THE INTERNATIONAL ECONOMY AND THE NATIONAL INTEREST

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Preface

The growth of the multinational corporation and the increase in international trade and money flows have unquestionably been among the most important economic phenomena of the post–World War II era. These developments have spurred new interest in international economic matters among economists and others who monitor the economic scene, and have even led to interest in this subject among the general population, as perhaps best evidenced by the way figures on trade balances and currency values are often accorded headlines by even the popular press.

Although interest appears to have grown in all aspects of international economics, the growth of the multinational corporation has attracted more attention in the professional literature than has the growth of international trade. There are good reasons for these differences in the engagement of professional attention. International trade is a subject that has been debated and discussed for centuries, and elegant theories explaining trade patterns and assessing their consequences have been developed that are so widely accepted that they border on being conventional wisdom. The multinational corporation, on the other hand, is a more recent phenomenon and has only lately received great attention. Although economists have not been amiss in proposing theories to explain the emergence of the multinational corporation and to assess its consequences, it can be asserted that the state of theory on this subject is still in flux and that no one proposed theory has come close to attaining the status of, say, the law of comparative advantage in the theory of international trade.

When it was suggested to me that I consider writing a book on the multinational corporation—similar suggestions apparently must have been made to many other economists—it was clear to me that the subject was sufficiently important and complicated to warrant my interest. There was initially some hesitation on my part, particularly as to whether I had anything fresh and of value to add to what had become a burgeoning literature. I also had not done much writing in the area of international economics; most of my work has been in microeconomic theory and industrial organization. But I proceeded on the grounds that the multinational corporation was also of interest to the field of industrial organization, and that my graduate work under Professor Nurkse and a stint as a foreign service officer would provide for me sufficient background to deal with the recent literature. I was also able to convince myself that my unfamiliarity with the recent literature might in some ways be an advantage, enabling me to take a fresh look at the field of international economics.

My first plan was to do an empirical study of the multinational corporation: this was the method in widest use, and the data being made available by governmental agencies and the work at Harvard under Professor Vernon virtually cried out for statistical analysis. But I shortly became convinced that what was more needed, and what I could do best, was a thorough reexamination and reformulation of *trade* theory, and then to build upon this reformulated trade theory a theory of international investment. There were several reasons for choosing this path. First, colleagues in the applied area that has become known as "international business" assured me that nobody with a practical bent was taking trade theory as it is recently evolving very seriously. Second, my review of recent developments in trade theory led me to believe that this branch of economics was becoming somewhat "precious." Third, it seemed to me that the conventional trade theory had no basis for explaining the multinational corporation, and that those trying to explain the multinational corporation by beginning with the current trade theory were engaged in an exercise in futility. Fourth, I became convinced that much of the empirical work on the multinational corporation was leading to contradictory and disappointing results because the lack of a theoretical framework made it difficult to ask the right questions and to assess properly the available data.

The book that emerged is therefore primarily one on theory. But, I like to think, the theory presented in it is not so abstract as to be inapplicable to an understanding of the real world. There will be a number of new ideas, most conspicuously a redefinition of the term "international trade." The theory will not always be elegant, in the sense that it takes the form of making deductions from a set of assumptions. Rather, it tries to point up the types of information required to assess international trade and investment. And the theory will contain no predilections that free trade and free foreign investment always lead to desirable results.

A number of acknowledgments of help I received are in order. Richard Robinson, of MIT, who reviewed an earlier manuscript, made many important suggestions and challenged me to explore more fully a number of difficult areas. Another reviewer, not known to me, and apparently somewhat taken aback by my attacks on conventional trade theory, contributed to the book by forcing me to reassess what I had written and

by making me present my arguments with a bit more circumspection. Conversations with a number of my colleagues, Richard Farmer, Paul Marer, and William Travis in particular, encouraged me to believe that many of my new views were on the right track. The International Business Research Institute, funded by the Ford Foundation, and chaired at Indiana University by Harvey Bunke, sprung me free for a whole summer from other duties. Our departmental secretaries, Beverly Ball and Ruth Shannon, uncomplainingly (at least to me) provided me with fast and accurate manuscript typing. Various students helped, through their questions, by inducing me to clarify my exposition. Although it is customary to thank one's family for the sacrifices in not seeing too much of its author/father/husband, my family demonstrated no great suffering, except perhaps for my wife, who possibly had to feign interest while listening to me talk about my work.

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CHAPTER ONE

An Introduction

This book takes on two interrelated tasks. One is a critical assessment of what may be termed the "established" theory of international trade and investment, with regard to both its positive and its normative aspects. The second is to propose alternative models when the established theory is found unsatisfactory. This introductory chapter sketches the growth of international trade and investment following World War II, some of the problems and controversies to which this growth has led, and some reasons why the established theory requires this critical assessment.

The postwar growth of international trade in goods has been well documented, with exports and imports for the industrial nations in particular rising faster than their gross national products. Largely because of the growth of international banking and multinational firms, huge sums of financial capital flow with increased freedom among nations. But the most spectacular growth of the international economy has been in direct foreign investment, in which firms owned and controlled by members of one nation locate and operate in other countries. For example, the recent value of American-owned firms located abroad is on the order of $150 billion.[1] Another indication of this growth in direct foreign investment is that the value of the output of foreign-located American firms engaged in manufacturing has been recently estimated at some two to three times that of manufactured exports from the United States.[2] Although direct foreign investment is not a new phenomenon, its current scope and importance have no antecedent in economic history.

Although some more or less natural economic forces have contributed to this growth, the major impetus has come from conscious decisions of national governments to reduce trade and investment barriers. In these endeavors, the United States has played the leading role. With the Reciprocal Trade Agreement Act of 1934 the underlying legislation, the United States has sponsored a number of tariff-cutting conferences. The success of these negotiations is reflected in the estimate that the average ad valorem tariff on imports into the United States has been reduced from 50 percent in 1945 to about 8 percent in 1967, when the "Kennedy Round" was completed.[3] The United States has been a leading member of the International Monetary Fund and a semiofficial member of the General Agreement on Trade and Tariffs (GATT), organizations designed to promote international trade. The United States has even promoted freer trade among other nations: the important European Community was organized with the encouragement of the United States.[4] In international investment, particularly direct foreign investment, American foreign investment has been encouraged with special tax provisions, an insurance system, bilateral "friendship, navigation, and commerce" treaties, sanctions against nations who expropriate American property (the Hickenlooper Amendment), and special low-interest loans to firms in the less-developed countries that take on American partners (the Cooley loans). Admittedly these policies have not been completely without opposition in the United States; yet they have been substantially adhered to by all postwar American administrations.

Although there are well-known and widely proclaimed arguments for free trade (the arguments for investment are more in doubt), it is surely international political considerations rather than a fresh appreciation of these arguments that has underlain American policy in this area.[5] The experience of the thirties led many to believe that trade barriers and problems impeded the coalition of Western Allies against the Axis powers, and that difficulties the latter experienced in securing sources of raw materials contributed to their aggressiveness. American postwar policy has of course been dominated by the decision to resist the spread of communism. The cohesiveness and integration to which free trade among the industrialized nations could lead were considered vital to this end—being in some ways the economic counterpart to NATO. For the developing third world countries, the response was not to be integration through free trade, but rather economic aid to develop their economies. Although this aid was at first on an official basis, American business interests were able to persuade the United States government that private investment by American firms could help these economies.[6] Accordingly, private foreign investment was encouraged even to the point of using official aid as a lever to overcome the resistance of some developing countries.

Perhaps somewhat incongruously, in recent years the United States government has encouraged some types of trade (although not yet investment to any great extent) with the Soviet satellites and even with the Soviet Union and China themselves. This has undoubtedly come about as the result of a new tack in policy toward the communist countries: to reduce Soviet hostility to the United States through increased contacts, and to reduce the economic dependence of the satellites on the Soviet Union.

American encouragement of foreign investment had another political basis. The aid commitments, the military bases throughout the world, the expanded size of official American representation, all require a great deal of foreign exchange. It was hoped that the earnings of American foreign ventures would be of help in providing this foreign exchange.

The American-led policies toward international trade and investment could be considered a success with regard to some goals. They have certainly led to an expansion of trade and investment, which to some appears to be an end in itself. There has been increased integration of national economies and successful growth of some developing economies. These policies may even have been successful in helping to contain communism, although of course such a claim would be more difficult to document. But these policies have also created problems and controversies of their own.

Perhaps the most important problem stems from the fact that free trade and investment integrate national economies into part of a broader international system. Although this integration is viewed as highly desirable to many, it does conflict with other important postwar economic developments. The most important of these developments is the extent to which governments have become more active in managing their internal economies. This management includes not only macroeconomic stabilization policy, but also a host of policies on pollution control, energy use, labor standards, income redistribution, and so forth. There is little doubt that the economic integration brought on by freer international trade and investment has increased the difficulties and reduced the autonomy of individual nations in managing their economies, a situation that is reflected in the increasing necessity to hold high-level international conferences to coordinate economic policies that only a decade ago were viewed as purely internal affairs. Because nations face different economic problems, and because their economic interests can clash, these conferences have not met with great success and it is increasingly apparent that many nations resent the loss of this economic autonomy.

For most of the postwar period, the American free trade policies appear to have enjoyed wide support. But in the troubled seventies, these policies are clearly coming under increasing attack, largely because of the disappearance of an American trade surplus of many decades standing. The loss of this trade surplus forced the United States to devalue the dollar and renege on its promise to convert foreign-held dollars into gold, a situation which led to the destruction of the fixed exchange rate system administered by the International Monetary Fund. The OPEC cartel, the huge oil imports, and the drive of other manufacturing countries to export to the United States in order to earn dollars to pay for their oil imports, have by the late seventies led to American trade deficits of unprecedented size. The problems created by these deficits are of such magnitude that American officials appear loathe to acknowledge them, much less deal with them.

Although trade problems are now paramount, for most of the postwar period it has been direct foreign investment and the multinational corporation that have captured our attention and become centers of controversy. The multinational corporation has both ardent admirers and caustic critics.[7] The admirers see the multinational corporation as the prime agent in bringing about worldwide economic development, spreading the fruits of technology to all, earning foreign exchange and advancing the interests of the United States, allocating more efficiently the worldwide supply of capital. Some even see the multinational corporation as a highly revolutionary development leading to a global reorganization of production, a complete internationalization of national economies, and even a reduction in the power of the nation-state as we now know it. On the other hand, the critics contend that the multinational corporation has led to a loss of jobs and exports for the United States, a decline in productivity and income in the United States, a decline of social control of business, undue exploitation of foreign labor and natural resources, the support (by the United States) of unpopular and undemocratic foreign governments. These claims and counterclaims have by no means been resolved, partly because the vested and ideological interests have made dispassionate dialogue difficult, but mainly because of deficiencies in those portions of economic theory dealing with this subject.

It is my central contention that the generally accepted international economic theory is incapable of dealing with many of the problems now facing the international economy, and also domestic economies. The established trade theory is open to many criticisms. To a considerable degree, it has wandered far from the brilliant formulation by David Ricardo, and even from the writings of such important modern theorists as Eli Heckscher and Bertil Ohlin. My major complaint is that the development of trade theory in the last few decades has stressed logical rigor and intellectual consistency at the expense of relevance and common-sense insights.[8] All models have to make some sacrifices of reality if they are to be tractable, and rigor and consistency are certainly in themselves not undesirable. But it can be argued that trade theory has gone much too far in its adherence to these qualities, making extensive use of highly dubious theoretical constructs and disregarding such important problems as oligopolies, labor unions, inflation, trade imbalances. One major objective here is to reformulate trade theory, to make it more relevant, simple, and consistent with the main body of economic theory.

The state of the established trade theory is also largely responsible for the lack of any generally accepted theory of international investment—particularly direct investment—and has even impeded the search for such a theory. This is so mainly because the established trade theory leaves little room for international investment. First, this theory is based upon the assumption that all factors of production are internationally immobile. Second, an important theorem derived from this theory is that free trade will equalize the returns to the factors of production in the trading countries, so that incentives for foreign investment cannot exist under these conditions. Any attempt to build a theory of foreign investment upon a trade theory that both first assumes and then deduces that foreign investment does not and cannot come about will surely be a futile exercise. A great deal of my effort will be devoted to developing models that can both explain international investment and assess its consequences.

This assessment emphasizes the economic welfare of the individual nation. Some will surely view this welfare criterion as too narrow and would bring other matters into consideration, such as obligations to help the struggling less-developed countries, to contain communism, to promote international unity, and so on. I do not reject these other considerations out of hand, but only point out that we may have to be aware of their economic costs. Furthermore, as an economist, I feel constrained to remain in my area of competency.

The major theoretical contribution I hope to make is to integrate international trade and investment into a single model. This will be done largely by a redefinition of "exports" and "imports." The term "international trade" as now used connotes goods, services, or money being traded between residents of different territorially defined nations. In my terminology, I refer to "transnational transactions," and define international trade as occurring when citizens or organizations of different nationalities transact business, regardless of their locations. This redefinition will enable us to see that indirect foreign investment (or foreign loans) is simply another type of trade while direct foreign investment *enables* new types of trade, such as the purchase by one country of the labor or land services of another.

Modern economic analysis has become increasingly characterized in its exposition by the use of mathematics and highly technical terminology. This development presents problems to all writers in this field. What training on the part of the reader is to be assumed? How much explanation and background of various concepts is required? The approach taken here is to make my work intelligible to the general economist as well as to the specialist in international economics. It is also my hope to make the work accessible to those who do not consider themselves professional economists—but they will have to have some familiarity with the tools of economic analysis. My attempts to reach a broader audience will at some points require discussion that will appear elementary to professional economists, but I hope that my colleagues will bear with me in these instances.