Globalization101

A project of SUNY LEVIN Institute

Investment and Globalization

TABLE OF CONTENTS

Introduction

When people think about globalization, they often first think of the increasing volume of trade in goods and services. Trade flows are indeed one of the most visible aspects of globalization. But many analysts argue that international investment is a much more powerful force in propelling the world toward closer economic integration. Investment can alter entire methods of production through transfers of knowledge, technology, and management techniques, and thereby can initiate much more change than the simple trading of goods.

Over the past years, foreign investment has grown at a significantly more rapid pace than either international trade or world economic production generally. In fact, foreign direct investment in the United States in 2012 equaled roughly $174.7 billion (down from its peak $325 billion in 2008) (Organization for International Investment).

The tremendous growth in levels of foreign direct investment is a recent phenomenon and is one of the most powerful effects—and causes—of globalization. In 1982, the global total of Foreign Direct Investment (FDI) flows was $57 billion. According to UNCTAD 2013), by the end of 2012, FDI flows reached an estimated $1.35 trillion, a 14 percent decline since 2011 (OECD). Global international investment has still not yet returned to pre-crisis levels.

But as with many of the other aspects of globalization, foreign investment raises many new questions about economic, cultural, and political relationships around the world. Flows of investment and the rules which govern or fail to govern it can have profound impacts upon such diverse issues as economic development, environmental protection, labor standards, and economic and political stability.

At the same time, focusing entirely inward on domestic production to limit foreign investment and international interaction is largely detrimental to one's economy. For some nations, this has manifested itself in import substitution industrialization (ISI), which refers to an international economic and trade policy based on the belief that a nation should reduce its dependency on foreign investment and goods by domestic production of industrial goods.

In Latin and South America, one region where ISI became common through the middle of the 20th century, domestic employment grew and global shocks (such as recessions) did not affect the region as harshly. But the negatives far outweigh the positives: The industries created under ISI became futile and inefficient, and did not create the institutions or infrastructure to maintain ISI. Additionally, countries typically participating in ISI lacked rich enough economies to sustain the system. Had foreign investment played a part, many of these industries might have been able to grow and develop (Baer, 1972).

The following Issue in Depth will explain the fundamental concepts of cross-border investment, define key terms, and explore the major controversies related to international investment.

What Are the Different Kinds of Foreign Investment?

International investment or capital flows fall into four principal categories: commercial loans, official flows, foreign direct investment (FDI), and foreign portfolio investment (FPI).

Commercial loans, which primarily take the form of bank loans issued to foreign businesses or governments.

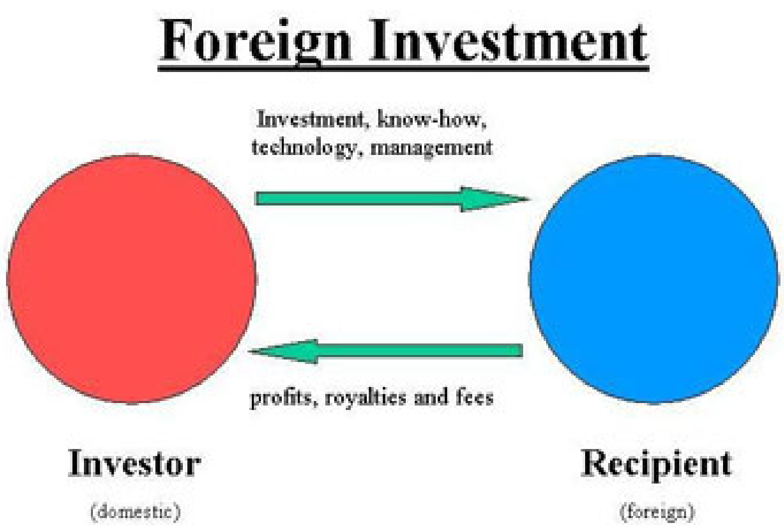
Official flows, which refer generally to the forms of development assistance that developed nations provide to developing ones.

Foreign direct investment (FDI) pertains to international investment in which the investor obtains a lasting interest in an enterprise in another country. Most concretely, it may take the form of buying or constructing a factory in a foreign country or adding improvements to such a facility, in the form of property, plants, or equipment.

FDI is calculated to include all kinds of capital contributions, such as the purchases of stocks, as well as the reinvestment of earnings by a wholly owned company incorporated abroad (subsidiary), and the lending of funds to a foreign subsidiary or branch. The reinvestment of earnings and transfer of assets between a parent company and its subsidiary often constitutes a significant part of FDI calculations.

According to the United Nations Conference on Trade and Development (UNCTAD), the global expansion of FDI is currently being driven by over 65,000 transnational corporations with more than 850,000 foreign affiliates.

An investor's earnings on FDI take the form of profits such as dividends, retained earnings, management fees, and royalty payments.



Foreign portfolio investment (FPI), on the other hand, is a category of investment instruments that is more easily traded, may be less permanent, and do not represent a controlling stake in an enterprise. These include investments via equity instruments (stocks) or debt (bonds) of a foreign enterprise that does not necessarily represent a long-term interest.

Stocks:	**Bonds:**
• dividend payments • holder owns a part of a company • possible voting rights	• interest payments • ownership of bond rights only

• open-ended holding period	• no voting rights • specific holding period

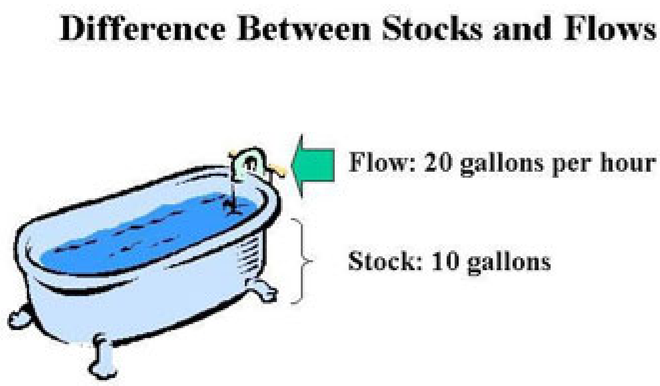
While FDI tends to be commonly undertaken by multinational corporations, FPI comes from my diverse sources such as a small company's pension or through mutual funds held by individuals.

The returns that an investor acquires on FPI usually take the form of interest payments or non-voting dividends. Investments in FPI that are made for less than one year are distinguished as short-term portfolio flows.

FPI flows tend to be more difficult to calculate definitively, because they comprise so many different instruments, and also because reporting is often poor. Estimates on FPI totals generally vary from levels equaling half of FDI totals, to roughly one-third more than FDI totals.

The difference between FDI and FPI can sometimes be difficult to discern, given that they may overlap, especially in regard to investment in stock. Ordinarily, the threshold for FDI is ownership of "10 percent or more of the ordinary shares or voting power" of a business entity (IMF Balance of Payments Manual, 1993).

Calculating Investment: Calculations of FDI and FPI are typically measured as either a "flow," referring to the amount of investment made in one year, or as "stock," measuring the total accumulated investment at the end of that year.



Until the 1980s, commercial loans from banks were the largest source of foreign investment in developing countries. However, since that time, the levels of lending through commercial loans have remained relatively constant, while the levels of global FDI and FPI have increased dramatically. Over the period 1991-1998, FDI and FPI comprised 90 percent of the total capital flows to developing countries. Over the period of 1996-2006, FDI and FPI outflows from the United States more than doubled (International Monetary Fund, 2007). Global FDI flows decreased significantly from 2007-2009 due to the Financial Crisis and finally started rising again in 2010, though have still not reached pre-crisis levels.

Similarly, when viewed against the tremendous and growing volume of FDI and FPI, the funds provided in the past by governments through official development assistance, or lending by commercial banks, the World Bank, or International Monetary Fund (IMF), are diminishing in importance with each passing year. Therefore, when one talks about the recent phenomenon of globalization, one is referring in large part to the effects of FDI and FPI, and these two instruments will therefore be the primary focus of this Issue in Depth.

Differences between Portfolio and Direct Investment

One of the most important distinctions between portfolio and direct investment to have emerged from this young era of globalization is that portfolio investment can be much more volatile. Changes in the investment conditions in a country or region can lead to dramatic swings in portfolio investment. For a country on the rise, FPI can bring about rapid development, helping an emerging economy move quickly to take advantage of economic opportunity, creating many new jobs and significant wealth. However, when a country's economic situation takes a downturn—sometimes just by failing to meet the expectations of international investors—the large flow of money into a country can turn into a stampede away from it.

By contrast, because FDI implies a controlling stake in a business, and often connotes ownership of physical assets such as equipment, buildings, and real estate, FDI is more difficult to pull out or sell off. Consequently, direct investors may be more committed to managing their international investments, and less likely to pull out at the first sign of trouble.

This volatility has effects beyond the specific industries in which foreign investments have been made. Because capital flows can also affect the exchange rate of a nation's currency, a quick withdrawal of investment can lead to rapid decline in the purchasing power of a currency, rapidly rising prices (inflation) and then panic buying to avoid still higher prices. In short, such quick withdrawals can produce widespread economic crisis.

This was partly the case in the Asian economic crisis that began in 1997. Although the economic turmoil began as a result of some broader shifts in international economic policy and some serious problems within the banking and financial sectors of the affected East Asian nations, the capital flight that ensued—some compared it to the great financial panics which took place in the United States during the 19th century—significantly exacerbated the crisis.

Example of FPI: John Yamashita, a Japanese citizen, purchases one hundred shares of stock in General Motors (GM). John now owns part of a U.S. corporation, the shares of which are part of his personal investment portfolio. John is eligible to receive dividend payments from GM, participate in shareholder decisions, or sell the stock for a profit/loss. John's share of GM is very minor, and his chief concern is not the long-term profitability of the company but the short-term value of his stock. He might therefore sell his share quickly if the share price goes up or down significantly.

Example of FDI: Hungry Dragon Toys, a Chinese company, is sitting on a lot of cash. The company's board of directors decides to take some of that money and purchase Cooperative Chemical, a plastics company in New Jersey. Hungry Dragon, a foreign investor, now owns a U.S. subsidiary company. Unlike John Yamashita's small investment in GM, Hungry Dragon's ownership of Cooperative Chemical is substantial and more likely to be long term. Hungry Dragon is unlikely to sell if the U.S. economy faces a temporary downturn. A comparison of FPI and FDI is useful to illustrate why some kinds of foreign investment tend to be more volatile than others.

Why Do Companies Invest Overseas?

Companies choose to invest in foreign markets for a number of reasons, often the same reasons for expanding their operations within their home country. The economist John Dunning has identified four primary reasons for corporate foreign investments:

Market seeking: Firms may go overseas to find new buyers for their goods and services. The top executives or owners of a company may realize that their product is unique or superior to the competition in foreign markets and seek to take advantage of this opportunity. Another motivation for market seeking occurs when producers have saturated sales in their home market, or when they believe investments overseas will bring higher returns than additional investments at home. This is often the case with high technology goods. As one analyst noted, "The minimum size of market needed to support technological development in certain industries is now larger than the largest national market" (Sutherland, 1998).

Resource seeking: Put simply, a company may find it cheaper to produce its product in a foreign subsidiary—for the purpose of selling it either at home or in foreign markets. The foreign facility may be able to obtain superior or less costly access to the inputs of production (land, labor, capital, and natural resources) than at home.

Strategic asset seeking: Firms may seek to invest in other companies abroad to help build strategic assets, such as distribution networks or new technology. This may involve the establishment of partnerships with other existing foreign firms that specialize in certain aspects of production.

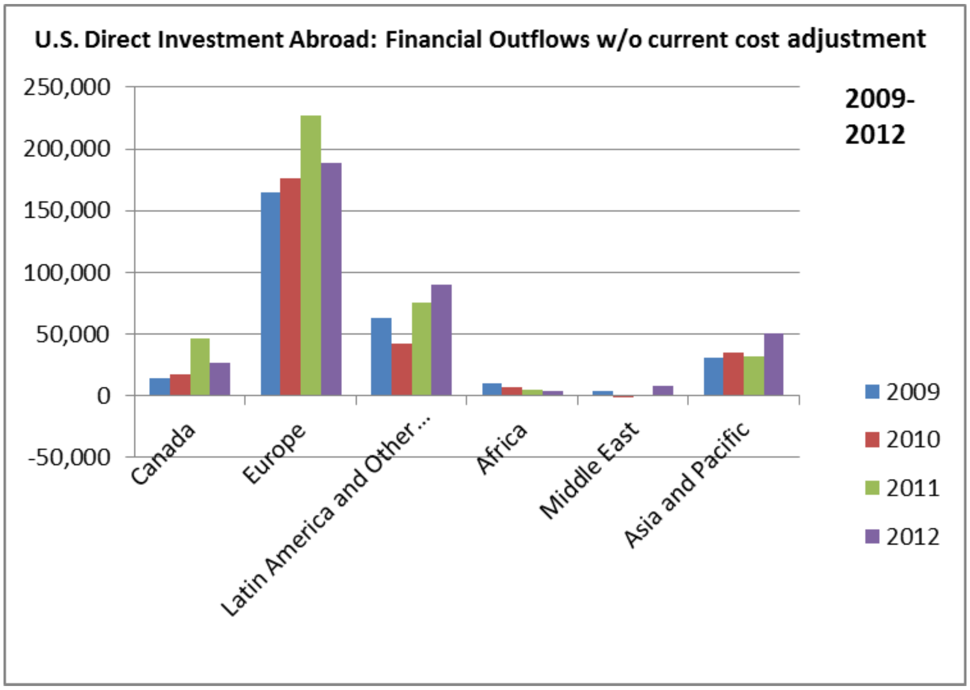
Efficiency seeking: Multinational companies may also seek to reorganize their overseas holdings in response to broader economic changes. For example, the creation of a new free trade agreement among a group of countries may suddenly make a facility located in one of those countries more competitive, because of access for the facility to lower tariff rates within the group. Fluctuations in exchange rates may also change the profit calculations of a firm, leading the firm to shift the allocation of its resources.

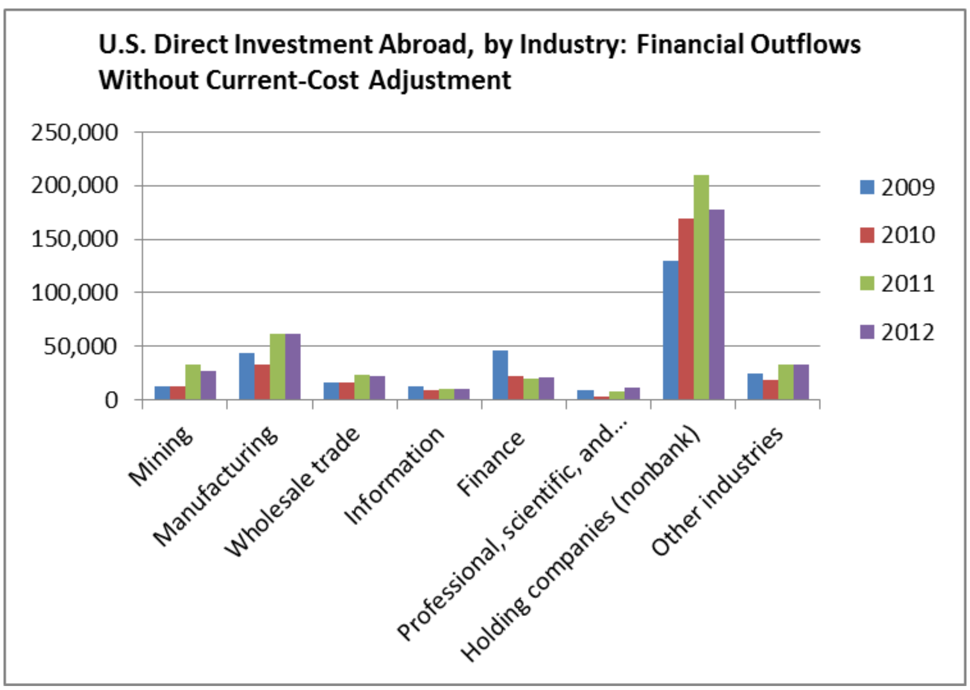
Concerns about Shifting Production Due to Foreign Investment

A concern raised by some critics of globalization is that corporations in wealthier countries are shutting down their higher cost domestic manufacturing operations and sending them overseas to developing countries (a.k.a. “outsourcing”), where they can take advantage of lower wages and, for example, less restrictive environmental regulations. This is alleged to result in a switch by corporations from domestic production toward a greater reliance on imports, and to cause higher unemployment domestically. These critics charge that workers overseas may be exploited as a result of this shifting production, and that moving manufacturing operations overseas lessens the competitiveness of the domestic economy.

While it may be true that some companies have moved their production facilities for these purposes, and the origin of manufactured goods consumed in United States has shifted considerably toward foreign sources, these kinds of investment activities comprise only a small percentage of total investment.

The figures below shows direct investment from the United States to other parts of the world from 2009 to 2012. It is clear that manufacturing is not the sector most targeted by US investors.





Of course, the fact that such an overwhelming percentage of the sales resulting from U.S. foreign direct investment takes place among developed countries, or that foreign production is overwhelmingly used for consumption local to that country, does not mean that concerns about FDI in developing countries are of no consequence. However, when one thinks about the forces driving globalization and the decisions to invest in overseas production, these figures can help keep matters in perspective.

Foreign investment can also raise concerns of a somewhat more nationalistic nature. Foreign investment, particularly when it involves control of prominent sectors of a nation's economy, individual companies, or even landmarks such as buildings, can raise alarms that foreign entities may be taking control of resources that are critical to a nation's identity or even security. This can lead to suspicions that the foreign owners may not have the best interests of the domestic society in mind.

These fears about foreign control can be particularly serious in developing countries, although even wealthy, developed countries are not immune to these concerns. In the 1980s, for example, many Americans became worried about foreign investment into the United States. The sale of prominent American landmarks such as Rockefeller Center in New York City to a group of Japanese investors made many Americans believe that they were losing ownership of their own economy.

Questions for Discussion:

1. How do you evaluate the benefits or detriments of foreign investment? How much weight do you give to the concern that FPI can lead to economic upheaval? Do you find the argument that foreign investment amounts to "buying" another country? What controls could be put in place to counter this concern?

2. What relationship do you see between FDI and employment? Looking at the United States as an example, have you noticed a shift in the distribution of jobs over the past decade? What jobs are leaving the United States? Where are these jobs going? What jobs are replacing them?

Why Has Foreign Investment Increased So Dramatically in Recent Decades?

As stated earlier in this brief, international investment levels have exploded in recent decades. These increases in the flows of foreign investment have themselves marked a new and distinct phenomenon in the era of globalization. Several factors have helped drive this growth:

1) Technology. Telecommunications and transportation advances have simply made it easier to do business across large distances. As former American President William Jefferson Clinton once pointed out, in the 1960s, transatlantic telephone lines could only accommodate 80 simultaneous calls between Europe and the United States. Today, satellites and other telecommunications infrastructure can handle one million calls at one time.

Fax machines, email and the drop in the cost of air travel have also contributed significantly to the growth of FDI. A business owner might think twice about trying to run an affiliate in a foreign country if communication with that office were not both easy and cheap. Changes in practices tend to be driven by changes in capabilities, and these new methods to communicate have unquestionably helped drive much of the subsequent desire to promote economic integration.

The 21st century has brought even greater changes with the development of Bluetooth technology, better satellite reception, and increased flexibility in telecommuting and teleconferencing.

2) The lure of higher profits. In the 1980s and early 1990s, a number of countries in East Asia (Hong Kong, Indonesia, Japan, South Korea, Malaysia, Singapore, Taiwan, and Thailand) began to experience enormous economic growth rates— in some cases piling up double-digit expansions in their GDP per capita year after year. These countries had built their phenomenal growth on a foundation based on greater integration into the international economy. In particular, they began emphasizing export-led growth. Investors from around the world realized that access to East Asian markets and their trading partners might help them attain much higher returns on their investments than they could obtain at home.

3) The fall of the Berlin Wall. The end of the Cold War had an important impact on international financial liberalization. First, many developing countries that had previously been committed to socialist models of economic planning began to turn toward market economies. The resulting efforts to privatize state-owned enterprises and changes in economic policies that were more favorable to capital investment made these economies much more attractive to potential investors.

In addition, the demise of the Soviet Union also gave many investors much more confidence in the political stability of developing countries in general. Fears that a government might be overthrown or voted out in favor of one that might expropriate foreign assets declined.

4) Financial liberalization. Prior to the 1970s, many countries, including the United States, imposed strict limits on the rights of companies and individuals to invest overseas, to purchase foreign securities, or even to hold foreign currencies. Many of these restrictions were put in place following the Great Depression of the 1930s, which had produced volatile movements of capital, triggering financial panics in some cases.

However, in the early 1970s, the United States went off the gold standard and the previous system of fixed exchange rates between foreign currencies was abandoned. In addition, many restrictions were lifted on the flows of international capital, making it much easier for investors to purchase foreign securities. Since that time, the United States has been in the forefront of efforts to remove remaining controls on the movement of international capital. The Reagan and Clinton Administrations in particular made de-regulation of capital movement a high priority on their international economic policy agendas.

Financial liberalization has been the most direct, and probably the single biggest, factor accounting for the growth of international investment flows over the past several decades.

Where Does Foreign Investment Take Place?

One of the most disturbing accusations about globalization is the charge that foreign investment takes place largely so that developed country industries can transfer their production overseas, especially to poorer developing countries, to take advantage of lower wages and other less stringent regulatory environments. To be sure, some companies have sought to move their production facilities overseas with such goals. But a look at the overall statistics on where foreign investment goes illustrates that this factor cannot be the primary objective of most companies.

In fact, the great majority of global FDI takes place among developed countries. However, as a result of the recent financial crisis, and its greater effect on developed countries, the developing economies have had less of a decline. According to the UNCTAD 2013 World Investment Report, in 2012, for the first time, developing countries received more FDI inflows than developed countries. In addition, developing countries generate one-third of the global FDI outflows. The top three recipients of FDI in 2012 include the United States, China, and Hong Kong (UNCTAD, 2013).

Although FDI flows have been increasing at a great rate over the past decade, developing countries in Southern Africa have actually been losing their share of global investment. These countries received a peak of world FDI inflows in 2001. When viewed this way, one might conclude that Sub-Saharan Africa is being left behind by globalization. On the other hand, the FDI inflows for the rest of the developing world have been increasing over the past decade as well, especially China.

In 2012, the investment climate started looking better for Africa, as the continent achieved a five percent increase in FDI inflows in 2012, compared to 2011. FDI inflows to the least developed countries also saw a rise in 2012 as well. Many of the developed countries saw huge declines, in fact declines in FDI to the European Union accounted for two-thirds of the global decline in 2012 (UNCTAD World Investment Report 2013).

According to International Monetary Fund regional statistics, nations in Latin America, the Middle East, and Europe relied mostly on FPI as the source for capital flows, Asia received most of its investment from FDI, and Africa receives most of its capital inflows from development assistance.

Factors Influencing Foreign Investment Decisions

Now that you understand the basic economic reasons why companies choose to invest in foreign markets, and what forms that investment may take, it is important to understand the other factors that influence where and why companies decide to invest overseas. These other factors relate not only to the overall economic outlook for a country, but also to economic policy decisions taken by foreign governments—aspects that can be very political and controversial.

The policy frameworks relating to FDI and FPI are relatively similar, although there are a few differences.

Direct investors tend to look at a number of factors relating to how they will be able to operate in a foreign country:

- the rules and regulations pertaining to the entry and operations of foreign investors
- standards of treatment of foreign affiliates, compared to "nationals" of the host country
- the functioning and efficiency of local markets
- trade policy and privatization policy
- business facilitation measures, such as investment promotion, incentives, improvements in amenities and other measures to reduce the cost of doing business. For example, some countries set up special export processing zones, which may be free of customs or duties, or offer special tax breaks for new investors
- restrictions, if any, on bringing home ("re-patriating") earnings or profits in the form of dividends, royalties, interest, or other payments

The determinants of FPI are somewhat more complex, however. Because portfolio investment earnings are more likely to be tied to the broader macroeconomic indicators of a country, such as overall market capitalization of an economy, they can be more sensitive to factors such as:

- high national economic growth rates
- exchange rate stability
- general macroeconomic stability
- levels of foreign exchange reserves held by the central bank
- general health of the foreign banking system
- liquidity of the stock and bond market
- interest rates

In addition to these general economic indicators, portfolio investors also look at the economic policy environment as well, and especially at factors such as:

- the ease of repatriating dividends and capital
- taxes on capital gains
- regulation of the stock and bond markets
- the quality of domestic accounting and disclosure systems
- the speed and reliability of dispute settlement systems
- the degree of protection of investor's rights

Questions for Discussion:

1. In what ways do the criteria for investing differ between FDI and FPI? Which countries do you think are more favorable for investment, given these criteria? Do you think these criteria are good indicators for successful investment?

2. What factors would you evaluate if you were an investor? Pretend you wanted to open a manufacturing plant to boost production of your wildly popular technological gizmo. What sorts of criteria would you evaluate in determining where to invest? Now pretend that you were looking for a short-term bond purchase for your company's retirement plan. What factors would influence your decision to invest in this case?

Controversies that may arise from host country policy decisions on these aspects of the investment environment will be covered in the following section of this Issue in Depth.

Efforts to Increase International Investment

Certain policy decisions of potential target countries of investment receive close scrutiny from international investors. Consequently, a number of international agreements have been written to specifically address those concerns. They include the following issues:

National treatment: This has been a core element of most agreements on trade in goods and services, and is also a critical issue pertaining to international investment. Typically, these provisions ensure that foreign investors and their subsidiary companies are "treated at least as well as their domestic counterparts," or "no less favorably" than domestic industries. A law which taxed foreign-owned entities at a higher rate than domestically owned entities would therefore violate these provisions. However, if a government wishes to give foreign-owned companies an incentive to invest, such as tax-free treatment of manufacturing in an export processing zone (EPZ), this would not generally constitute a violation of these agreements. Thus countries may treat foreign corporations with better or more favorable regulations, but not poorer ones.

Domestic Content: Another limitation sometimes imposed on foreign investors is "domestic content requirements." These require foreign investors to purchase a certain percentage of intermediate goods from the host country. Domestic content requirements are perhaps the most common form of interventions by governments on foreign investment, and many economists believe they are the most harmful to economic development. Rules on investment developed among all 159 members of the World Trade Organization (WTO) have limited substantially the opportunity for imposition of such requirements.

Expropriation: The seizure of foreign assets by governments has historically been a major concern for international investors. Changes in governments in developing countries, or sometimes just changes in policies, have led to government takeovers of foreign assets. In the past, these expropriations have nationalized key industries (e.g. oil, electric power, mines, or telecommunications), often providing little or no compensation to the original owner. This has long been a significant deterrent to foreign investment. Hence, provisions on expropriation both in U.S. law and in bilateral and regional agreements, as well as in customary international law seek to ensure that any losses by investors must be fairly compensated without delay.

But the "expropriation" issue has come to hold new meaning in legal disputes over property. Although the actual seizure of assets by governments is relatively uncommon today, the use of the term has been broadened to include other kinds of regulatory activities.

Consider the following example: an investor purchases property overseas with the intention of building a manufacturing plant there. She may have even begun construction on the facility, spending millions of dollars. However, in the midst of this construction process, the host country government introduces new regulations, declaring the location of the facility unsuitable for industrial use, perhaps re-zoning it for exclusively residential purposes or declaring that it is an environmentally protected area that cannot be developed.

As a result of this ruling, the investor has not only lost the money that was spent on building a factory on the site, but the real estate probably cannot even be resold for the purchase price because no other investor would want it given the new limitations on its use. In economic terms, the government regulation has therefore reduced substantially the value of the property to the investor. The investor may seek to claim that this new regulation constitutes an expropriation of property and that she therefore is entitled to compensation by the government for the loss she has suffered.

Environmental activists have especially serious concerns about this interpretation of the meaning of expropriation. If provisions seeking to give investors protection from such "takings" are not carefully and properly implemented, argues a report by the International Institute for Sustainable Development and the World Wildlife Fund, "any environmental law worth adopting will affect business operations and may often end the use of, or trade in, certain products, and therefore will have a significant impact on the business in question."

Free transfer of funds: Another practice that has historically been of serious concern to foreign investors is the limitations on the transfers of funds—especially out of a country. During periods of economic crisis, foreign investors may wish to withdraw their assets, and have often found that foreign governments have imposed rules blocking their ability to do so. The wisdom of government policies restricting capital outflows, particularly of short-term portfolio investments, is still a matter of widespread debate among economists and public officials as well as individual investors, for the liquidity of funds and capital are important issues.

Dispute settlement: These provisions typically spell out clear procedures that must be followed in the event of disputes between investors and host governments, to ensure that rules are adhered to and that arbitration may be established by mutual consent.

Most Favored Nation treatment: To ensure that nations do not disadvantage foreign investment from certain nations in favor of investment from other ones, this basic concept of international trade agreements—-and now the key provision in international agreements on investment—-seeks to prevent discrimination among investors from different countries. The phrase "most favored nation" refers to the obligation of the country receiving the investment to give that investment the same treatment as it gives to investments from its "most favored" trading partner.

The case for reducing these kinds of barriers to investment is well-grounded in economic facts. Obstacles to investment prevent countries from making optimal use of their own and other countries' resources. Countless billions of dollars of potential wealth—for investors in the form of profits, for workers in the form of wages, and for consumers in the form of lower prices—are lost every year due to barriers to trade and investment.

Countries may impose these kinds of measures with the intention of protecting domestic industries from international competition and promoting their economic development, but this usually leads to misallocation of resources away from the natural economic capabilities of nations.

Measures to Increase International Investment

Steps taken in recent years to encourage international investment highlight the distinction between the current era of globalization and prior times. These steps are also the source of some of the more significant political controversies surrounding globalization.

The old system of the General Agreement on Trade and Tariffs (GATT) from 1947 to 1994 was almost exclusively concerned with the reduction of tariffs, i.e. barriers at the borders between nations. As discussed in the Trade Issue in Depth, tariffs inhibit trade, and result in reduced economic efficiency. But in 1994, the GATT system was replaced by a new formal international organization, called the World Trade Organization (WTO). The WTO established for the first time rules on trade in services (in addition to goods); rules for the protection of intellectual property; rules for technical, sanitary and phyto-sanitary standards; and others.

Today, everything from banking services to movies and computer software move across international borders at a rapid pace, so a new set of agreements was needed.

In addition to facilitating this explosion of trade with new rules on intellectual property, services, and technical standards, the WTO and other groups have undertaken steps to promote internal economic liberalization that goes beyond simply removing tariffs at the border. Efforts to improve the global environment for international investment have produced some helpful initial steps.

TRIMS

The Uruguay Round negotiations (1994) produced the Agreement on Trade-Related Investment Measures (TRIMs). This agreement cautiously sought to limit the scope of the investment barriers described above. Because the mandate of the GATT and the WTO was to specifically deal with trade-related issues, TRIMS was limited only to investment that affects international trade. Thus, investment in a facility producing solely for the local market would not be covered.

The agreement included provisions to ensure national treatment; to prohibit domestic content provisions; and to discourage export performance requirements (known as "trade balancing requirements"), i.e., that a new investment facility export a certain percentage of its production. It also established a committee to monitor the operation and implementation of the Agreement, providing a forum to explore concerns over these measures more clearly.

TRIMS requires WTO member governments to notify the WTO and fellow-members of all investment measures that do not conform with TRIMS. Developed countries were given two years to eliminate these provisions (until 1996); most developing countries were given until 2000; and the least developed countries were given a grace period beyond 2000.

NAFTA Chapter 11

The North American Free Trade Agreement (NAFTA) is a multilateral trade agreement between United States, Mexico, and Canada. NAFTA, which was signed in 1993, also contains provisions on investment, in its Chapter 11. Although Chapter 11 received little attention in 1993, it has emerged as among the most controversial in ensuing years, and served as the basis for some of the strongest criticism of globalization.

The provisions were included precisely because of Mexico's questionable history of regulating foreign investment, and these were therefore among the most serious concerns that investors had about entering the Mexican market.

Chapter 11 comprised many of the provisions listed above, providing for most-favored nation treatment and prohibitions on export targets, domestic content, or technology transfer requirements. The agreement also established a more formal dispute resolution procedure and contained provisions on expropriation that have turned out to be among the most controversial.

As discussed earlier in this Issue in Depth, certain regulations can diminish the economic value of an investment. A new environmental rule, for example, which restricts industrial development on a piece of land, might be considered to be a "regulatory taking." In such an instance, the owner of that land might claim to have a right to be compensated for this expropriation of the value of their real estate. Consequently, concerns have been raised by civil society activists that a vast array of laws and regulations, relating to everything from the environment to civil rights, could be endangered by trade agreements.

New Kinds of International Economic Disputes

The reasons why pressure has built for new agreements beyond the original scope of the GATT may seem confusing, but are actually quite simple.

For example, think about a manufacturer of automobiles 40 years ago faced with the sudden imposition of tariff barriers in another country. In confronting this kind of economic discrimination against foreign producers, this manufacturer might have been able to find recourse in the GATT's provisions on tariffs on goods traded internationally.

But today, heavily regulated service industries, such as banking, are a growing component of international trade. Several decades ago, banks were generally limited to operating within their home country. However, thanks to globalization (and especially to the telecommunications revolution that has wired the world together), banks are much more willing and able to obtain approvals abroad to expand their operations across borders.

Think of a hypothetical bank that is entering a foreign market. After enjoying great initial success, the international bank begins to take so much market share that it is a competitive threat to local banks in the new country. As a result, the foreign government decides to intervene to protect its local banking sector which is less efficient and offers fewer services at more costly rates. The foreign government imposes new regulations that specifically target—or discriminate against—foreign banks. Unlike the automobile manufacturer, who could raise a protest through the GATT procedures, the banker would have had no similar recourse until the WTO covered services and investment.

Because a branch office of a bank offers services rather than traded goods, this dispute could not have been addressed within the context of the GATT. To better address a dispute over this kind of economic activity, a new agreement had to be implemented. Disputes of this type formed the basis for the General Agreement on Trade in Services (GATS).

The MAI

The attempt to draft a Multilateral Agreement on Investment (MAI) was one of the most controversial chapters in the era of globalization, and the failure of the effort taught many lessons about the sensitivities of investment issues.

As noted earlier, the great majority of foreign direct and portfolio investment originates in developed countries, and is invested in other developed countries. OECD trade ministers recognized that controversies about foreign investment policy occur most frequently in developing countries. Therefore, an initial effort to draft a MAI was initiated by governments of the OECD nations in the hope they might be like-minded and would readily agree on terms for investor protection. However, after several years of discussion, the negotiations ended without a draft agreement.

The negotiators found that there was relatively little will within their member countries to address several significant elements of cross-border investment policies such as taxation, for example. Every nation wanted to carve out a list of exceptions to protect domestic industries or domestic regulatory practices. As a result, the draft that emerged, rather than removing barriers to foreign investment, seemed to do little more than preserve the status quo.

The foundering of the MAI also demonstrated the new-found power that non-governmental organizations (NGOs) now wield in the era of globalization. More than 600 NGOs from around the world—from consumer rights groups such as Public Citizen, to environmental groups such as Friends of the Earth and the Sierra Club, to major American labor unions—joined the effort to derail the MAI negotiations. Among NGOs, the provisions of the MAI that dealt with expropriation, modeled on those that appeared in NAFTA's Chapter 11, were the most controversial.

Critics believed that the MAI would restrict government ability to curb the participation of foreign corporations in critical areas, and any bans on specific investment procedures preexistent would not be able to function under the MAI. Additionally, foreign corporations might take precedent over than domestic companies in terms of international investment. Some critics, such as Mark Vallianatos of Friends of the Earth, argue that accountability and appropriate responsibilities in exchange for rights should be arranged and made clear (Vallianatos, 1997).

The effective opposition of NGOs underscored the new reality that negotiations on agreements on international trade and investment will benefit from input from citizen groups, many of which are transnational themselves.

Questions for Discussion:

1. What role have NGOs played in the development and enforcement of investment? What sources of leverage can you think of that make them influential in decisions concerning international trade?

2. What are the ramifications of these multilateral attempts to facilitate investment? How do they affect the host and target countries differently?

Positive Effects of Foreign Investment

International investment is important to most economies, and can be particularly vital for developing countries. In many instances, developing countries have both the demand for a good or service, and the labor and natural resources to supply it, but they lack the access to capital necessary to begin producing. In the United States, most businesses start when an entrepreneur goes to a bank and takes out a loan. Larger enterprises may go to an investment bank to sell stocks or bonds, to get their businesses going. But in many developing countries, either banks do not exist in adequate numbers or they do not have enough capital to lend to even the majority of worthy borrowers. Thus, foreign investment provides essential capital to help spark the creation of productive enterprises.

Capital Inflows

A positive side effect of helping entrepreneurs get started is the creation of jobs, which leads to increased income levels and thereby to increased consumer demand. Such demand in turn triggers opportunities for other enterprises and, through this multiplier effect, the capital that comes with foreign investment often helps produce economic growth.

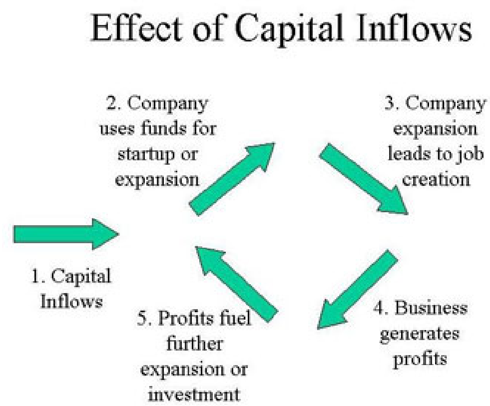
Over the past several decades, the hundreds of billions of dollars of foreign capital that has been invested in the United States have been of tremendous benefit to the U.S. economy, strengthening the dollar, and helping to bring down interest rates by increasing the supply of capital for loans to business and individuals. The decreased investment flows due to the Financial Crisis and the Sovereign Debt Crisis certainly negatively impacted the flow of capital to the U.S. and Europe.

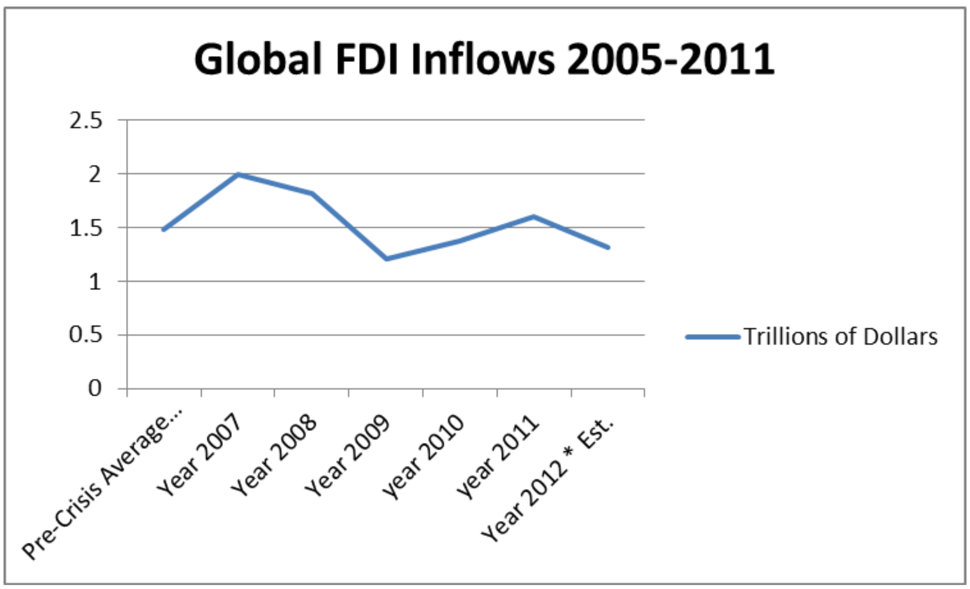
In recent history the world's largest recipient of foreign investment has been the United States. In the first half of 2012 though, China surpassed the United States and became the world’s largest recipient of foreign direct investment, though by the end of 2012, the U.S. regained its number one spot. In 2003, China did beat out the United States for the number one position. One reason might be the fact that the China is growing faster than the U.S. and most developed countries, even though the growth rate in Asia is slowly down. Another reason may be that China no longer seems to be a risky investment.

According to a 2012 IMF Working Paper, for developing countries:

> Reductions in the global price of risk and in domestic borrowing costs were the main contributors to the increase over time in net capital inflows and domestic credit. However, the large cross-country differences in domestic and international finance are best explained by fundamentals such as institutional quality, access to international export markets, and an appropriate macroeconomic policy. Both private capital inflows and domestic credit exert a positive effect on investment; they also mediate most of the investment impact of the global price of risk and domestic borrowing costs. Surprisingly, neither greater domestic credit nor greater institutional quality increase the extent to which capital inflows translate into domestic investment (Luca, Spatfora, 2012).

This means that developing countries can strengthen their institutions and better attract foreign investment though improved institutions do not always translate into better domestic investment (domestic companies investing locally).


Effect of Capital Inflows
1. Capital Inflows
2. Company uses funds for startup or expansion
3. Company expansion leads to job creation
4. Business generates profits
5. Profits fuel further expansion or investment


Global FDI Inflows 2005-2011
2.5
2
1.5
1
0.5
0
Pre-Crisis Average...
Year 2007
Year 2008
Year 2009
year 2010
year 2011
Year 2012 * Est.
Trillions of Dollars

Employment

Stated very simply, when a company builds a factory in a foreign country, it generally creates new jobs. Foreign investment in the United States contributes significantly to domestic employment. In 2010, roughly four percent of the U.S. labor force (six million Americans) was employed by foreign-owned enterprises (Jackson, 2012). (Note: Because most foreign investment into the United States is portfolio investment, rather than direct, as discussed above, one might assume that foreign investment would account for more than four percent of the jobs in the United States. Portfolio investment undoubtedly accounts for a large number of jobs in the U.S., but is harder to quantify because it often involves ownership of a portion of a company, making the numbers harder to disaggregate.)

Opponents of globalization often express concerns about jobs lost in the domestic economy when a factory moves abroad, and about downward pressure on wages at home due to the availability of cheaper labor abroad. Job losses can mean that displaced domestic workers, though unlikely to remain unemployed permanently, may be forced to take lower-paying jobs. But any downward pressure on wages in general (for those in trade and non-trade related industries) may be offset by lower prices for domestic consumers as a whole due to the movement of the factory.

Consider the following process: a company moves its factory to a less developed country to take advantage of lower labor costs and increase its profits. The poorer country may be said to have a comparative advantage in the production of low-skill, labor-intensive goods, such as textiles and apparel. Other companies follow to gain the benefits of lower costs of labor, and are likely to cut their prices to compete with the company already established in the poor country. As competition increases, consumers in the home market as well as those in the poor market will benefit from lower prices, while the less developed country has all the benefits of new know-how, jobs, and related consumer demand.

Globalization has raised numerous issues of concern about labor markets. Foreign investment, trade, technology, and immigration, to name a few issues, are all disruptive to traditional means of productions. While most economists believe that the changes brought about by these factors tend to work to promote economic efficiency, and have great potential to improve the living standards of people all over the world, a host of concerns remain. Numerous proposals have been put forth to help mitigate the disruptions caused by globalization.

Bringing down the prices of goods and services has the same effect as giving a pay raise to every worker who has access to these cheaper goods: their paycheck can now buy more.

Production Advantages

Increased outward orientation: Foreign based affiliates tend to be more outward oriented. As multi-nationally based operations themselves, they are often more aware of the opportunities of foreign markets and therefore more likely to seek to export. This also helps improve a nation's balance of payments. In turn, this outward orientation often helps domestic firms become more aware of international opportunities.

Technology transfers: When companies build plants in foreign countries, they tend to bring the same production techniques and technologies with them that they use in domestic production. This helps raise the skill level of the workers employed in the new plants. The economist Raymond Vernon has observed that direct investment possesses a "life cycle," starting with innovation in a firm's home market, successful application of that new knowledge or technology, and ending with the replication of that innovation in foreign affiliates.

Productivity spillovers: Productivity spillovers can spur growth and raise productivity in industrialized countries as well as developing economies. For example, "just in time" manufacturing allows firms to minimize their needs for inventory by receiving necessary inputs immediately before they are needed. This reduces the need for warehousing and inventory costs. This manufacturing innovation was brought to the United States from Japanese firms. It was adopted by many domestic firms and helped improve the productivity of many American businesses.

Improved production processes: Companies can enjoy significant improvements in productivity from economies of scale, which can be augmented by participating in global operations. Foreign investment need not mean duplicating production and distribution networks in new markets. Rather, foreign investment can make production more efficient by purchasing elements of a final product in the country with a comparative advantage in making that product. Globalization has produced an integration of production and marketing of goods across national borders.

Increased competitiveness in domestic industry: Competition from foreign corporations often encourages domestic companies to become more efficient and globally competitive. These improvements can result from the effect known as "backward linkages." Backward linkages are the long-term relationships that develop between a foreign investor and other firms in the host country. For example, when a firm decides to build a plant that assembles electrical appliances in a foreign country, the firm not only provides a certain number of people with new jobs, but the location of the plant is also likely to encourage the development of new local industries that can supply it with electric motors, fans, and other parts for its production.

Concerns about Foreign Investment

Financial Volatility

One of the first major economic crises in a more globalized economy was the turmoil that struck East Asia beginning in 1997. Although the crisis was rooted in broader international economic developments, such as the severe and lengthy downturn in the Japanese economy, and weakness in bank supervision and loan practices in several East Asian countries, the presence of large amounts of short-term foreign portfolio investment exacerbated what might have otherwise been a relatively small downturn in one region. The flight of that short-term capital out of South Korea and Thailand helped produce a collapse in those economies and several of their neighbors.

A recent study by the Bank for International Settlements quantified the economic impact of the volatility of this short-term investment capital, noting, "In many emerging markets, financial cycles have been particularly pronounced, typically being reinforced by large swings in the flow of international capital. The cost of these cycles has been high, with the direct cost of resolving bank crises often exceeding 10 per cent of gross domestic product and the indirect costs in terms of lost output higher still."

Another major economic crisis is the global financial and economic crisis of 2007-2009. The main cause of this crisis can be sourced to a credit boom. After the information technology bubble between the mid-1990s to early 2000s and its ensuing burst,(Galbraith, Hale, 2007) the US Federal Reserve kept interest rates at the lowest levels in history—close to one percent in 2003 and 2004—in an attempt to offset the subsequent decline in stock prices; but that only fueled the real estate bubble (Sachs, 2008).

By the time *that* bubble had burst, the entire financial system had already become weak due to "the transfer of assets from the balance sheets of banks to the markets, the creation of complex and opaque assets, the failure of ratings agencies to properly assess the risk of such assets, and the application of fair value accounting [as well as the] failure of regulators and supervisors in spotting and correcting the emerging weaknesses" (Fratianni, Marchionne, 2009).

Low-quality (or subprime) mortgages are not necessarily the direct cause of the crisis (a popular notion), although they did make its effects more widespread. While the world is still feeling the overall effects of the crisis, Robert Zoellick, president of the World Bank, has prognosticated that the global financial system reached a “tipping point [which] will trigger business failures and possibly banking emergencies. Some countries will slip toward balance-of-payment crises.” (Cho, Appelbaum, 2008).

Specifically, with regard to global foreign direct investment, the crisis has had an effect, as well. Prior to the crisis, from 2003-2007, global foreign direct investment generally increased, culminating in record levels in 2007 (United Nations Conference on Trade and Development Investment Brief, 2009). But as the US subprime crisis began in the summer of 2007, “various indicators during the first half of 2008 already suggested a decline in world growth prospects as well as in investors' confidence” (United Nations Conference on Trade and Development, 2009). Indeed, FDI flows had already begun to decline by the middle of 2008 (United Nations Conference on Trade and Development Investment Brief, 2009).

By late 2008, the crisis had worsened as non-financial sectors of the economy suffered and some nations were turning to the IMF for assistance. Now in 2013, several economies are still experiencing a recession, or at the very least low levels of growth.

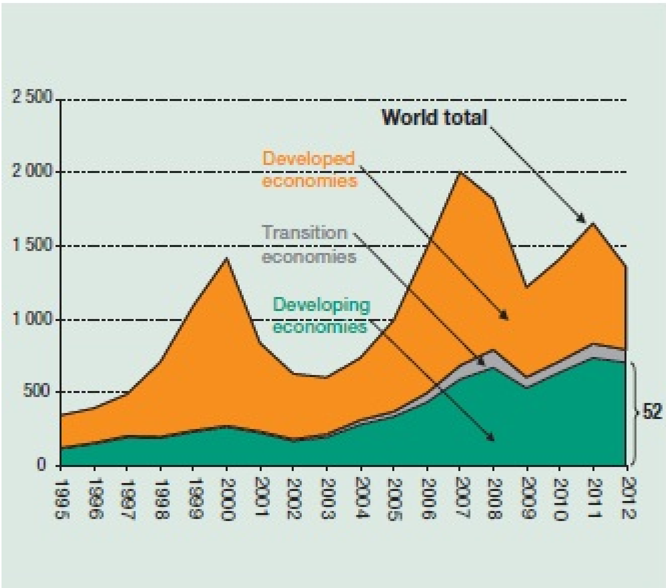
Developed economies are experiencing more of a decline in foreign direct investment than transition or developing economies (see table below). This is because the crisis originated in, and therefore more directly affects, the developed world (United Nations Conference on Trade and Development, 2009). Developing and transition economies are seeing a slowdown in FDI inflow growth, although growth rates will still remain positive (see table below). Europe, Japan and West Asia will suffer the greatest decline in FDI, (see tables below).

Table 1. FDI flows by region, 2010–2012
(Billions of dollars and per cent)

Region	FDI inflows			FDI outflows		
	2010	2011	2012	2010	2011	2012
World	**1 409**	**1 652**	**1 351**	**1 505**	**1 678**	**1 391**
Developed economies	696	820	561	1 030	1 183	909
Developing economies	637	735	703	413	422	426
Africa	44	48	50	9	5	14
Asia	401	436	407	284	311	308
East and South-East Asia	313	343	326	254	271	275
South Asia	29	44	34	16	13	9
West Asia	59	49	47	13	26	24
Latin America and the Caribbean	190	249	244	119	105	103
Oceania	3	2	2	1	1	1
Transition economies	75	96	87	62	73	55
Structurally weak, vulnerable and small economies	**45**	**56**	**60**	**12**	**10**	**10**
Least developed countries	19	21	26	3.0	3.0	5.0
Landlocked developing countries	27	34	35	9.3	5.5	3.1
Small island developing States	4.7	5.6	6.2	0.3	1.8	1.8
Memorandum: percentage share in world FDI flows						
Developed economies	49.4	49.7	41.5	68.4	70.5	65.4
Developing economies	45.2	44.5	52.0	27.5	25.2	30.6
Africa	3.1	2.9	3.7	0.6	0.3	1.0
Asia	28.4	26.4	30.1	18.9	18.5	22.2
East and South-East Asia	22.2	20.8	24.1	16.9	16.2	19.8
South Asia	2.0	2.7	2.5	1.1	0.8	0.7
West Asia	4.2	3.0	3.5	0.9	1.6	1.7
Latin America and the Caribbean	13.5	15.1	18.1	7.9	6.3	7.4
Oceania	0.2	0.1	0.2	0.0	0.1	0.0
Transition economies	5.3	5.8	6.5	4.1	4.3	4.0
Structurally weak, vulnerable and small economies	**3.2**	**3.4**	**4.4**	**0.8**	**0.6**	**0.7**
Least developed countries	1.3	1.3	1.9	0.2	0.2	0.4
Landlocked developing countries	1.9	2.1	2.6	0.6	0.3	0.2
Small island developing States	0.3	0.3	0.5	0.0	0.1	0.1

(UNCTAD World Investment Report 2013 Global Value Chains: Investment and Trade for Development, 2013)

Figure I.1. FDI inflows, global and by group of economies, 1995–2012
(Billions of dollars)



(UNCTAD World Investment Report 2013 Global Value Chains: Investment and Trade for Development, 2013)

Due to declining profits and increasingly difficult access to credit, as well as bad short-term economic growth prospects, transnational companies are cutting down on foreign direct investment. However, the situation could improve in the future as financial and economic crises provide opportunities for firms to purchase foreign assets at relatively low prices. Firms also seem to be committed to longer-term investments in foreign nations; although FDI flows have decreased, FDI stocks have not (United Nations Conference on Trade and Development, 2009).

Firms that are from “emerging economies and countries that are well-endowed with natural resources, are becoming a growing source of FDI,” too (United Nations Conference on Trade and Development, 2009). Lastly, specific industries might be well-suited for escaping from the crisis. According to UNCTAD, these include industries in life sciences, agro-food, transport equipment, business services, personal services, information and communication technologies and energy, chemistry and environmental conservation (United Nations Conference on Trade and Development, 2009).

Contagion

The phenomenon known as "contagion" is closely related to the concern about volatility. Put simply, when investors decide to flee one market, the "herd effect" of investors following each other can produce economic crises in other countries that previously appeared to be fundamentally sound.

During the East Asian financial crisis, the global contagion effect was driven significantly by the use of financial derivatives. These are financial instruments which typically involve calculations and risk-taking about the price of one good or economic entity against another. Investments in such instruments are often highly leveraged, that is, purchased with only a small percentage of the purchase cost coming from the buyer and the rest coming from lenders to the buyer.

Consequently, when one basket of goods fails to perform the way investors expected, the investors may be forced to sell off other assets to cover the risks they have taken. In 1997-98, when Asian economies started collapsing, many investors were forced to sell off assets held in Russia, which led to a decline in stock prices there and a weakening of their currency. The downturn in Russia helped set off a similar downturn in Brazil.

In fact, analysts of the East Asian financial crisis found it instructive to look at the difference in the impact discernable in two nations that were long considered economic "twins" of East Asia—-South Korea and Taiwan—because their development had followed such similar paths. Although South Korea suffered a real catastrophe, with its currency losing 80 percent of its value and its stock market losing 42 percent, Taiwan emerged from the region-wide crisis relatively unscathed.

A principal difference between their economic profiles was South Korea's much greater reliance on foreign investment, especially on portfolio investment. While Taiwan's reliance on foreign investment over the previous four decades amounted to less than ten percent of total investment, in South Korea foreign investment accounted for sixty percent of the total. Similarly, the debt/equity ratio in the critical manufacturing sector in Taiwan was 87 percent, but in South Korea the ratio was 300 percent.

The handling of the crisis by the International Monetary Fund (IMF) was also the subject of considerable criticism. Prominent economists such as Nobel Prize-winner James Tobin argue that, when facing currency crises that endanger "both financial systems and whole economies, [the IMF and leaders of the financial community]...invariably give priority to finance."

Under intense pressure by investors and international institutions to maintain the value of their currency, South Korea, Thailand, Taiwan, and their neighbors' economies were forced to raise interest rates to levels which strangled large numbers of small businesses and necessitated their taking out large loans from the IMF in vain efforts to protect their currencies.

The global financial and economic crisis of 2007-2009 could correlate with a global contagion. Whereas previous contagions were geographically limited, the high level of global economic integration at present means that any contagion related to the current financial crisis could engulf the world, reaching all sectors and all nation (Financial crisis goes global, 2008).

Problems with Capital Inflows

Given the problems described above in the East Asian financial crisis, it is clear that sudden outflow of capital can be very damaging. But what does this say about capital inflows? The ability to manage capital inflows is perhaps the more pertinent issue in current times. Large capital inflows can increase vulnerability to external shocks and shifts of market sentiment. In a way the capital inflows and outflows problems are two sides of the same coin.

Critics of globalization such as economist Joseph Stiglitz have cited the example of Thailand's deregulation of capital inflows as an example of the dangers. Until the 1980s, Thailand used to have very restrictive policies surrounding real estate investment. However, under pressure from the IMF and the U.S. Treasury, the Thai government liberalized its investment policies, removing restrictions on bank lending for real estate. An over-capitalized domestic market—that is, one with too many investment dollars chasing too few real opportunities—resulted in a lot of very risky and sometimes poorly planned investment projects.

This led in the 1990s to a boom in office building construction, and many of these offices now sit empty. However, the Thai government still must repay the loans taken out for their construction, taking money from other developmental priorities such as building schools and roads.

A final awareness that grew out of this turmoil was that due to the new linkages in the world economy, with the assets of firms spread across many countries, a crisis of significant magnitude can affect not only poorer countries but more advanced economies as well. Many analysts were surprised that middle-income countries such as Russia and Brazil were affected by the events in East Asia. Indeed, some economists in the U.S. feared that a more serious downturn in Brazil could have had a domino effect upon the rest of Latin America, continuing up to Mexico, which would then inevitably have had substantial implications for the U.S. economy.

Although economists seldom achieve a consensus on major economic policy issues, many agree that one of the lessons learned by the East Asian crisis was that financial liberalization in developing countries should not get ahead of reforms in the banking and finance sectors. Many observers concluded that the supervision of East Asian banks, reserve requirements, and other traditional safeguards were not sufficient to manage the enormous capital inflows which began in the 1990s.

Investment and Labor

The effects of globalization and investment on labor raise a number of concerns with respect to wages, job security and working conditions. During the U.S. 1992 presidential campaign, candidate Ross Perot famously asserted that the "sucking sound" Americans were going to hear soon would be from American jobs going to Mexico, as a result of the elimination of trade and investment barriers in the NAFTA agreement. Indeed, a substantial number of American jobs have been eliminated, especially in the textiles and apparel industry, because companies have transferred their production overseas in search of lower wages.

Some labor activists, critical of globalization, charge that the shifting of production facilities across international borders has implications beyond simply jobs that may be lost due to the change. They have alleged that these kinds of transfers may be leading to a "race to the bottom" on international labor standards; that industries may be searching the globe for the countries with the cheapest wages and worst working conditions.

The economic premise behind this argument is very simple: when capital mobility increases (i.e., by making it easier to invest in production across new borders), the labor sector is disadvantaged, because it is inherently less mobile (labor is less mobile because it is harder for to people to move across borders than money or goods). Investors can therefore pick and choose where to build their factories, based on which country will offer the lowest costs. And workers in developed countries, according to this argument, are forced to keep outbidding workers in other countries, in an attempt to offer the lowest wages to win the jobs.

Export Processing Zones

Often relating closely to general concerns about globalization and labor is the practice of granting certain kinds of tax and other regulatory exemptions to international investors through Export Processing Zones (EPZs). EPZs are special arrangements—often a distinct geographic area near a port—which are set up to promote export industries. These are often assembly plants using low priced labor to bring together components from different countries so that a new product can then be exported. The EPZ's often apply a different set of regulatory rules from the rest of the country. They are typically established by developing country governments with the explicit purpose of attracting foreign investment.

In many cases, host governments will invest in infrastructure to help guarantee reliable electricity or water supplies, which may not be universal. Often they will also allow "one stop shops" where companies can complete all their necessary paperwork, and will exempt the facilities from customs or duties on items they import. EPZs are found in many middle-income nations, as well as the least developed countries.

But labor advocates charge that EPZs are created to evade national labor laws, that workers within EPZs are not allowed to organize, and that they receive lower wages. EPZs are also known as "free trade areas" in many countries, and in Mexico they are referred to as "maquiladoras."

However, a study by the International Labor Organization (ILO)—an international institution which is part of the UN and includes representatives of governments, business, and labor—has found that while the occurrence of these practices in EPZs are disturbing, they "are not common to all employers in export-oriented factories."

In fact, the ILO says these practices are present in a minority of cases. In addition, the study noted that in one country where many reports of violations had been recorded, "the majority of those disputes involved foreign enterprises from non-OECD countries (i.e, other developing countries)." The study also found that workers in the EPZs, even without being unionized, were nonetheless better paid and enjoyed amenities and working conditions of a higher standard than workers outside the zones.

Nonetheless, the ILO recognizes that the conduct of employers and the condition of workers in EPZs is a serious concern. This raises the important question of whether globalization leads corporations to transfer production to countries with the lowest wages. Stating the proposition this simply, the answer is clearly no. Investment is most attracted to countries that have an overall favorable environment for capital. Labor conditions and wages are just parts of a larger equation. Other factors include the skill level of the work force, access to markets through transportation infrastructure, tax policies, overall political and economic stability, and the prevalence of corruption.

When asking whether it is beneficial to locate production in developing countries for those sectors that do specifically seek low wage labor, one should also consider the effect that this new production will have on the recipient country labor market. Before workforces can be organized to demand better protection, there must first be a workforce. Although incidents of sweatshop labor have not been uncommon and are very disturbing, there is also evidence that international investment in labor-intensive industries, in the long term, tends to raise wages and strengthen the bargaining power of local workers.

Globalization May Increase Inequality

There is a considerable debate among economists about the extent to which globalization—and specifically the liberalization of trade and investment—may increase inequality. As discussed earlier, international investment leads to changes in the use of technology and may shift production—especially in lower skill sectors—into developing countries that have lower prevailing wage levels. The lowest wages may also be falling in industries struggling to compete with new imports, while higher-paying export industry jobs are increasing in number but remain unavailable to the relatively unskilled labor force.

These changes taken together mean that economies are putting a higher premium on skilled workers. This creates pressure to pay higher wages to skilled employees, while diminishing the value of lower-skilled workers. The net result globally has been a significant growth in inequality, both between nations and inside them.

Critics of that view counter that globalization has helped produce a significant expansion of global wealth, and that, in spite of a rapidly growing global population, the absolute number of people living in poverty has remained relatively constant. The question of the role that globalization plays in exacerbating inequality depends very much on how the question is asked. Data varies considerably by region and by what kinds of indicators are selected.

Even assuming that absolute poverty is decreasing somewhat while inequality is widening rapidly (that is, the rich are getting richer while the poor stay the same), some economists and sociologists also question whether an economic benefit of this character is outweighed by the political and social costs brought about by inequality. For more information on this controversial topic, see the section on globalization and inequality in the Development Issue in Depth.

Environmental Concerns

Some analysts are concerned that the environmental cost of globalization is extremely high. It is believed that the global corporations depend upon never-ending resource supplies, ever-expanding markets and constant supplies of cheap labor. Critics say these goals have been given priority over preservation of nature and public health. The world, they say, is on the brink of an environmental collapse and the current levels of global production are unsustainable. Another pertinent issue is that many advanced nations are able to circumvent environment laws in their countries by setting up production facilities in countries that do not have stringent environmental rules. This phenomenon has been termed as a "race to the bottom" in environmental standards as countries fight to attract more foreign capital and keep domestic investment at home.

As described earlier, provisions in certain investment agreements such as NAFTA's Chapter 11 that deal with expropriation or "regulatory takings" are also of great concern to environmentalists, because they can threaten environmental regulations.

Conclusion

The Net Benefits of Global Investment

As you can see, international investment, like many aspects of globalization, presents opportunities as well as challenges. You may wonder where the balance of costs and benefits lies. The question is particularly acute for developing countries: many of the greatest controversies about financial liberalization covered in this issue brief are raised when investment flows from developed to developing countries. To be sure, many of the problems of developing countries stem from internal deficiencies, ranging from the inadequate supervision of the banking sector to corruption or inadequate labor and environmental standards.

On the one hand, very few economists—even among the harshest critics of financial liberalization—dispute that international investment can be a powerful engine for economic growth. A look at development statistics shows that there is a correlation between investment and growth in developing countries. Proponents of liberalization such as David Dollar of the World Bank point out that essentially no developing country has managed to achieve rapid and sustained growth, successfully raising the prosperity levels of their population, without increasing their openness to foreign investment (Blustein, 2001).

But critics question the extent to which these success stories can be attributed to foreign investment *alone*. They tend to argue that what is most important for a developing country is that it supports an environment that is *generally* supportive of investment. That is, when the climate is favorable for domestic investment, it is likely to be favorable for international investment. Economists from this school of thought—while not denying the importance of international investment—tend to promote policy prescriptions that are more focused on internal concerns.

For example, when asking whether a developing country with a limited government budget should spend funds improving infrastructure at an EPZ to help attract foreign investors, or spend that money on local and national courts, police, and prosecutors to improve the management of their justice system to eventually help control corruption, they would argue for the latter. Their reading of the data posits that investment tends to *follow* growth, not *lead* it.

Other economists have suggested that, when disaggregating the data on growth and investment in developing countries, many of the supposed problems associated with foreign investment flows can be attributed to certain *kinds of restrictions* on investment. According to Theodore Moran:

> *"Foreign direct investment is most likely to be harmful—actually damaging—to the growth and welfare of developing countries and the economies-in-transition when the investor is sheltered from competition in the domestic market and burdened with high domestic content, mandatory joint ventures and technology-sharing requirements" (Moran, 1999).*

If this is the case, then it would appear that the most damaging scenario for developing countries would be in receiving foreign investment in the *absence* of strong agreements like TRIMs, the MAI, or NAFTA's Chapter 11.

Other economists have stressed that there can be big differences in the effects on development according to the *types of economic activities* in which foreign investment is involved. In particular, many analysts have suggested that investment in the extraction of natural resources can have deleterious effects on a nation's development and environment, but investment in more labor-intensive manufacturing is more likely to be beneficial.

Investment and Trade

As you have learned from this Issue in Depth, there are many relationships between international trade and investment. Roughly one-third of the world's volume of trade occurs within the same company's affiliates across borders. Furthermore, a higher percentage of the goods and services produced by facilities financed in part by foreign direct investment tend to be exported than by other domestic firms.

In this way, foreign investment can be seen as both a complement and a substitute for trade. A company that wishes to sell its goods and services in a foreign market may often ask whether its goals are best achieved by manufacturing in its home country and exporting its products, or by relocating production to the foreign market. A company's decision on which method to pursue in reaching foreign markets, via trade or investment, may well be determined by the comparison of trade barriers with the investment environment.

Questions for Discussion: Students of globalization may ask many questions about the relationship between these activities. Is it better for your economy to produce goods at home, or is it preferable to move production overseas so that consumers may pay lower prices? What is the effect on developing countries of these shifts in production? Is it better for to create jobs in these areas? How should concerns about labor and environmental standards be taken into account?

The Role of Government

As with many issues pertaining to globalization, concerns and hopes about international investment revolve in many ways around what governments may do. This means both what governments may do to regulate foreign investment, perhaps to make it less volatile, as well as actions government may take simply to get out of the way of the market, clearing the existing barriers to capital. In addition, the role of government refers not only to individual nations, but to international institutions such as the WTO and the IMF, which serve functions relating to global governance.

Some of the steps these institutions of governance can take to help influence the choices made by international investors include:

- The creation of new infrastructure and other facilities to attract foreign investment. As described earlier, an array of services can help promote foreign investment in a country, ranging from basic services such as the provision of electricity and clean water, to fair and effective dispute resolution systems.

- The ability of governments to prevent or reduce financial crises also has a great impact on the growth of capital flows. Steps to address these crises include strengthening banking supervision, requiring more transparency in international financial transactions, reducing the risk of moral hazard, and ensuring adequate supervision and regulation of financial markets. The majority view among economists is that financial sector reform must precede capital account liberalization.

  Other steps have been suggested to help limit the volume of volatile short-term capital such as small taxes on foreign exchange transactions. One prominent advocate of this idea was Nobel Prize winning economist James Tobin.

  Although many countries have imposed limits or taxes on capital outflows, another creative way to address volatility was applied by Chile, which imposed a small transaction fee on capital *inflows*. This measure served to limit the amount of short-term investment, but did not create a risk of deep concern to investors, namely, of having trouble getting their money out of the country at some point in the future.

- Working with developing country governments in particular to help establish more stringent labor and environmental standards to prevent either one from being exploited.

- Protecting domestic infant-industries only long enough to allow them to become competitive internationally. This step remains controversial, but some economists have pointed out that a number of developing countries—indeed many of the countries that have recorded the highest long-term growth rates—have done so after resorting to some protection of sectors of domestic industry.

As you can see from this list of policy options, people from almost the entire spectrum of beliefs about globalization have prescriptions for government policy, even those who advise that governments need only act to remove market-distorting tariff and regulatory barriers. And this list is by no means comprehensive.

Ongoing events are leading an increasing number of analysts of globalization to suggest that we explore the challenges and opportunities of globalization more fully, to better understand its consequences and learn how to maximize its potential benefits while mitigating its disruptions.

Economic events such as the East Asian financial crisis and more recent incidents such as the collapse of the Argentinean economy in late 2001 have made many economists argue for improved market mechanisms, such as regulatory measures and oversight. The fact that different countries encountering similar problems have received different prescriptions from the international community has also led many to argue for a more firmly established set of ground rules.

Coordination between governments will be crucial for dealing with the global financial and economic crisis of 2007-2009. According to UNCTAD, "the challenge is to restore the credibility and stability of the international and financial system, to provide stimulus to economic growth in order to prevent the risk of a spiraling depression, to renew a pragmatic commitment to an open economy, potentially put at risk by rising protectionist tensions, and to encourage investment and innovation" (United Nations Conference on Trade and Development, 2009).

In addition, political events such as the large protests in 1999 at the Seattle WTO meeting or in 2001 at the G8 meeting in Genoa, Italy, have led some political leaders to conclude that certain kinds of market interventions or regulations are necessary to assist those who are endangered by globalization, simply to sustain political support for continued liberalization.

Joseph Stiglitz, formerly chief economist of the World Bank and Nobel Prize winner for economics in 2001, has characterized the globalization of international finance as suffering from "global governance without global government." He notes that the nationalization of the U.S. economy, which began 150 years ago and was analogous in many ways to the process of globalization, was accompanied by a significant expansion in government oversight and regulation, to help temper crises and provide accountability.

One surefire prediction about the globalization debate is that much of the discussion will continue to revolve around appropriate government policies.

Learning More

In many ways, participants in the debate over globalization can be divided into three general camps:

1) Supporters: those who are the staunchest advocates of globalization, believing that markets, not governments, tend to best promote economic development and human society;
2) Reformers: those who support globalization with reservations, believing that markets should be promoted and international barriers to trade and investment should be reduced, but that government regulation can help mitigate some of the harsher aspects of the new changes;
3) Opponents: the most severe critics of globalization, who believe that global economic and political integration corrodes many human values, and who support efforts to promote an economic system that emphasizes local production.

To learn more about this fascinating and ongoing debate, students may wish to read more of the writings of economists such as David Dollar, Anne Krueger, and Jagdish Baghwati, on the pro-globalization side. For critiques of the current system that accept many of the basic principles of free markets, authors such as Amartya Sen, Joseph Stiglitz, William Greider and Dani Rodrik have written some of the most prominent works. And for the analysts of globalization who are the most critical and want to stop or reverse the process, students may turn to Gerry Mander, Lori Wallach, or organizations such as Global Exchange. The bibliography of this Issue in Depth includes specific works by these authors.

Glossary

Balance of payments (BOP): BOP is a statistical statement that summarizes, for a specific period (typically a year or quarter), the economic transactions of an economy with the rest of the world. It covers:

- All the goods, services, factor income and current transfers an economy receives from or provides to the rest of the world
- Capital transfers and changes in an economy's external financial claims and liabilities

Bond: A certificate issued by a government or company representing a promise by the bond issuer to pay the bondholder interest in addition to the principal amount of the bond after a specified period of time. For example, a 10-year bond purchased today costs $35. When you "redeem" or cash in the bond after ten years, the issuer repays the $35 principal plus interest at a rate established when the bond was issued.

Debt/equity ratio: The debt/equity ratio measures the extent to which a firm's capital is provided by lenders (through debt instruments such as fixed-return bonds) or owners (through variable-return stocks). A greater reliance on financing through debt can mean greater profitability for shareholders, but also greater risk in the event things go sour.

Domestic content requirements: These require foreign investors to purchase a certain percentage of intermediate goods from the host country.

Economies of scale: Produces are often able to enjoy considerable production cost savings by buying inputs in bulk, mass-producing or retailing their end product. These lower costs achieved through expanded production are called economies of scale.

Exchange rate of a nation's currency: Currency like other commodities, rises or falls in "price" with demand. When investors leave, they sell their holdings in a country's currency and as demand falls, the "price" of that currency will also fall. This "price" change of currency is what the exchange rate refers to.

Export processing zones (EPZs): EPZs are special arrangements, often a distinct geographic area near a port, which are set up to promote export industries.

Foreign direct investment (FDI): This category refers to international investment in which the investor obtains a lasting interest in an enterprise in another country. Most concretely, it may take the form of buying or constructing a factory in a foreign country or adding improvements to such a facility, in the form of property, plants or equipment.

Foreign portfolio investment (FPI): FPI is a category of investment instruments that are more easily traded, may be less permanent, and do not represent a controlling stake in an enterprise. These include investments via equity instruments (stocks) or debt (bonds) of a foreign enterprise that does not necessarily represent a long-term interest.

Gold standard: When a country is said to be on the gold standard, the value of its currency and the quantity of its currency in circulation is tied the nation's reserve of gold. Such a system tends to restrict the country's monetary supply.

Import Substitution Industrialization: An international economic and trade policy based on the belief that a nation should reduce its dependency on foreign investment and goods by domestic production of industrial goods

International Monetary Fund (IMF): The IMF is an international organization of 185 member countries, established in 1947 to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment.

Interest rates: Interest rates have a powerful effect on the volume of a nation's money supply. By raising interest rates, i.e., making the cost of borrowing money more expensive, governments or banks can decrease the money supply. A decrease in the money supply tends to be counter-inflationary, which makes a currency more valuable compared to other currencies.

Moral hazard: Critics of the IMF often assert that the knowledge that bad economic decisions, e.g., imprudent bank loans, are often bailed out by the IMF is likely to make lenders and investors less cautious, and only increase the number of economic crises. The "moral hazard" is that economic actors will not have to face the consequences of their own actions.

Most Favored Nation: The phrase "most favored nation" refers to the obligation of the country receiving the investment to give that investment the same treatment as it gives to investments from its "most favored" trading partner.

National treatment: This has been a core element of most agreements on trade in goods and services, and is also a critical issue pertaining to international investment. Typically, these provisions ensure that foreign investors and their subsidiary companies are "treated at least as well as their domestic counterparts," or "no less favorably" than domestic industries.

Organization for Economic Cooperation and Development (OECD): OECD is a descendant of the U.S.-European cooperation required to execute the Marshall Plan and rebuild Europe after World War II. A tribute to the success of that effort is the fact that the 30 or so members of the OECD now include Japan and Korea as well, are thought of as the wealthy nations of the world.

Stock: A certificate issued by a corporation that represents partial ownership of the corporation (equity). Different kinds of stock confer different rights and responsibilities on the stockholder, including the right to receive dividends and the ability to participate in corporate decision-making.

Subprime credit: General term for borrowings of low-quality debt—such as mortgages, loans, et. al—made to people with less-than-perfect credit or short credit histories. Subprime credit includes the original borrowing itself, as well as any derivative products such as securitizations that are based on subprime loans and then sold to investors in the secondary markets.

Works Cited

Introduction

Baer, W. (1972). Import Substitution and Industrialization in Latin America: Experiences and Interpretations. In *Latin American Research Review*. Vol. 7 (Spring): 95-122.

Organization for International Investment. Trends in Foreign Direct Investment (FDI). Retrieved from: http://ofii.org/resources/trends-in-foreign-direct-investment-fdi.html

Sutherland, P. D. (1998, October 4). Managing the International Economy in an Age of Globalization. In The 1998 Lecture.

United Nations Conference on Trade and Development. *World Investment Report 2013.* Retrieved from: http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf

United Nations Conference on Trade and Development (2013, January 28). MULTI-YEAR EXPERT MEETING ON INVESTMENT FOR PRODUCTIVE CAPACITY-BUILDING AND SUSTAINABLE DEVELOPMENT. Regional Integration and Foreign Direct Investment. Retrieved from: http://unctad.org/meetings/en/Presentation/diae_stat_2013-01-28_en.pdf

Factors Influencing Foreign Investment Decisions

Vallianatos, Mark (1997, July 1). Multilateral Agreement on Investment. *Foreign Policy in Focus*. Retrieved from: http://www.fpif.org/briefs/vol2/v2n39mai.html.

Positive Effects of Foreign Investment

China Becomes World's Largest FDI Recipient (2012, October 25. Retrieved from: http://www.indolink.com/displayArticleS.php?id=102412093717

Foreign Direct Investment 2011. Retrieved from: http://chartsbin.com/view/2222

Jackson, J. K. (2012, October 26). *Foreign Direct Investment in the United States: An Economic Analysis*. Congressional Research Services. Retrieved from: http://www.fas.org/sgp/crs/misc/RS21857.pdf

Luca, O., Spatafora, N. (2012). Capital Inflows, Financial Development, and Domestic Investment: Determinants and Inter-Relationships. *International Monetary Fund Working Paper*. Retrieved from: http://www.imf.org/external/pubs/ft/wp/2012/wp12120.pdf

Concerns about Foreign Investment

Blustein, P. (2011, November 4). Cause, Effect and the Wealth of Nations. *The Washington Post*, 1.

Cho, D. , Appelbaum, B. (2008, October 7). Unfolding Worldwide Turmoil Could Reverse Years of Prosperity." *The Washington Post*. Retrieved from: http://www.washingtonpost.com/wp-dyn/content/article/2008/10/06/AR2008100603249.html.

Financial crisis goes global. (2008, September 19). *The New York Times*. Retrieved from: http://www.nytimes.com/2008/09/19/news/19iht-19oxan-CRISIS.16311607.html

Fratianni, M., Marchionne, F. (2009, April 10). The Role of Banks in the Subprime Financial Crisis. Retrieved from: http://dea2.univpm.it/quaderni/pdfmofir/Mofir023.pdf.

Galbraith, J. K., Hale, T. (2007, January 14). Income Distribution and the Information Technology Bubble." *University of Texas Inequality Project*. Working Paper 27.

Mann, H. (2001). *Private Rights, Public Problems: A Guide to NAFTA's Controversial Chapter on Investor Rights*. Canada: International Institute for Sustainable Development.

Moran, T. (September 1999). Foreign Direct Investment and Development: A Reassessment of the Evidence and Policy Implications. In OECD Conference on the Role of International Investment in Development, Corporate Responsibilities and the OECD Guidelines for Multinational Enterprises. Paris: OECD, 20-21.

Sachs, J. (2008). *Crowded Wealth: Economics for a Crowded Planet*. New York: Penguin Press

Stiglitz, J. E. (Winter 2002).Globalism's Discontents. In *The American Prospect.* 16-21.
United Nations Conference on Trade and Development Investment Brief (2009). Global FDI in Decline Due to the Financial Crisis, and a Further Drop Expected." Retrieved from: http://unctad.org/en/Docs/webdiaeia20095_en.pdf.

United Nations Conference on Trade and Development (2009, January 19). Assessing the impact of the current financial and economic crisis on global FDI flows. Retrieved from: http://unctad.org/en/docs/webdiaeia20091_en.pdf.

United Nations Conference on Trade and Development. World Investment Report 2013. Retrieved from: http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf