Opinion **Free Lunch**

How foreign investment changed the world

The economic geography of the new globalisation

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Last night I was the respondent to an inaugural professorial lecture in economic geography at the London School of Economics. Riccardo Crescenzi assumed his chair with a tour d'horizon of his research on the role of foreign direct investment flows in regional and local industrial economic growth. I highly recommend his interactive tool mapping FDI's strong positive effect on patent innovation in the receiving economy — at least when the investing company implants itself in local labour markets and supply chains.

This snapshot of economic geography struck me by how much it contrasts with the traditional view of international economics, which reflects the international economic reality of its time, up to about the mid-1980s.

Traditional trade theory focuses on *trade in final goods*. Since David Ricardo conceptualised the theory of comparative advantage 200 years ago, economics has tried to explain what goods countries trade with one another. In the 20th century, resource endowments had pride of place — capital-rich countries export goods that take relatively much capital to produce and labour-rich ones export goods that can be produced with larger inputs of labour. The "new trade theory" of the 1980s tried to explain the fact that a lot of trade saw the same type of product go both ways — France and Germany both selling each other cars — which was explained by increasing returns to scale and consumers' taste for variety. Still, it was all about final goods.

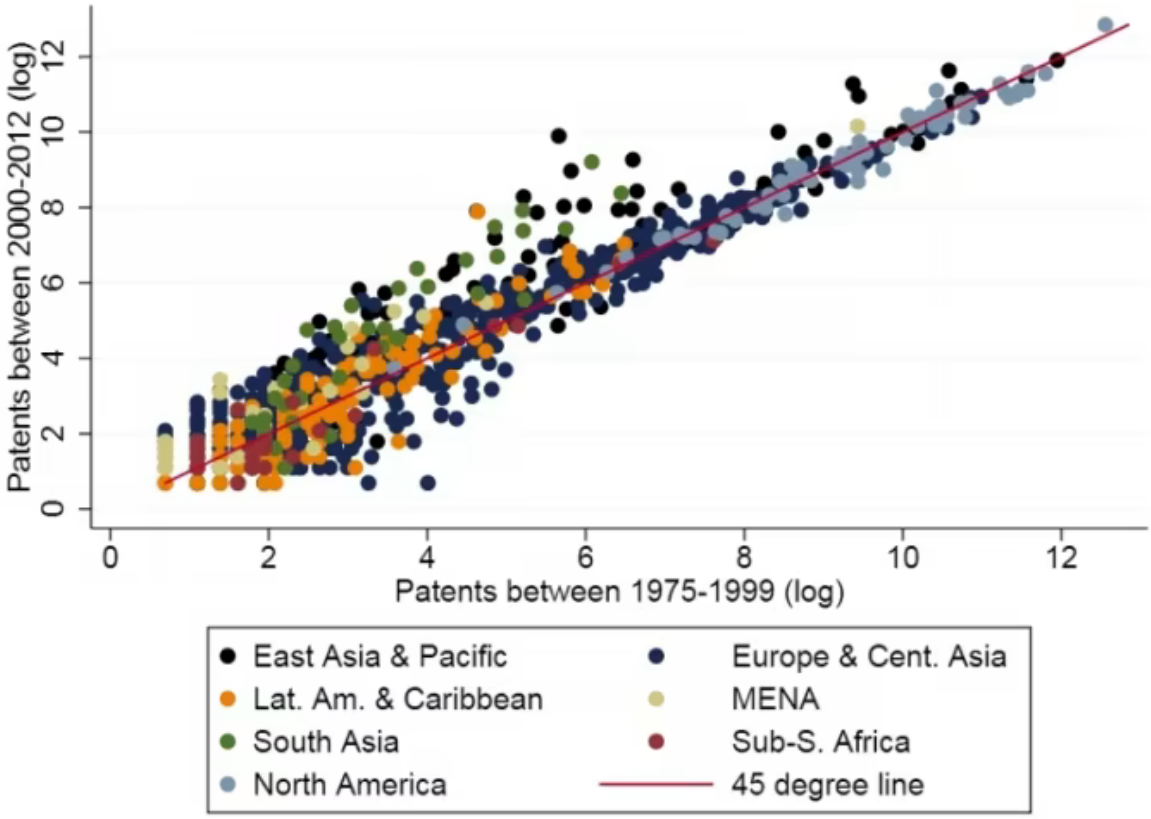
But contemporary trade flows are dominated not by the finished "made in China" or "made in the US" products consumers find in shops, but by intermediate capital goods in multi-country supply chains. On one estimate, as much as two-thirds of cross-border trade is carried out within value chains. That means trade is intimately tied to *investment* by which a multinational company builds a production process that straddles national borders.

And direct investment flows are different from final goods flows in the way they carry *knowledge* along with them. That means production technologies and know-how, including the ability to build on existing knowledge — also known as innovating — move around the world in this type of trade more than it did with the traditional kind. Crescenzi establishes that patent innovation is strongly boosted in regions of east Asia and Europe after they first receive direct investment from a foreign multinational company; the effect is weaker in other parts of the world.

That makes protectionism an even more losing proposition than it used to be. Erecting trade barriers, given the dominance of cross-border supply chains, is like putting up a wall across a factory floor, as Richard Baldwin has argued: it stops the exchange of knowledge and information, and the specialisation this makes possible, on which productivity depends.

Crescenzi and his colleagues also observe that "multinationals . . . tend to follow location decisions of others". In other words, clustering is an important determinant of which regions progress technologically and which lag behind. Whether driven by real benefits from being in a network of producers or by "information cascades" (where a previous investor's location choice is taken as a sign of hard-to-know advantages of the location), geographic agglomeration stands in contrast with the traditional driver of comparative advantage: relative abundance of some resource rather than another, or simply economies of scale (unrelated to geographic proximity).

The combination of knowledge transfers embodied in trade and investment flows with a tendency of multinationals to cluster their locations makes it relevant to think about innovation inequality. Crescenzi, Arnaud Dyèvre and Frank Neffke document that innovation as measured by patent registration is extremely unequally distributed across space (see their chart below) within countries as well as between them. This inequality is very persistent, but some regions have managed to climb the innovation league table, including Guangdong in China, Karnataka in India, the Algarve in Portugal and Chonburi in Thailand.



There are two strong reasons why policymakers should pay full attention to these changes in the nature of economic integration. One is that it plays straight into the most intense political challenges of our time: the bias of economic rewards towards those individuals and regions that can participate in innovation; the ascendancy of cities and the decline of rural areas; the futility of protectionism; and the importance of place and spatial inequality including within countries.

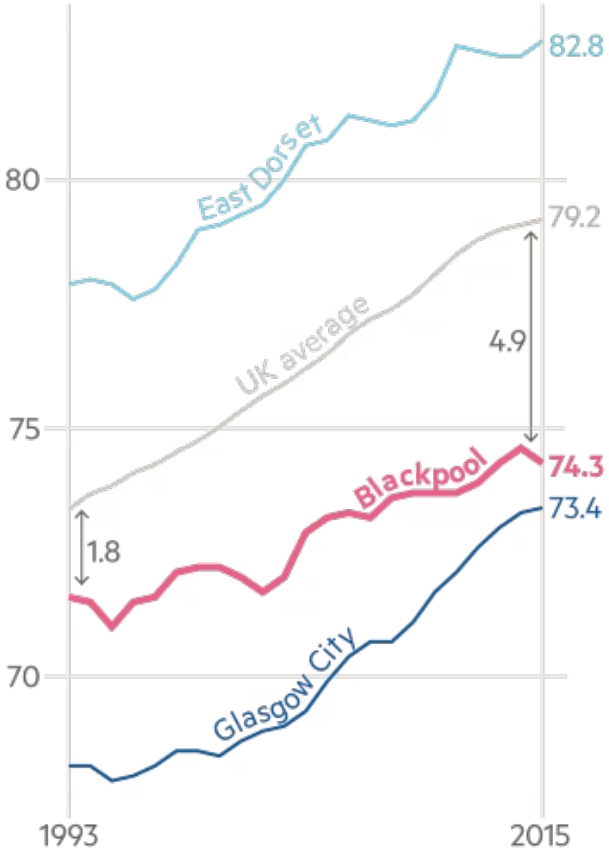
The second reason is that there is more to come. Global FDI is about $1.5tn a year — a huge number, but only 2 per cent of global gross domestic product. Within countries, the rate of business investment is typically 10 times greater, on the order of 20 per cent of GDP, and higher in many of the high-growth emerging economies. In a truly frictionless world, we would expect much more of this investment to cross borders than is yet the case. Enormous as the transformation of the past three or four decades has been, we have only seen the beginning of it.

Other readables

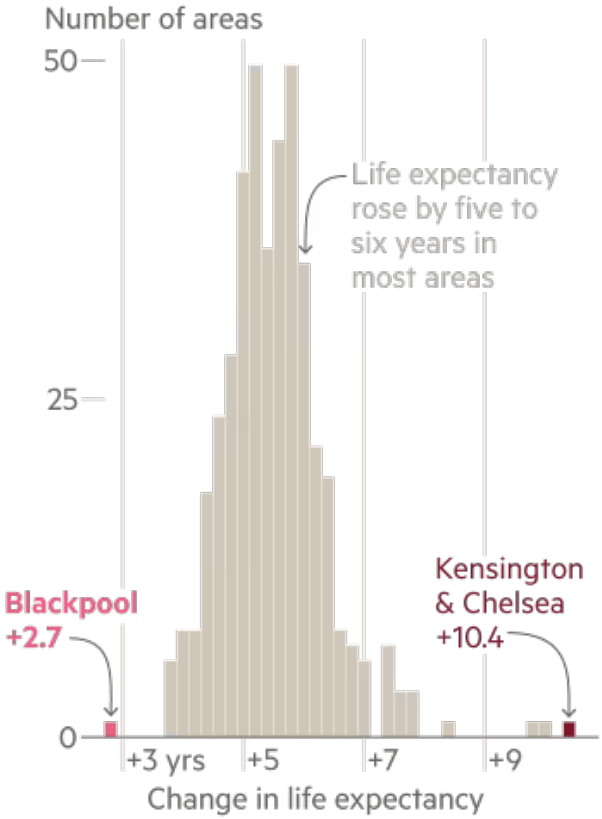
- Read Sarah O'Connor's illuminating magazine article on Blackpool, a vortex of the UK's left-behind and its epidemic "Shit Life Syndrome".

Boys born in Blackpool can expect to live just 74 years — the second lowest in the UK, and up by just 2.7 years since 1993

Male life expectancy at birth in selected local authorities, 1993-2015



Distribution of change in male life expectancy at birth from 1993 to 2015, all UK local authorities



Source: ONS
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