



# Reevaluating the role of trade agreements: Does investment globalization make the WTO obsolete?

Emily J. Blanchard\*

Department of Economics, University of Virginia, P.O. Box 400182, Charlottesville, VA 22904-4182, United States

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## ABSTRACT

International ownership alters the role of multilateral trade institutions by redefining pecuniary externalities among countries. Regardless of the underlying cause – whether foreign direct investment, international portfolio diversification, cross-country mergers, or multinational firms – international ownership can mitigate incentives that lead large countries to set inefficiently high tariffs. At the same time, however, foreign ownership introduces the potential for expropriation by investment-host countries, which can extract rent from foreign owners by manipulating local prices. The basic principle of reciprocity continues to serve as an important guide to efficiency, though its application must account for the pattern of international ownership in addition to traditional measures of market access.

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## 1. Overview

A common caveat overshadows the current understanding of the role of negotiated tariff liberalization: standard models cannot address the potential for international ownership to influence governments' preferences over trade policies. Conventional national ownership models necessarily frame trade negotiations as an us-versus-them mercantilist battle for market access. Yet in an age when national economic interests are increasingly divorced from geographic boundaries through international investment and cross-border ownership, the link between market access and national welfare is no longer obvious.

The recent surge in gross private capital flows<sup>1</sup> suggests that national commercial interests both depend more on foreign markets through offshore investment, and at the same time diverge from the pattern of domestic production where foreign interests are present in the local economy. For investors in large countries like the United States, greater investment overseas means increased internalization of the effect of domestic trade policies on world markets. At the same time, as foreigners hold a greater stake in the local economy – either through direct

investment or portfolio holdings – the host government may recognize the opportunity to shift rents away from foreign owners in favor of local constituents through domestic policy changes. To the extent that governments adjust commercial policy in response to changes in the interests of their constituent industries, evolution in the pattern of firm ownership and operations across the globe can be expected to induce a concomitant shift in governments' trade policy objectives.

Anecdotal evidence suggests that international ownership may already influence governments' motives in drafting trade legislation. In a chapter dedicated to analyzing the increasing internationalization of production, the OECD's 2002 *Economic Outlook* emphasizes geographic trends in both the level and change in intra-industry trade (particularly in manufacturing) concentrated in certain areas.<sup>2</sup> Notably, all but one of the OECD's designated “high and increasing intra-industry trade” (from 1988 to 2000) countries – the Czech and Slovak Republics, Hungary, Poland, Germany, Mexico, the U.S., and Portugal – were also key players in recent major expansions of regional trade agreements.<sup>3</sup> Of course, correlation does not imply causality – not least because trade policy surely influences the decisions of potential international investors –

\* Tel.: +1 434 924 3607; fax: +1 434 982 2904.

E-mail address: [blanchard@virginia.edu](mailto:blanchard@virginia.edu).

<sup>1</sup> The World Bank estimates that between 1990 and 2003, gross private capital flows as a percentage of GDP rose from 2.8 to 4.6 in low-income countries, from 6.7 to 13.2 in middle-income countries, and from 11.1 to 26.6 in high-income countries. (World Bank, WDI 2005, Section 6.1, Table 6.1.)

<sup>2</sup> (OECD, 2002). At the outset of the report, the authors argue that measures of intra-industry and intra-firm trade provide the best evidence of internationalization of firms in light of aggregate data limitations.

<sup>3</sup> The first four were major recipients of investment from Germany and joined the European Union in 2004, while Mexico has been a major recipient of export-platform investment from the U.S. since the creation of its maquiladora program in the mid 1960s, and signed NAFTA in 1993. Portugal has been a member of the EU since 1986.

but as argued by Gruben (2001) in the case of NAFTA, it seems likely that causality runs both ways:

This globalization process was not a creature of NAFTA. If anything NAFTA was a creature of this globalization process. If the reductions in transportation and communications costs that motivated globalization had not taken place, the political pressures that permitted NAFTA would not have been so strong. (p.6)

This paper demonstrates that international ownership can influence governments' incentives to manage global market access, and may thereby translate into an altered role for multilateral trade agreements such as the General Agreement on Tariffs and Trade and its successor institution, the World Trade Organization (GATT/WTO). By combining a simple illustrative model of endogenous tariff determination with the Bagwell and Staiger (1999, 2002) politically augmented terms of trade framework, the model formalizes how the conventional understanding of pecuniary externalities across countries must be updated in an environment with international investment. The result is a unified platform for evaluating the implications of international ownership for the institutional agreements that govern world trade.

Fundamentally, cross-border ownership restructures the relationship between national welfare and prices. Whereas traditional national ownership models admit a single pecuniary externality through which large countries can extract rents from trading partners – world relative prices – models with international ownership permit three potential cost-shifting margins. In addition to potentially severing the traditionally understood link between a country's terms of trade and its welfare, cross-border ownership introduces two more potential cost-shifting margins: the absolute (local relative to world) price level, which can be used to shift rents from local producers (which may be partially foreign owned) to local consumer-constituents, and the local relative price, which can be manipulated to shift rents across sectors – away from those with a relatively high degree of foreign ownership and toward those that are provincially owned. By formally defining these price to welfare mappings, the model identifies the channels through which global equity holdings influence government policy objectives, and thus the potential role of negotiated trade agreements.

To capture the trade policy implications of the broadest possible range of international investment mechanisms in a single framework, the paper restricts attention to the ownership effects of cross-border equity holdings. The common trait across virtually all forms of cross-border investment – whether due to the acquisition of domestic firms by foreign interests, foreign direct investment (FDI), multinationals' foreign affiliate activities, international portfolio diversification, or cross-country mergers – is that the international pattern of ownership is divorced from countries' domestic production portfolios. The critical implication is that international investment – however broadly defined – allows countries' gross domestic product (GDP) to differ in both level and composition from gross national product (GNP). Since it is generally held that countries' welfare is tied more closely to GNP than to GDP, this simple observation carries considerable importance.

The caveat imposed by the model's generality is that ownership must be taken as exogenous. While it would be ideal to endogenize the structure of global investment positions, doing so would require making assumptions over the process by which foreign ownership is achieved; those assumptions necessarily would limit the universe of possible international ownership patterns in the model, and thus would reduce the generality of the results.<sup>4</sup> The key contribution of

<sup>4</sup> For instance, one might assume that ownership is due to physical capital flows by atomistic investors (as in Kemp (1966), Jones (1967), Neary (1995) or Blanchard (2007)), but then the model would not admit bidirectional capital flows within a single sector, which are both widely observed in practice and important for the structure of trade agreements, as demonstrated later in the paper. Modelling investment as risk diversification (as in (Stockman and Dellas (1986)) or Devereux and Lee (1999)) requires stochastic shocks and presents its own set of complications.

this paper is simply to identify all of the channels through which international ownership influences trade policy; introducing specific assumptions to endogenize international investment would shift the relative strength of each of the mechanisms in equilibrium, but would not otherwise change their roles in multilateral tariff setting.<sup>5</sup> Finally, although taking international ownership as exogenous constitutes rather a heroic simplification of the model, it is well precedented. For example, Bhagwati and Brecher (1981) assume fixed supplies of foreign inputs, but argue convincingly that their model nonetheless provides a meaningful caution to nationally oriented policy makers not to adopt blindly the standard welfare conclusions about trade policies in an environment with international investment.

In a pedagogical first step, the first part of the paper develops a simple two-country, two-good general equilibrium model to demonstrate how the pattern of international ownership enters a national income maximizing government's optimal tariff function. In so doing, the model generalizes and combines insights from existing theoretical work.<sup>6</sup> Initially assuming that the pattern of international ownership is industry-neutral (equal ownership shares across sectors), the model identifies two distinct channels through which cross-border ownership affects governments' optimal tariffs. The first, termed the *internal effect*, encompasses earlier findings from trade literature, that a government's optimal tariff decreases with its recognition of the degree of foreign ownership of local industry.<sup>7</sup> The second, the *external effect*, generalizes earlier findings by Stockman and Dellas (1986) and Devereux and Lee (1999), that the government has less incentive to manipulate the terms of trade when its constituents hold a stake in the foreign economy.

A brief extension to the basic model then introduces the potential for *compositional effects* by allowing the intersectoral composition of foreign ownership to vary from the industry-neutral benchmark. The thought experiment highlights the potential for sectoral bias in ownership patterns to induce governments to manipulate local prices in favor of industries with a relatively higher proportion of national ownership. For instance, foreign ownership bias towards the import-competing sector would strengthen the internal effect in the host country, while weakening the external effect for the foreign (source) country. A practical implication is that in a world with many goods, the tariff liberalizing potential of cross-border investment may be limited to those industries in which foreign investors hold a meaningful stake. One thus might expect that sectors such as agriculture or basic textiles, which are predominantly nationally owned, will continue to be contentious issues at the multilateral negotiating table, while industries with more international investment and multinational firm activity,

<sup>5</sup> Endogenizing investment would tend to mitigate (or even eliminate) the equilibrium internal effect as potential investors anticipate host governments' attempts at rent expropriation, and hence invest less (or not at all). Conversely, the equilibrium external effect would be magnified as potential foreign investors recognize that their claims abroad will lead to lower tariffs at home, which further increases the profitability of overseas holdings (as in Blanchard (2007)). Compositional effects interact with both the internal and external tariff mechanisms as the equilibrium pattern of investment shifts towards more profitable industries.

<sup>6</sup> Most related is the pioneering work by Kemp (1966) and Jones (1967) who developed a "Neo-Heckscher-Ohlin" version of the canonical  $2 \times 2 \times 2$  framework with simultaneous movement of both goods and capital, and Schweinberger and Vosgerau (1997), who conducted a similar analysis in a  $2 \times 3$  Ricardo-Viner framework. Their results offer specific examples of both the internal and external effects identified in Section 2 but do not consider arbitrary patterns of ownership or politically motivated governments; nor do they address the implications for multilateral trade agreements, the central thesis of this paper.

<sup>7</sup> See Olarreaga (1998) for the case of an apolitical government, or Grossman and Helpman (1996), Olarreaga (1999), Neto (2006), and Blanchard (2002), in the context of the Grossman and Helpman (1994) 'Protection for Sale' framework. Important precursors to this literature study the welfare effects of foreign capital inflows taking tariffs as fixed (e.g. Uzawa, 1969; Brecher and Diaz-Alejandro, 1977; Bhagwati and Brecher, 1980, 1981; Brecher and Findlay, 1983) and "quid pro quo" direct investment (Bhagwati et al., 1987; Bhagwati et al., 1992).

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