

Capital xenophobia and the national interest

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CAPITAL XENOPHOBIA AND THE 'NATIONAL INTEREST'

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CAPITAL XENOPHOBIA AND THE 'NATIONAL INTEREST'

Executive Summary

This paper examines the significance of international investment in Australia, arguing that foreign capital is not to be feared, but instead should be welcomed in view of its beneficial economic effects.

It first highlights the inconsistency between official support for liberalising trade in goods and services, but not further liberalising international investment. The same kind of protectionist, economic nationalist thinking that promotes trade restrictions and supports “Buy Australian” campaigns influences foreign investment policy. However, economic arguments similar to those used to support liberalization of trade in goods and services can be applied to foreign investment.

By investing excess saving through equity participation, loans to resident firms and purchases of real assets from residents, foreigners finance that much more domestic investment. Moreover, the pool of funds available for investment is also supplemented when real domestic assets like property are bought by foreigners.

Foreign direct investment in particular confers productivity gains via technology transfer, international management practices and product development and can spur greater domestic competition and imitative behaviour by existing locally-owned firms.

When foreigners buy existing Australian assets at higher prices than other residents buyers would be willing to pay, the Australian residents who sell such assets to foreigners make capital gains which they otherwise would not have made. The proceeds of the sale of assets may then be used to create new domestic assets, be spent on consumption, or ever be used to acquire new foreign assets.

Estimates of national income gains attributable to foreign investment, broadly defined, confirm that the gains have been positive and significant because the extra production made possible by foreign investment has on average significantly exceeded investment income paid abroad.

The term ‘national interest’ has not been adequately defined in this context and is really devoid of any economic meaning. It only makes sense in the context of quarantining defence and national security related industries from foreign control.

In light of the economic benefits foreign investment bestows, this paper proposes that the true ‘national interest’ would be better served by re-examining the purpose and role of the FIRB with a view to eliminating restrictions on foreign investment that stymie growth in Australia’s living standards and wealth.

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Contents

Introduction

Why Free Trade but Not Free Investment?

The Economic Case Against Capital Xenophobia

 Macroeconomic Arguments

 Microeconomic Arguments

 Estimates of National Income Gains

What Really is the 'National Interest'?

Sovereign Wealth Funds: A Cautionary Note

Conclusion

CAPITAL XENOPHOBIA AND THE 'NATIONAL INTEREST'

Introduction

Capital xenophobia is an acute form of economic nationalism that becomes most virulent whenever foreign investors target iconic Australian brand names for takeover. Trade protectionism, the other major strain of economic nationalism, is motivated by aversion to foreign-produced goods and services. Like trade protectionism, aversion to foreign capital implies a major role for government intervention in commercial transactions between residents and foreigners.

The role of foreign investment, especially foreign direct investment and multinationals has been extensively debated for a century, most notably beginning with claims by Vladimir Lenin, the founder of the former Soviet Union. Lenin asserted that foreign investment was inherently exploitative of host countries and a manifestation of the final stage of global imperial capitalism. This inimical view of direct foreign investment contrasts markedly to the attitudes of contemporary governments in the developed and developing world.

Governments of varying ideological hues around the world actively seek higher shares of transnational investment flows. Yet the Australian Government, through the Foreign Investment Review Board (FIRB) continues to discourage certain forms of foreign investment, particularly in the financial, media, real estate and transport sectors. Indeed, there is a popular view that Australia's foreign investment policy is not restrictive enough and the idea that foreign acquisition of Australian enterprises should be blocked by government has in the past found strong support from fringe political parties at both the left and right ends of the political spectrum, such as the Australian Democrats and One Nation.

The ultimate official justification for protecting segments of the economy from foreign acquisition is that a move to foreign ownership of firms in certain industries somehow contravenes the 'national interest'. However, this phrase, though frequently invoked, has never been properly defined and, as we will see, is really devoid of any economic meaning.

In highly globalised economies households, firms and governments are integrated via inward and outward flows in markets for goods and services that manifest as exports and imports. They are also increasingly integrated through asset markets, as the global financial crisis has reminded us, which manifest as foreign capital inflows and outflows. These two-way flows are illustrated in Figure 1. While copious attention has been devoted to liberalising and expanding opportunities for international goods and services trade, the same can not be said for cross-border trade in assets.

¹ 'Capital xenophobia' was the title of a 1984 monograph on foreign investment by Wolfgang Kasper, recently revised by Stephen Kirchner (2008).

This paper addresses the significance of international trade in assets.² Its primary aim is to advance the argument that foreign capital is not to be feared, but instead should be welcomed in view of its beneficial economic effects. This argument is developed first by highlighting the inconsistency between advocacy for freer international trade in goods and services but not for freer international trade in capital.

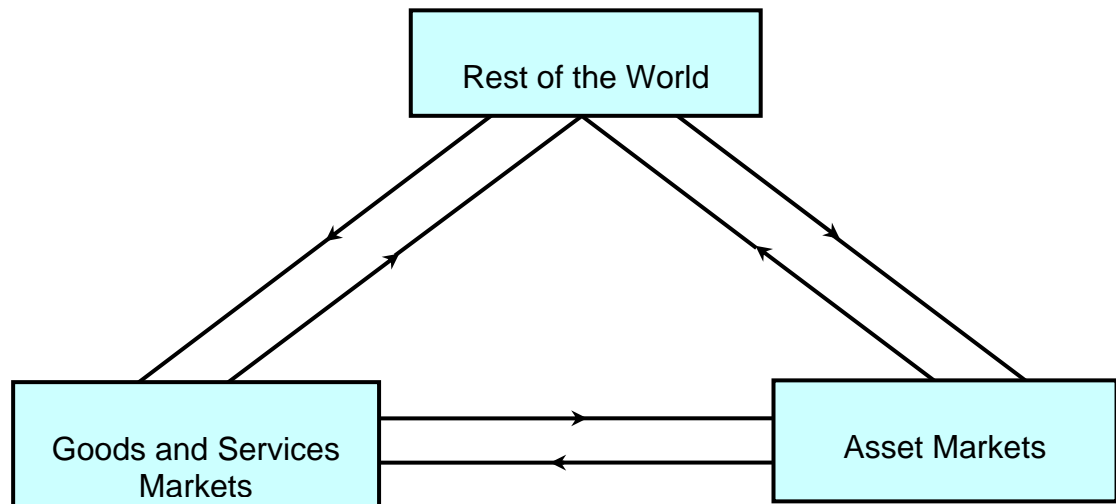


Figure 1 International Trade and Investment Linkages

Next it advances macroeconomic and microeconomic economic arguments against capital xenophobia. In light of the economic benefits foreign investment bestows, it then questions what the ‘national interest’ really means in this context. It concludes with recommendations for foreign investment policy.

Why Free Trade But Not Free Investment?

Generations of economists have argued that free trade in goods and services improves economic welfare. A corollary of their arguments is that trade restrictions, especially in the form of tariffs and quotas on imports, reduce economic welfare because they impose additional direct costs on consumers and indirect costs on exporters.

What is apparently not recognized by policy makers is that many of the economic arguments used to support liberalization of trade in goods and services can also be applied to thinking about international trade in assets and funds for investment. As a general principle, the greater the international trade in assets, the greater the potential economic welfare gains.

Though the idea that freeing up international trade in goods and services is widely accepted as welfare enhancing, somewhat inconsistently when it comes to thinking about international trade in assets, both financial and real, the gains arising from mutual exchange are often ignored.

² Some of these points have previously been expressed in Makin (1996a, 1996b, 2006, and 2007).

Increased foreign investment could conceivably play as important a role in Australia's economic development as increased international trade in goods and services because trade in assets and investment allows funds to move to places where capital can be used most productively.³

Calls to protect domestic firms from foreign takeovers in particular are influenced by the same kind of economic nationalist thinking that urges consumers to "Buy Australian" in the sense that locally grown enterprises warrant special patronage regardless of the quality and price of products these enterprises make available for sale. Ironically, in the case of foreign investment it is often only when foreigners are actually allowed to Buy Australian (firms, not goods in this case) that product quality improves.

Industry protection, particularly in the form of tariffs has been thoroughly criticized in the past on the grounds that tariffs on imports allow inefficiencies to develop at the firm level which, in turn, delays adoption of the best international techniques available.

Similarly, protecting domestic firms from the threat of foreign takeover through investment restriction also creates an environment where inefficiencies may develop. Further relaxation of foreign investment policy to allow foreign takeovers in now-quarantined sectors would conceivably motivate managers of domestic firms to further maximize their firms' profit opportunities thus ensuring the wealth of resident shareholders is at its highest level.

There is an anomaly when it comes to thinking about free trade and foreign investment. On one hand, calls for higher tariffs to restrict trade in specific goods or services in order to protect owners and management from overseas imports now verges on the unmentionable. This is a direct result of the academic arguments and prevailing policy consensus that exists on the benefits of free international trade in goods and services.⁴

But on the other hand, it is still quite acceptable to propose restricted international trade in assets even though there are strong arguments to support unrestricted capital flows. Admittedly however these are not as yet elaborately developed as centuries-old arguments for free trade in goods and services. Let us now turn to some basic economic arguments in favour of liberalising foreign investment.

The Economic Case Against Capital Xenophobia

This section presents both macroeconomic and microeconomic arguments in favour of foreign investment. Before elaborating these arguments, consider the following preliminaries that facilitate understanding of the issues.

3. International empirical evidence on the gains from foreign investment flows is provided by Carkovic and Levine (2005) and Chandra (2005) and Haveman, Lei and Netz (2001).

⁴ See Baldwin(2004) for related discussion.

According to national accounting conventions foreign capital inflow is linked to domestic saving and investment as shown below.

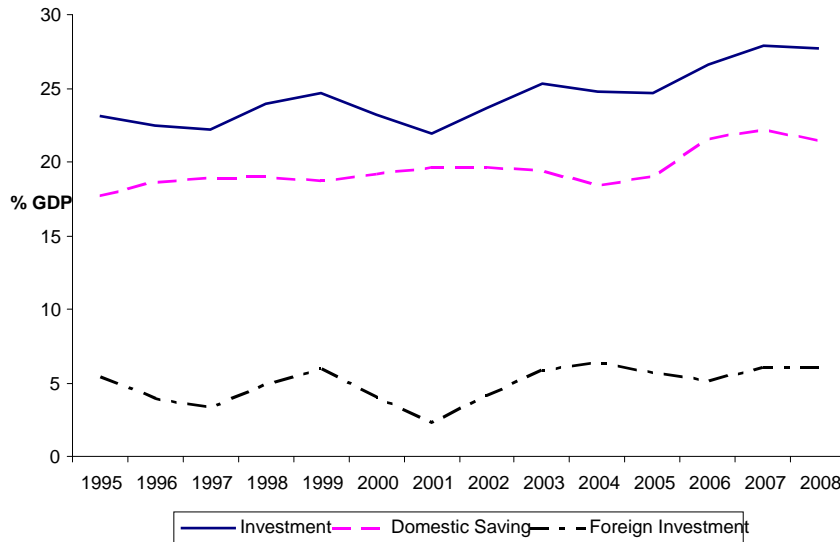
Household Saving	Gross National Saving	Gross Investment
Corporate Saving		
Public Saving		
	Direct Foreign Investment	
	Indirect Foreign Investment	

Figure 2 - Domestic Saving, Investment and Foreign Investment

Figure 2 shows that according to national accounting conventions an economy's use of foreign saving or net inward foreign investment, equals its investment- saving gap. Hence, increases in the domestic real capital stock are partly financed by domestic saving and partly by foreign investment, broadly defined.

By investing excess saving through equity participation, loans to resident firms and purchases of real assets from residents, foreigners finance that much more domestic investment. Moreover, the pool of funds available for investment is also supplemented when real domestic assets like property are bought by foreigners.

In other words, net capital inflow that matches the current account deficit enables Australia to accumulate more real capital. Another way of thinking about the significance of foreign investment is that it measures the volume of consumption spending that Australia would have to forego as a nation in order to lift domestic saving to the level required to fund our investment needs. The extent to which a steadily increasing share of foreign investment combined with domestic saving to fund domestic investment in Australia over recent decades is illustrated in Figure 3.



Based on data from International Monetary Fund, *International Financial Statistics*, various.

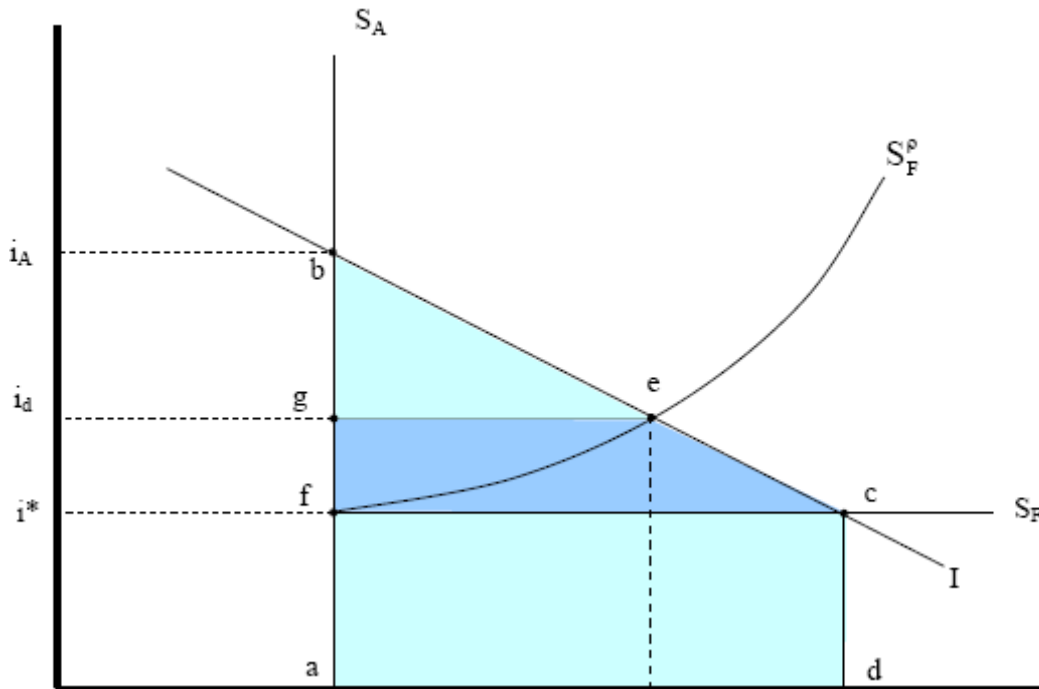
Figure 3 - Domestic Saving, Investment and Foreign Investment, Australia, 1995-2008.

Foreign capital has on average funded around one-fifth of total gross domestic investment in Australia over this period which is high by OECD standards. However, this foreign capital inflow has overwhelmingly been in the form of foreign borrowing, with the small share of net foreign direct investment, presently under one per cent of GDP, actually declining over this time.

Macroeconomic Arguments

The following simple model allows us to draw the macroeconomic implications of foreign investment.⁵ If foreign investment, broadly defined, was prohibited completely, total investment spending has to be funded from domestic saving, the residual between national output and private and public consumption. Let the demand for capital funds as a function of the real interest rate be depicted by the schedule I in Figure 4.

⁵ This sub-section draws on Makin and Robson (2006).



Foreign Investment and Domestic Saving and Investment

Figure 4 – Macroeconomic Gains from Foreign Investment

In a closed economy the market for funds would clear at the equilibrium real interest rate, i_A given a fixed supply (S_A). In contrast, with open capital markets, a small economy's investment requirements over and above available domestic saving can be satisfied by foreign investors providing funds at the given international cost of capital (or world interest rate), i^* .

Domestic investment therefore exceeds domestic saving at i^* to the extent of foreign capital inflow. This *ex ante* foreign inflow is shown by distance fc in Figure 4. Hence, if capital inflow is initially nil, it reaches level fc by period end. As the real world interest rate is lower than the real autarky interest rate, investment under autarky is always lower than when international investment is permitted.

Figure 4 also reveals how foreign investment raises national income. The marginal product of capital determines the slope of the investment demand schedule, so that given i^* , the extra units of foreign financed capital, times their marginal product, add to *GDP* to the extent of the area $abcd$.

However, of that, the rectangular area $afcd$ is paid to foreign lenders, leaving a *net* national income gain equivalent to the triangular area abc . International investment therefore enables lower domestic interest rates and higher national income, provided the productivity of the extra foreign-financed capital exceeds its cost. This approach is consistent with McDougall's (1960) two region neo-classical foreign investment

model.⁶ However, the difference is that here we focus on saving and investment flows and assume the economy is small.

If foreign lenders perceive high foreign liabilities, especially debt, as a sign of heightened country risk and diminished creditworthiness, they may demand an interest premium (ρ), to compensate. This explains the foreign lending schedule rising from the world interest rate, i^* in the Figure . The more averse foreign investors are to rising foreign debt, the steeper the slope of the S_F^{ρ} schedule and the higher the risk premium. At some point, foreigners could judge the level of lending risk prohibitive, equivalent to the foreign lending schedule becoming vertical.

In the presence of a risk premium, the foreign investment schedule is no longer flat. The risk premium is the difference between the interest rate foreign lenders demand under imperfect capital mobility and the interest rate i^* under perfect capital mobility. Hence, $i_d = i^* + \rho$ where i_d is the equilibrium domestic interest rate and ρ is measured by the distance gf in Figure 4. Foreign investment-related risk therefore limits potential national income gains. In the Figure 4, the welfare loss is area $fgec$ but foreign borrowing still confers a net welfare gain of gbe .

In sum, at the macroeconomic level, total foreign investment in all forms is reflected in the capital account surpluses which match the regular current account deficits of a host foreign investment nation. What is generally not appreciated is that the more foreign investment an economy attracts, the higher its current account deficit and foreign liabilities are likely to be.

Microeconomic Arguments

At the disaggregated level, foreign investment can take many forms as shown in Figure 5. Of these types direct foreign investment involving the establishment of new subsidiaries of foreign multinationals or the takeover of domestic firms by foreign interests generate most controversy.

⁶ See also Grubel (1987) and Ruffin (1984).

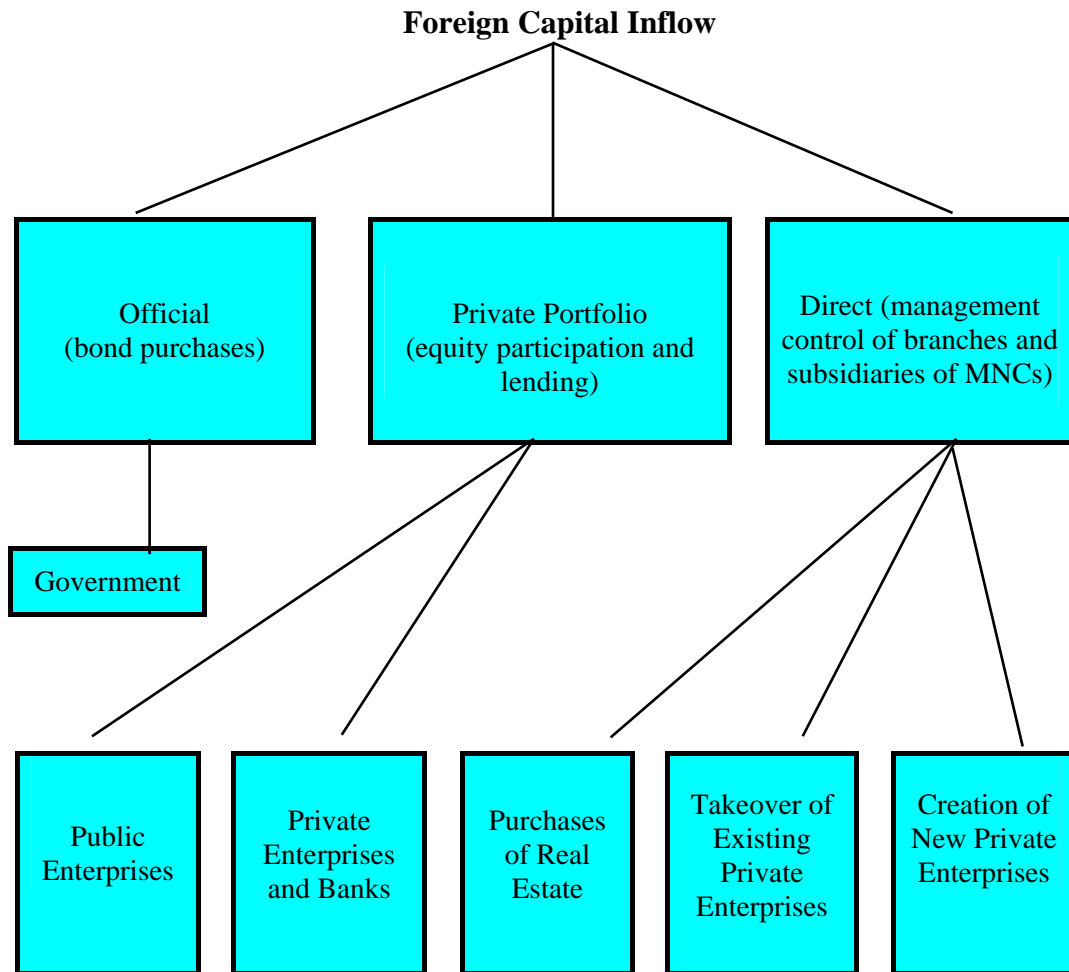


Figure 5 - Forms of Foreign Investment

The economic impact of direct foreign investment and multinationals (MNCs) is best considered at the enterprise or industry level. The reason that governments of all ideological persuasions are actively vying to attract ever greater shares of direct foreign investment is that multinational corporations can directly and indirectly generate productivity benefits through the transfer of technology and through product development.

Furthermore, domestic employees of foreign-owned firms are exposed to international management practices and the presence of new entrants in domestic markets stimulates imitative behaviour and acts as a spur to greater competition.

In turn, the higher labour productivity also allows domestic wages to be higher than would be possible with the smaller capital stock, resulting from reliance on domestic saving alone. The amount of additional economic activity in a range of domestic activities would not be as great and overall GDP growth would be lower without the benefit of foreign investment.

It is of course possible that foreign dominance of certain industries could result from foreign merger and acquisition activity which in turn could limit domestic competition in those industries. However, this then becomes a matter for the ACCC treating the foreign owned firm no differently from domestically owned firms. Similarly there could be problems with transfer pricing by multinational firms. But this too need not be an issue for foreign investment policy *per se*, but a matter for the Australian Tax Office.

A commonly expressed concern about private foreign investment in Australia relates to direct investment specifically to the loss of control of established domestic firms through foreign takeovers or the acquisition of real estate by non-residents. It is often said that whenever this happens on a large-scale we are either 'selling off the farm' or, for the more urban minded, 'selling off the family silver'.

Against these nationalistically inspired concerns however, there are always economic benefits which accrue to the residents who choose to dispose of their assets to foreigners. It is generally not appreciated by opponents of foreign investment that whenever domestic financial or real assets are purchased by non-residents, the quantum of funds available to residents for additional spending is supplemented as a result of the asset sales.

When foreigners buy existing Australian assets at higher prices than other residents buyers would be willing to pay, the Australian residents who sell such assets to foreigners make capital gains which they otherwise would not have made. The proceeds of the sale of assets may then be used to create new domestic assets, be spent on consumption, or ever be used to acquire new foreign assets.

Such economic gains suggest that, as a nation, we may be better off allowing foreigners greater freedom to purchase domestic assets, including all forms of real estate. Colloquially speaking, sales of domestic assets by residents to foreigners actually enable residents to upgrade the old set of silver or spend the proceeds acquiring something else entirely.

Estimates of National Income Gains

To the extent that, in aggregate, the productivity of the extra physical capital acquired through foreign capital inflow exceeds the servicing costs on that foreign investment, then national income can grow faster than otherwise. The total size of Australia's capital stock is now a large multiple of the value of its foreign liabilities and the extra production made possible in Australia from using foreign funds has indeed on average significantly exceeded interest and other investment income paid abroad.

Estimates of national income gains attributable to capital inflow confirm that the income gains have indeed been positive and significant. Based on an economic growth accounting method using national accounts data to compare the productivity of foreign capital with its cost, these estimates show that over the decade 1996-2006 extra real national income stemming from foreign-funded investment has been close to \$25 billion.

This translates to around \$2,500 extra income per worker per year, roughly equivalent to a \$50 a week tax cut. It is also equivalent to around \$1,100 per head of total

population. Moreover, the data clearly shows that the total size of the nation's capital stock is a large multiple of the value of its net foreign liabilities.⁷ The estimates may however understate the income gains as they do not include the extra productivity benefits that accompany the direct foreign investment component of capital inflow.

In the meantime, the high current account deficit remains the best measure of the extent to which foreigners are voting with their own money to express confidence in the Australian economy. It will persist as long as that confidence is warranted.

What Really is the 'National Interest'?

The idea that foreign investment in Australia needs to be officially monitored and occasionally blocked in the national interest originates from federal government policy initiated back in the 1970's - the height of economic nationalism in this country. It was then that the Foreign Investment Review Board (FIRB) was established which thankfully no longer operates as restrictively as it used to.

Restrictions which impede international exchange of assets and funds impose sometimes hidden costs. In Australia's case most of these costs stem from the existing regulations governing international investment, notably those involving takeovers of domestic firms.

Other legislative restrictions specifically governing foreign investment in banking and the media also exist and date from even earlier times. These restrictions deny resident shareholders of firms in proscribed sectors the opportunity to reap higher capital gains than otherwise and therefore limit national wealth.

From FIRB annual reports we do know that billions of dollars worth of foreign investment has been rejected outright by successive Treasurers over recent decades. Because additional investment was effectively prevented from taking place, Australia's existing stock of real capital is consequently smaller than it could have been. So too is its national income. This is contrary to the true national interest which requires setting economic policy in ways that maximise Australia's living standards and wealth.

Encouraging more not less foreign investment is really in the national interest to the extent it enables faster growth in the size of the nation's capital stock. This would create additional employment opportunities and via the technology transfer that comes with direct foreign investment improve the overall productivity of the workforce. The phrase 'national interest', though frequently invoked in this context, has never been properly defined and is really devoid of any economic meaning. It only makes sense in the context of quarantining defence and national security related industries from foreign control.

It is difficult to think of other industries that warrant special protection from foreign investors, although there may be grounds for treating the banking sector a little differently for prudential and monetary control reasons. Quarantining other

⁷ See Makin (2006) for elaboration.

commercial sectors of the economy from foreign ownership, such as real estate and media, is arguably *against* the national interest.

Moreover, as argued above foreign investment improves the Australia's economic welfare to the extent that it frees the nation from the constraint of its own saving level. Without foreign capital inflow, the level of long-term interest rates would also be higher, as the economy would then be totally reliant on domestic sources of funds to finance its investment requirements. If we consider improving the nation's economic welfare as central to the national interest, then it follows that we should have a less restrictive foreign investment policy.

Sovereign Wealth Funds: A Cautionary Note

Heavily managed exchange rates and persistently large trade and current account surpluses have enabled East Asian central banks and Middle Eastern oil exporters to accumulate huge foreign exchange reserves that have reached multi-trillion dollar levels.

No longer simply invested in US and other government bonds that helped keep world interest rates low, these massive money holdings are now directed elsewhere, via sovereign wealth funds established by these countries to amass a wider portfolio of higher yielding assets worldwide. With inflexible exchange rates and controls over private capital outflows, the more these economies accumulate foreign reserves, the more this signifies their currencies are undervalued.

What we need to understand is that the ever-growing capacity of these economies to invest abroad, including in Australia, largely reflect their fixed exchange rate policies. Quite simply, if these economies allowed their currencies to find their own level in the absence of further capital account liberalisation, they would appreciate quickly and strongly. So in effect, accumulating foreign reserves and mushrooming sovereign wealth are indicative of congealed currency undervaluation.

This does not suggest that foreign investment by sovereign wealth funds in Australia should be discouraged, just that its lineage is quite different to capital inflow from more traditional sources such as the United States and United Kingdom.

If sovereign wealth fund investment raises domestic asset values and induces more domestic investment it should in principle be welcomed. But revalued exchange rates would not be as politically sensitive an issue and perhaps just as beneficial if that boosted Australia's exports to those countries undervaluing their currencies.

Conclusion

In general, foreign capital inflow in aggregate improves Australia's economic welfare to the extent that it frees the nation from the constraint of its own saving level. As the above theory suggests, without foreign capital inflow, the level of long-term interest rates would also be higher, as the economy would then be totally reliant on domestic sources of funds to finance its investment requirements.

Foreign direct investment in particular should also be welcome because it delivers productivity gains via technology transfer, international management practices and product development and can spur greater domestic competition and imitative behaviour by existing locally-owned firms.

The national economic interest is therefore best served by encouraging, not discouraging, foreign investment because in general, official restrictions which limit the purchase by foreigners of Australia-owned asset impose an overall cost on the economy to the extent that they needlessly deprive the economy of much needed capital for economic development.

The FIRB has now been operating without interruption for a long time. Since it was established, the world has globalised immensely and views about foreign investment and the international policy climate have changed markedly. It is timely to ask what the economic rather than political rationale of the FIRB is.

The *modus operandi* of the FIRB could in fact be completely changed, so that instead of deterring foreign investment as it now does, the FIRB could reinvest itself and play a new role as the primary public sector advocate of foreign investment. The existing anomaly between Australia's policy towards international trade in goods and services and its policy towards international trade in assets – supporting one but not the other is likely to become more internationally apparent in the near future.

Whereas foreign capital was once generally discouraged in many advanced and emerging economies via extensive economic nationalist controls it is now generally welcome around the world. The OECD has long been advocating freer capital movements through the Code of Liberalisation of Capital Movements, first draped in the early 1960s and a new OECD agreement on global capital flows proposes that foreign investment be treated no differently to domestic investment.

Not only does Australia's foreign investment policy inadequately recognise the benefits of freer capital movements, it is also inconsistent with the 1994 APEC Bogor declaration which advocated "free and open investment in the region" on the same principle as contained in the OECD code that foreign and local investors face equal treatment.

The point often missed by those suspicious of foreign capital and which is unrecognized by present foreign investment guidelines is that foreign investment creates extra economic activity and raises national income and wealth. Hence it would be in the national interest to re-examine the role of the FIRB, and substantially further liberalise foreign investment policy by dispensing with the bulk of existing regulations prohibiting foreign acquisition of Australian owned firms and assets. Less

restrictive foreign investment policy would then maximize national income and wealth.

This is ultimately what lies in the national interest. Foreign investment flows can be interpreted as a measure of how much money foreigners are willing to invest in the economy's future. Hence, foreign investment in its many forms should, as a rule, not be feared but feted.

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