5TH EDITION

INTER-NATIONAL TRADE & INVEST-MENT

ROOT

5TH EDITION

INTER-NATIONAL TRADE & INVEST-MENT

The Wharton School
University of Penns

H61 SOUTH-WESTERN PUBLISHING CO.

CINCINNATI WEST CHICAGO, ILL. DALLAS PELHAM MANOR, N Y PALO ALTO CALIF

ISBN: 0-538-08610-6

Library of Congress
Catalog Card Number: 81-85862

1 2 3 4 5 6 7 D 9 8 7 6 5 4 3
Printed in the United States of America

PREFACE

International Trade and Investment offers the reader an integrated treatment of theory, policy, and enterprise in international trade and investment. A knowledge and understanding of these interdependent subjects is vital for all those who plan to enter an international business career or work for governments and international organizations in activities that relate to international economic relations. Apart from career interests, persons who want to improve their understanding of the world in which they live are seriously handicapped without an awareness, if not comprehension, of the economic dynamics and policy issues of trade and investment flows among nations.

Theory refers to the body of knowledge that seeks to explain the causal factors that determine the size, composition, and direction of international economic transactions. A grasp of theory enables us to analyze events occurring in the world economy and to evaluate the wisdom of national policies.

Policy encompasses the role of governments in their efforts to regulate, restrict, promote, or otherwise influence the conduct of international trade and investment. A study of national policies brings us to an intersection of international economics and international politics, an amalgam traditionally designated as political economy. This book carries the description and analysis of national policies to a greater depth than is customary in a basic text, with emphasis on contemporary problems and issues.

Enterprise designates the multinational enterprise, which undertakes production in many countries in pursuit of a global business strategy transcending national jurisdictions. Study of the multinational enterprise brings us face to face with the business firms that are responsible for much of the trade and most of the direct foreign investment in the world economy today.

International economists have traditionally maintained a *macroscopic* perspective of international economic relations by considering trade and investment only at the national level. This macroscopic approach is necessary but no longer sufficient to explain the behavior of the world economy. Possessing vast resources, multinational companies enjoy a market power that makes them independent actors in the international economic system, forcing changes in national economies and provoking policy responses by governments. Hence, to understand the contemporary world economy we must combine the traditional, macroscopic perspective with a *microscopic* perspective of the multinational enterprise. This text offers a systematic presentation of the multinational enterprise as the dominant institution in international trade and investment.

International Trade and Investment is a major revision of the previous edition, both in form and content. As for form, I have placed the treatment of *International Payments* before that of *International Trade*. By starting with

"The Balance of International Payments" readers are exposed to the full breadth of international economic relations as revealed in the balance of payments. Also, the other subjects of Part One are probably more appealing to the majority of readers than the theory of trade and, therefore, offer a less "painful" approach to the study of international economics.

As for content, I have revised every chapter and, in some instances, almost completely rewritten them to account for recent theoretical and policy developments. This revision was undertaken at a time of massive troubles afflicting the world economy. Indeed, the very existence of an open world economy remains threatened by trade wars and international financial collapse. I have tried in a period of rapid, often drastic, change to make this edition as up to date as possible without neglecting those conditions and forces that will shape our world a long time into the future.

In closing, let me express my thanks to readers who cared enough about this text to make suggestions to improve it. I have worked hard to achieve a balance between theory, policy, and enterprise that I hope will please some of them without unduly annoying the rest. My thanks also to my wife who knew when to leave me alone.

Franklin R. Root

CONTENTS

Chapter 1 The International Economy and the National Interest 1

The International Political System, 2. The International Economic System, 4. The Multinational Enterprise System, 5. Distinctive Features of International Trade and Investment, 6. The National Interest in International Trade, 8. The Goals and Instruments of Foreign Economic Policy, 14. Some Empirical Dimensions of International Trade, 22. What Lies Ahead, 26.

PART ONE / INTERNATIONAL PAYMENTS 31

Chapter 2 The Balance of International Payments 33

The Compilation of the Balance of Payments, 33. Balance of Payments Presentation, 37. Balance of Payments Analysis: Equilibrium and Disequilibrium, 41. Concepts of Surplus and Deficit, 45. The Need for Adjustment, 48.

Chapter 3 The Transfer of International Payments 51

Transfer Through Private Compensation, 51. The Foreign Exchange Market, 52. The Monetary Effects of International Payments, 59. International Financial Centers, 61.

Chapter 4 Foreign Exchange Rates and Their Determination 66

The Rate of Exchange, 66. Freely Fluctuating Exchange Rates, 68. Stable Exchange Rates, 72. Controlled Exchange Rates, 75. Exchange Arbitrage, 77. Exchange Speculation and Capital Flight, 79. Some Additional Remarks on the Determination of Exchange Rates, 80.

Chapter 5 Forward Exchange and Hedging Against Exchange Risks 83

The Forward Rate of Exchange, 83. Interest Parity Theory, 84. The Modern Theory of Forward Exchange, 89. Hedging Against Foreign Exchange Risks, 92.

Chapter 6 International Payments Adjustment in a Stable-Rate System 100

Short-Run Adjustment, 100. The Classical Theory of Adjustment, 102. National Income, Foreign Trade, and Domestic Absorption, 104. International

Payments Adjustment and Domestic Absorption, 110. Equilibrating Changes in Domestic Absorption Through Real Income Effects, 111. Equilibrating Changes in Domestic Absorption Through Monetary Effects, 115. Equilibrating Changes in Domestic Absorption Through Price Effects, 116. Balance of Payments Policy: Internal and External Balance, 119. The Monetary Approach to the Balance of Payments, 121.

Chapter 7 International Payments Adjustment in a Variable-Rate System 126

Variable Rates: Introduction, 126. Elasticities Approach to Exchange Rate Adjustment, 130. Absorption Approach to Exchange Rate Adjustment, 136. Monetary Approach to Exchange Rate Adjustment, 139. Forecasting Exchange Rates, 142.

Chapter 8 Nonmarket Suppression of External Payments Disequilibrium: Exchange Control 149

The Origins of Exchange Control, 149. The Objectives of Exchange Control, 151. Single-Rate Systems of Exchange Control, 153. Multiple-Rate Systems of Exchange Control, 156. The Effects of Exchange Control, 158. A Synoptic View of Contemporary Exchange Control Practices, 160.

Chapter 9 The Collapse of the Bretton Woods International Monetary System 164

The International Monetary Fund (IMF), 164. The Central Reserve Role of the U.S. Dollar, 168. The U.S. Balance of Payments Deficit, 170. Monetary Crises in the Late 1960s, 175. The International Monetary Crisis of 1971, 176. The Smithsonian Agreement, 178. Weaknesses of the Bretton Woods System, 179.

Chapter 10 The Contemporary International Monetary System 186

Foreign Exchange Arrangements, 186. Exchange Rate Behavior, 186. Central Bank Intervention in Foreign Exchange Markets, 191. International Reserves and the Formation of International Liquidity, 192. The Continuing Role of the International Monetary Fund, 195. The Eurocurrency Market, 197. Performance of the Contemporary System, 201.

PART TWO / INTERNATIONAL TRADE 207

Chapter 11 The Modern Theory of International Trade: Comparative Advantage 209

Production Possibilities of National Economies, 210. Dissimilar Factor Endowments of National Economies, 217. Offer Curves: The Determination of the Terms of Trade, 223.

Chapter 12 Qualifications of the Modern Theory of International Trade 228

Unemployment and Comparative Advantage, 228. Transportation and Other Transfer Costs, 229. Heterogeneity and Change in Factor Endowments, 233.

Technological Innovation: Factor Productivity, Dissimilar Production Functions, and New Products, 246. The International Mobility of Factors, 250. Restatement of the Theory of Comparative Advantage, 254.

Chapter 13 New Theories of International Trade 258

The Leontief Paradox, 258. Human-Skills Theory of Trade, 261. Technology Theories of Trade, 263. Intra-Industry Trade: Overlapping Market Segments, Product Differentiation, and Economies of Scale, 268. International Trade Theory and Multinational Enterprise, 273. Trade Theory and Trade Policy, 274.

Chapter 14 Free Trade and Arguments for Protection 278

The Case for Free Trade, 278. The Case for Protection, 280. Fallacious Arguments for Protection, 281. Questionable Arguments for Protection, 284. Qualified Arguments for Protection, 287. Sophisticated Arguments for Protection, 290. Persistence of Protection, 293.

Chapter 15 Tariffs and Nontariff Trade Barriers 296

Tariffs and Tariff Systems, 296. Economic Effects of Tariffs, 299. Nontariff Trade Barriers; Quantitative Restrictions, 305. Other Nontariff Trade Barriers, 309.

Chapter 16 GATT and U.S. Trade Policy 316

The General Agreement on Tariffs and Trade (GATT), 317. The Tokyo Round of Multilateral Trade Negotiations (MTNs), 321. U.S. Trade Policy, 326. The Resurrection of Protection, 330. Whither U.S. Trade Policy? 336.

Chapter 17 The European Economic Community 340

The Creation of a Customs Union, 341. Building a Common Market, 345. Toward an Economic Union, 347. The Theory of Economic Integration, 350. External Economic Relations of the Community, 355.

PART THREE / INTERNATIONAL DEVELOPMENT 361

Chapter 18 The Developing Countries in the World Economy 363

The Economic Situation of the Developing Countries, 363. Capital Formation, Economic Growth, and Constraints on Domestic Investment, 372. International Trade and Economic Development, 376. Export Problems of the Developing Countries, 379. Trade Policies of the Developing Countries, 382.

Chapter 19 The Demand for a New International Economic Order (I) 387

The Radical Critique of the Contemporary International Economic System, 388. The Program of Action, 392. Export Cartels, 393.

Chapter 20 The Demand for a New International Economic Order (II) 399

International Commodity Agreements, 399. Preferential Treatment of Manufactures, 404. Economic Development Through Regional Integration and Nonregional Preferential Arrangements, 406. External Assistance to the Developing Countries, 412. Whither the NIEO? 419.

PART FOUR / INTERNATIONAL INVESTMENT/MULTINATIONAL ENTERPRISE 423

Chapter 21 The Nature and Scope of Multinational Enterprise 425

The Multinational Enterprise as an International Transfer Agent, 426. The Contribution of the Multinational Enterprise to the World Economy, 440.

Chapter 22 Theories of Direct Foreign Investment and the Multinational Enterprise 448

Statistical Overview of Direct Foreign Investment, 448. Requirements of a Theory of Direct Foreign Investment, 455. The Theory of International Portfolio Investment, 456. The Monopolistic Advantage Theory of Direct Foreign Investment, 457. The Internalization Theory of Direct Foreign Investment, 464. The Eclectic Theory of Direct Foreign Investment, 466. The Choice Among Export, Licensing, and Direct Foreign Investment, 467. Toward a Synthesis of International Trade and Investment Theories, 469.

Chapter 23 U.S. Policy Toward the Multinational Enterprise 472

Traditional U.S. Policy Toward Direct Foreign Investment, 473. Balance of Payments Controls on U.S. Direct Foreign Investment, 474. U.S. Labor's Opposition to the Multinational Enterprise: The Employment Issue, 479. U.S. Tax Policy Toward Multinational Enterprise, 482. U.S. Antitrust Policy and the Multinational Enterprise, 487. Promotion of Direct Investment in Developing Countries, 490. U.S. Policy Toward Direct Foreign Investment in the United States, 492. The Foreign Corrupt Practices Act, 494. The Need for a Comprehensive U.S. Policy, 496.

Chapter 24 Host Country Policies Toward the Multinational Enterprise 501

The Economic Benefits and Costs of Direct Foreign Investment to Host Countries, 501. The Challenge of the Multinational Enterprise to the National Sovereignty of Host Countries, 511. Policies and Actions of Host Governments to Minimize the Political Costs of Direct Foreign Investment, 516. Investment Incentives and Performance Requirements of Host Countries, 524. Toward an Accommodation between Nation-States and the Multinational Enterprise, 527.

Glossary of Abbreviations and Acronyms 535

Index 537

CHAPTER 1

THE INTERNATIONAL ECONOMY AND THE NATIONAL INTEREST

No nation inhabits an economic vacuum. Its industries, its commerce, its technology, its standard of living, and all the other facets of its economy are related to the economies of foreign nations by complex flows of goods, capital, technology, and enterprise. Every nation must come to terms with this interdependence, and every nation can enlarge the benefits and lessen the costs of interdependence through rational policies. But to do so, nations—individually and collectively—must base their policies on the objective analysis of international economic relations. It is the social function of international economists to develop the concepts and theories that make objective analysis possible.

From a broader perspective, every nation inhabits a global political and social environment as well as a global economic environment.[1] At the immediate, sensational level of perception, the international environment appears as a bewildering sequence of seemingly random events: a coup d'etat occurs in country A, prices rise in country B, the government of country C devalues its exchange rate, the government of country D expropriates a foreign-owned company, and so on. When each event is perceived as a unique, isolated phenomenon unrelated to other phenomena, then it is impossible to understand *why* the event has occurred. To comprehend the international environment, therefore, we must simplify by classifying individual events into groups or categories of events and by tracing out the relationships among these aggregates. In other words, we must construct a *system* that is characterized by defined elements (variables) and their interrelationships that together determine the behavior of the system. We are then able to interpret an event in terms of its place in the system. If the system is a good approximation of the fundamental conditions and forces actually at work in the world, then we can also predict the consequences of an event with a reasonable degree of confidence. What we have done is to build a model that enables us to comprehend a reality that defies comprehension in the raw.

In our exploration of international economic relations we shall make use of many concepts (such as the nation-state, gross national product, the balance of payments, and multinational enterprise) that bring together diverse phenomena and order them in ways that facilitate analysis. We shall also employ theories that seek to explain *why* the international economy behaves as it does, or how it *should* behave to maximize certain values. However, before proceeding with our study of the international economy, some preliminary remarks are in order about the *international political system*.

[1] Ecologists dramatically remind us that every nation also inhabits a global physical environment.

THE INTERNATIONAL POLITICAL SYSTEM

The human race is organized in a society of nation-states. The elemental constituents of a nation-state are a people, a territory, an economy, and a sovereign government. The necessary constituent of statehood is *national sovereignty*.

National Sovereignty

International law recognizes the national government as having exclusive jurisdiction over the territory of the state and as being the only legal representative of the state vis-à-vis other states. The state is not subordinate to any legal authority, and it has the right to abrogate any agreements with other states or with their citizens. Furthermore, national states have a legal monopoly on physical force both at home and abroad. Since states control the entire land surface of the earth, every individual and organization is a legal resident of a particular state and is subject to its authority.[2] Among its other consequences, the principle of national sovereignty raises many problems for international economic cooperation and for multinational enterprises, which operate on the territory of more than one nation.

Although *legally* a state can do as it pleases, its actual conduct in international affairs is constrained by the power of other states. For a very weak state, national sovereignty may become a legal fiction even within its own territory.

External Relations of States

Each state seeks to have relations with other states that will sustain or promote its own national interests as they are conceived by government leaders. Foremost among these interests is the continuing survival of the state itself; economic growth and development are also prominent interests of contemporary states.

To carry out its foreign policies a state must be able to influence the behavior of other states. In this sense, *power* is the essence of international political relations. The elements of state power include the armed forces, economy, population, geography, government, morale, ideology, and other intangible factors. Because of the latter, precise measures of national power are illusory. Moreover, national power is a *relationship* between two or more states that depends, in part, on how each state perceives its own power compared with the power of others. History affords us many examples of misjudgments by states of their relative power positions.[3]

To say that international political relations are essentially power relations is not to say that they always involve conflict. National governments understand that the achievement of many, if not all, of their foreign policy goals depends on *cooperation* with other governments. States are willing, therefore, to take actions that benefit other states if those governments reciprocate in some measure. Cooperative arrangements among states are highly developed in economic and functional areas, such as trade, finance, communications, and transportation.

Antagonistic relations express a clash of interests between two or more states. When these interests are considered vital, they may limit or destroy other cooperative arrangements. Because of the "cold war," for instance, trade between the United States and the Soviet Union is restricted to very low levels.

Many international relations are *competitive* rather than cooperative or antagonistic.

[2] This system of sovereign territorial states was formally established by the Peace Treaty of Westphalia in 1648. At first limited to Europe, it has since spread to encompass the globe. See Joseph Frankel, *International Relations* (New York: Oxford University Press, 1964), p. 7.

[3] A recent example of such a misjudgment was the attempt by Argentina in 1982 to take over the Falkland Islands (a British crown colony) by military force.

States exhibit various forms of rivalry that fall short of direct opposition to each other. They compete in economic performance, technological innovation, ideology, cultural achievements, and so on.

To conclude, the external relations of states are essentially power relations that are expressed in changing mixes of cooperation, competition, and antagonism. When account is taken of the existence of some 150 heterogeneous sovereign states, the pattern of international political relations becomes intricate indeed.

Nationalism

In the contemporary world, states are also nations. While the state is a political entity, the nation is an ethnic or social entity. When these two entities combine they form a *nation-state*.

The citizens of a nation share a sense of common identity stemming from a common community, history, language, religion, race, or ideology. *Nationalism* is the emotional cement that binds a people together to make a nationality; it is marked by loyalty and devotion to a nation that exalt it above all other nations. At least since the French Revolution in the late 18th century, nationalism has been the driving force in the creation of new states. Born in Europe, nationalism was the primary force in the transformation of European colonies into independent states following World War II; it is now being experienced by all the world.

In the 20th century it became a widely accepted principle that each national community merits its own government and political independence. Self-determination, however, has its practical limits. In recent years, several very small states have entered the United Nations, although their political and economic viability is highly questionable. At a time when sizable European states have begun a process of integration to overcome the liabilities of "smallness," the emergence of so many ministates in the past quarter century is a gross anomaly. The basic principle of self-determination also threatens the stability of older states that contain two or more ethnic groups, as witnessed by the separatist movements in Canada and Belgium. Ironically, many new states in Africa that owe their birth to the principle of national self-determination may eventually founder on divisive tribal loyalties that take precedence over national loyalties. The tragic civil war in Nigeria has emphasized the formidable obstacles to nation building in a multiethnic state.

However, for the most part the states of the world command the loyalties of their peoples and may be accurately depicted as nation-states, namely, "a form of political organization under which a relatively homogeneous people inhabits a sovereign state."[4] Because the citizens of a modern state share a common national society and culture, national boundaries carry a sociocultural significance as well as a political one.

Nationalism injects an emotional energy into international relations, bedeviling cross-national communication and inciting governments to behavior that can undermine the achievement of their own political and economic goals. Encompassing a personal identification with, and a loyalty to, a particular state, nationalism often expresses negative attitudes toward other states. But nationalism is also a cultural phenomenon. Even before the emergence of nation-states, ethnic and tribal groups held attitudes toward other groups, ranging from xenophobia (a hatred and fear of all foreigners) to, at times, cosmopolitanism (a sophisticated, open view of foreigners). Today, nationalistic attitudes toward economic relations with foreigners animate many government policies that restrict international trade and investment. When, for example, a business enterprise starts operations in a foreign country, its reception by the government and people will

---

[4] *Webster's Seventh New Collegiate Dictionary* (Springfield, Mass.: G. & C. Merriam Co., 1963).

depend in substantial measure on the blend of nationalism that predominates there.

International Organizations

Cooperation among nation-states has led to the creation of many international organizations to serve both political and economic purposes. Although these organizations seldom have any explicit supranational powers, they may gain an institutional strength over time that enables them to influence the behavior of individual states to a significant degree. Hence, they may assume an autonomous international role that makes them "actors" in the international political and economic systems along with the nation-states. For example, the policies of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) are more than a simple consensus of the national policies of their member states. Even more impressive in this regard is the European Economic Community.

Summing up, the international political system comprises some 150 sovereign nation-states and their mutual power relations, which may be characterized as cooperative, competitive, or antagonistic. Nationalism, which generally carries an antiforeign bias, adds an emotional tone to the foreign policies of nation-states, making them less cooperative than would otherwise be the case. On the other hand, some international organizations have emerged as autonomous (or quasi-autonomous) actors in the international political system along with the nation-states.

THE INTERNATIONAL ECONOMIC SYSTEM

Every nation-state has an economy, and the mutual relations among national economies constitute the *international economic system*. Just as the distinguishing feature of the political relations among states is power, the distinguishing feature of their economic relations is *market transactions*. With the rather modest exception of unilateral transfers ("gifts"), international economic relations result from the exchange of assets having market value. The sum of a nation's economic transactions with the rest of the world over a period of time is recorded in its balance of payments. Transactions give rise to flows of merchandise, services, money, capital, technology, and enterprise, thereby creating patterns of interdependence among national economies. Shifts in the size and direction of these flows that are initiated in one national economy will affect, directly or indirectly, the behavior of other national economies. The economic theory that explains *why* these flows occur and *how* national economies as a whole interact with the world economy is one of two themes that animate this book.

Contemporary nation-states, however, are not willing to allow their international economic relations to be determined *only* by market forces. All national governments have foreign economic policies that are intended to regulate, restrict, promote, or otherwise influence international trade and investment. The description and evaluation of these policies is the second theme of this book.

The relative importance of noneconomic or political factors in the determination of foreign economic policies varies from one nation-state to another. However, we can loosely classify countries into two groups in that regard. International transactions of the *industrial countries* (mainly those in North America, Western Europe, and Japan) and of the *developing countries* (mainly nations in Africa, Asia, and Latin America) are predominantly undertaken by *private business firms*, most notably in the form of multinational enterprises. Because the motivation behind these transactions is economic gain, the trade and investment flows among these countries are mainly explicable in economic terms. Nonetheless, government policies in these countries both constrain and stimulate international economic transactions so as to bring about a divergence from the pattern of interdependence that would result from purely market forces.

The second group comprises the *centrally planned countries* (mainly countries of Eastern Europe, the Soviet Union, and China), which, in accordance with Communist ideology, outlaw private enterprise. All foreign economic transactions are conducted by *state enterprises*, whose decisions are guided by national economic plans and foreign policy. Hence, the international economic relations of the Communist countries are highly "politicized." Although state trading organizations may choose to maximize economic values (behaving like private firms), they can also choose to behave as purely political organizations, ignoring economic gain.

It is fruitless to speculate in the abstract on whether international economic relations determine international political relations (as the Marxists contend) or whether international political relations determine international economic relations. International economic and political relations are interdependent; both the international economic and political systems are best regarded as subsystems of the same national-state system. In some circumstances, political forces may dominate economic forces, while in other circumstances just the opposite occurs. One thing, however, is certain: Whenever a government considers the behavior of some or all of its country's international economic transactions as vital to national interests, the government will try to make that behavior conform to those interests.

THE MULTINATIONAL ENTERPRISE SYSTEM

International economists have traditionally maintained a *macroscopic perspective* on international economic relations. By considering trade and investment only on the national level they have implicitly regarded national economies to be the *agents* of international transactions. Although we shall rely on the macroscopic (or national) perspective in Parts One, Two, and Three, we must recognize that this perspective is necessary (but no longer sufficient) to explain the behavior of the international economy. Multinational enterprises have become responsible for a sizable (and increasing) share of world trade and for most international investment. As big, oligopolistic companies, multinational enterprises possess a market power that makes them independent actors in the international economic system. Unlike firms in purely competitive markets, multinational enterprises enjoy managerial discretion in their decisions; they do not simply respond to market conditions and public policies in a predetermined way. Indeed, their actions force changes in national economies and compel governments to respond to them. Thus, to understand the contemporary international economy we must supplement a macroscopic perspective with a *microscopic* perspective that considers the role of the multinational enterprise. This is the task of Part Four, and here we make only a few additional comments on this subject.

A firm becomes a multinational enterprise when it extends its production and organization into foreign countries.[5] The *multinational enterprise system*, therefore, consists of a parent company; its producing and marketing affiliates in foreign countries; and the flows of products, services, capital, technology, management, and funds among them. These *intraenterprise transfers* (flows) cross national boundaries and therefore enter the balance of payments of nations in the same way as international transactions between independent buyers and sellers.

Although it has roots in the past, the multinational enterprise has become a dominant institution only in the last quarter century. Since the late 1950s, the political and economic systems of the industrial West (primarily the North Atlantic region) have favored the spread of international production by corporations in

[5] For a fuller definition, see Chapter 21.

search of market opportunity. As a consequence, the traditional *international* economy of traders is giving way to a *world* economy of international producers. Our comprehension of this world economy is modest indeed. Part Four, therefore, will be an exploration of new terrain in international economic relations.

DISTINCTIVE FEATURES OF INTERNATIONAL TRADE AND INVESTMENT

The distinctive features of international trade and investment are traceable to the environment in which they occur—the nation-state system and its political, sociocultural, and economic subsystems. In particular, national sovereignty is the ultimate source of most of the differences that distinguish international trade and investment from their domestic counterparts. Since we have already indicated some of the implications of these environmental systems for international trade and investment, this section is partly a recapitulation of our earlier discussion.

Different Languages and Customs

Most nations have a distinctive linguistic and cultural identity in addition to a basic political identity. This is not always true; we can all call to mind nations that have more than one official language and more than one cultural group in their populations. Moreover, several nations may share a common language and a common cultural heritage. Nevertheless, it is true that people tend to be like each other in more ways when they belong to the same nation than when they belong to different nations. Hence, international trade and investment, unlike most interregional trade and investment within nations, involve persons of different languages, customs, attitudes, values, and other cultural traits. Although such differences do not affect the basic economic similarity between interregional and international trade and investment, they do complicate relations between governments and introduce many new elements into the conduct of international business enterprise. As noted earlier, nationalism intensifies the sociocultural differences among the world's peoples.

Separate National Economic Policies

National economic policies may be compatible with the free flow of merchandise, services, and enterprise between nations, or they may be responsible for the regulation and suppression of that flow. As we shall discover, national economic policies that are apparently wholly domestic in nature may have profound effects on international trade and investment. To maintain an equilibrium in its international payments without resort to controls, a nation must keep its economy adjusted to the world economy. This means, for example, that it must pursue fiscal and monetary policies that keep its prices and costs competitive with those of other nations. It also means that there is sometimes a conflict between the aims of domestic policy and international adjustment. Because of political pressures this conflict is often resolved in favor of the former, while international maladjustment is frozen by the imposition of controls over foreign trade and payments.

When certain nations adopt domestic policies that are detrimental to their external stability, all trading nations suffer the consequences. For the international economy to function in an atmosphere of freedom there must be agreement among nations as to the criteria of sound domestic and international economic policies. It too often happens, however, that nations follow policies that are conceived in purely domestic terms, and the resulting welter of policies causes international maladjustments that are met by a rash of restrictive measures. Unlike domestic trade and investment, therefore, international trade and investment is subject to the influence of many separate national economic policies that are often in disharmony with each other.

One consequence of separate national policies is jurisdictional overlap. For instance, a multinational enterprise may be taxed on the same income by two governments (double taxation). More generally, the enterprise may be subjected to the conflicting demands of both home and host governments in any number of policy areas.

National Monetary Systems

Unlike their domestic counterparts, international trade and investment take place between economies that have different monetary systems. This gives rise to the need to exchange one currency for another using an agreed ratio. The purchase and sale of foreign currency is conducted in the foreign exchange market, and the exchange ratio between currencies is known as the *exchange rate*. Dealings in foreign exchange often appear mysterious to the average individual, and perhaps more than anything else, except nationalism, they have convinced such a person that international trade and investment are entirely distinct from the familiar domestic trade and investment. Even domestic producers have been daunted by the prospect of dealings in foreign exchange until relieved by the calm advice and aid of bankers.

Actually the presence of different monetary systems need not alter the character of international trade and investment from that of their domestic counterparts. When exchange rates are stable and currencies are freely convertible into each other, international payments are just as easily made as are domestic payments. In these circumstances the national monetary systems comprise one international monetary system, and for all practical purposes they are one and the same. Before World War I such an international monetary system did in fact exist. Nation currencies were linked to gold and were freely transferable into each other; an international payment differed from a domestic payment only in that it involved residents of different countries.

Today the situation is far different, and international trade and investment are sharply set off from domestic trade and investment by the restrictions imposed by many governments on transactions in foreign exchange and by variations in foreign exchange rates. Although the currencies of the industrial countries (mainly in North America, Western Europe, and Japan) are freely convertible at variable rates, the currencies of many nonindustrial countries and of all Communist countries are inconvertible in one way or another. Currency inconvertibility can have profound effects on the conduct of international trade and investment. An importer may not be able to buy merchandise from a given country because of the impossibility of buying the necessary foreign exchange from his or her government. The importer may be compelled, therefore, to import inferior or higher priced goods from a country to which he or she is permitted to make payments. When currencies are freely convertible but only at variable rates (as today), foreign traders and investors may suffer exchange losses unless they can hedge against them. We should remember, however, that it is more the exercise of national sovereignty to restrict international payments or vary exchange rates than the mere presence of national monetary systems that is a distinctive feature of international trade and investment.

Government Regulation of International Trade and Investment

Governments have interfered with international trade and investment ever since the beginnings of the nation-state system some five hundred years ago. Even during the last half of the 19th century, when the majority of governments followed a policy of laissez-faire with respect to domestic economic activities, the use of tariff protection was commonplace. Great

Britain and the Netherlands were the only important trading nations that rid themselves of protective tariffs and adopted free trade in that period of liberal economic policies. Since World War I all nations without exception have regulated their foreign trade and investment and have done so with many new control devices.

As noted previously, many contemporary governments restrict the convertibility of their currencies. This is known as *exchange control*; it allows a comprehensive regulation of the international movement, not only of merchandise, but of services and capital as well. Commodity trade is also regulated through quotas, licenses, tariffs, bilateral trading arrangements, commodity agreements, and other techniques. Restrictions are generally applied against imports, while exports may be stimulated by subsidies, exchange depreciation, bilateral agreements, and other methods. Mention should also be made of the fact that government regulation involves a great deal of red tape and bureaucratic delay that are often a potent deterrent to trade and to the entry of foreign firms.

The International Mobility of Factors of Production

In the 19th century, classical economists distinguished international trade from domestic trade by the criterion of factor mobility. It was assumed that the factors of production—natural resources, capital, management, and labor—moved freely within a country but did not move between countries. For this reason international trade obeyed laws of economic behavior that differed from those of domestic trade.

As the 19th century progressed, these twin assumptions of perfect factor *mobility* within countries and perfect factor *immobility* between countries came more and more into conflict with the facts of economic life. Neoclassical economists observed that factors of production often did not move freely from one place to another inside the same country and, on the other hand, that a substantial migration of capital was proceeding from Europe to the other continents. Economists came to agree, therefore, that a sharp distinction between domestic interregional trade and international trade could not be drawn in terms of factor mobility. Rather, *both* kinds of trade were based on factor immobilities; that is, trade was a substitute for investment and other factor movements.

In the absence of political restrictions on the international movement of capital, enterprise, and persons, it is likely that factor mobility between countries would still be somewhat less than factor mobility within countries. International differences in customs and languages, distance, and the like would work in this direction. Under these circumstances no one would argue that factor movements between countries were essentially different from factor movements within countries. In actuality, as we all know, they *are* different, for nations throughout the world restrict immigration (and sometimes emigration) as well as the movement of capital and enterprise. Thus, the exercise of national sovereignty has greatly limited the international mobility of productive factors, and in so doing it has altered the scope and character of international trade and investment. At the same time, the multinational enterprise has remarkably accelerated the flow of factor services among countries in the last quarter century.

To conclude, although the international mobility of factors tends to be less (and in the case of ordinary labor, much less) than their domestic mobility, the degree of factor mobility does not provide a *fundamental* distinction between domestic and international trade. It follows that international economic theory must encompass both trade flows and factor flows (mainly via the multinational enterprise) if it is to explain the behavior of the contemporary world economy.

THE NATIONAL INTEREST IN INTERNATIONAL TRADE

What is the national interest in international trade? This question has colored many