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How much trade and FDI theories help in analyzing competitiveness-related issues?

Introduction

Ever since the famous quibble of Paul Krugman [1997] competitiveness is seen as a „dangerous obsession". As is so often the case, an intellectually valid statement, torn out of its original context, leads a life of its own and results in interpretations completely out of line with its original meaning. The latter, in Krugman's case, has been an insight that international trade is by no means a zero sum game, thus the gain by one country does not necessarily equals the loss by another.

While at the level of economic theory this is nothing more and nothing less than a rehash of the original Ricardian theory of comparative advantage – one of the fundamental (and popularly least understood!) inventions of economics – at the level of policy-making the statement is anything but trivial. Krugman's exclamation was triggered by legitimate concerns about growing protectionism in the US at that time directed against the relocation of some labor-intensive industries to Mexico. A decade later it could have been leveled against outsourcing of services to India and other low-cost countries.

But is competitiveness indeed just a buzzword for ignorant politicians? At the level of economic theory nations do not exist, only localities, firms and the global interchange. Therefore, an existence of the national economy is an artefact at best, bringing about only distortions in the smooth process leading to general equilibrium, at least for the microeconomically founded modern macroeconomics. For that reason mainstream economic theory does not find a place for competitiveness on other than the firm level. And even on that level the usual concern is unit labor costs and an existence or non-existence of distortionary governmental practices, such as taxation, licensing, arbitrary customs' duties and other regulations and administrative decisions, rendering directly unproductive activities, such as rent-seeking, profitable [Bhagwati,1998].

1. Institutions Matter - But Which Ones and How?

This approach, though legitimate as a first approximation, as well as a way of ordering one's thoughts on the subject, is to an increasing extent a simplification, when confronted with present day realities and the experience of emerging markets. For one, locational competition has become a decisive paradigm [Siebert ,2006] in explaining changes in the pattern of production and trade. Locational competition, includes a much broader range of issues than unit labor costs, distorted/modified by wedges brought about by governmental regulatory and redistributive concerns and policies.

It involves an ever broader and more complex web of institutional arrangements, formal and informal alike. The quality of institutional infrastructure, the existence or lack of an honest, non-corruptible government, the provision of public services, as well as the level of trust – all count among the contemporary components of what the World Bank terms „good governance" [Wolfensohn and Bourgignon, 2004]. In that broader context it is no longer true that corporations compete and macropolicies matter only to the extent they create a non-distortionary environment for the general equilibrium to be attained via spontaneous adjustment processes of the market agents.

It has long been observed by representatives of the mainstream economic theory [see, *e.g.*, Lucas,1990] that real world processes do not mirror the once dominant Heckscher-Ohlin view of international trade, which explained international exchanges on the basis of factor endowments. Therefore, contrary to the expectations raised by the said theory, capital typically has not been flowing from rich to poor countries over the past several decades. Rather, both physical and financial capital flows tended to be concentrated in advanced market economies. The explanation, in view of Lucas, has been found in the policies of the poor countries, which tended to be hostile to foreign penetration, not only in terms of ownership, but also in terms of products and factors' flows.

This explanation was, indeed, quite relevant at the time, when import substitution, state-led industrialization and, more generally, economic nationalism dominated the global arena. With the collapse of the Soviet Union, as well as a gradual conversion of former protagonists of inward looking policies of various sorts to the new orthodoxy of outward orientation, this explanation has lost much of its weight. All the more so, since outward orientation has not been a unidimensional step, changing only the assessment and workings of the trade regime. Rather, it has been complemented by broader systemic policies that promoted across the board market-oriented reforms of various sorts in most if not all of the major economic sectors.

Since these polices have proven to be quite effective in a number of ways, including also poverty reduction, according to a broad survey of surveys by Winters *et al*. [2004], the appeal of various idiosyncratic, non-market strategies has been relegated to the margin of the economics' profession as well as of the mainstream policy-making everywhere (including most of the poor countries). The conspicuous advances of the first and second round of newly industrializing nations, with the latter including North Africa and Botswana in the post-1990 period, have supported this line of thinking in a decisive manner. Leaving aside the ever vocal anti-globalization movements, which are, *alas*, typical Western middle class protest phenomena, the new orthodoxy does enjoy sizable support among major policy-makers and international institutions.

Despite these impressive achievements, which might have changed not only the pattern of thinking, but also actual trends of trade and financial flows, a similar reorientation of the latter could not be observed. Despite opening up of capital markets in developing countries [Caprio, Honohan, and Stiglitz, Eds., 2002], capital flows continue to be concentrated in the advanced market economies. Likewise, despite the opening up by the poor countries and discontinuation of statist policies in most of these, FDI also continues to be focused on advanced economies. In other words, institutional quality, as well as the regulatory environment, still make a difference.

It is intriguing to observe that the new wave of capital market liberalization has not brought about the abolition of the so-called *home bias*. The phenomenon in question that has long been puzzling the students of international finance. In short, capital investors, contrary to widely acceptable theoretical concepts, do not actually roam around the global marketplace. Instead a typical investor invests at home, with saving and investment anchored domestically in over 90% of cases [as empirically demonstrated in the famous paper of Horioka and Feldstein, 1980]. The foregoing means that growth continues to be determined by domestic factors such as savings, innovation and the efficiency of domestic capital market allocation, while other factors, including the role of international markets, remain subordinate.

While more recent research [see, Blanchard and Giavazzi, 2002] have presented much lower numbers, the basic insight is unlikely to change for a number of reasons. First, capital flows have been roughly balanced, as, for example, in the OECD area. Second, and more important, if capital flows are balanced, then they are not able to alter significantly the domestic saving/investment equation. Thus, long run economic growth is largely domestically determined. And, third, there are exceptions (such as USA and Japan), which prove the rule rather than undermine it.

Such reality suggests, *inter alia*, that the much discussed issue of tax competition can by no means be taken as decisive or important from a macroeconomic perspective. For whatever the difference in the tax levels, it cannot fundamentally change the flow of investments, which continue to be financed, in their lion's share, from domestic savings.

This might explain why the quality of domestic financial and legal system may be much more relevant, against competing considerations, than it is currently fashionable to appreciate. Financial intermediation tended to be de-emphasized during the dominance of Keynes-inspired macroeconomic polices, where the *per se* valid claim that savings and investments are accounting identities overshadowed the complexities between intended and unintended savings, as well as the importance and implications of the categories of savers. That is, whether it is households, the state, or the corporate sector that saves. Furthermore it matters, whether the foregoing identity holds *ex ante* or only *ex post*, given the existence of forced savings and other inefficient arrangements [see, Erdős, 2003]. Likewise the importance of contracts and enforcing mechanisms via court systems [Shleifer *et al*., 2003] have become increasingly important in understanding the process of development. These insights have fundamentally affected economic thinking.

In the traditional Samuelson type neoclassical growth accounting technological change accounted for about 25% of productivity (and thus overall) growth, while the rest have been attributed to other, usually unspecified, factors. By contrast, the seminal paper of Hibbs [2001] demonstrated that the inclusion of those factors that are usually watched by rating agencies, such as rule of law, enforcement of private property rights, freedom of contract, and inflation together explain almost 80% of growth performance of countries in a neoclassical growth function in the long run. Likewise, Heitger [2004] has proven, using regression analysis, the dominant role of private property rights in explaining the historical performance of countries over the long run.

2. Theories of Competitiveness and Their Implications

The idea of competitiveness is not, therefore, derived from, or is congruous with, the dominant mainstream theories. Rather, as an exhaustive survey of Török, Borsi, and Telcs [2006, pp. 14-15] rightly emphasizes, the idea originates from, and reflects the concerns of, management sciences, where the microeconomic approach is by and large given. It is hardly by chance that the founding father of competitiveness idea, Michael Porter [1990], re-baptized the traditional comparative advantage into *competitive advantage* – a concept later developed in several influential publications of global business management. Accordingly, they have fundamentally shaped public perceptions, way beyond the business community.

Political actors and the median voter do care nowadays, and increasingly so, about the relative position of his country with regard to the level of well-being, not only about its absolute advance over preceding periods. They may fear of their countries lagging behind others. For such may be consequences of ever more previously poor countries joining the global economic interactions. They may be afraid of the demise of the nation state, as well as the loss of the once attained social rights and public provision of welfare.

Even leaving aside the fears and hopes related to globalization, the content of the competitiveness' concept has undergone a basic change. First, comparative advantage, originally a cost-based supply-side measure, has become much broader by involving demand side, as well as other components: institutional variables and macroeconomic variables [Neary, 2003]. Second, research on competitiveness has moved away from traditional measures of specialization, revealed comparative advantage and export pattern analysis. Instead, quite in line with the endogenous growth theory, it has shifted its focus to research and development and to broad measures of the business environment, such as the role of education, law enforcement, the level of public services, or the quality of human capital. They even include such non-traditional issues such as the cooperative or class-struggle oriented approach of labor to industrial relations.

The more theoretical analysis have been broadened over and above the analysis of absolute and relative market shares, trade openness, the qualities of the trade regime, or the share of IT-intensive or, more generally, high-tech products in aggregate exports, the more the earlier described macro-approach tended to penetrate what used to be exclusively a micro-approach. The recent extensive survey of the literature by an authoritative Hungarian research group headed by Tamás Szentes [2005, pp. 231-362] includes such areas as trade policy, exchange rate policy, fiscal policy, social policy and even the role of NGOs and the civil society. In other words, all public activities aimed at - or invoked with reference to – market imperfections are included. And as a result dimensions of competitiveness extend to such fields as the role of multinational corporations in the economy, the type of activities relocated by the multinationals to the host country, the evolution of dynamic sectors in the economy as well as the ability of the host country to draw regularly and advantageously on external resources (financial, technological and organizational alike).

Altogether, a quite interesting development may be observed in economic theorizing. In line with observable trends, while macrotheories have for long been acquiring microfoundations, microtheories are increasingly seen through the lenses of macro-oriented theories. These interactions are interesting not only for economic theorists. They also enable policymakers, including those in emerging economies, to make better informed decisions than abstract trade theories or too much business-oriented (and, thus, management-based) FDI theories would have allowed them to do in earlier times.

Early trade theories tended to focus too much on factor endowments, an approach that clearly reflected the conditions of the XIX century, a colonial, period, but greatly misleading during the period of delocalization, dematerialization and generally the period, when value creation is increasingly detached from the process of manufacturing the physical inputs and simultaneously increasingly dependent on intellectual inputs.

The foregoing is the reason why R & D outlays and institutions have been given a new prominence in more recent considerations. Since economic growth theory no longer rests solely or predominantly on factor accumulation and related models [see, Easterly and Levine, 2001], so trade theories no longer concentrate on resource abundance. On the contrary! The experience with resource abundance during the post-1973 period have invariably pointed to grave dangers inherent in a resource abundant economy, especially, though by no means exclusively, at higher levels of economic development.

The first such experience was that of the Netherlands, where the exploration of rich natural gas fields has lead to structural ossification, as the government could afford to pay for the continued existence of activities and sectors, whose revenue earning capacity had already been seriously reduced by the changed relative world market prices. As long as the Dutch economy as a whole could afford and was ready to pay for the undifferentiated maintenance of existing jobs and their security, Holland has lagged in her structural adjustment and the corrective measures, when at last undertaken, have been much less decisive than required – and therefore less efficient. This has been called in the literature as the *Dutch Disease*.

It is interesting to note that the old debate of the Dutch Disease, i.e. whether and, if so, to what degree a resource abundance is a curse, has been recently revived in the debate over recent Russian economic growth. It is demonstrable [Mau, 2005] that Russian economic recovery from the 1998 crisis has been driven by such factors as currency devaluation and reliance on ever dearer primary exports.

These circumstances have triggered a wide-ranging debate if and for how long such growth path is sustainable. Side by side with the traditional doubters, a proposition has been voiced [Köves, 2005] that the theory of comparative advantage should caution against attempts „to save Russia from its oil wealth”. While a rebuke that point to the need to specialize along the lines of comparative advantage is well taken, the conclusion suggested that there is a need to worry about Russia’s lopsided export pattern.

Drawing lessons from the Dutch Disease, we may state the following. The policy, which delay the adjustment may, *i. a.*, bring about the structural ossification and increase the costs of adjustment in the future. Moreover, future adjustment will be unavoidable in any case. It will be imposed by markets and will be more costly.

Of course, unless the everlasting growth of prices for primary commodities *in toto* is being postulated - contrary to historical experience and economic theory in general.[1]

The latter considerations include such more than century-old insights as Engel’s Law, based on the different demand elasticities of final and intermediate products, or the secular decrease of the contribution of primary inputs to the aggregate wealth creation due to the nature of technological progress in the post-1973 period.

Perhaps and even greater distortion of economic development is what the political economy literature on developing countries has termed the “resource curse” [Ross, 1999]. The curse in question is worse than Dutch Disease. For in some developing countries Dutch Disease-like economic ossification has been complemented by the reliance on authoritarian methods of control (both in the economy and in the political system). The emergence of such distortions has already been tested on a number of empirical cases, especially on the Middle East oil monarchies, and increasingly also on Central Asian states.

The capital intensive and cooperation-poor nature of fuel extraction, that does not require the famous Hirschman’ian forward and backward linkages in terms of technology, market interactions and interfirm/intersectoral linkages in general is, furthermore, supportive of the authoritarian governance methods (in contrast with the Toyota-generated revolution, based on lean hierarchies and broad cooperation among teams and their committed members). On the contrary, the rents appropriated by the despots can in part be used to buy out most of the population and cement the dominance of oppressive regime. Thereby a vicious circle is created of lopsided specialization-authoritarian rule-rent seeking-low economic and social efficiency-low mobility-deepening corruption of society. The above sequence explains the otherwise puzzling fact that resource-poor countries of East Asia have been flourishing, while resource-rich countries of the Middle East have not. In the worst case scenario, theorized by Ross, the distributional conflict enhances the probability of civil war and complete state failure (as evidenced, *e.g.*, in Sierra Leone or Angola or Sudan).

[1] This is not to belittle the dangers inherent in the geological and organizational constraints on crude oil production, that is, according to informed scientific analysis [Bárdossy and Lelkes, 2005] likely to lead to peaking of oil production in 10-15 years. But other sources of energy remain, thus the relative price of all energy inputs, as different from gasoline, is unlikely to explode in direct proportion to the price of the latter.

The more we are aware of the dangers of resource-dependent development, the more we are likely to care about the pattern of exports. The latter is not necessarily to be measured by composite indices of various sorts, or evaluated on abstract considerations, but primarily by the observed ability of firms to earn sufficient amounts of foreign exchange, needed to cover the demands of modernization of consumption, production, and investment at the country level.

As empirical evidence has long been indicative of the superiority of export patterns dominated by high-tech engineering and other products, the improvement of export patterns in the foregoing direction remains relevant. But with the transition to the services economy, dominated by the tertiary sector, the share of services, especially financial services, is likely to increase. This also means that the process of localization – the counterpart of globalization – is likely to reverse the trend of ever greater openness of national economies in quantitative terms.

3. The Spatial Dimension

Economics, especially in its mainstream version, tended to crowd out such traditional factors of economic development as history and geography. They are absent, for example, in growth regressions. Likewise, in formal trade theory, nations or corporations are being modeled – and their gains and losses assessed – in an aggregate fashion. This is in sharp contrast to traditional political economy approaches, where redistributive concerns among sectors, social groups, and nations used to figure high on the agenda.

It is a common knowledge that the emergence of increasing returns, economies of scope, etc., have fundamentally changed the assumptions of traditional economics, in which diminishing returns were axiomatic. Also, the experience not only of developing, but also of developed capitalist economies has called attention to the importance of spatial concentration of economic activities and called for public policy intervention, remedying the consequences of these developments.

From these casual observation an entire strand of literature has emerged under the heading of *New Economic Geography* [Ottaviano and Puga, 1998]. That line of thinking has been quite influential in providing new insights and more plausible explanations of certain, often registered, developments that seem to have fallen outside the scope of explanations provided by the dominant trade theories. This line of thought has proven the relevance of the spatial factors, by pinpointing a number of cases, where location rather than other factors has been demonstrably responsible for most of the outcomes.

In those cases, where closeness to major growth poles is shown to matter, explanations of new economic geography sound anything but counterintuitive. For we tend to think in terms of importance of forward and backward linkages and of the physical and human infrastructure, stressed by more conventional economic theories of development.

However, the new economic geography literature has gone much further than that. For instance, the already quoted home bias phenomenon, diametrically opposed to the very idea of general equilibrium and CGE models, dominating trade analysis, has proven to be persistent rather than diminishing with the passage of time [Head-Major-Ries, 2000]. This runs counter to such widespread beliefs (beliefs rather than theories!) such as the global tax competition, the unbridled unleashing of forces of globalization, allegedly having taken unprecedented scales, or an assumption that trade openness grows in a secular manner, while the impact of localization is temporary. While the beliefs in question dominate a considerable part of international relations and political science literature, they do not take account the empirical evidence to the contrary.

Likewise growth is normally related to technological progress and innovation, which are in the final analysis domestic factors. Because of the limited and temporary role played by FDI, it is domestic savings, domestic financial intermediation, and domestic investment among the factors determining the long run rate of economic growth [Erdős, 2006/. As those factors can only indirectly be influenced by governmental policies (and with uncertain effects at that!), the long term growth potential of a national economy is not influenced by governmental policies.

Moreover, the international factors, such as foreign direct investment, allow only for a temporary increase in growth rate, as with the passage of time its contribution to technological progress is bound to diminish. Furthermore, the inward direct investment is gradually followed by outward direct investment, a process turning the capital balance close to zero already at medium level of development. While this is the standard reasoning, new economic geography has found a strong correlation between agglomeration effects and endogenous capital formation [Baldwin, 1999]. It is through the foregoing back door that the spatial dimension re-entered to formalized theoretical approaches.

An even more intriguing insight comes from the seminal paper of Krugman and Venables [1995]. The two leading authorities of the NEG strand of theorizing come back to one of the oldest issues in international trade, that is to the transport costs. They show the changing influence of transport costs for monopolistic markets, when globalization is also taking place. While under such circumstances high transport costs may lead to the spontaneous emergence of core-periphery relations, as postulated by the old dependency school, with the decrease of transport costs the situation may indeed be reversed. Less developed countries stand to gain more and more, while developed nations less from such interactions.

The morale of this – still unfolding – intellectual experiment is straightforward. As long as the IT revolution renders distance increasingly irrelevant for a large number of economic activities, thus making global sourcing and global market strategies a rule rather than an exception, the chances of less advanced nations of being able to profit from more involvement in international exchanges is likely to increase. This finding is basically supportive of earlier insights [*e.g.*, Balassa, 1993] on the advantages of outward orientation, broadly understood, *i.e.* encompassing not just the trade régime, but the entirety of an economic system evolving in a market-conforming manner.

New economic geography has brought about interesting insights in the analysis of transition economies as well. While the mainstream theories of transition tried to attribute the success or failure of individual countries to institutional or policy factors in its entirety, the spatial dimension has indicated some interesting modifications. For instance Slovakia`s economic performance, as measured by market shares, export patterns and dynamics, has already been remarkable in the Meciar period, that is in the years preceding the radical reformist policy of the Dzurinda governments. In explaining the outcomes Soós [2000] has proven the decisive importance of Slovakia’s location. Being situated quite close to the growth pole of central Europe, which is the Munich-Milan axis, the country has outperformed not only most of its competitors, but the levels suggested by theoretical models, under the usual *ceteris paribus* assumptions.

Finally, a mention should be made of the recent analytical ventures, stressing the continuing, secular importance of the geographic factor in shaping trade and even investment flows. This finding runs counter to the naive expectation based on introductory microeconomic insights that would expect financial liberalization and globalization to eliminate the impact of geography, while approaching the global general equilibrium. In reality, as the analysis of Guerlin [2006] has shown, geography remains relevant even after controlling for macroeconomic fundamentals. This is one explanation of the already noted empirical phenomenon, namely the dominant North-North FDI flow, while the North-South flow is much smaller. In his interpretation, geography can be taken as a proxy for information costs, a finding that is in line with the previously quoted Krugman and Venables insight.

4. Foreign Direct Investment: A Curse or Blessing?

It might be legitimate to recall that the role of FDI has always been seen in a broader context. As long as development economics tended to be a revolutionary sub-branch of economics, deliberately defying considerations of the mainstream [Walbroek, 1998, Szentes, 2002] its economic thinking tended to be largely reactive. That is reactive to the experiences of the colonial period, characterized by free trade, currency convertibility, and full capital mobility. The ensuing traditional developmental paradigm was, thus, inward looking, statist, hostile to FDI and capital account openness in general. In a way this has been a coherent, though by no means efficient, worldview that had laid the foundation of policies for most of the 1950-90 period.

It is hardly by chance that the gradual emergence of the new developmental paradigm, based on open markets and export orientation, less state activism in picking winners, and a more friendly attitude towards private property has triggered a change in the assessment of the role of foreign investors. The new paradigm has become friendly to foreign investment and appreciative of its multiple benefits, static and dynamic. In short, foreigners are able to introduce precisely those elements of the business environment that used to be missing under the conditions of seclusion (*i.e.* inward orientationn). Those include management skills, relational capital, know how, technology, market access, continuous upgrading of physical and human capital, as well as spillovers of various sorts to all those areas of the economy that relate, one way or another, to the external sector, often dominant in most of the poor countries.

Therefore, it is only at the intellectual margin that one can find views that continue to adopt an openly hostile and merely ideological approach towards foreign investment, consider the pro-FDI approach in terms of return of intellectual colonialism and a discourse aimed at restoring colonial dependencies [Biccum, 2005]. The critical mainstream has adopted a more sophisticated approach. There are still those who disagree with the emerging new development paradigm, emphasizing the focal and lasting role of FDI in the continuous upgrading of local economies and integrating these in global processes in the broadest possible sense.

They do accept that reliance on FDI is perhaps inevitable, at times even favorable to the host country. However, they emphasize the asymmetry in the mutual dependence and the unfavorable side-effects of too much integration. In their thinking, as in mainstream neoclassical economics, a regulatory failure is conducive to perverse, socially harmful outcomes of unregulated market processes. If you accept the foregoing, what remains contested is, however, the overall theoretical significance of those insights. It still remains unclear, how and on what grounds individual cases they refer to may lend themselves to sweeping (and highly critical) generalizations. Especially, when individual cases are always context-dependent.

One of the more powerful arguments, cautioning against too much FDI, is based on the Mexican experience, generalized in the theories of the *maquiladora* industries. These mean assembly line production plants, whose output is typically exported in its bulk, mostly to distant/foreign markets, thus leaving little room for domestic linkages of any sort. The traditional, inward-oriented criticism, as explained *inter alia*, in Broad and Cavannagh [1991], points to the fact that such type of development leaves little room for national industrial or structural policies, including ones that would aim at a better integration of domestic and export oriented sectors, or upgrading the domestic economy, along priorities set by a sovereign state.

A related thinking, with its renewed emphasis on production patterns, is observable as well. In line with the traditional structuralist approach, having dominated both old political economy and development economics, the unequal dependence within the production chains is being emphasized [Gereffi, 1997]. Once a locality is integrated as a subcontractor, its role in the value chain is likely to be cemented at a low rank. Commodity chains that emerge via global sourcing and marketing create new inequalities.

It would be wrong to deny the potential for such adverse developments. However it would be equally wrong to deny the major successes in terms of structural upgrading in two dozens of countries over the past thirty years. If the trend toward differentiation along Marxian intuition would indeed hold, with the poor becoming poorer while the rich richer, all due to the logic of market mechanism, catching up could have only been marginal and transitory. Yet this has not been the case [Crafts, 2004; Kelly, 2005]. Therefore, particularist claims should be meaningfully embedded in the thinking about the global economy.

It is interesting to note that in his newer analysis Gereffi *et al.* [2005] also point to the diversity of the forms of coordination and dependence observed in the workings of the MNCs. In their categorization various coordination sets exist. These are hierarchies of captive, relational, modular and market types, with linearly decreasing level of explicit coordination. While this insight, drawn from management sciences, may be pertinent to the developmental issues discussed here, it does not follow that those starting up from lower levels are bound to remain there.

Actually, both Hungarian and global experience is indicative of a process of gradual maturing of national economies. In short, while in low quality-low trust environments more centralized control forms and the inflow of expatriates, trusted by the hub/corporate center dominate, the situation may change with the passage of time and the evolution of the business environment. Even in relatively less developed institutional infrastructures, such as the Romanian one, tacit and local knowledge may be the key to success. Thus, the interest in finding highly qualified or intra-firm trained locals is the economically viable strategy.

Likewise, if the usual assumptions of economic theory hold, poorer countries are characterized by lower overall price levels. As productivity is mostly also lower, this does not necessarily mean a real cost advantage. However, when the first basic technology-intensive investments are made and human capital is trained above the minimum level, the incentive to increase local content across the board becomes dominant. Therefrom stems the crucial role of proper exchange rate policies, especially of real exchange rates; their importance received robust empirical substantiation in the recent literature [see, Xing and Wang, 2006].

One broad strand of the literature continues to be continuously agnostic about the developmental effects of FDI. Chowdury and Mavrotas [2006] emphasize the mutual relationship between growth and FDI, a finding that is similar to modern growth theory, which accepts that growth may require and thus cause investment, rather than the other way around, as had been postulated by the more traditional approaches [Blomström *et al*., 1996]. In terms of FDI, therefore, the co-evolution rather than the causation that would run from FDI to growth could be postulated.

Another basically agnostic analysis is, however, more positive in terms of policy implications. In their findings Hansen and Rand [2006] stress that if FDI causes growth, it does so via knowledge transfer and the adoption of new technologies. The latter may, then, contribute to the accumulation of endogenous growth factors.

The foregoing is in line with earlier views [Bruton, 1998] that rejected the strategy of import substitution precisely on the grounds of impediments the strategy created to knowledge transfer and local innovative forces alike. While the criticism of import substitution obviously follows from the statist nature of such industrialization, their criticism is more far reaching and in-depth than a mere rehash of the traditional criticism of Soviet style industrialization.

In the same vein, the knowledge and skills' component of FDI is being reconfirmed as bringing about the spillovers to the rest of the host economy. In their overview, Kar and Guha-Khasnobis [2006] find that trade liberalization and well targeted local policies to be the key. If trade liberalization allows for more FDI in the labor-intensive local industries, it may generate technology transfers, but only if local absorbtive capacity is being built up. In such case labor-biased FDI is likely to contribute to the decrease of the wage gap; thus, even from the social point of view outcomes are likely to improve.

It is important to note that new FDI theories, complementing previous insights, are typically in line with mainstream neoclassical and endogenous growth theory. Also, the new theories have become more receptive to institutional insights, appreciative of contextual factors, especially when the analysis is being conducted at a lower level of abstraction, with the aim of influencing those policy outcomes that fall normally outside the scope of mainstream analysis.

5. Some Policy Implications

The above survey – far from exhaustive – of more recent theorizing on trade and foreign investment is suggestive of the existence of some policy relevant insights as well. First and foremost, we do not see any major shift to the old developmental paradigm of statism and import substitution.

Second, those views that turn back to the once dominant Marxist, structuralist and other approaches, such as sectoral political economy (a modernized version of the structuralist approach, trying to explain economic development barriers on the base of sector-specific issues), and dependency theory, are a demonstrable minority, both in the intellectual and in the policy arena. While nationalism and the resultant autarchic and statist suggestions pop up occasionally in the policy discourse, they are marginal in the academia.

A third finding is that with the convergence of the more applied and more theoretical lines of analysis, the policy recommendations typically tend to converge along more standard propositions that Walbroek [1998] aptly termed the *one world consensus*. The idea that what is a sound policy for OECD countries should also hold for less developed nations is no longer seriously challenged after the fall from grace of development economics.

The source of received wisdom, as we demonstrated by the selection of references, is by no means the output of the international financial institutions, as it is oftentimes alleged in and assumed by a part of globalization and policy oriented literature. The advice of these institutions, as was demonstrated already at the onset of transition by Winiecki [1993] has usually been narrowly oriented and fragmentary. The *dictum* applies to both the theory and policy perspectives. In our survey we have rarely relied on the intellectual output of the IFIs. Additional references from these quarters, if needed, would, however, point to the fact that analysts employed by these institutions also swim with the broader intellectual tide, combining mainstream and neo-institutional insights, could well have been shown.

Fourth, also in line with the broader developmental literature, the role of FDI and an economic openness is being increasingly appreciated. It does not mean that any FDI in any amount, at any point of time, and in any form is good (and for any economy). Such extreme cases as those of Azerbaijan or Gabon, when in certain years inward FDI in extractive industries exceeded the nominal value of GDP are obviously to be seen as fallacies of overinvestment along the colonial pattern, creating little spillover to the national economy. But the fact that a beefsteak may be overdone does not imply that it also must be served overdone under all circumstances.

It is interesting to observe that the literature on the fastest growing economies, such as China and India, is basically positive on the growing role of FDI there [see, e.g., Kehal, H.S., (Ed.), 2005]. A large body of literature on the emerging economies in general and of the postcommunist experience in particular has shown the beneficial impacts of FDI [Csaba, 2005]. On the quantitative plane we do not find any single case where the sufficently high rate of export growth could have been secured without reliance on FDI in the strategic sectors.

Moreover, if not only economic growth, but also broader issues of development and modernization are considered, the foregoing opinions are even more pronounced. In line with the broader literature, technology transfer, skill development, competitive pressures, modernizing influence of networking, management know how, and many other themes promise the dominance of favorable effects of FDI.

The sixth finding is that some host countries may indeed need a more sophisticated policy than reliance on low unit labor costs and overgenerous tax rebates or tax holidays, as is customary in countries where policies are unreliable and, thus, the business environment is a high-risk one. By contrast, successful countries, such as Ireland or Belgium, do not compete on tax grounds. The more traditional „suspects", such as good physical and human infrastructure, the rule of law, observance of property rights and a low inflation/low budget deficit environment, seem to matter much more for the developmental success. Governments may try to reduce the risk level in the domestic business environment by attempting to improve the institutional and other characteristics, even if it runs contrary to short term policy or fiscal interest of current politics.

Seventh, and last, it is important to observe that the analysis of emerging economies [Keren and Ofer, 2002] has shown the importance of banks' privatization during this process. If banks are not privatized they are likely to become objects of rent seeking by industrial interests, as well as subjected to political corruption. In a way easily corruptible state banks contribute to the emergence of captive, inefficient states, which in turn prove unable to play their basic roles of being an impartial referee, enforcing the rules, rather than serving vested interest. If the latter happens to be the case, the underdevelopment follows, as the posthumous work of Mancur Olson [2000] repeatedly demonstrated.

6. Concluding Remarks

In spite of having surveyed a broad spectrum of theories, this paper has not aspired to be exhaustive. Yet it is reasonable to conclude that the concept of competitiveness remains without firm anchoring in any established school of economic theory, be that macro or micro. „Composite" theories are by no means equivalent substitutes. Still, the broad Schumpeterian view of development we employ underpins our analytical efforts.

In these concluding remarks it is legitimate to expect an answer to the question posed in the title of this paper. The answer presented here consists of three parts. The first is a suggestion that international trade and FDI theories – rather than debates about theories – offer analysts and policy-makers some insights into what o t to do. This may be less than a blueprint for reform, a cookbook to go by, or a master plan with a list of tasks to be solved in an optimal sequence. Still, thinking of the Ten Commandments, one may be tempted to appreciate simple rules, with clear, even if complex, implications for action (or refraining from action as the case may be).

Second, these theories *converge with broader macroeconomic theories*, including the economic development and economic policy literature. All the foregoing literature stresses the need for sound fundamentals as a precondition for addressing any specific issue of development. Fiscal sustainability, transparency, rule of law (also in taxation), eliminating the exchange rate risk (by joining currency unions) are the ways for emerging economies to progress in terms of freedom and welfare. If these get out of hand, specific policies aimed at enhancing competitiveness, such as granting tax holidays or keeping ULC low, may eventually backfire.

The third suggestion warns addicts of policy intrusions: *beware of micromanagement*! The more any government gets involved in a series of measures aimed at specifically bolstering various detailed aspects of competitiveness, such as granting targeted subsidies to specific forms of FDI, or, by contrast, attempting to squeeze foreigners for domestic populist/redistributive purposes, the higher is the likelihood of failure. The warning is rooted in the experience that administrative and analytical capabilities of any bureaucracy are limited, while the number of practical problems is infinite. If limited administrative capacities are wasted on special interest politics and micromanagement, the basic function of preserving macroeconomic stability is likely to remain unattended. Once public deficits, growing debt, weakening law enforcement, and the provision of high quality R+D and proper education are neglected, the government may cease to be a provider of public goods, and regresses into yet another – and often predatory – interest group.

Last, but not at all least, as our survey of New Economic Geography indicates, *distance still matters.* This applies to the distance from the technological frontier, as well as in its spatial dimension. In the former, the more backward a country is, at the starting point, the greater the potential for a temporary but accelerated catch-up (provided the institutions and policies are right). In the latter, being located close to growth centers is *per se* a plus, while being distant, small and landlocked, surrounded by crisis areas, is a minus. This feature may indeed overshadow other effects. Baldwin and Krugman [2004] talk about an agglomeration rent that allows for the core region to levy higher taxes and still not fear the massive outflow of capital (thus, tax harmonization is rarely observable in real world economies, also among OECD countries). It follows that actual long-term outcomes should not be fully ascribed to good or bad policies; limits to policy makers' actions should, therefore, clearly be acknowledged.

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