Transnational corporations and the changing international economic system

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This article attempts to answer an important question: given the growing role of transnational corporations and transnational banks during the past three decades, is it possible to say that the very nature of the international economic system has changed? An epistemological approach has been chosen to point out that the traditional Ricardian trade theory is no longer a relevant paradigm for the new world economy. The first part contrasts the basic assumptions of the traditional trade model with the new features of the world economy. The second part relates current economic policy dilemmas to the inadequacies of the traditional model as a framework for Government intervention.

This article deals with an ambitious question: given the growing role played by transnational corporations (TNCs), including transnational banks, the emerging process of integrated international production and the increasing importance of off-shore finance, is it possible to demonstrate that, as a result of these developments, the very nature of the international economic system has changed? To put it differently, is it still relevant to apply the classical analytical framework suggested by David Ricardo at the beginning of the last century to the new world economy? Does it makes sense to keep the same paradigm for economic policy decisions and negotiations at the national and multilateral levels despite the changing behavioural patterns of firms and States?

For most observers and decision makers, especially for managers of large firms, such a question might appear naïve. For them, it is obvious that the world economy is totally different today from what it was thirty years ago. For those who are involved in international business, it is a daily experience that the rules of the game are no longer the same. Nevertheless, all empirical evidence that can be brought to support this viewpoint is unable to demonstrate that the very nature of the international economy has changed. The empirical argument is

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for an international optimal allocation of resources among nations based on the principle of comparative advantage (in contrast to Adam Smith's absolute advantage) under a free-trade regime. The sophistication brought later to the original "two countries — two goods" model by prominent economists occurred within the Ricardian paradigm. For example, Heckscher, Ohlin, Samuelson and others developed a neo-classical framework for the Ricardian concepts. The same applies to those economists who have introduced new variables, such as technology (W. Leontieff and R. Vernon) and, more recently, oligopoly theory and economies of scale (P. Krugman and the advocates of the so-called "strategic trade policy"). Even these modifications of the classical paradigm do not cope effectively with the new features of the world economy. In essence, they do not radically challenge the three basic assumptions of the classical trade theory, namely:

- The old paradigm is uni-dimensional. The benefits of free trade and the subsequent optimal allocation of resources are exclusively related to the exchange of goods and services among nation-States based on the principle of comparative advantage. Capital flows, technology transfer and labour migration are excluded from the model.

- Comparative advantage is determined by the factor endowments of nation-States. These endowments — labour, capital, land and technology — must be subject to constant returns to scale; otherwise, it would be impossible to define an optimal division of labour among nations. It must be stressed that comparative advantage is determined *ex ante*, that is before the opening of an economy to trade, according to the static comparative approach. Factor immobility within the borders of a nation-State is the most crucial assumption of the model. As it has been demonstrated by R. Mundell, relaxing the factor immobility assumption does not preclude the hypothetical existence of an international optimal allocation of resources. But, then, this result will be reached through the movement of capital and, as a consequence, goods are no longer traded among countries. In other words, trade theory cannot survive if the factor immobility assumption is dropped.

- Nation-States are the only actors in the international economy. Country borders determine the characteristics of the "black boxes" inside which factors of production are combined in perfectly competitive markets. As a result of this approach, firms are not taken into account. Trade is reduced to a relationship among nation-States. Data provided in the balance-of-payments accounts are the only relevant source of information to assess the external economic situation of a country.

The rules of the game in today's world economy

The new rules of the game in the world economy are in contradiction with the basic assumptions of the Ricardian paradigm. The world economy today is a multidimensional system within which factors of production move according to decisions that are made by transnational agents operating in oligopolistic markets.

To understand the dynamics of the new world economy, it is necessary to consider together trade flows, capital movements, inward and outward FDI, technology flows and labour movements. Such an approach implies not only that exports and imports of goods and services are no longer the exclusive forms of economic transactions among nation-States, but also that the various dimensions of the world economy are tightly interconnected. Therefore, it is no longer feasible to develop separate analytical frameworks for trade, financial markets, international monetary movements and migration as if these belonged to distinct fields that are subject to separate theories. Neither can the workings of the world economy be made understood by simply adding up distinct pieces of knowledge. The very nature of the new world economy is the existence of close interactions between FDI, trade, technology transfer, finance and labour movements. Exports that flow from country A to country B induce new opportunities and constraints for FDI. These investments are financed from local and international sources. Technology transfer and the presence of expatriates with experience in a company's activities can improve an affiliate's performance. Foreign affiliates generate import and export flows that can benefit country A and country B. In the new world economy, trade has become a part of a package that includes also capital, technology and human resources. Competitive performance is more and more dependent on countries' and firms' ability to combine various fields of expertise. World-wide economic integration is no longer built solely on more intense trade flows among countries; it is now the result of a multidimensional and complex set of interrelations. A new way of comparing the level of economic development among countries is by observing the predominant forms of their integration into the world economy. The most developed countries are connected to other countries through both inward and outward flows of trade, FDI, technology and capital. Less-developed countries are connected mainly only through trade. For those countries, FDI, technology and capital flows play only a minor role — especially outward FDI, technology transfer and capital lending — when compared with exports of raw materials. For these countries, the old paradigm is still largely relevant. But this is no longer true in the case of the newly industrializing economies and, *a fortiori*, in the case of the developed countries.

In contradiction with the old paradigm, factors of production are increas-

an automatic improvement of the current account, at least in the short term. Once again, the import content of the exported goods reduces the positive impact of a depreciation on exports. At the same time, a depreciated domestic currency may deter local firms from investing abroad and, as a result of missing an acquisition opportunity, or because they have failed to be a first mover, national firms can lose world market shares.

Industrial policy at bay

The rationale for industrial policy is to strengthen national firms. From the adoption of an import-substitution model to the provisions of support for "national champions", the objective of industrial policy — irrespective of a country's level of development — is to help local firms in the public or private sectors to compete against imported products or acquire the size that will enable them to enter — or to stay in — the selective "club" of world leaders in some industries.

Because of this national — sometimes even nationalistic — approach, Governments have been suspicious of foreign investors crossing borders and developing business in the host country and eventually competing with local firms for domestic market share. Therefore, most investment codes and national regulations used to discriminate against foreign companies. Although the restrictions imposed on foreign investors have, traditionally, been more constraining in developing than in developed countries, some concerns about FDI were held in common. By limiting foreign participation in the ownership of local firms, imposing local-content requirements and import-compensation ratios and making technology transfer a prerequisite for FDI approval, Governments aimed at pursuing two objectives: to protect national firms against the powerful competition from TNCs and to use FDI as a tool for the industrial development of their countries. Foreign firms were welcomed as long as it could be demonstrated that they would be able to help the Government in reaching the medium- and long-term objectives of its national plans. In some industries, FDI was prohibited for non-economic reasons. This was the case for industries that were considered as having strategic importance for the national sovereignty of the country (defence-related industries, communications, transportation, steel, electricity, water, gas), as well as in the production of commodities for export that were crucial for strengthening the domestic currency.

Since the mid-1980s, Governments' attitudes towards TNCs have changed drastically. Instead of being suspicious of TNCs, Governments now welcome them. In most countries, previous investment codes have been liberalized, incentives have multiplied and administrative procedures have been simplified. At the same time, an increasing number of countries are establishing investment

promotion agencies to attract and service potential investors, to improve the country's image abroad and to implement promotion strategies. The promotion of a country's attractiveness to foreign investors is now a key priority (Wells and Wint, 1992). Because it is difficult to be attractive and, at the same time, keep a constraining set of trade-related investment measures, countries are abolishing these measures, are substituting them with incentives, or tie them to each other. Investors have to commit themselves to export part of their output, create employment, or locate their facilities in depressed regions within a host country in order to benefit from those incentives. But there is no obligation to submit applications, and investment projects increasingly do not need official authorization. Ultimately, the on-going liberalization of FDI laws will put an end to the discrimination against foreign investors.

Global strategy versus national interest

The uncertainty and confusion that are plaguing macroeconomic, as well as industrial policies, are, to a large extent, the result of the transformation of the world economy. Macroeconomic theory, which is used as a framework for Government intervention, refers to national aggregates based on national-accounting techniques that ignore the rules of the game of the new world economy. Industrial-policy objectives are determined by a nationalistic approach that no longer corresponds to the strategy and structures of TNCs, whatever their country of origin. The old paradigm impedes Governments from realizing that the political frontiers of a country no longer coincide with the economic borders. As it was discussed in the previous section, the widening dichotomy between a nation and a State is not only the result of a greater openness of the economy — with openness defined in terms of trade flows — but also, and above all, the result of the multidimensional nature of its integration into the world economy. This has an important implication: TNCs are the most significant economic players in the world economy, although this is not yet recognized by the existing official economic data, national administrations and international institutions.

Moreover, TNC strategies and structures have been evolving in the past three decades, with significant implications for host and home countries (UN-DTCI, 1993). Since the 1980s, an increasing number of TNCs has followed global strategies and has adopted global structures. Gradually, more and more TNCs are moving away from multinational strategies and structures. A global approach means, first of all, that investment decision-making is less local market-oriented than in the case of a multinational strategy; TNCs' main target is expanding world market shares. Second, foreign affiliates located in different countries tend to be specialized, and flows among them are internalized to reduce transaction costs. The implications of the global strategies and structures

of TNCs explain most of the paradoxical results that presently confront those host and home-country Governments that uphold the traditional policies. An illustration of these results may be found in the cases of trade and industrial policies.

With TNCs following global strategies and structures, any effort to assess a country's competitiveness on the basis of its current account is misleading. Following a global approach, TNCs are locating their activities according to the comparative advantages of potential host countries. These companies manufacture and market their products in a number of countries. As a consequence, imports of home countries consist, in part, of inputs produced abroad by the affiliates of the home country's TNCs. At the same time, an increasing share of the turnover of those TNCs is generated by its foreign affiliates selling in the markets of host countries, or exporting to third countries, including the home country. Finally, to evaluate the competitiveness of a national economy on the basis of the performance of its trade balance is becoming irrelevant. In today's world economy, the competitiveness of a country has to be measured by the world market shares of the companies located in its territory. According to that approach, market shares include exports from a country and sales abroad of the foreign affiliates of TNCs based in that country. If country X has a negative current-account balance in the automotive industry or in chemicals, for instance, this does not mean that the competitiveness of that country in those industries is weak, because, at the same time, companies originating from country X and operating in those industries may have increased their world market shares and improved their cash flows. Under these circumstances, is it still relevant to refer to the national origin of a company? The promotion of FDI is a good case for pointing out the ambiguities of the question raised by Robert Reich (1991): "who is us?"

In a paradoxical way, it is not certain that the liberalization of FDI laws will be the crucial factor for attracting inward investment. During the 1960s and 1970s — and despite restrictions on TNC activities imposed by developing countries — the share of FDI directed to those countries was higher than in the 1980s, and was more evenly distributed among them. Transnational corporations following a multinational strategy — as opposed to a global strategy — adapted to the restrictions imposed by host countries so long as access to local markets was guaranteed and protected from external competition. For TNCs adopting a multinational strategy, the international competitiveness of their foreign affiliates was of secondary importance as long as their output was sold in the protected local market. Any additional costs induced by trade-related investment measures would be passed on to the local consumers. With a global strategy, the logic is totally different: outward FDI, the delocation of manufacturing or services activities, mergers and acquisitions are all aimed at strength-

ening a firm's competitiveness in the world market. Therefore, local constraints, such as "red tape", complex regulations etc., are no longer acceptable to TNCs, because they increase transaction costs and, thus, affect their international competitiveness. A global firm is not ready to spend a lot of time negotiating with a host-country Government; instead, it looks for another, more convenient location. Today, countries are no longer in a position to screen and control potential investors as was the case in the past decades; on the contrary, companies select countries on the basis of their location-specific comparative advantages. But those comparative advantages are not to be confused with those in the Ricardian paradigm. Comparative advantages are evaluated by TNCs according to their likely contribution to the strengthening of their own international competitiveness.

In a multi-dimensional world economy, not only are the *ex-ante* static comparative advantages of the old paradigm irrelevant, but also the comparative advantages that make a territory attractive are no longer the result of natural endowments. Increasingly, comparative advantages are created. Comparative advantages are built up, first, by the activities of foreign affiliates and their linkages with local firms and, second, by the governmental measures aimed at improving a country's investment climate. To use Michael Porter's "diamond" (Porter, 1990), a country with a large diamond will be at the same time attractive to both foreign and national investors, notwithstanding the fact that foreign and local firms are not necessarily investing in that country for the same reasons. From the point of view of employment and value added, the best situation can be reached when the delocating operations of the home-based TNCs are compensated by new activities developed by foreign-based TNCs. As a result, the traditional foundation of industrial policy — to support national companies — is no longer relevant: what is good for General Motors in France is as good for the French economy as what is good for Renault.

However, when defining their FDI promotion policies, Governments have to be very attentive to changes in TNC corporate strategies. For instance, in the past, global strategies and internalization processes were supposed to go together. In the future, with the spread of "network, "virtual" or "hollow" firms that are becoming a substitute for tightly controlled networks of specialized affiliates linked through ownership, as opposed to a set of agreements among independent partners, things might be different (Michalet, 1991). As a consequence, measures for strengthening local production units that are efficient and able to comply with the network's specifications, might become as important for attracting TNCs as FDI promotion.

The basic lesson is that the world economy is in a constant process of transformation. The 1980s have been characterized by two main factors. First, the

tremendous attraction to FDI exercised by Europe and the United States through, mainly, mergers and acquisitions. Second, the growing number of TNCs from a growing number of home countries has resulted in intense competition among these companies, compounded by stagnant growth in the Triad countries, especially in Europe and the United States. The 1990s might see a revival of FDI in Latin America, as well as the continuing attraction of the South and South-East Asian countries, with India becoming a new "country-continent" target, after China. But whatever future trends may be, the dynamism of the world economy has been pushed and will continue to be pushed by TNCs and their activities.

Concluding remarks

Transnational corporations are the main agents of the transformation of the world economy. In the above sections, it has been pointed out that dramatic change has not been integrated into mainstream economic theory, which continues to stick to the old Ricardian paradigm. With the declining role of the nation-State, TNCs are playing an increasingly crucial role in the functioning of the world economy. The new concept of governance (Dunning, 1992) requires therefore that Governments satisfy, to the extent possible, TNC demands for trained human resources, good communications and transportation networks, transparent and stable laws and regulations, social order and political stability. An enabling environment is one in which firms' transaction costs are reduced as much as possible, that is, market forces are not constrained or distorted. Finally, that logic would require that the regulation of the world economy would need to be left to world market forces. From that viewpoint, there is obviously neither a need for State intervention, nor for an international framework for TNC activities.

Unfortunately, the world market does not look like the one described in a macroeconomic textbook. There is no doubt that competition exists, but it is not the type that is supposed to lead to an optimal allocation of resources. The world market is an oligopolistic market. To protect themselves against the inherent uncertainties of oligopolistic competition, firms play several alternative games. One is the competitiveness game: to be a leader in the world market, or to be the best in a niche and then eliminate competitors (at least, most of them). Another game is buying competitors through cross-border mergers and acquisitions. A third game is forming strategic alliances with competitors with the objective of reinforcing the capabilities of the firms in the alliance, especially in financing research and development and in controlling access to markets through technological norms and distribution networks. The first two oligopolistic games are conducive to increasing industrial concentration. The third game may eventually be used as a tool for developing cartels. In the face of

those corporate strategies, the optimistic view is to trust TNC rationality in being able to generate alternative forms of efficient organization that are substitutes for a perfect market. It would be the triumph of hierarchies against markets. In contrast, the pessimistic view is to compare oligopolistic competition with economic warfare. Advocates of that approach will put pressure on Governments to obtain support for national companies in their struggle against foreign ones. In both cases, the ideal world of free trade depicted by the old international trade paradigm seems to be far removed from the realities of today's world economy. ■

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