

April 2009

POLICY BRIEF

How have trade and FDI performed recently?

What is new about the current crisis?

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A global economic crisis risks becoming a crisis of globalisation, with serious effects on recovery and future prosperity. The depth of the current downturn is more severe and widespread than any since the Great Depression. Governments are developing effective responses and are building a political consensus at home to implement domestic measures to restore financial stability and contain the rise in unemployment.

The crisis is placing strains on the global trade and investment system. Although many measures have been proposed, so far few are protectionist in intent, but history reminds us not to be complacent. Beggar-thy-neighbour policies in the 1930s, such as higher tariffs and restrictions on capital flows, did not cause the Great Depression but no doubt contributed to its depth and duration, as well as inflicting lasting harm on global integration. The world economy is far more integrated than it was in 1929, implying that even small policy changes might have a large effect on trade and investment. Just as the size of the economic gains from removal of remaining trade and investment barriers is significant (Box), so too is the likely cost of imposing further barriers to trade and investment. Trade and international investment did not cause the current crisis and cannot by themselves bring about a recovery, but they are a crucial component of sustainable long-term development.

Experience suggests that crises are also sometimes opportunities: some countries faced with a severe crisis have liberalised in areas that would previously have been considered politically infeasible. While governments are legitimately concerned that public financial support serves its ultimate objective of restoring domestic growth and saving jobs, they should remain vigilant about economic nationalism while at the same time exploring areas where a national or multilateral consensus for reform might be achievable. They should take this opportunity to craft a positive economic agenda, including the successful conclusion of the Doha Development Round of WTO negotiations. They should also ensure that emergency measures implemented during the crisis move in the direction of industrial restructuring rather than resisting it and are both transparent and temporary, with a clear exit strategy once the crisis has abated.

Box. OECD analysis on gains from trade and investment liberalisation

- A 10% increase in trade is associated with a 4% rise in per capita income
- An open foreign direct investment climate could be expected to yield a 0.75% increase in OECD area GDP per capita
- Lower regulatory barriers to competition could result in a 2-3% increase in OECD area GDP per capita
- More efficient customs procedures could improve global welfare by 100 billion USD
- Full tariff liberalisation in agriculture and industrial goods could increase global welfare a further 100 billion USD
- Much higher gains would be expected if services trade were liberalised

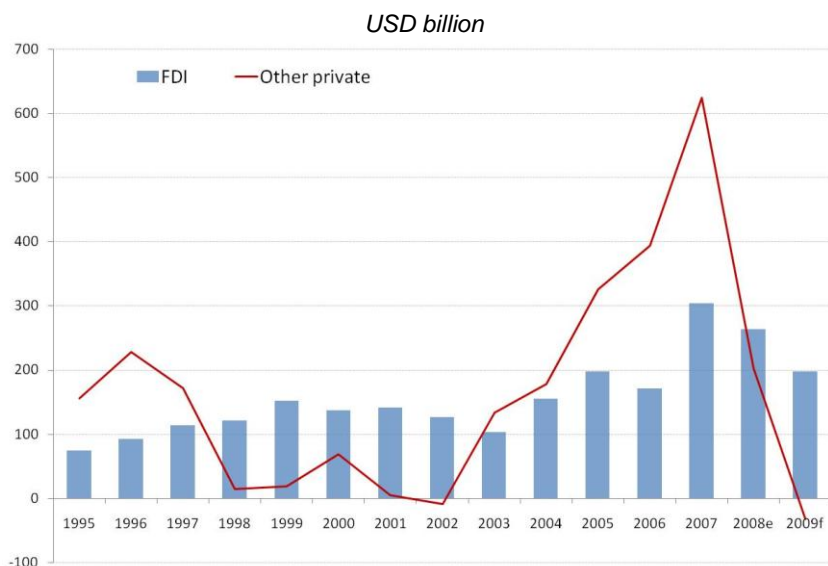
HOW HAVE TRADE AND FDI PERFORMED RECENTLY?

In the third quarter of 2008, the value of exports and imports of goods and services in OECD countries, measured in current US dollars, fell by a seasonally-adjusted 1.6% and 0.2% respectively compared with the previous quarter. These were the first declines since the third quarter of 2006. More recent monthly figures are likely to show an even greater slowdown in both OECD and non-OECD economies owing to the sharp economic contraction in major markets. The World Trade Organization estimates that world merchandise trade is likely to fall 9% in volume terms in 2009.

Cross-border investment is typically more volatile than trade flows. Like any form of investment, it often falls in downturns as firms have less cash to invest abroad and fewer profitable growth opportunities in the short term. In this crisis, however, there is an added element as firms facing insolvency sell off stakes in foreign companies to repair balance sheets at home. While it is premature to talk of a process of “deglobalisation”, the crisis is nevertheless likely to see a major rebalancing of ownership structures in global industries. The OECD estimates that member country outflows of foreign direct investment (FDI) fell 6% while inflows dropped 13% in 2008. These declines are not excessive given the deepening crisis in OECD countries, but experience in previous downturns suggests that flows are likely to continue to fall in 2009. In the last cyclical downswing in cross-border investment after 2000, as a result of a relatively mild recession, FDI flows fell 50% from peak to trough.

During times of crisis, the long term benefits of FDI in terms of technology transfer and integration of the host economy into global production networks take second place to the more elemental role of FDI as a source of foreign capital. In spite of the overall cyclical nature of FDI mentioned earlier, it can play an important counter-cyclical role for individual economies in times of crisis. Its usefulness at a time of capital scarcity can be seen from the chart below which divides foreign capital flows to 24 emerging markets into FDI and other private capital flows. While FDI flows are expected to fall in both 2008 and 2009, they remain at historically high levels and show considerable stability over time. In contrast, other private capital flows to these economies – principally bank lending – are expected to lead to a net outflow of foreign capital in 2009. Steady or rising inflows of FDI during a crisis have been observed in many countries, such as Mexico, Korea or Thailand. Investors have often been encouraged by liberalisation in the host economy and can be thwarted both by economic nationalism in the crisis country and by measures in home countries to discourage outward investment in order to retain capital at home.

Figure 1. Private capital flows to 24 major emerging economies, 1995-2009



Note: e = estimate; f = IIF forecast

Source: Institute for International Finance

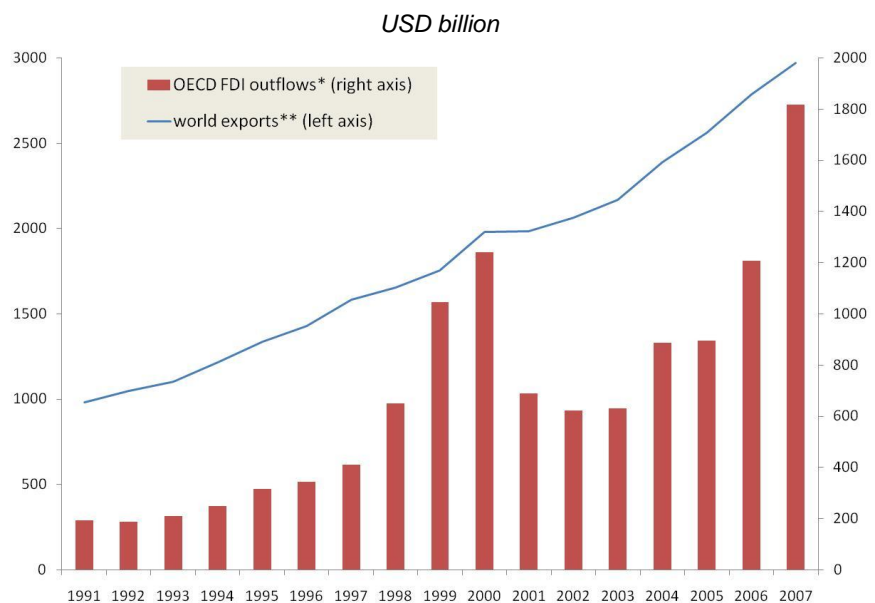
WHAT IS NEW ABOUT THE CURRENT CRISIS?

National economies are now closely integrated with one another, both regionally and globally, as evidenced by the complexity of vertically-integrated production patterns with parts shipped from dozens of destinations. Not only do imports represent a rising share of domestic consumption but they are also increasingly used as inputs in the production of goods and services for export. Furthermore, the number of multinational enterprises is steadily rising, as more firms from more countries invest abroad than ever before. This heightened integration has implications for the impact of emergency crisis responses both on the country implementing the measure and on the global economy. When each economy is part of a vertically-integrated chain with complex ownership structures, a disturbance in any part of the link can disrupt the entire chain.

World trade and FDI were at historic highs in absolute terms in 2007 and have, on average, been growing faster than world GDP for decades. Since 1950 the volume of world exports of manufactures has grown twice as fast as world GDP, with particularly rapid growth since the mid-1990s. Foreign direct investment has also outpaced economic growth, with a sharply rising stock of FDI relative to GDP over the past decade. These figures provide a ready reference to capture the growing integration of the world economy, but the stylised facts presented below speak to the depth of this integration:

- On average in OECD countries, one third of all manufactured goods sold are imported.
- For manufacturing industries, the share of foreign inputs in domestically-produced goods has increased from 38% in 1995 to 44% in 2005 on average for OECD economies.
- Foreign-owned firms in OECD countries account for almost a quarter of manufacturing employment on average and up to almost one half in Ireland.
- Foreign-owned firms account for anywhere from 18% to 92% of host country exports, based on a sample of OECD countries.

Figure 2. Exports and FDI outflows, 1991-2007



Note: *OECD FDI outflows, current prices and exchange rates.

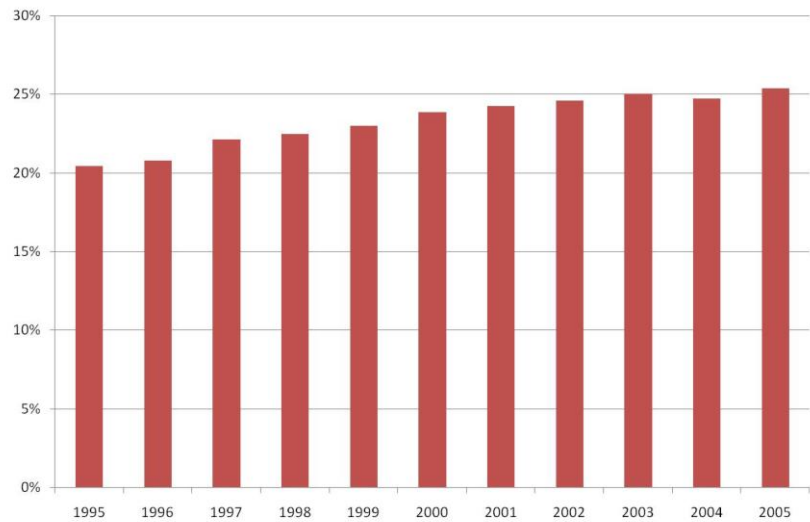
**Volume of world exports of goods and services, billions of 2000 USD

Source: OECD



The growth of world trade and FDI are not unrelated events: They are part of the same tendency of firms to allocate activities on a global basis. Production is increasingly being fragmented, and as a result vertical trade, measured as the import content of exports, has risen steadily in OECD countries as well as emerging economies. China, for example, is importing components from the rest of Asia, assembling them often in foreign-owned factories and then exporting them to markets outside of the region.

Figure 3. Vertical trade: the import content of exports in OECD countries and selected emerging economies*, 1995-2005



Note: ** trade weighted average for OECD economies, Argentina, Brazil, China, Estonia, India, Indonesia, Israel, Russia, Slovenia and South Africa.

Source: OECD

This integration makes emergency responses to a crisis both more complex and potentially more damaging than previously. Integration, the attendant obligations at multilateral, regional and bilateral levels and the lessons of history all make a repeat of the 1930s unlikely, but at the same time deep integration implies that even small and seemingly innocuous policy changes can sometimes have far-reaching consequences. Globalisation is not some immutable force of nature: it can be undone by government actions, and once undone can take years if not decades to recover.

WHAT ARE THE PROTECTIONIST RISKS?

Governments have by and large exercised considerable restraint to date in the area of trade and investment policy, but pressures are growing to privilege domestic over foreign production and domestically-owned firms over foreign-owned ones. International obligations at many levels may help to restrain protectionist measures, but governments nevertheless retain substantial flexibility to impose restrictions. Various policies which might affect either trade or foreign investors are discussed below.

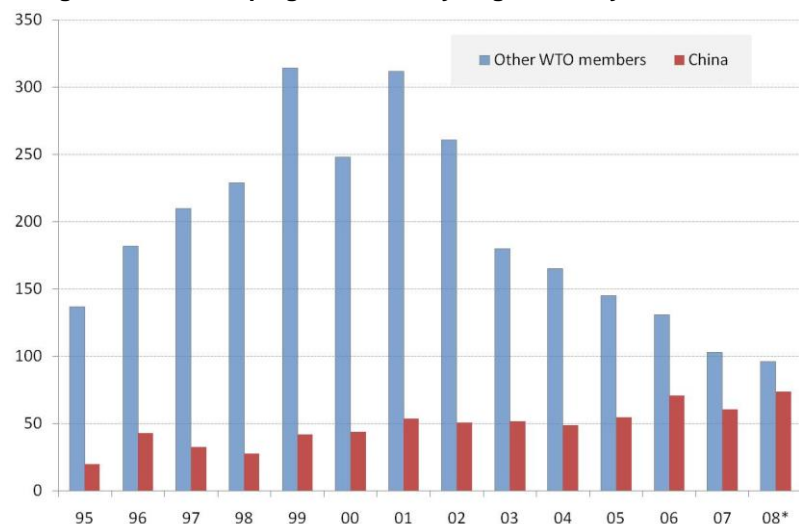
Applied versus bound tariffs

Many WTO members, particularly emerging economies, have applied tariff levels which are significantly below the bound levels under WTO commitments. A study by the International Food Policy Research Institute estimates that if governments raised tariff levels from applied to bound levels, it could double the tariff rates faced by exporters from rich and middle-income countries and triple them for exporters from the poorest nations. In a theoretical scenario where the applied tariffs of major economies would go all the way up to currently bound tariff rates, world trade would decrease by 7.7%. OECD member countries tend to have much less scope in this area since the difference between the two rates is often slight in their case.

Anti-dumping

Anti-dumping duties may be imposed by one country against exports from another country in a particular product category where there is evidence that sales at less than “normal value” are causing injury to domestic producers. Such duties are an accepted method for WTO members to respond in a targeted way to domestic pressures for protection from goods sold at prices below those in the home market or below the cost of production. Seen in a medium-term perspective, anti-dumping initiations are at a decade low level, having fallen steadily since 2001 in spite of the rapid growth of world trade. Yet according to the WTO, in the first half of 2008 – even before the financial crisis broke – the number of anti-dumping cases initiated was almost 40% higher than in the similar period in 2007 and the number of new final anti-dumping measures was 6% higher. China was the most frequent subject of these actions. A phenomenon in recent years has been the marked increase in anti-dumping actions by emerging economies, now representing a clear majority of new actions taken. It remains to be seen whether the recent growth trend will continue as the crisis spreads and deepens, but there is not yet evidence of a rush to restrict imports through anti-dumping measures.

Figure 4. Anti-dumping initiations by target country, 1995 - 2008



Note: *First half of 2008 at an annualised rate.

Source: WTO

Procurement

To assure domestic audiences that money devoted to stimulus packages will bring maximum domestic benefits, governments are tempted to include provisions requiring that money be spent on nationally- or locally-produced goods and services – in spite of the difficulty of identifying eligible goods and services at a time when production is strongly characterised by global value chains. Given the ambiguities in this choice, it is highly doubtful that national or local benefits can be increased in this way. Moreover, many countries have international and domestic obligations to ensure competition in their procurement markets, including under the WTO Government Procurement Agreement and various free trade agreements. Whether or not governments fall foul of these obligations when implementing stimulus packages, “buy national” requirements run the risk of encouraging retaliation from countries that are excluded – thus further reducing benefits that might accrue to the initiating country.

Sectoral subsidies

Another response in times of crisis is to resort to targeted sector-specific programmes, through which governments aim to facilitate structural adjustment in companies hard-hit by the crisis. The prime examples recently have been financial companies and the automobile sector. A key principle should be the distinction between two different types of aid: support to firms for systemic reasons, and aid for firms with structural problems, but no systemic dimension. Concerning the latter, while measures that are available across the whole economy (e.g. general tax measures, training programmes, etc.) may reduce adjustment strains and promote recovery without distorting resource allocation, support that is limited to one sector disadvantages the rest of the economy as well as competing sectors in other countries. If other countries then move “to level the playing field”, a competition in subsidies can result that in the end benefits no country. And once allocated, subsidies to deal with a short term sector-specific problem are notoriously difficult to remove.

Foreign investment restrictions

In recent years, some governments have strengthened national security provisions in their investment laws concerning foreign investors while keeping a close eye on investments by foreign state-owned enterprises. Policies adversely affecting foreign investors have been rare in previous crisis situations. Indeed, crises have often been accompanied by liberalisation of investment restrictions in an attempt to recapitalise local firms or to support the balance of payments. But as economies start to recover and international investment picks up, governments might resist takeovers by foreign investors of local firms that have received substantial public assistance or whose assets appear undervalued.

Discrimination against established foreign investors

Many emergency measures have raised the possibility of discrimination against established foreign-owned firms, including through bail outs, subsidies and government spending more broadly, as well as through tax, trade and competition policies. There is some limited evidence of discrimination against foreign-owned firms in domestic economies during the current crisis – either *de jure* or *de facto* as a result of conditions attached or the selection criteria to qualify.

The risk of discrimination can be seen in the automotive sector where many governments have developed measures to assist the sector, including in Brazil, Canada, China, France, Germany, Spain, Sweden, the United Kingdom and the United States. In most cases, this aid is offered to both foreign- and domestically-owned producers, since the aim is to preserve domestic employment at all costs regardless of the ownership of the firm. Nevertheless, existing discretion in targeted interventions could be used to discriminate in one way or another against “transplants”.

Constraints on outward investment

Crises have often led governments to try to keep domestic capital at home, without usually going so far as to restrict capital outflows. There have also been calls – both from the public and even within government – in the past to discourage FDI outflows such as through the tax system in order to preserve jobs at home. This was particularly true in the 1970s, but even more recently firms have faced criticism for foreign outsourcing or offshoring. Certain conditions attached to emergency measures during the current crisis might have implications for the ability of local firms to invest abroad if foreign production is seen to substitute for that at home. The growing financial and ownership role of national governments in key sectors may increase public pressure to constrain the freedom of local firms to invest abroad in the future. Even where conditions are not attached to bailouts in this respect, the firm could face political pressure not to shift production abroad and to favour local producers in purchasing decisions.

WHAT ARE APPROPRIATE POLICIES?

The costs from inappropriate policies are many: delayed restructuring of industries characterised by chronic over-capacity; higher risks for foreign investors and therefore less finance from abroad; and a decline in world trade in favour of domestic producers to the detriment of consumers, exporters and the broader public interest. Retaliation will spread these risks like a virus and, as a result, governments wishing to protect the weakest firms will end up punishing the strongest. For these reasons, governments need to resist the temptation to backslide on their international commitments.

Once in place, policies are often hard to undo. One of the most enduring lessons of the 1930s is not only that economic nationalism can exacerbate a crisis but also that emergency measures can continue to impair global economic integration and growth well after the crisis has abated. The broad measures introduced during the Great Depression in the form of tariff hikes and capital controls had a devastating effect on world trade and international investment. For many countries, trade as a share of GDP did not return to the level it had achieved in 1929 until the 1970s.

Emergency measures should be designed with a clear exit strategy in mind and they should be both temporary and transparent. In cases where chronic overcapacity contributed to a sector's weakness during the crisis, government assistance needs to be linked to restructuring, rationalisation and consolidation of the sector – preferably on a global basis. Both within economies and internationally, capital should flow to where it can be used most productively if it is to provide the greatest contribution to economic growth. Policies enacted in the midst of the current crisis, together with any conditionality attached to state aid, risk raising exit barriers in key industries which keeps capital locked into unproductive uses, making structural adjustment more difficult to achieve.

A positive agenda for reform during the crisis

Crises exact a heavy toll, particularly on the poorest and least skilled, but they also offer opportunities. An OECD cross-country study of policy reform over time found that *economic crises can promote reforms because bad economic conditions make it clearer that existing policies are no longer sustainable...Crises introduce a degree of urgency in the decision-making process, weaken opposition to reform, and raise the cost associated with pre-reform institutional arrangements.*

The current crisis might induce some governments to reduce restrictions on foreign investment, including by opening sectors previously closed to foreign investors in a bid to recapitalise ailing firms. It might also encourage the restructuring of industries characterised by overcapacity. In addition, the successful completion by WTO members of the Doha Development Round of negotiations would send a powerful signal that governments are committed to respecting their international obligations and to cooperating to find global solutions to a crisis from which no country is immune.

WHAT IS THE ROLE OF THE OECD?

In November 2008, the OECD Executive Committee in Special Session issued a trade pledge, joining its voice to those warning of the danger of yielding to protectionist pressures and stressing the importance of concluding the Doha Development Agenda negotiations. New analyses will contribute to government efforts to avoid protectionism and to open markets further, thereby contributing to improve future economic prospects.

The OECD also provides the forum for establishing common approaches and rules for official export credits. In support of the recent G20 communiqué, OECD and some non-OECD governments have pledged to ensure continued capacity in order to maintain trade flows.

The OECD hosts the Freedom of Investment process which aims to help governments preserve and expand an open environment for international investment while also safeguarding their essential security interests and taking action to recover from the current crisis. By comparing policies and collectively assessing their effects, the process helps governments to stick to their commitment to keep markets open for investment. Non-OECD countries, including G20 members, participate as equal partners in the FOI process.

For further information

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For further reading:

Protecting Freedom of Investment at the OECD
www.oecd.org/daf/investment/foi

The Economic Crisis and Trade Policy Response
www.oecd.org/trade