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Multinational Firms and New Protectionisms

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24.07.2007

Multinational Firms and New Protectionisms[1]

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Abstract

Recent initiatives to hold back cross-border mergers and acquisitions for 'strategic' reasons have made headline news. We discuss whether the initiatives may mark the start of a new protectionist era. We argue that standard globalization indicators show no such signs. However, an increasing divergence of incomes and increased insecurity might raise resistance against the globalization process. We discuss the benefits of globalization benefits in terms of lower prices for consumers, a greater variety of available products, lower risks, and higher economic growth. But we also outline the risks in terms of greater inequalities and greater need for flexibility. Protectionism is a double-edged sword. Many historic episodes show that the return to protectionism did significantly more harm in terms of reduced growth than generating benefits in terms of greater stability and smaller income differentials.

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1 Plan of the Report

Recent initiatives to hold back cross-border mergers and acquisitions for 'strategic' reasons have made headline news. These initiatives alone would not necessarily be a challenge to globalization. However, seen together with the failure of the recent WTO round, the anti-globalization resentment in wide parts of the population in developing and in OECD countries, and the disagreement about the OECD's MAI[2] initiative, these cases add to a picture of globalization on retreat. Moreover, many of the recent headline cases concern mergers and acquisitions involving firms from OECD countries. They affect the core of the globalized world. Hence, they might be seen as the start of a new era of protectionism, turning back the wheel of globalization which has characterized the post-war era and in particular the past two decades. Yet, these anti-merger initiatives could also be isolated showcases that make it into the news precisely because they are so rare.

Understanding the motives of governments to restrict activities of multinational firms is important because globalization is shaped by policy decisions. Although globalization is viewed as a destiny by many, it has certainly been driven political decisions to deregulate markets and to promote foreign entry. Technological change has, of course, contributed as well. Political decisions, however, can be reversed. Such reversals have occurred in history. The first globalization wave from 1840 to 1913 was gradually eroded by pressure towards higher tariffs since the 1870s. Ultimately, all countries ended up with higher tariffs. Free migration also ended during this time, and most of the quota systems for immigration put into place then are still in effect today. The opening up of markets in the post-war period was a political decision as well. And, not least, the lifting of the iron curtain and the integration Central and Eastern Europe was, without any doubt, a political decision.

If there is a risk of a new wave of protectionism, which would lead to a decline in welfare across countries, this risk should be high on the policy agenda. In this report, we thus assess the imminence of a new protectionist era, and we develop implications for economic policy. Considering the far-reaching nature of the issues of stake, we have to be selective:

First, we focus on the integration of capital markets and, in particular, on the activities of multinational firms. We document stylized facts of the current state of capital market integration, the structure of capital flows, and on global imbalances.

Second, countries restrict the activities of multinational firms for various reasons. Considerations of national security and resource access, the fear of foreign dominance, or the aim of countries to develop 'national champions' are perhaps the most important ones. Rather than discussing individual cases of anti-globalization sentiment towards multinational firms,

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[2] MAI = Multilateral Agreement on Investment.

we draw on time series indicators of integration to detect possible evidence for a trend slow down of integration.

Third, in discussing the risks and benefits of globalization, we again focus on multinationals. The key point that will evolve from this discussion is more general though. Globalization, if properly administered, is welfare-enhancing for the society as a whole. At the same time, globalization generates winners and losers, and public political support depends on the ability of the winners to compensate the losers. Anti-globalization sentiment will thus dominate political decisions if the ability or willingness to compensate dwindles, if the losers become better organized politically, or if the losers become more numerous.

Fourth, drawing on historical evidence and on considerations of political economy, we will assess whether early warning indicators can lead us to expect an imminent threat of a new protectionist era. We argue that changes in the distribution of incomes can lead to increased resistance against globalization.

We develop these arguments in five steps. In the following Second Part, we provide a brief account of the recent patterns of global capital flows, focusing in particular on multinational firms and foreign direct investment. In Part Three, we collect evidence on regulations affecting multinational firms, which are comparable both across countries and across time. The aim of this section is to show whether there is systematic evidence on protectionist tendencies which might require counterbalancing policy initiatives. At the same time, we argue that taking pro-active measures against a flourishing of protectionism requires an understanding of the underlying polit-economic forces. Hence, in Part Four, we discuss these mechanisms in the context of multinational firms, and we draw on historic evidence to show the mechanics of previous episodes of a closing down of markets. We collect recent evidence on possible threats to globalization. In Part Five, we conclude and provide a set of recommendations for economic policy.

2 New Patterns of International Capital Market Integration

International capital markets have integrated and developed rapidly over the past decades. To set the stage for our analysis below, we here document a couple of key developments related to the structure of (gross) capital flows, the global imbalances in (net) capital flows, and the structure of foreign direct investment (FDI) and thus the activities of multinational firms.

2.1 Structure of Capital Flows

International capital flows can be grouped into three main categories. Foreign direct investment denotes equity investments in excess of a threshold of the acquired firms' equity.

Hence, FDI is closely related to the activities of multinational firms (see Section 2.3).[3] Foreign portfolio investment captures equity investments below that threshold as well as foreign portfolio debt investments, i.e. the purchase and sale of bonds. A final category comprises other capital flows, mostly cross-border bank lending and trade credits.

As regards the patterns of cross-border capital flows, the recent globalization period has been characterized by a significant increase in *gross* foreign assets and liabilities. That is, most of the global capital flows do not take the form of one-way 'development finance' but rather the form of two-way 'diversification trade' (Obstfeld 2004). This could be an indication that countries are increasingly using one of the key benefits of international financial integration: the ability to shield against country-specific risks by investing abroad and reaping the benefits of (portfolio) diversification. Empirical studies, however, tend to find that mainly industrialized countries can use international financial markets to share risks across borders (Kose et al. 2007).

The increase in gross foreign asset holdings has been accompanied by a shift from official to private capital flows and by a shift from cross-border bank lending to portfolio investment and FDI. To date, FDI is the most important source of external finance for many non-OECD countries.

Within the group of non-OECD countries, there is a considerable degree of heterogeneity though. First, capital inflows are not equally divided across the non-OECD area, they rather flow mainly into the higher income emerging markets. Many developing countries receive a disproportionally small share of global capital flows and of FDI. Second, developments differ across regions (see also Lane and Milesi-Ferretti 2006). Emerging Europe, the Commonwealth of Independent States (CIS), and several Latin American countries experienced an increase in their net external liabilities in the period between 1996 and 2004. Other regions such as the Middle East, Asia, and Africa, significantly improved their external positions due to the increase in oil prices and the aim to improve external balance sheets following the Asian crises.

2.2 Global Imbalances

In the recent debate on the patterns of capital market integration, increasing global imbalances have received special attention. Global imbalances address the cumulating current account deficits of the United States. These deficits are largely financed by the accumulation of foreign exchange reserves of Asian central banks. The euro area as a whole has a relative

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[3] Multinational firms are firms that own a significant equity share of another company (subsidiary or affiliate) operating in a foreign country. If a firm holds equity by more than 10% of a company in a foreign country, this investment is classified as foreign direct investment (FDI). Equity holdings below 10% are treated as portfolio investment. Typically, multinational firms hold significantly more than 10% of the equity and thus aim at influencing the foreign companies' business.

balanced external position vis-à-vis the rest of the world. Still, a rebalancing of world portfolios would affect Europe through a change in international relative prices. Moreover, the individual euro area countries have quite different external positions and would thus be hit differently by such an adjustment in prices.

Explanations for the emergence of the recent global imbalances are plentiful. Low US savings (the 'savings glut'), expectations of future GDP growth in the US, low investment in Asia (the 'investment drought'), and China's exchange rate policy are among the most prominent ones. Moreover, while the US dollar is forecasted to depreciate over the medium-run, several soft and hard landing scenarios are conceivable (see, e.g., Cavallo and Tille (2006) for an overview). In the present context, global imbalances have two main implications:

First, economies need to be sufficiently flexible to deal with an adjustment of international relative prices. This holds in particular if a 'hard landing' scenario materializes. In this case, relative prices will adjust rapidly, necessitating a rapid dislocation of factors of production across sectors and firms. If this adjustment does not take place, an increase in (temporary) unemployment is likely.

Second, the new patterns of global capital flows affect the adjustment mechanisms and transmission channels of global macroeconomic shocks. Emerging markets with a large share of their foreign liabilities in the form of debt liabilities denominated in foreign currency would suffer when their currency depreciates. This valuation effect of exchange rate changes weakens if a large share of external liabilities is in the form of FDI. Hence, FDI can have a stabilizing impact in times of crises.

2.3 FDI and Multinational Firms

Foreign direct investment has become increasingly important as a share of global capital flows, and it has implications for the transmission of shocks across countries. Yet, the importance of FDI and of multinational firms (MNEs) goes beyond the importance for global capital flows. MNEs are the main drivers of globalization. About 75% of foreign trade is related to the activities of MNEs, and about 33% of global trade takes place *within* firms. Moreover, in 2004, sales of foreign affiliates of MNEs have been almost twice as high as exports (UNCTAD 2005). Hence, at least since the mid-1980s, activities of MNEs have grown faster than exports and much faster than domestic production.

While the strong increase in MNEs' activity in the 1980s was predominantly an intra-OECD phenomenon, the 1990s have seen a much more active involvement of emerging markets. The developed countries are still the main international investors but the share of the non-OECD countries as *recipients* of FDI has increased. Today, activities of foreign affiliates of MNEs in non-OECD countries account for more than one-third of the total.

In addition to their foreign investments, multinational firms play a key role in research and development (R&D) and thus in promoting innovations across countries. About 75% of all

international transfers of knowledge and capital take place within multinational firms, which is even higher than the intra-firm share in international trade. The high productivity of multinational firms results mainly from their strong position in R&D. About 50% of global R&D spending takes place *within* multinational firms (UNCTAD 2005), and the share of foreign affiliates in R&D spending is growing. There are several reasons for the increase in R&D offshoring. Qualified personnel in the home countries is becoming more scarce, communication costs are falling, manufacturing processes are increasingly global, and education systems are converging. However, the internationalization of R&D is mainly an OECD phenomenon, and only a few developing countries, such as India, participate. In many developing countries, a limited absorptive capacity of the host economy, i.e. a lack of human capital, experience, and infrastructure prevents the spill-over of knowledge and R&D investment.

Summary: This section has documented a couple of stylized facts of today's global capital markets. There is, first of all, a growing share of two-way asset trade which shows that countries are increasingly using international capital markets to diversify their home-country risks. The current pattern of net capital flows is unlikely to be sustainable in the long-run as it implies net capital flows from emerging markets towards the developed world, in particular the US. As regards the structure of capital flows, FDI has increasingly gained in importance – with implications which go beyond the mere transfer of capital.

3 Regulatory Changes Affecting Cross-Border Capital Movements: Evidence for New Protectionism?

The past decades have witnessed a significant degree of liberalization of cross-border capital movements. Many developing countries and emerging markets have followed the lead of the members of the OECD and the EU, who have committed themselves to free capital flows. This deregulation of cross-border capital flows, together with enhanced technological progress, has been the main driving force behind the expansion of global capital flows documented above.

3.1 Case Study Evidence

However, several recent initiatives at the national level show an increasing willingness of governments to restrict cross-border capital movements, in particular foreign direct investment. Many of these cases are concentrated in sectors seen as 'sensitive' such as energy, utilities, and banking, as shown by the following examples:

- In February 2006, Dubai Port acquired the British firm P&O which owned a subsidiary in the United States that managed six major US ports. Although the sale

was approved by the executive branch of the US government, an intensive political debate on the possible threat to US port security started. In March 2006, Dubai Port announced that it would divest its US business. As a consequence, a reform of the Committee for Foreign Direct Investment in the United States (CFIUS) is currently under debate. The CFIUS has been in place since 1975 to approve FDI projects in sensible areas. One possible outcome of the reform of the CFIUS could be that national security will receive greater weight.

- In 2005, the Chinese company CNOOC withdraw a bid on UNOCAL, the ninth largest oil producing firm in the United States, following resistance to the take-over from the antitrust authority and the US Congress.
- In Europe, the energy sector has been among the headline cases as well. In 2006, the French government, for instance, was involved in the GDF Suez merger that blocked the acquisition of Suez by the Italian ENEL. The Spanish government took action against the acquisition of the Spanish Endessa by German EON.
- In banking, the Polish government resisted the merger of two Polish bank, both owned, by the Italian Unicredito, as consequence of the acquisition of German HypoVereinsbank in 2005. When Unicredito bought HypoVereinsbank, it also acquired HypoVereinsbank's Polish subsidiary. Since Unicredito owned also a Polish bank, it now owned with two Polish subsidiaries. Their merger into one unit met the resistance of the Polish government that feared job losses in the merger process.
- Governments in OECD countries have also taken steps towards a greater regulation of FDI, using strategic considerations as the main argument. The initiative on part of the French government in 2005 to declare several domestic firms as strategic, for instance, has been justified with the aim to protect sensitive sectors. In Germany, a law to protect German firms from take-overs by foreign state-owned funds is under discussion.

These case studies are instructive. But they do not necessarily mark the start of a new era of protectionism. Government's interference in free capital movement in areas such energy, utilities and, banking has been pervasive until very recently. Hence, it is not the government's involvement which is new, but rather free capital movement in these areas. Many of these sectors have been shielded from (domestic and foreign) competition for many decades. In some sense, firms and regulators must still get used to the new competitive environment for which, in Europe, groundwork has been laid mainly by initiatives of the European Commission. Consequently, the EU has recently reinforced its commitment to lean against protectionist action. Moreover, as for any case study, there are also counter-examples. On the other side of the globe, for instance, the Japanese government has issued new regulations that intend to ease cross-border M&As.

Ultimately, assessing whether strategic considerations are sufficiently important to justify the prohibition of FDI is an issue which is beyond economic reasoning. There are two aspects worth stressing though.

First, as regards the banking sector, there are a number of empirical studies showing that foreign ownership does not harm countries but rather, in many cases, comes to the benefit of the host countries (see, e.g., Claessens 2006). At the same time, these studies support the need to strengthen the role of competition policy in financial services provision on an international basis.

Second, special concerns are often voiced against FDI of state-owned firms. State-owned firms, it is argued, might pursue interests that differ from those of private firms, and they may enjoy significant market power. Many of these concerns can be addressed within the context of existing antitrust regulations and the principles of reciprocity that can be laid down in international investment agreements. Hence, joining forces to successfully pass international investment agreements along the lines of the OECD's MAI-initiative seems the most fruitful way to address concerns about (foreign) state ownership of firms.

3.2 Multilateral Investment Agreements

Multinational investment agreements are the most promising route for addressing possible negative effects of multinational firms. The declaration of Doha of November 2001 thus recognized "the case for a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border investment, particularly foreign direct investment" in order to reach "non-discrimination" and "modalities for pre-establishment commitments" (cf. Sections 20 and 22).[4]

However, efforts to reach binding international investment agreements have been very limited so far. The Ministerial Conferences in Cancun and Hong Kong failed to achieve a multilateral investment agreement going beyond the Doha declaration. The deadlock in the negotiations of investment measures within the WTO has led to a surge of bilateral investment treaties in the last few years. The number of these agreements reached 2,500 in March 2006 (up from about 400 in 1990). These treaties aim at guaranteeing reciprocity and can deal with potential problems linked to the state-ownership of firms. However, since they are agreed on a country-by-country basis, they are ineffective in laying down general guidelines for activities of multinational firms.

At the OECD level, members have agreed to general principles governing international capital flows. In 2005, the OECD published the "OECD Code of Liberalization of Capital Movements"[5] in which all member countries accepted legally binding obligations on capital

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[4] http://www.wto.org/English/thewto_e/minist_e/min01_e/mindecl_e.htm

[5] http://www.oecd.org/dataoecd/10/62/4844455.pdf

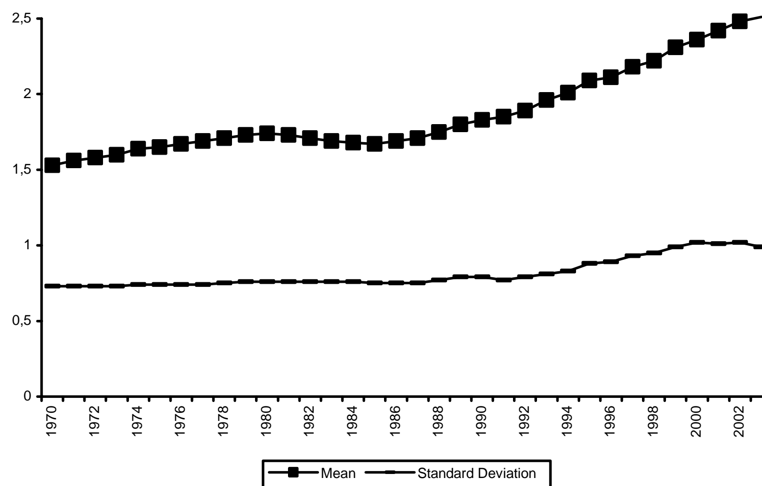
liberalization. In Article 1, the treaty states that "members shall endeavour to treat all non-resident-owned assets in the same way irrespective of the date of their formation" and "shall endeavour to extend the measures of liberalisation to all members of the IMF". In Appendix B, reservations to the general rules are listed country by country. Four countries (Island, Korea, Mexico, Turkey) listed reservations with respect to foreign state owned firms' investment in some sensible industries such as electricity, petroleum, and the financial sector. Reaching more specific agreements geared towards the regulation of multinational firms, however, failed even at the OECD level. In 1995, the OECD launched negotiations on a Multilateral Agreement on Investment (MAI). These negotiations ceased in December 1998 though.

3.3 Time Series Indicators

Given that reaching multilateral agreements governing international investment has been difficult, the interesting question is whether the above protectionist case studies are signs of a general trend or rather isolated cases. One way to answer this question is to look at indicators of globalization, which have been collected over a relatively long time period and for a large number of countries and regions.

Figure 1: KOF Globalization Index (Total)

The index measures three main dimensions of globalization: economic, social, and political. An increase in the index indicates that countries are more open. Data are available on a yearly basis for 123 countries over the period 1970-2003.



Source: KOF = Konjunkturforschungsstelle ETH Zürich, http://www.kof.ethz.ch/globalization/

Overall globalization indices show no indications for protectionist tendencies. The KOF Globalization Index, for instance, shows an unabated globalization trend through the 1990s (Figure 1).

One disadvantage of broad globalization indicators is though that they rely on a large range of datasets and are thus available only with a considerable time lag. The most recent entry on the KOF Index, for instance, is for the year 2003.

More recent evidence comes from survey evidence such as the 'Index of Economic Freedom' published by the Heritage Foundation. The 'Index of Economic Freedom' includes a sub-index capturing FDI incentives. For the years 1995-2006, this index shows no discernable trend.

Evidence provided by the World Investment Report 2005 largely supports these patterns. It shows that, in absolute terms, many more regulatory changes favorable to FDI have been implemented recently than changes unfavorable to FDI. On average, only about 8% of all changes reported have been unfavorable. In recent years, the share of these cases has been increasing. In 2004, 36 changes in regulations have been to the disfavor of FDI. These cases have been concentrated on Latin America and the Caribbean countries, where 24% and 19%, respectively, of all changes were unfavorable. Yet, about one third of these cases involved the withdrawal of FDI incentives granted earlier. These withdrawals of investment incentives are thus not necessarily a sign of new protectionism. However, they may also reflect the growing disappointment of many developing countries to attract FDI (UNCTAD 2005: 22).

According to these more systematic indicators, OECD countries show no tendencies to become more protectionist. This is important because history shows that great globalization reversals originated in the core countries of world markets, not in the periphery.

Table 1: National Regulatory Changes Affecting FDI, 1991–2004

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Number of countries that introduced changes	35	43	57	49	64	65	76	60	63	69	71	70	82	102
Number of changes	82	79	102	110	12	114	151	145	140	150	208	248	244	271
Of which														
Favourable to FDI[a]	80	79	101	108	106	98	135	136	131	147	194	236	220	235
Unfavourable to FDI[b]	2	-	1	2	6	16	16	9	9	3	14	12	24	36

[a] includes liberalizing or changes aimed at strengthening market functioning, as well as increased incentives
[b] includes changes aimed at increasing control, as well as reducing incentives

Source: World Investment Report 2005: Table I.14.

At the same time, it should not be overlooked that, even though direct barriers to the integration of markets have been lifted by OECD countries at a rather unprecedented scale, many indirect barriers to integration still persist. Despite extensive liberalization of international transaction and international policy coordination, in particular within the European Union, there is thus scope for further reducing barriers to the integration of markets (Nicolletti et al. 2003). Besides removing direct FDI restrictions, policy should thus aim at promoting the domestic competitive environment, improving the adaptability of labor markets, and ensuring an adequate level of infrastructures.

Summary: Indicators of globalization, which are available over a relatively long time frame and for a large range of countries, do not provide clear warning signals that protectionist and anti-globalization sentiment get the upper hand. However, this does not mean that these sentiments do not exist. In order to understand the political economy behind protectionist tendencies, one needs to understand the welfare gains of globalization and the distribution of these gains across and within societies. In the following section, we develop this argument for the case of multinational activity and FDI.

4 Winners and Losers of Globalization: Understanding the Political Economy of Protectionism

Numerous studies show that, overall, countries benefit from integrating into international markets and participating in the international division of labor. Yet, while the overall welfare effects of globalization are positive, the benefits and costs are not equally divided across different groups of society as well as across countries. Moreover, even under the most ideal of circumstances, a perfect compensation of the losers through the winners will not be possible. The consequence may be that losers of globalization, in particular if they are politically well-organized, can block further liberalization or even overturn progress that has already been made. Here, we discuss the welfare effects of globalization using the case of multinational activity and FDI.

4.1 Benefits and Costs of Globalization: The Case of Multinational Activity and FDI

4.1.1 Production Costs versus Market Access

In principle, costs and benefits of multinational activities and FDI arise very much in parallel to the costs and benefits of international trade. Typically, two main motives for becoming a multinational firm are distinguished: cost reduction and market access.

According to the first motive, the *production cost motive*, firms become multinational to take advantage of differences in factor costs between countries which stem from differences in factor endowments. Firms in high-wage countries split up the production process and relocate labor-intensive stages of production into countries where labor is relatively cheap. Relocation of production takes place according to the comparative advantages of countries. This type of FDI is beneficial because resources are used more efficiently and because prices for consumers fall.

According to the second motive, the *market access motive* for internationalization, multinationals are vehicles to overcome distance and to facilitate access to foreign markets.

Generally, firms have different channels for entering a foreign market. Each of these channels incurs different costs. A firm has the choice between producing at home and exporting final products to a foreign market (which involves variable ‘distance costs’) and producing abroad (which involves the additional fixed costs of setting up a plant in the host country). For this type of FDI, the size of countries and the realization of scale effects matter, not the relative factor endowments of countries. Consumers gain from this type of FDI through lower prices and a greater variety of products that are available on the domestic market.

Distinguishing between the two motives of FDI is important because implications for the labor market and for the income distribution differ. Since FDI driven by market access takes place on a bilateral basis and since it helps expanding output markets, jobs lost with domestic firms investing abroad are potentially compensated by gains in employment in foreign firms that invest in the domestic economy. Net employment losses are unlikely. The domestic economy may even gain in employment as firms increase their market shares abroad. Also, FDI driven by market access considerations has similar effects on all factors of production. Hence, the income distribution between different factors is not necessarily affected.

Production-cost-driven FDI, in contrast, can have adverse effects on the distribution of incomes and on the labor market outcomes of low-skilled workers. Employment and/or wages of low-skilled workers may fall if labor-intensive stages of production are moved to foreign countries. At the same time, this type of FDI also helps lowering costs and thus improving the overall competitiveness. At the end of the day, the employment effects of production-cost-driven FDI must thus be assessed in terms of the counterfactual. That is, one needs to answer the question how employment at home would have developed had the firm not moved parts of its production abroad.

Ultimately, assessing the effects of FDI on domestic employment is an empirical question. Research to date gives a somewhat more positive answer than the public discussion might suggest. The bulk of FDI still takes place between developed countries, and it takes place because firms seek access to new markets. Production-cost-driven FDI accounts only for a relatively small share of total FDI. Hence, empirical research to date finds relatively little evidence that most MNEs choose their location predominantly in search of low factor costs. At the same time, the share of FDI driven by production cost considerations has been on the rise – thus potentially aggravating labor market prospects of low-skilled workers in the developed countries.

4.1.2 Productivity Gains and Spill-Over

Apart from the traditional arguments in favor or against multinational firms, productivity spill-overs are a potentially powerful channel for welfare gains. Countries or regions within countries compete fiercely for investments of MNEs. In 1994, for instance, the state of Alabama paid Daimler-Benz $ 230 million to attract a new plant by Mercedes. For their

second Chip factory in Dresden with an investment volume of €2.4 billion, which starts production in 2006, AMD received €660 million from the German tax payers.

FDI incentives in the form of public subsidies can make economic sense for two reasons. First, the MNE might serve as a nucleus for an agglomeration of other firms, including suppliers, customers, and competitors. One reason for such agglomerations can be that firms draw on the same pool of employees with specific skills. Second, knowledge spill-over might increase the productivity of other firms in the same region. Agglomerations of firms thus have the potential to shape the surrounding area, often creating long-lasting structures in terms of infrastructure and knowledge bases.

Welfare gains from knowledge spill-overs can be huge, but their positive welfare effects in terms of higher growth materialize only in the long-run. Evidence differs by region though. In developed countries, foreign direct investment can have sizable welfare effects through increased productivity. For emerging markets and developing countries, it is much harder to find positive long-run growth effects. This might be surprising since FDI plays a relatively important role for these countries in terms of capital inflows and domestic capital accumulation. There are two reasons for this.

First, cross-country studies have demonstrated that a sufficiently qualified labor force is necessary to reap knowledge spillovers from FDI. FDI contributes to cross country growth convergence for those countries that exceed a certain minimum development level but not for developing countries which have not yet reached that level. This can explain the growing frustration particularly among developing countries with globalization (Borenzstein 1998, Mayer-Foulkes and Nunnenkamp (2005)).

Second, firm- and plant-level studies show that increased competition of MNEs can have negative effects on domestic firms. If technological and productivity differences are too large, domestic firms are not only unable to use the spillovers and to learn from foreign firms, but they may even be forced to leave the market (Aitken and Harris 1999).

4.1.3 Costs of Globalization

The previous discussion has shown that FDI can have positive welfare effects through lower prices for consumers, a greater variety of products, and the spill-over of knowledge. Yet, the positive effects of globalization do not come for free. Global competition implies increased competition. Increased competition requires adjustment and forces some firms to exit the market. This is not without costs. Workers have to move, they loose part of their human capital, and physical capital depreciates as well.

When thinking about the incidence of these costs, it is important to think not only of the *level* of employment and a relocation of workers away from shrinking towards expanding industries. Rather, there is a significant amount of labor market turnover also *within* narrowly defined industries – and the need for such turnover increases as markets become more

integrated. In all industries – expanding industries with comparative advantages and shrinking industries with comparative disadvantages –, there is a continuous process of firms entering and leaving the market. However, the patterns of adjustment differ across industries.

Shrinking industries loose firms, market shares, and employment. Although new firms enter also in these industries, the net effect on employment in these firms is negative because exit exceeds entry. That is problematic for factors intensively used in these industries because expanding industries do not use these factors in the same intensity. In OECD countries, it is likely that unskilled labor is laid off over-proportionally from shrinking industries, while skilled labor is used more intensively in growing industries. That leads to relative wage cuts of unskilled workers or to increasing unemployment. The income distribution widens. This is the traditional channel through which structural change affects the relative demand for different types of workers.

Growing industries gain jobs. This may imply that adjustment in these sectors is not costly. However, while workers are more likely to stay in the same *industry*, they are not necessarily more likely to stay with the same *firm*. Theoretical and empirical studies show that gross job flows in growing, comparative advantage industries are even larger than those in declining industries. Market entry and exit are higher in these industries. Since globalization magnifies comparative advantages, it also magnifies entry and exit, and therefore job flows within expanding industries.

These considerations show that globalization has effects not only for the allocation of employment across industries but also for the allocation of employment across firms within narrowly defined industries. This has two important implications for the current policy debate.

First, increased dynamics, in particular in expanding industries, explains why globalization so glaringly reveals barriers to the adjustment on factor markets, in especially on labor markets. Globalization increasingly requires labor market institutions which allow workers to flexibly move across firms *and* across industries.

Second, increased dynamics can explain why so many people – and not only the low-skilled workers – fear globalization.[6] In many sectors and across many skill groups, the perceived degree of labor market instability has increased. Workers perceive their employment prospects to be less secure. Moreover, switching jobs within the industry might still require wage cuts, since firm-specific knowledge must be written off.

Increased labor market instability is only one potential cost of multinational firms. Multinational firms might also pose risks to host countries in terms of increased market power. Multinational firms are typically large firms. They are more productive than firms

[6] Survey evidence shows that, on average, 47% of the population in the EU25 countries believe that globalization represents a threat to employment and companies. By occupational scale, these responses range from 39% (students) to 51% (manual workers). See Eurobarometer (2006).

producing only for the home market.[7] The size and the high productivity of MNEs have positive as well as negative implications for the host economies. On the positive side, entry of large and productive firms creates opportunities for knowledge spill-over.[8] Moreover, consumers benefit from higher quality, lower prices and possibly a larger number of product varieties. However, while the entry of multinational firms often results in increased competition, this is not necessarily always the case. If the productivity advantage of the multinational firm relative to the domestic firms is too large, domestic firms are forced to exit the market, and competition will decrease. Antitrust authorities must, therefore, protect competition without giving away the benefits resulting from increasing productivity. This need is particularly relevant for developing countries, where the domestic firms are less likely to compete successfully against foreign entrants and where effective antitrust authorities are often missing.

Finally, there is an additional potential cost of globalization, which might be particularly relevant for developing countries. Foreign firms might disregard of social issues, and they might lack loyalty vis-à-vis other stakeholders. Systematic evidence in favor of these alleged costs is hard to find though. Quite to the contrary, foreign employers on average pay higher wages than domestic firms, and only part of this wage gap can be explained by differences in the quality of labor. Nevertheless, there have been several cases of corporate abuse of power and cultural and social ignorance. Such cases have created strong opposition in developing and OECD countries and have led to (unbinding) codes of conduct for multinationals issued by the United Nations, the European Union and, the OECD. [9] These codes cannot rule out miss-behavior by multinationals in the future but might give the affected countries a mean to manifest the issue.

Summary: Balancing the costs and benefits of globalization is important to understand the polit-economic forces behind protectionist tendencies. While societies as a whole benefit from an increased integration of markets and a more efficient international division of labor, there are also groups in society that fall behind. Ensuring public support for integration requires efficient mechanisms for the winners to compensate the losers as well as social security systems which are geared towards protection against increased instabilities.

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7 See, e.g. Yeaple (2005) for the United States, or Kleinert and Toubal (2006) for Germany.

8 Keller and Yeaple (2003) find high spill-over from multinational firms to U.S. firms. Such knowledge spill-over are particularly likely for firms which are integrated in MNEs networks in the host country as Smarzynska Javorcik (2004) found for Lithuanian firms.

9 http://www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/index.html
http://europa.eu.int/eur-lex/pri/en/oj/dat/1999/c_104/c_10419990414en01800184.pdf
http://www.oecd.org/document/28/0,2340,en_2649_34889_2397532_1_1_1_1,00.html

4.2 Can Winners Compensate the Losers?

The costs of globalization go some way in explaining why there is so much public resistance and skepticism. In addition, there certainly exists a perception bias. While the benefits of globalization in terms of greater varieties, lower prices, and access to new markets spread out widely across a large number of consumers and firms, the incidence of the losses is typically more concentrated. Pressure on wages and the closure of factories are often concentrated in specific regions and sectors and thus receive more attention in the media. These considerations show that communicating the benefits and costs of globalization is important.

However, improved communication alone is not going to solve the problem. There is a deeper issue related to the question whether societies are well-prepared to deal with the new chances of globalization in a way that enhances growth and ensures an efficient redistribution between winners and losers.

Losers do not benefit from knowing that, on average, society is better off following globalization. They benefit from an effective safety net which protects them against excessive risks of losing their job and from persistent unemployment. Redistributive safety nets based on progressive tax systems and transfer payments are in place in all OECD countries. Studying their appropriateness would be beyond the scope of the present study. Two remarks are in order though.

First, it is often argued that globalization triggers a race to the bottom and an erosion of existing safety nets. Such a 'race to the bottom' finds relatively little support in empirical studies (see, e.g., Agell (1999) and Rodrik (1997, 1998). In principle, the safety net should thus be able to deal with globalization effects in the OECD countries. In emerging markets and in particular in developing countries, however, sufficient safety nets are often absent.

Second, the perhaps more important issue relates to the question whether safety nets in the developed countries are effective and flexible enough to deal with the new requirements. Current welfare systems redistribute large amounts of funds which is, at least in theory, able to dampen systematic risks of globalization. Unemployment insurance systems should, in principle, also be able to cope with increased job dynamics. Experience of the past, however, shows that the persistence of unemployment has been relatively high in many countries. If, as has been argued above, globalization requires a more rapid turnover of workers – and thus temporary unemployment – unemployment insurance should be geared towards lowering unemployment persistence. Also, social security systems should protect workers, not jobs. If social security systems fail to address these tasks, labor markets problems might increasingly be attributed to globalization, and protectionist pressure might increase.

In fact, there have been examples in history for reversals of policy towards protectionism and market disintegration. When divergence of incomes within countries became large and therefore unbearable for the society, countries have often opted for a policy change. With

respect to migration policy, some of these policy changes are still effective to date. Empirical studies show that attitudes of the population towards globalization are indeed shaped by their relative position in society as winners and losers of globalization (Mayda and Rodrik 2002, O'Rourke and Taylor 2006, O'Rourke 2003). Thus, it is worth looking at history to draw some lessons for the globalization debate today.

4.3 Historical Lessons[10]

The previous discussion has shown that, overall, welfare gains from globalization are positive. But the costs and benefits are not divided equally within the society. If the losers of globalization become too numerous and better organized politically, anti-globalization sentiment may start to dominate. Whether such risks are imminent today cannot be assessed on the basis of globalization indicators. Instead, it is instructive to look at globalization and anti-globalization episodes in history.

Globalization can affect the distribution of incomes *within* and the *between* countries. The first globalization wave (1830-1913) caused income convergences *within* the European countries. Moreover, it caused convergence *between* the countries which today form the OECD. This increase in convergence enhanced the sustainability of the integration process. However, within-country income differentials tended to widen in the United States, Canada, and Australia, which eventually triggered protectionist responses.

The first globalization wave caused *within*-country convergence for two reasons. The first reason was that trade liberalization strengthened comparative advantages, thereby creating winners and losers. In the food-exporting countries, workers won. In the food-importing countries, such as the UK, capital owners won while workers and land owners lost in nominal terms. Yet, changes in the distribution of nominal incomes tell only one part of the story. Workers in the food industries of food-importing countries indeed lost in terms of nominal incomes but they gained massively through much lower prices of food (imports) in their consumption basket. Food accounted for the bulk of expenditures. In real terms, workers in the food industries even in food-importing countries gained.

The second reason for *within*-country convergence was migration. During the first globalization wave, workers from resource-scarce, labor-abundant (European) countries moved to resource-abundant, labor-scarce countries in the New World. This drove up wages in the source countries (leading to convergence *within* these countries) and lowered wages in the host countries. Rising wages in the poor source countries of migrants and falling wages in the rich migrants receiving countries led to income convergence *between* countries.

However, mass migration *increased* income differentials within the receiving countries (United States, Canada, Australia), leading to anti-globalization movements and quota

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[10] The following section is largely based on Williamson (2003)

systems for migration which ended the time of free migration between Europe, North America, and Australia. Hence, it was pressure from the poor in the receiving countries which forced these countries to restrict free labor mobility.

Protectionism first rose in Eastern Europe and in Latin America. This rise in protectionism did not put an end to globalization. Globalization rather ended when the core countries in Europe and the United States shielded their markets. Watching protectionism in OECD countries is thus especially important because these countries are at the core of today's global markets.

It has also been the countries at the core of the industrialized world which initiated a shift in integration policies. The second globalization wave could start when these countries agreed on multilateral reductions of tariffs and on the elimination of capital controls after the 1950s.

Some adjustment patterns have differed though during the ongoing second globalization wave. The prices of importable goods, for instance, did not fall as strongly as they did during the first globalization wave. Moreover, because of the lower share of manufacturing in total production and the growing importance of services, importables were not as important in the consumption basket.

In addition, at least since the 1980s, there has been a growing divergence of incomes within the OECD countries. In countries with relatively flexible labor markets, this has been reflected by growing disparities of incomes.[11] In countries with less flexible labor markets, unemployment rates have tended to increase. Globalization is often blamed for these widening income differentials.

Moreover, there has been a rise in the share of production-cost driven FDI which, as has been argued above, has potentially more adverse effects on income distributions than FDI driven by market-access considerations. Hence, there is a certain risk that history might repeat itself with respect to anti-globalization movements.

4.4 Is it Globalization, after all?

While history might repeat itself with respect to the anti-globalization movements, it is not all that clear that globalization *is* actually the source of the growing divergence of incomes within OECD countries. Although globalization is the natural suspect since it de facto tends to increase the relative supply of low-skilled labor, downward pressure on wages for low-skilled workers might also result from other sources of changes in the relative labor supply. There are in fact two alternative explanations for widening income gaps.

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[11] Germany has typically be one of the countries with relatively small income differentials (Prasad 2004). However, recent evidence shows that income disparities in Germany have been widening (Kohn 2006).

First, technological change can have effects very similar to those of globalization. Technological change, in the last 30 years, primarily occurred in a way that increased the relative demand for skilled labor. Disentangling the impact of globalization and technological change is very difficult, in particular when modern forms of international division of labor like multinational firms and outsourcing are taken into account. Empirical studies tend to conclude that trade has played a significantly smaller role than technological progress in worsening the labor market situation of the low-skilled. Nevertheless, even if globalization is probably not the main cause for the labor market problems in many OECD countries, it has certainly magnified these problems.

Second, education can contributed to a widening of the within-country income distribution and to an increase in the relative wage of skilled labor. Unless the education system ensures vertical mobility within society, it can create and consolidate income and wealth divergence. The recent PISA test results in fact point to significant differences with respect to accessability of the education system to all societal groups across the OECD countries.

5 Policy Implications and Action Plan

Benefits of globalization: Globalization brings many benefits in terms of lower prices for consumers, a greater variety of available products, lower risks, and higher economic growth. The significant improvements in living standards that have been achieved in many countries around the globe are, at least partly, attributable to the international integration of markets. Activities of multinational firms additionally have positive implications for the development of new technologies, spreading of technologies to emerging markets, and thus worldwide growth. These first-order welfare effects are often overlooked when discussing the risks and benefits of globalization.

Risks of globalization: However, globalization also implies risks in terms of greater inequalities and greater need for flexibility. Labor market prospects for low-skilled workers worsen, leading to widening income differentials, lower wages and/or higher unemployment. Job turnover is likely to increase between and within industries. Structural change is an inherent feature of economic life. Yet, the need to adjust to new external conditions is greater now than it used to be, both because of globalization and because of technological change. Even if these risks of globalization may not counterbalance the overall positive welfare effects, they yet pose a potential threat to the globalization process as a whole.

Is protectionism an answer? Considering that globalization has not only welfare benefits but also imposes costs on society, increased protectionism might appear as a solution. By shielding domestic workers against competitive pressure from abroad, workers might gain more time to adjust. Firms might be able to preserve market shares that would otherwise be eroded by international competition. However, protectionism is a double-edged sword. Many

historic episodes show that the return to protectionism did significantly more harm in terms of reduced growth than generating benefits in terms of greater stability and smaller income differentials. Countries less willing to open up their markets to foreign competition have tended to fall behind.

***Three-pillar pro-globalization strategy*:** Given that globalization brings net gain to society as a whole and that protectionism is unlikely to ensure higher growth, greater equality, and greater stability, an appropriate pro-globalization strategy should consist of three main pillars. First, governments should push further towards integrated markets. Policies should aim at ensuring equal market access and a level playing field for all competitors. Second, social security systems should combine appropriate incentives for market participants with mechanisms shielding the individual worker and household against undue risks. Third, absorptive capacities in developing countries should be enhanced to ensure a wide participation of the population in the benefits of globalization.

***Pillar I – Promoting market integration*:** Many developed countries owe their currently high living standards to their high degree of integration into international markets. As regards the first pillar of this strategy, the developed world should thus reinforce its support of free markets and signal its commitment also to the developing countries. The OECD countries are at the core of today's global markets, and their policies towards open markets are decisive for the future of globalization. This requires a strengthening of pro-competitive forces internationally, and the enforcement of existing regulations, including antitrust regulation, at the multilateral level. Also, policy should aim at removing indirect restrictions by promoting the domestic competitive environment, improving the adaptability of labor markets, and ensuring adequate infrastructures. Multilateral investment agreements that address these aspects are an effective way of laying down core principles. Hence, efforts to strengthen existing initiatives and to reach agreement on multilateral investment conditions should be intensified. As an integral part of Pillar I, governments should also strengthen the public acceptance of globalization and of multinational firms by communicating the benefits of globalization.

Pillar II – Reforming social security: As regards the second pillar of this strategy, the protection against undue risks, societies need to discuss the appropriateness of their social security systems. Currently, many systems are geared towards a protection of jobs, not workers. Incentive systems are often working against an efficient redistribution from the winners towards the losers of globalization and against a smooth process of structural change. In reforming social security systems, protection of workers, mechanisms to lower the persistence of unemployment, and incentives to work, coupled with net transfers to those falling below social security levels, should have priority.

Pillar III – Strengthening absorptive capacities: The growing frustration with globalization, particularly among developing countries, is a possible threat to the integration process. Thus,

in many developing countries, policies aimed at strengthening the absorptive capacities of countries receiving FDI can be a way to ensure greater participation of the society as a whole in the benefits of globalization. This requires encompassing policy initiatives aimed at improvements in the legal and supervisory frameworks, development of human capital, lower corruption levels, greater transparency, and improved fiscal and corporate governance. Also, passing codes of conduct as have the European and the OECD can be a way to contain miss-behavior by multinationals.

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