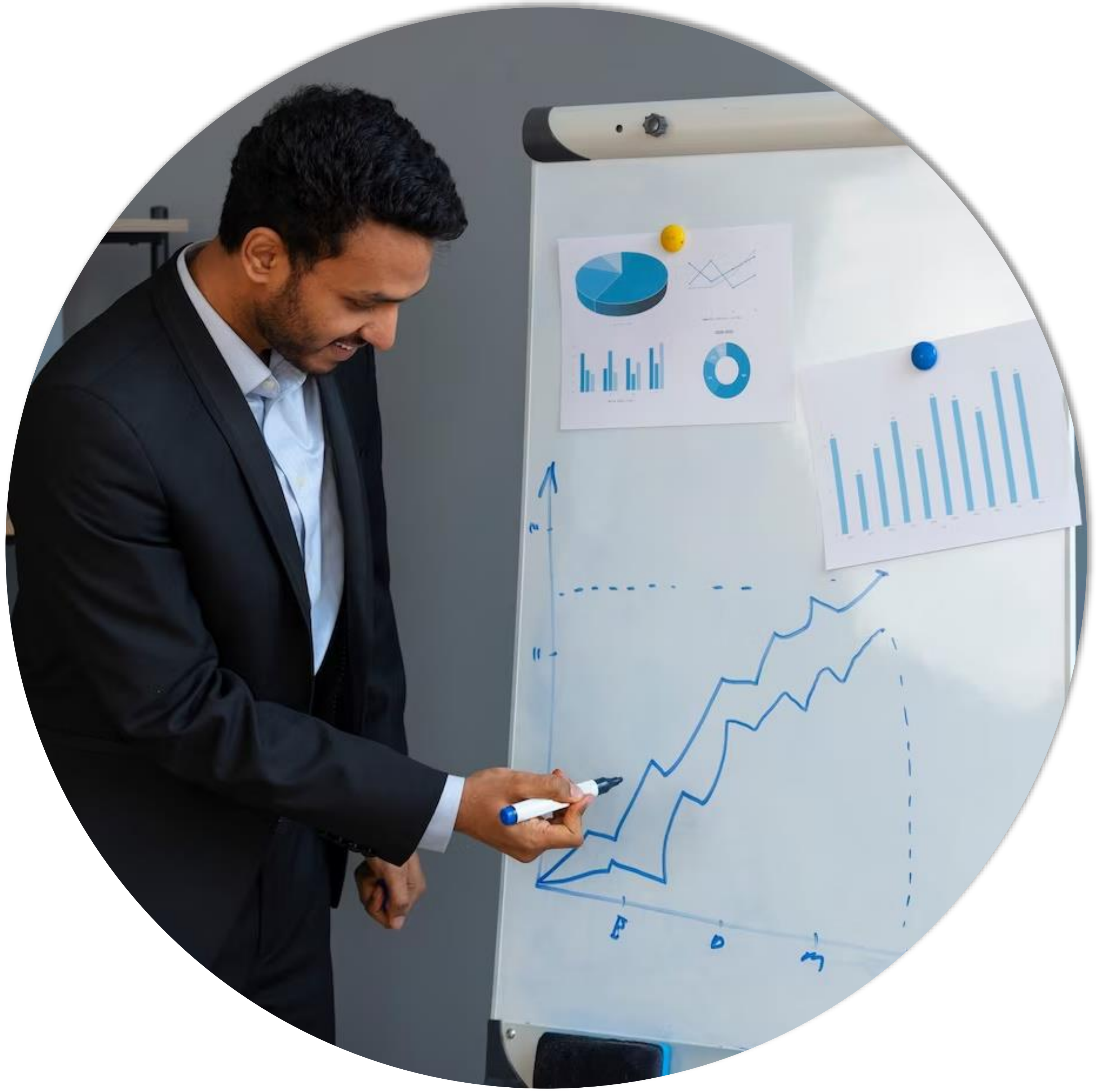
Brownfield Investment:

Brownfield Investment is characterized by the infusion of fresh capital and assets into an existing venture after acquisition. It represents a hybrid form that combines elements of both greenfield investments and M&As.

Characteristics:

- Integration of New Capital: Brownfield investments inject new capital into an already established venture, facilitating growth and revitalization.
- Hybrid Nature: Combining features of both greenfield and M&As, brownfield investments offer a flexible approach to strategic expansion.

These classifications in the nature of investment highlight the diverse ways in which foreign entities establish, collaborate, and inject capital into operations in host countries. Each approach carries unique characteristics that cater to different strategic objectives and market conditions.



3. Based on Strategic Objectives:

Resource-Seeking:

- Objective: Resource-Seeking FDI aims to capitalize on natural resources present in the host country. Companies pursuing this objective seek to secure access to raw materials, minerals, or other valuable resources.
- Outcome: This form of FDI is likely to promote exports in the host economy, as companies extract and utilize local resources for production.

Market-Seeking:

- Objective: Market-Seeking FDI is centered around serving a market directly through local production and distribution instead of relying on exports. Companies pursue this strategy to gain proximity to target markets.
- Outcome: By adopting Market-Seeking FDI, companies gain access to large overseas markets and benefit from economies of scale through localized operations.

3. Based on Strategic Objectives:

Efficiency-Seeking:

- Objective: Efficiency-Seeking FDI aims to establish cost-effective and competitive global production networks. Companies pursuing this objective seek to optimize their production processes and supply chains.
- Outcome: Efficiency-Seeking FDI allows companies to achieve gains from synergies, cost efficiencies, and improved competitiveness on a global scale.

Strategic Asset-Seeking:

- Objective: Strategic Asset-Seeking FDI is driven by the desire to acquire critical assets such as innovative technology, management expertise, or other strategic advantages. Companies pursue this strategy to enhance their global competitiveness.
- Outcome: By strategically acquiring assets, firms engaging in Strategic Asset-Seeking FDI strengthen their overall competitive position in the global market.

4. Based on Operations:

Horizontal FDI:

- Nature: Horizontal FDI involves investments in the same operation or industry. In this strategy, companies expand their presence within the same sector, often across different geographical locations.
- Significance: This form of FDI allows companies to capitalize on industry-specific expertise, achieve economies of scale, and strengthen their market share within a particular sector on a global scale.

Vertical FDI:

- Nature: Vertical FDI takes a more comprehensive approach by encompassing investments in both upstream (backward) and downstream (forward) operations. Upstream investments involve activities earlier in the production chain, while downstream investments occur later in the chain, closer to consumers.
- Significance: Vertical FDI enables companies to integrate their production processes, control supply chains, and enhance operational efficiency. By engaging in both upstream and downstream activities, firms can streamline their operations and adapt to changing market conditions.

Benefits of FDI to Host Country:

Resource Transfer Effects:

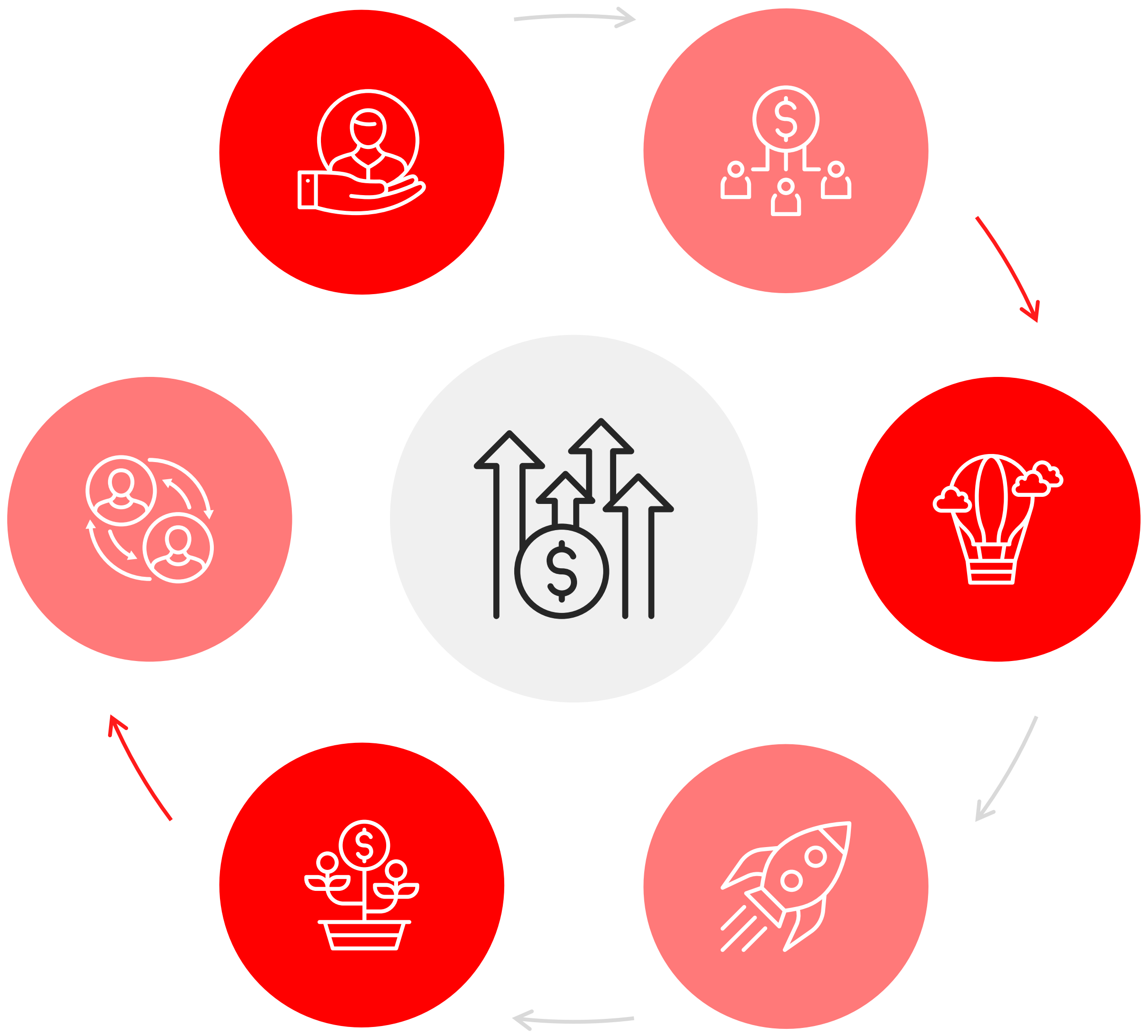
FDI brings in capital, technology, and expertise, facilitating the transfer of resources to the host country.

Employment Effects:

FDI generates job opportunities, reducing unemployment and contributing to the host country's economic development.

BOP Effects

FDI can positively impact the Balance of Payments (BOP) by bringing in foreign currency through investments, reducing trade deficits



Effect on Competition and Growth

FDI stimulates competition, fostering innovation and efficiency, leading to overall economic growth

Revenue to Government

Host governments benefit from tax revenues generated by FDI, contributing to public finances

Less Volatility

FDI is a stable source of investment, providing a consistent inflow of capital compared to volatile financial flows.

Costs to Host Country:

Adverse Effects on Competition:

FDI can lead to monopolistic practices, negatively impacting domestic competition

Adverse Effects on BOP

Excessive imports associated with FDI can lead to a negative impact on the host country's Balance of Payments

National Sovereignty and Autonomy

There may be concerns about FDI influencing national policies, compromising sovereignty and autonomy

Capital-Intensive Technology

FDI may introduce capital-intensive technologies, potentially leading to skill gaps and unemployment in traditional sectors

Benefits to Home Country:

BOP Benefits:

Home countries benefit from a positive Balance of Payments through dividends and repatriation of profits

Acquisition of Skills:

Companies from the home country gain access to new markets and skills through international expansion.

Employment Benefits:

FDI from home countries can create jobs locally, supporting employment.

Cost to Home Country:

Current A/C - More Imports:

Increased imports from subsidiaries abroad may negatively affect the home country's current account.

BOP Effect:

Initial capital outflow from the home country's Balance of Payments can occur during the establishment phase of FDI.

Current A/C - Less Exports:

FDI may lead to a decrease in exports as production shifts to foreign markets, affecting the home country's trade balance.

Employment Effect:

The relocation of jobs abroad can lead to employment challenges in the home country.

Thanks

Have questions? Or just want to say hello?

Contact me at youlonelyfuck@die.com