

The majority of the analysis to date has focused on a traditional factor endowment model (Heckscher-Ohlin) of international trade. Early work showed that tariff barriers could induce a capital flow from the exporting country to the importing country, completely substituting for commodity trade.³ Allowing for incomplete specialization, imperfect competition, as well as differences across economies in technologies and consumer preferences, can reverse the aforementioned result and generate cases where factor flows lead to greater trade volumes.⁴ In addition, the literature has shown how FDI and other capital flows can lead to suboptimal welfare levels, and even reduce welfare below pre-flow levels, when host industries are protected by import restrictions.⁵

The view that trade and investment are complementary was stressed somewhat earlier among economists analysing direct investment. Trade-creating effects of direct investment in the natural resource sector was the focus of early studies, while an examination of Japanese FDI in the natural resource and manufacturing sectors demonstrated how trade-oriented FDI can generate higher levels of welfare than FDI dependent on import-substitution policies.⁶ This result is based on the assumption that FDI in comparatively advantaged industries brings about greater technological progress than FDI in import-substitution industries, where no comparative advantage exists.

Although problems exist with integrating FDI into trade theory, the analyses do suggest two major points for public policy. First, the analyses demonstrate how FDI flows in protected industries can be welfare reducing. Thus, stimulating any investment, be it domestic or foreign, in protected sectors can lead to a misallocation of resources and a suboptimal level of welfare, a major lesson of economic theory that is exceedingly important to remember. Second, some analyses emphasize the perception that FDI's most positive impacts are generally not as related to capital transfers as they are to transfers of intangibles such as technology that can come with direct investment. This view implies that the often observed investment policy emphasis on transfers of technology and other intangibles is to be expected and clearly warranted.

³ See Mundell (1957).

⁴ See Purvis (1972), Markusen (1983), Svensson (1984), Markusen and Svensson (1985) and Wong (1986).

⁵ See Bhagwati and Tironi (1980), Khan (1982), Casas (1985) and Buffie (1985).

⁶ See Kojima (1978).