The Globalization Trend

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That the world business is caught up in a globalization trend is one of the more popular cliches of the 1990s. But it is a cliche whose implications have not yet begun to be appreciated and absorbed.

Background Facts. The most obvious evidence of the globalization trend has been the growth over the past four decades of the role of foreign trade. With few exceptions, the yearly growth of foreign trade in the world has exceeded that of domestic trade by a few percentage points. The impact of that difference accumulating over so long a period has been profound.

But the globalization trend has had even deeper implications through its impact on the structure of world business. For example, for 1990, the 100 largest business firms in the world reported that about one-half of their total sales were taking place in markets outside their home countries; and most of those foreign sales were taking place through producing subsidiaries located in the country of sale. If one were to attempt to reproduce the analogous proportion in, say, 1970, it could hardly reach one-quarter. Pointing in the same direction is the trend in the flows of foreign direct investment; from 1970 to 1991, such flows grew in the world at an annual rate of 13 percent, far higher than the rate of growth in analogous domestic investment. As a consequence, a major part of the world's output is accounted for today by the parent firms and their foreign subsidiaries that make up the world's multinational networks. In manufacturing, the importance of these networks in world output world output is particularly large, probably on the order of 60 percent.

Apart from the growth of multinational enterprises, observers have taken note of the mushrooming of transborder business alliances, embodied in contracts, licenses, and joint ventures, and often involving competitors in similar lines of business. High-tech industries provide especially strong manifestations of the alliance trend, often between firms with complementary technologies in a given product.

A consequence of these trends that is not immediately obvious is that the parent firms in multinational networks are losing a little of their relative importance in their home economies, especially in manufacturing. In **the United States,** that trend is usually described as a decline in the relative importance of the big-business sector and a rise in the relative importance of small and medium-sized enterprises. But that generalization slights the arresting fact, shown below, that some significant part of the relative decline is accounted for by the growth in the importance of the U.S. subsidiaries of multinational enterprises that are headquartered in foreign countries.

Shares of U.S. Total Manufacturing Product

Contributed by:

	U.S.-based MNE parent	Foreign-owned sub.	Total
1977	68.8%	3.4%	72.4%
1982	65.7	7.4	73.1
1989	61.1	11.3	72.4

The moving forces behind these trends are not hard to find. Between World War II and the present time, the real cost of long distance communication has fallen on the order of 90 percent, accompanied by incredible improvements in the availability of communications facilities and the quality of the services provided. The real cost of transportation, especially for long distances, has gone through a similar metamorphosis, only a little less spectacular. The combined effects of these changes have been to alter the perspectives of producers, changing feasible logistical strategies, altering the related technologies of production, and changing the structures of the business firms involved. One can picture a set of governmental policies, I suppose, that would have headed off these developments before they occurred. But that did not happen in the postwar period. And it is doubtful that governmental policies today can seriously interrupt a continuation of the trend.

<u>Motivations</u>. One should not assume, however, that the globalization of business represents a simple drive on the part of business to reduce the costs of labor inputs by moving toward countries in which wages are lower. The bulk of foreign direct investment in

manufacturing has in fact been between countries with very high wage levels; and in many industries, we observe the phenomenon of intra-industry investment flows, that is, simultaneous flows of investment in a given industry both into the country from foreign firms and out of the country to foreign subsidiaries.

The principal reason for foreign direct investment in manufacturing in the past has been a firm's perceived need to produce closer to its prospective market. Firms with foreign markets, of course, usually have a range of alternatives for serving those markets. While producing in the market through a foreign subsidiary may represent one such alternative, exports from the home location or the licensing of local producers may also serve. But the export route has its limitations: Governments may threaten to impose import restrictions; as sales grow, the lowest cost means of serving the market may shift from exports to local production; and after-sales service may be sufficiently important in a high-tech world as to handicap the exporter that is in competition with a local producer.

As for the licensing route, it too has its drawbacks. One of these is the difficulty of negotiating a contract in which one party is being asked to buy a technological pig-in-a-poke, while the other is being asked to surrender its crown jewels. Another is the difficulty of transferring technology between firms, especially when the transfer has to surmount different firm cultures. So a controlled subsidiary is usually the preferred route for serving an established market.

Another motive that explains the past patterns of foreign direct investment in manufacturing is the pervasive drive of firms in oligopolistic industries to hedge themselves against the sallies of rival firms. In practice, the hedging often includes a follow-the-leader pattern of investment, so that the hedging firm can match such advantages as the leader may have, deriving from its access to markets, technology, and sources of inputs.

Cases do of course exist in which a foreign direct investment decision rests on a simple search for low-cost inputs, without much regard for the behavior of rival firms or of access to markets; but such cases account for only a fraction of the investments of multinational enterprises. Some raw materials investments can be explained in these terms; so, too, can some investments in industries in which price competition is very strong such as toys and consumer electronics. But by and large, industries in this situation use foreign trade rather than foreign investments to serve their needs. In such cases, the impact on labor has to be traced through imports and exports rather than through the changing shape of the multinational enterprise.

Increasingly, however, international trade like foreign direct investment is being driven by forces other than the national prices of capital and labor. The inputs to production have been changing in such a way as to increase the importance of intangibles and reduce those of labor and capital. Although the ability to search for lowest-cost production sites has increased, economies of scale and of agglomeration, and access to technology and infrastructure appear at the same time to have taken on increased importance. The widespread impression (occasionally supported in part by some relevant data) is that the importance of wage levels in determining total costs has declined considerably.

All this is by way of observing that the consequences arising out of the growing importance of the multinational enterprise are extremely complex. The multinational enterprise is much more than a simple machine wholeheartedly committed to a search for lower priced inputs. Its locational decisions will be driven by a preference for the familiar and the avoidance of uncertainty, by the containment of political and economic risk, by considerations of scale, by factors of agglomeration and infrastructure, and by the requirements of rivalrous tactics. Moreover, where a given country is the object of the protection, the effects of inbound investment will have to be weighed alongside of the effects of outbound investment. Therefore, any serious projections of the future consequences of the growth of multinational enterprises in a given country, such as Mexico or the United States, will require analysis at a level of detail that so far has not been attempted.

The Trend toward Regionalism. Various studies suggest that, over the past two decades, the growth of international trade and international investment within regions has been somewhat greater than the growth of such activities within the world at large; the concentration has been especially apparent in Europe and Asia. It remains true, as is suggested earlier, that the direct investment flows among the triad--Japan, the United States, and the EC--are much more important than those within the regions to which each of these is attached; but the trend toward regional concentration raises the possibility that the regions could eventually emerge as dominant. How is that possibility to be related to the behavior of the multinational enterprise?

I am prepared to guess that, as the number of multinational enterprises has grown in recent decades, the new entrants in the roster of multinational enterprises have contributed disproportionately to the growth of intra-regional investment. New entrants, various studies indicate, have a strong preference for making their early foreign commitments in areas that are near at hand in geographical, cultural, and linguistic terms--a preference almost certainly related to their perceptions of risk. With increased overseas experience, firms add to their foreign commitments in increasingly distant areas. Any new surge in the multinationalization of industry, therefore, is likely at first to have a regional tilt.

The regional bias is particularly strong in Asia. Part of that bias, visible in both trade and investment, is linked to the unusually rapid growth of the area; where investors are setting up subsidiaries to be closer to the market, rapid growth induces rapid increases in foreign direct investment. And the fact that so large a proportion of the investors come from countries like Hong Kong and Taiwan reflects in part the fact that these are early ventures in the evolution of these investors toward a mature multinational network.

Another part of the Asia story, however, comes from the rising cost structures of Japan and the Four Tigers, pushing some of their firms outward toward lower cost areas such as Thailand and Indonesia. Here, too, we are probably encountering the phenomenon of the young multinational, favoring nearby sources for its processing activities until it learns to scan a wider and less familiar world.

A steady-state model of foreign direct investment, however, would not display the same regional bias, a fact that accounts for the sustained high level of foreign direct investment among the highly industrialized countries of different regions. In a world of shrinking communication and transport costs, the various factors I have listed earlier that stimulate firms to make such investments exert great power over long distances. The regionalization issue, therefore, seems to me to have far less significance than it is receiving in current discussions.

The Larger Environment. Paradoxically, however, there are some projections regarding the future economic and social environment in which multinational enterprises will operate that seem based on relatively firm ground.

One is the continued in-migration of people from poor to rich countries. As long as significant income differences persist, transportation costs remain low, and a cadre of countrymen are already established in the receiving country, the probability that the inbound stream will continue is very high. Moreover, these in-migrants are likely to continue to establish themselves in the first instance in areas in which obsolete housing is to be found--old central cities and industrial enclaves for the most part.

Another trend that seems inescapable is the continuation of the outmovement of earlier American settlers away from the areas that are receiving the in-migrants, the outmovement increasingly involving relocation in rural areas.

Still another trend that seems inescapable is the aging of Americans, creating changes in occupations and industries (including agriculture) and changes in the types of services demanded by households. Those changes will generate tensions with the other changes described above.

These changes, I would judge, will be far more instrumental in determining the future use of rural areas than any that will stem from the increased importance of multinational enterprises or from regionalizing trends.