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The Contradictions of Free Market System and The Impacts of FDI and Foreign Trade on Economy

By Hasan ALPAGU †

Abstract. This paper examines the effects of the FDI and foreign trade (Exports and Imports) as well as their importance in international economic activities. A central subject the study is to examine the impact of FDI and foreign trade on the growth and prosperity status of countries. Whereby the paper examines the role of international business on the developing progress of countries. The economic growth of a country depends on the quantity and productivity of the economic factors. For that reason FDI and Import-Export are most significant economic activities, which have substantial effects on the quantity as well as quality of economic factors in any country. On the other side, customs union, quotas and regional trade pacts deactivate partly or in some cases even completely the projected effects of Smith's absolute and Ricardo's comparative advantages theories in the international production cooperation. The study examines this situation from a modern economic point of view.
Keywords. FDI, Export, Import, Capitalist System, Less Developed Countries, Trade, Customs Union, Less Developed Countries, Laissez-Faire, Invisible Hand
JEL.

1. Introduction

The Capitalist economic system operates as the strategy of a group of mountain climber. The climbers track same route, equipped with the same equipment and share a common pulling rope to the summit. However, each of them experience a dissimilar physical and psychological state. Most importantly, each member of the climbers group has only one goal: "The summit must be achieved at any price." Therefore, in climbing it is common that many climbers fall, and only some of them can reach the summit. At this point experiences and psychological advantages take a decisive role in order to maintain challenging condition of climbing.

The capitalist economic system is acting similarly with such strategy. It can be observed especially in international economic activities and in case of an economic crisis. The economic relations of countries are based on the continuous interactions of companies, which targeting to reduce their costs and increase the share of their profit.

Also the ultimate goal of FDI seekers are reducing the costs of production and realizing profit-maximizing investments. The governments are backing the firms of their countries through economic agreements as well as quotas and customs duty in order to make their trade position more favorable. Hence the firms are performing through the FDI and foreign trade to realize this target. Moreover, the investments and foreign trade are most significant determinants of these international economic

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relations. While FDI makes the locations of companies more flexible and more effective, foreign trade mobilize local and national goods internationally and globally.

This paper considers these significant mechanisms of economic activities through a multidimensional context. It defines international trade as a derivers of international economic relations. It takes a closer to look at the background of liberal economic system from a critical point of view.

2. Methodology

In this study, we applied a pioneering way of scientific examination, we have determined the structure of the work as a questionnaire similar method, in which the parts of study are represented by a leading question.

The facts, evidence and hypothetical arguments have been discussed in light of given questions. The ultimate aim of these questions is to contribute some original and thought provoking ideas to the discussion on the international economic relations.

Is the Free Market System Objectively Free?

In scholar circles it is typical to praise customs union and trade agreements between countries as well as give respects to multinational structures like EU, BRICS, MERCOSUR, NAFTA and ANDEAN GROUP. However, we have to ask ourselves, "What will happen to the economic structures of the less developed countries, which remain outside of such unifications?"

Although such kind international agreements make the trade position of their members favorable, however, on the other side, they make the cleft between developed and less developed countries larger. This is one of most significant reasons why and how are the FDI and Export-Import activities various from country to country.

However, on the other side, customs union, quotas and regional trade pacts etc. are party or in some cases even completely deactivating promised effects of Smith's absolute and Ricardo's comparative advantages theories in the international production cooperation.

Moreover, all kinds of unions have more than one target. Their strategy is based on long-term economic and political goals. If we look at the parameters for free movement of capital, the EU and NAFTA provide a very good capital circulation system. Although there is a common policy of economic and political integration of EU members, there are still some limitations and lack of integration. Nevertheless, in comparison with other groups of countries, the EU is still the leading and best organized Union.

The EU has a significant favorable position in comparison with other unions for the competence of International Institutions. In comparison to the EU, other regional groups have a poor position with regard to this common policy.

Monetary coordination of each of these countries is generally insubstantial.

We can diagnose this fact as a consequence of monetary policy in individual countries.

Monetary movements of countries depend on the economic decision makers of a government. Governments as political actors play a significant role by influencing economic decisions and especially the monetary policies of central banks (such as interest rates, currency circulations etc.).

As a result, money circulation can influence the economic situation of a country positively or negatively. While every single country's currency will be regulated by its central bank, in EU, the ECB acts as a coordinator and upper regulator over its member's central banks. In other words, it is hard to fix a functioning common

monetary policy. In fact, monetary decisions are very irregular and fragile. They can change anytime in any country due to global as well as national economic and political crises or some other factors such as expectations and speculations.

Fiscal coordination relates to financial matters that are managed by the government, like money circulation, taxes, debts etc. And the monetary coordination is concerned with a country´s money and to the systems that a country uses for controlling its money supply and other monetary parameters like interest and exchange rate structures, credits rates, saving and investments etc. (Longman, 2003).

The targets of monetary and fiscal coordination are keeping control of the monetary activities and inflation in order to keep the currency and fiscus stable in an economy.

The EU as a supranational organization tries to influence and coordinate the monetary and fiscal policy of members through the ECB. However, as in the case of the fiscal and currency crises in Greece, Spain, Italy and Hungary, the ECB was not able to manage the crises in time. Therefore well-coordinated collaboration with member countries is needed. During the Euro crises in Greece and Spain, Germany and France were the most important financiers of EU. However, popular criticism arose in Germany and other states against the EU policy for rescuing Euro in crisis zones. Such criticisms can force the EU to change its rescue policy towards crisis-prone countries.

We would propose that the ECB and other economic authorities of the EU commission draft a common monetary policy against possible economic crises which could stabilize European economy patterns. However, it seems that individual countries are not willing to give up any power. How the EU will overcome this challenge remains to be seen.

How Convincing are the Propositions of Laissez-Faire and Invisible Hand?

The principle of laissez-faire and invisible hand will not work, if a country have not enough capital to invest abroad or have not proper infrastructure to attract FDI inflows.

Other obstacles are quotas and regional agreements. For instance the Common Agriculture Policy of the EU, in short CAP, limits all processed agriculture products from third world countries into the EU. The CAP is a program, which provides agricultural subventions and implements agricultural planning.[1] Applying tariffs and quotas to goods from outside of the EU is the basic aim of CAP in order to protect its agriculture production. CAP enables a comparative advantage for some products such as cereals, meat and milk. Morocco also implements a quota system in order to protect the Moroccan banana production. On the other hand, Morocco has a comparative climate advantage in agricultural production, of tomatoes, for example. However, this advantage is limited through the common agricultural policy of the EU. Morocco has been allowed to export tomatoes at a preferential price to the EU only in times when agricultural production in the EU is low-from October to May.

TABLE 1. *Preferential Quotas for Imports of Moroccan Tomatoes by EU (Monthly)*

Monthly base quotes	Tons
October	10 600
November	27 700
December	31 300

[1] The Common Agricultural Policy, a partnership between Europe and Farmers, European Commission Directorate-General Agriculture and Rural Development

January	31 300
February	31 300
March	31 300
April	16 500
May	5 000
Additional quote	28 000
Global quote	213 000
Authorized maximum amount	215 130

Source: Lemerle (2011).

Furthermore, there are several countries, in which the share of FDI relative to domestic agricultural investment is much higher than the average for all developing countries.

China and Vietnam are examples for countries that have included agriculture among their priority areas for attracting FDI and which also do so, unlike some other developing countries.

Why Countries have to Deal with International Economic Issues?

The economic growth of the countries depend on the quantity and productivity of the economic factors. For that reason FDI and Import-Export are most significant economic activities, which have substantial effects on the quantity as well as quality of economic factors in any country.

Whether developed or less developed country, every single country have to deal with the international economic issues. Hereafter, FDI and export-import are the main mechanisms to deal such challenging issues, that the countries are facing.

On the other side, FDI and the export-import and decisions of wealthy countries have significant impacts on the trade balance all countries. With other words, such decisions effect the consumer behaviors, labor market, and budgetary deficits of countries. Even some macroeconomic handling of such leading countries can effect on the economic position of other countries. For instance FED interest rate decisions effect directly the financial market of developed countries.

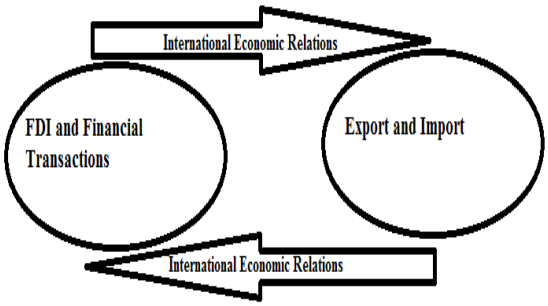

Image 1. *The International Economic Circulation*

Are the Resources Absolutely Scarce and Needs / Wants Strictly Unlimited?

It is argued that the resources are limited and people will never totally satisfied with the quantity and variety of goods and services they consume.

When we consider whole universe as a source of resources, that we need to satisfy our requirements, there are limitless resources in universe. However, the resources, that currently available are limited. For instance possible energy in other planets in the universe or the mining in deep and other undetected natural resources are not in progress, hence people have to try to outcome with available limited resources at least in current period of time. Likewise, when we consider the needs of people, there are limited needs but unlimited desires of people.

Why Developing Countries attract more FDI Inflows?

Developing economies of the world show a tendency to attract more FDI as long as their economic and political situation stay stable. The reasons behind this tendency can be listed as follow:

- They have a large amount of consumers, which tend to change their usual consumption behaviors.
- Economic and political stability cause economic growth and it makes the consumers better-off and they want to increase their expenditures by using the prosperity-surplus, which gained through economic growth.
- Although there is a growth in the wealth of these countries' inhabitants, it takes time to increase the supply to cover increasing demand.
- In short-run the costs of three main production factors; land, labor and capital show an unchanging tendency, hence firm want to practice this advantage.
- Other determinant factors are market size, growth prospects, infrastructure facilities and trade policy of host countries.

Why less Developed Countries are suffering under permanent economic deficiency?

The most significant reasons of permanent underdevelopment are lack of national and international investments and low volume of foreign trade. We can describe this phenomena through the basic economic formulation of GDP:[2]

$Y = C + I + G + X - M$

The percentage of I and X-M in an economy is an indication of the measure as well as the international competition position of a country.

In less developed countries the proportion of I and X-M remains significantly low. Whereby C and G remain most essential component of GDP. That means the volume of trade is low and the economy significantly depends on the government expenditures. Additionally consumers have a low level of income and so they are not in the position to purchase imported goods and services as well. As a result, while in less developed countries economies are dominated by C and G, the share of I and X-M appear significantly poor.

3. FDI Inflows into and FDI Outflows from Developed and Developing Economies in Comparison

The development theory examines the causes of lower level economic development in the developing countries. This theory is divided into the modernization and dependency theory and the imperialism theory.

According to Todaro and Smith, the problems of developing countries can be listed as follows (Torado & Smith, 2009:39-41):

- Lower levels of living and productivity
- Lower levels of human capital
- Higher levels of inequality and absolute poverty
- Higher population growth rate
- Greater social fractionalization
- Larger rural populations with rapid rural-to-urban migration
- Lower levels of industrialization and manufactured exports
- Adverse geography
- Underdeveloped financial and other markets
- Lingering colonial impacts such as poor institutions and varying degrees of external dependence (economic, political, cultural, and environmental).

[2] Y: Yield, C: Consumption, I: Investment, G: government purchases X: Export, M: Import

Economic relations between countries are mostly concerned with the physical international products market. International trade has many dimensions, "as cross-border trade increases, the circulation of other trade goods increases also; so also increases the demand for supply chain, logistics, raw materials, parts, finished goods, packages, and documents around the world" (Cavusgil et al., 2008:416).

The neo-classic theses are as follows (Dornbush & Fisher, 1998:7-8):

- Economic agents always try to make optimal decisions.
- Economic expectations are calculable and they use all possible information to maximize their profit.
- Consequently, economic processes balance themselves.

Market economy in any country has three main components; production, distribution, consumption. If one of these elements is not successful, the market economy falls into economic crisis.

That is why firms try to trade globally, in order to distribute their products as well as they can; furthermore they try to produce more profitable products.

Foreign direct investments as well as exports and imports are purely profit oriented economic activities.

FDI inflows and outflows are important not only for home countries but also for host countries. A home country is the country from which an investor comes; a host country is the country in which he invests. Every country tries to attract more imports of goods and expertize as well as to realize more export of their own products and know-how. This target can be realized by FDI inflow/outflow.

FDI inflow shows the following advantages for host countries (Lipsey, 2002:2-5):

- Increase of technological knowledge and Know-how
- Innovative and more dynamic production facilities
- More efficiency than non-multinational firms
- Job creation effect and contribution to higher qualifications on the labor market
- Higher wages than domestic firms (wage spillovers)

The effects of FDI inflow in developing countries have not been as high as expected.

The following reasons show why this kind of investment gives an advantage primarily to firms of the homeland (Bayraktar, 2003:43):

- Employing local labor force with low wages, and using advanced technology for most of the production in the host country.
- Cooperation with local firms for low production costs and other cost reducing measures
- Investment in capital intensive sectors

Furthermore, multinational companies apply the latest technologies and production methods. That's why they need mostly qualified labor from their own country and the most important parts of fabrication use modern machines. In this sense, FDIs in developing countries take recourse mostly to a marginal quantity of the local labor force. Table 8 lists the employment in various high-ranking multinational firms. Multinational firms employ a significant number of employees from other countries. These employees can be classified into two categories. The first category represents experts and highly qualified employees, for example many US firms employ IT-Experts from India and Poland. The second category is unqualified employees employed in multinational firms in the host country. Legal preconditions for employing foreigners and local government policy also have effects on the number of local and foreign employees in a multinational company. The inflow of qualified and skilled employees is an important phenomenon related

to FDIs. Some governments even encourage these skilled labor inflows from abroad. For example, the USA and some European Union countries have installed special visa programs in order to attract more skilled employee such as IT-experts and certain other branches.

The most important source of FDIs are multinational companies. Almost all of these companies have their headquarters in developed countries.

The investment choices of multinational companies are influenced by the economic policy and political decisions of their home countries.

The economic and political situation and governmental decisions of target countries are crucial in order to attract FDIs. Here, especially tax rates, legal and political conditions dominate decisions.

However the headquarters of these multinational companies almost always remain in the respective country of origin.

Consequently, capital, Know-how and sustainable investments reside in the country of origin. They invest in developing countries mostly for secondary production and supplement markets and build flexible structural production facilities which they can quickly move in case of political or economic crises. This means they do not permanently transfer their Know-how, capital and qualified personal to the host country. In fact, they can move out of their host county at any time. Therefore it is not a sign of sustainable investment in developing countries. Finally, the target country will be just a temporary location for FDIs from developed countries. The most important point is that the establishment of economic and political stability in developing countries can extend the positive effects of FDIs. Furthermore local companies can benefit from the Know-how and capital accumulation of foreign companies. For example, new technology and economic mobility, model for local companies etc. can be considered to be such long-term benefits. Principally, developing countries suffer from economic deficits in many significant fields, which can be partly or even completely eliminated by the capital and Know-how transfer through FDIs. That's why developing countries should undertake more tangible measures to attract FDIs in their country. For instance, in comparison to Turkey, Morocco has more deficits by attracting FDIs than Turkey. However the Moroccan trade policy is inefficient and ineffective.

Many studies prove that home as well as host countries benefit from FDIs. If the spillover effect is positive for the host country, than it is a clear win for it.

A study (Erkilek, 2003) has proved that foreign-owned Turkish plants had higher productivity than domestically-owned plants in the period of 1993-1995. Moreover some evidence has been found for productivity and knowledge spillovers to domestic firms in Turkey.

According to a study by Haddad and Harrison, "for Morocco, the output per worker was higher in the period of 1985-1989, and deviations from best-practice frontiers were smaller in foreign-owned firms than in domestically-owned firms in 12 out of 18 industries, and in all eight of the industries in which the differences were statistically significant" (Lipsey, 2006:37-43).

Spillover effects (Toprak, 2007) of FDIs are significantly important. They are externalities of economic activities that can also influence those who are not directly involved in a common economic activity.

For instance, local small companies and entire populations of host countries, etc. can profit from spillover effects. Spillover effects are an advantage for host country firms and citizens who automatically profit from the investments of foreign firms in the host land.

However, the main winners of FDIs are home countries. In fact, a bigger part of profit and accumulative turnover is transferred to the headquarters of firms in their

homelands. Furthermore, most benefits of FDI' go to home countries. These benefits can be listed as follows:

- New economic resources such as profit, cost-effective assets and other advantages of new market
- Low-cost labor force and low priced raw material
- Expansion of firm
- Image and credibility for investing firm
- Internationalizing of firms etc.

Foreign inward and outward investments can be represented in different categories and volumes. To measure their dimensions and effects, there are many different methods and point of views. According to Lipsey there are two main ways to measure FDI (Lipsey, 2002:2):

1. Quantity of capital which flows from the home country to the host country. The home countries have strong representatives in the host countries, for example as Holding, own firm office and branches in the host country or hold a certain share of voting rights in a host country firm.
2. Economic activities or operations, which are carried out in a host country by firms controlled or partly controlled by firms in an another country; for example, production, employment, sales, the purchase and use of intermediate goods and fixed capital, and the carrying out of research.

3. FDI and Economic Transformation

Foreign direct investments are significantly important for the transformation of any economy into a competitive global economy. To attract more FDIs, countries have realize many economic improvements such as reformation of the tax system according to international standards, which provide more advantages to investors. These investment friendly economic reforms have enabled privatization in the public sector as well.

The target of economic reforms and privatization policy is to realize a sustainable economic growth, increase investments and strengthen the competitive capability of the national market against international competition, to realize more employment opportunities and the creation of innovative technological developments. The final goal of these reforms is to get closer to the global economic standards.

The FDI decisions are long term economic choices of investors. To make such decisions, investors analyze the economic and political situation of the host country according to criteria like stability, credibility and global and local confidence in the government's program. In short, FDI inflows into a country are among the signs of economic development of a country.

Furthermore, the economies of countries are effected decisively by inner political and social developments.

4. Concluding Remarks

International business activities can take place in several forms. Direct investment and export-import are key components of such activities. They also have significant contributions to other economic factor movements such as labor, capital and innovation. Accordingly, there are an international market of goods and services and there are a constant flow of FDI in / out flows and exports-imports of goods.

On the other hand, in academic circles there are general accepted certain guidelines and way of handling methods of research topics. Researcher are whether not dare to change this way making researches or even have fears to not being

reconditioned in their field, in case when they attempt to be different from such general accepted scientific point of views.

In order to make our argument more clear, this situation can be compared with the stream of forwarding automobiles in the same highway. Despite having different speeds or different brands of automobiles, every single driver has to follow the traffic signs and rules of this mentioned highway and these rules are almost same in any country and in any time.

This example also valid for the economists and researchers. In economics, there are two main perspectives: These are liberal and socialist standpoints. Although these two standpoints are accepted as opposition to one another. However, both perspectives are moving in the same course. In order to discover new way of thinking, we tried to take the matter from a nontraditional point of view.

In conclusion, we feel to stress that the subject of this article need more research and time to present more precise inputs. Through this paper, we try to give researchers a visionary consideration in handling with subjects of economic science and provide them some indication for further studies.

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