

International Trade and Investment

Seventh Edition



Franklin R. Root

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The Wharton School
University of Pennsylvania



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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 interest, 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 on 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.

This edition of *International Trade and Investment* is a major revision of the previous edition. I have revised every chapter and have almost completely rewritten some to account for recent developments in theory and policy. Chapter 21,

"Eastern Europe and China in the World Economy: The Transition from Centrally Planned to Market Economies," is entirely new.

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 and reviewers who cared enough about this text to make suggestions to improve it. In particular, I would like to thank the following colleagues for their observations and suggestions concerning the current edition:

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I have worked hard to achieve a balance among theory, policy, and enterprise that I hope will please most of them without unduly annoying the rest.

Franklin R. Root
The Wharton School
University of Pennsylvania

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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'état 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 one or more abstract models that represent the international environment by identifying key variables and their functional relations. We are then able to interpret an event in the context of our model. If the model 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

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

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*.

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 relations and for multinational enterprises that 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,

²This 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.

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 cooperative arrangements. Before the "cold war" ended in the late 1980s, for instance, trade between the United States and the Soviet Union was restricted to very low levels.

Many international relations are *competitive* rather than cooperative or antagonistic. 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 185 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 experience a common identity stemming from a shared 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 eighteenth 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 has now spread to all the world.

In the twentieth century it became a widely accepted principle that each national community merits its own government and political independence. Self-determination, however, has its own practical limits. In recent years, several very small

³A recent example of such a misjudgment was the attempt by Iraq in 1990 to take over Kuwait by military force.

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 half 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, Belgium, and Spain.⁴ 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 in the 1960s and the recent collapse of Somalia have 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 whereby a relatively homogeneous people inhabits a sovereign state. 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 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

⁴In the case of Yugoslavia, self-determination has spawned a tragic war among ethnic groups. Another example of ethnic self-determination is the disintegration of the Soviet Union into separate nation-states.

policies of their member states. Even more impressive in this regard is the European Community.

Summing up, the international political system comprises some 185 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 goods, services, and financial 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 the three 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 comprise 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 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 purely from market forces.

The second group comprises China and the countries of Eastern Europe and the former Soviet Union that until the 1990s were *centrally planned* (communist) economies in which all transactions were undertaken by state enterprises whose decisions were guided by a national planning authority rather than by market forces. Hence, the international economic relations of the communist countries were tightly controlled by state agencies. Now these countries are engaged in a historic transition to market economies. If this transition is successful, then all the world's countries will participate in a global economy by the end of the century.

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 system and the international political system are best regarded as subsystems of the same nation-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 taken a *macroscopic perspective* on international economic relations. By considering trade and investment only at the national level, they have implicitly regarded national economies as the *agents* of international transactions. Although we shall rely on the macroscopic (or national) perspective in Parts I, II, and III, 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 third theme of this book, which is taken up in Part IV. 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,

⁵For a fuller definition, see Chapter 22.

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 since the late 1950s, when the political and economic systems of the industrial West began to favor the spread of international production by corporations in search of market opportunity and lower costs. As a consequence, the traditional *international* economy of traders has now given way to a *world* economy of international producers. Our comprehension of this world economy is modest indeed. Part IV 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, socio-cultural, 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 inter-regional 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 goods, services, and enterprise between nations, or they may be responsible for the regula-

tion 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.⁶ Unlike domestic trade and investment, therefore, international trade and investment are often subject to the influence of many separate national economic policies that are 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. The purchase and sale of foreign currency are 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 person, and perhaps more than anything else, except nationalism, they have convinced the average 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 make the character of international trade and investment different from that of their domestic counterparts. When exchange rates are stable and currencies are freely convert-

⁶A current example (discussed in Chapter 9) is the enormous U. S. trade deficit that has spawned growing demands for U.S. import protection.