CHAPTER II

TRADE LIBERALIZATION AND INVESTMENT REGIME

A. The Beginning of Trade Liberalization

Throughout the flow of history, states have been interchanging between the periods of protectionism and trade liberalization (Cohn, 2008). On the period of the 1950s, 1960s, 1970s, protectionism[1] paradigm was dominating the international political economy. Many economists, thinkers, academician places their support on protectionist view. However, later on, there were several groups of academics that gave another argument regarding their approach toward the alternative regime. They argued about the significant impact which brought by a more open and outward-oriented economy. After conducting various research and significant empirical investigations, these group of academics found plenty evidence which suggests that states need to change their approach, from protectionist view and restrictive trade practices into freer trade practices and open their foreign trade sector to increase the quality of their economic performance. This view started to become popular since the 1980s (Edwards, 1993).

After World War I, to cope with the harsh economic conditions, states increased their tariffs. It resulted in the Great

[1] Protectionism is a theory or practice about how a state should shield domestic industries from foreign competition by taxing imports. It refers to the actions or policies of government that restrict international trade with purpose of protecting domestic businesses from foreign business. Read more: https://www.investopedia.com/terms/p/protectionism.asp#ixzz5DkZgcSZ4

Depression[2] which happened from 1929-1939. The rampant protectionist policies adopted by many countries include imposed tariffs, import quotas, and exchange controls to restrict spending on foreign goods. On the 1930s, which indicated by the severe eruption of protectionist trade policies. This phenomenon considered as the peak of protectionism, in which all countries were struggling to impose higher trade barriers (Eichengreen & Douglas, 2010). The effect is catastrophic, as, between the period 1929 and 1933, world trade declined from US$35 billion to US$12 billion (Cohn, 2008).

To prevent such devastating occurrences from happening again, the U.S and Britain held a bilateral discussion in 1943. The purpose is to arrange the groundwork for postwar trade negotiations. This discussion later resulted in the basis for multilateral negotiations and became the foundation for GATT (General Agreement on Tariffs and Trade) establishment in 1948 (Cohn, 2008).

The trade liberalization becomes famous after this. The GATT serves as the front door for a more open and outward economy. After facing the Great Depression, the governments around the world learn in a hard way about the risk of high tariffs. The establishment of GATT is to reduce those tariffs and other trade barriers. It exist up until now -although under the name of WTO (World Trade Organization)- as the postwar global trade regime.

[2] The Great Depression happened from 1929-1939, and considered as the worst economic downturn in industrialized world history. The rampant protectionist policies adopted by many countries, include imposed tariffs, import quotas, and exchange controls to restrict spending on foreign goods. Read more: https://www.history.com/topics/great-depression

B. GATT/WTO as the Global Trade Regime

GATT established and started to operate in 1948. The purpose is to provide the outline for international trade negotiations or simply put, serves as the guideline on how to conduct international trade well, corresponding to the set of rules that already decided beforehand. It attempts to regulate the world trade (Nello, 2005).

Post World War II, every country expressed their intention to create International Trade Organization (ITO). ITO Convention ever being held, but the difficulties in ratification made the plan unfortunately stopped. As a result, the establishment of GATT becomes ‘temporary' arrangement for it. Naturally, it became unofficial/informal international trade organization (Nello, 2005).

It is important to note that GATT serves as the guideline for world trade practices, that means GATT also limited trade activity to some extent. Although the contracting parties agreed to liberalize trade, GATT also advocated the importance of safeguards and exemptions to protect countries' social policies and balance of payments (Cohn, 2008).

Stephen Krasner (1983), in his book *International Regime*, defines a regime as :

> "...implicit or explicit principles, norms, rules and decision-making procedures around which actors’ expectations converge in a given area of international relations."

Following Krasner's definition about regime above, it can be said that GATT is a regime that regulate the international trade. As it is not only serves as the guideline for its contracting parties, but also because it provide the basis principles, norms, rules, and decision-making procedures for global trade. The following part will explain about the principles of the trade regime (Cohn, 2008) :

1. Trade Liberalization. It is the core of the trade regime principle. This principle talked about lowering tariffs and regulating non-tariff barriers. So basically, GATT consider tariff as permissible, but it will reduce the total amount of tariff.
2. Nondiscrimination. It called as "the fundamental cornerstone" of the global trade organization. It emphasizes on equal treatment for every contracting party. It has two dimensions :
    a. External dimension (most favored nation / MFN treatment)[3];
    b. Internal dimension (national treatment)[4].
3. Reciprocity. The idea for this principle is that if a state gain benefit from trade negotiations with another state, then that state need to return roughly equal benefit.
4. Safeguards and Contingent Trade Measures. The idea for this principle is that if a state gain benefits from trade negotiations with another state, then that state needs to return roughly equal benefit.
5. **Development.** This principle is already exist since GATT times, but the practices is not that visible until GATT is transformed into WTO. This principle

[3] Specified in Article 1 of the General Agreement. This principle ensures that countries can not discriminate between their trading partner. Grant someone special favor (such as a lower customs duty rate for one of their products) and you have to do the same for the other contracting parties. Read more: https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm

[4] Specified in Article 3 of the General Agreement. This principle ensures the equal treatment of imported and local goods. To put it simply, giving others the same procedure as one's nationals. Read more: https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm

ensures special assistance and trade reduction to developing countries.

WTO established in 1995, replacing GATT as a formal international trade organization as the result of Uruguay Round on 15 December 1993. Different from GATT which consists of contracting parties, WTO consists of member countries. It has a bureaucratic body, full and legal institutional status, also a permanent forum for discussion in the trade issues. The main reason on why GATT transformed into WTO, is due to the lack of constraining presence of the rules, and the weakness of GATT dispute-settlement procedure (Nello, 2005). To put it simply, WTO is an upgraded version of GATT. While previously GATT only deal with tariff and trade regarding goods, WTO includes more than that. It covers services, investment measures, and intellectual properties.

WTO is the only international organization that deals with trade matters. The goal is to help the business activity between the member countries. It also a forum for trade dispute settlement and the place where government from many countries can come together to discuss trade agreements. The list made in July 2016 shows that it consists of 164 member countries, including the European Union. The EU became WTO official member since 1 January 1995 (World Trade Organization, 2017).

C. The Growing Importance of Investment

Since the 1980s, Foreign Direct Investment (FDI) flows have increased significantly at a fast pace. Trade and investment relationships develop in a way that enables both to become much more integrated into a worldwide level. The development of technology and communication at a global level led to dramatic change in international trade. By this, for example, the amount of business that happens in the form of the transfer of goods at various stage of production so that products can be a result of another product from multiple states in the world (Held, 2000). For example, the design for Ford's Lyman car came from Germany, but the components used is the result of other states' production, like the gearing system from Korea, pump from the U.S, and engine from Australia (Shangquan, 2000).

FDI conceived as economic growth stimulator in many countries. It is because FDI can be the source of capital, and they have excellent aptitude in the usage of technology and insubstantial, such as organizational and management skills, they also have vast business networks. FDI can provide the incentive to competition, innovation, savings, capital formation, which indirectly can resulting in more job vacancy and economic growth (World Trade Organization, 1996). It is no wonder that investment become one of the leading agenda of every country and international organizations in which operating in the trade and development sector.

The new growing importance of FDI had to change the investment into something more independent. Previously, investment is a part of a production, one of the principal elements of the global economy, along with trade, finance, and labor. But political economists now examine FDI separately, as investment overseas has upsurged intensely over several decades. The presence of MNCs is crucial in this process (McGrew, 2005).

Although the swift global expansion of MNCs is a story of post World War II, the growth process of FDI ever faced an investment downturn after World War I because of after-war political and economic instability then. The Great Depression and World War II shortly happened due to that, and during that time there is a severe reduction in MNC activities. It was not until post World War II, MNC and FDI started to pick up their pace again, in their relentless growth (Cohn, 2008).

1. MNC as the Leading Actor of Economic Globalization

McGrew (2005), argued that according to the various interpretation of globalization by many academics in the political economy study, the globalization is widely recognized as the process of global economic integration in deeper and more complicated level. Globalization perceived as a multidimensional process, rather than single process. It is proved by how globalization not only influencing the political or economy aspect, but also cultural, military, social, etc. So that means globalization, by itself, is not necessarily the same as economic globalization, because few explanations about globalization can, or do, ignore the economic dimension.

The term globalization is often associated with concepts of liberalization, internationalization, Westernization, or modernization, however none of them able to adequately explain about the globalization, neither its distinguishing traits nor its quality. From this, we can understand globalization as a process rather than phenomena. Economic globalization not only can be identified as a process of a single, global economy, but also indicate an evolving transformation or qualitative shift in the organization that attempts to regulate the world economy. To put it simply, as the transborder economic activity starts to dissipate the line that separates the national economic units, the operation of world economy increasingly integrated into a single system. The proof is the formation of global markets in which production networks, or business competition, operate in correspond with the international trade organization such as WTO (McGrew, 2005).

The economic globalization is highly supported by the development of technology and communication. It reduced the cost for transportation and communication, and also increase the quality of product significantly, turning it into a driving force that intensifying the market competition. Trade liberalization becomes the current trend, and under the framework of GATT/WTO, many countries steadily cut down their tariff and non-tariff barriers, and have a more inclusive foreign trade policy. All of these considerably fuelled the development of trade and investment (Shangquan, 2000).

Multinational Corporations, (MNCs) assumed as the leading actor of economic globalization. The way they manage the existing product and resources with the purpose of profit maximization and their global expansion have reshaped the operation of world economies. The transborder economic activities by MNCs become a challenge for traditional international trade and investment theories. The independent business activity of MNCs is indirectly restructuring and readjust global industry. With the advancement of IT, the industry activity of many countries have been upgraded, and it gradually gave birth to a more competitive international market among enterprises, giving economic globalization a push forward (Shangquan, 2000).

According to United Nations Conference on Trade and Development (UNCTAD) (2017), the global FDI flows is bumpy as it can quickly lose its momentum and recover. In the World Investment

Report (WIR) 2017, UNCTAD noted that the global FDI flows ever decrease in 2016, contrary to its strong growth in 2015. FDI inflows decrease by two percents to US$1.75 trillion, as assumed by MNCs. Not only that, UNCTAD's new database on state-owned MNCs confirmed that about 1.500 state-owned MNCs (which mean 1,5 percent of all MNCs) own more than 86.000 foreign affiliates (nearly 10 percent of all foreign subsidiaries). The greenfield investments[5] accounting for 11 percent of the global total in 2016. It increases significantly since the 8 percent in 2010. The facility/headquarters are scattered around the world, with more than half located in developing economies, and almost third of it in EU. It also noted that China is the current largest home economy.

2. Introduction to Google, Inc.

The history of Google, Inc. started with two students from Stanford University, Larry Page, and Sergey Brin. In 1995, working together from their dorm rooms, both of them came up with the idea of search engine that used links as the tool to decide the significance of websites on the World Wide Web. With Google, a user can attain accurate information faster and more efficiently, as results produced by Google search engine is 'sorted' by how much it related to the thing user searched, and how is the reputation and

[5] Greenfield investment, is one of two different types of FDI, along with Brownfield investment. Greenfield investment happens when a parent company or government begins a new project by constructing new facilities abroad, outside the country where the parent company located. Read more: https://bit.ly/2HOMDkh

credibility of the information inside based on how many visitors open the said website (Google, n.d).

The public showed a favorable response toward Google search engine. It considered appealing not only to the academic community but also investors. In fact, over the next few years, it successfully got many investors from Silicon Valley[6]. Google, Inc. officially established on 4 September 1998. In following years, the company developed rapidly. It hired engineers, organized a sales team, and formulate an idea for innovation. The Google headquarters (known as Googleplex) also moved up from the single garage to its current headquarters in Mountain View, California. Nowadays, with more than 60.000 employees and operating in 50 different countries, Google is widely used by people all over the world. Their products, such as YouTube, Android, and Google Search also already becoming a part of majority's daily life (Google, n.d).

In "An Owner's Manual" for Google's Shareholders, which contains 2004 Founders' IPO[7] Letter, Larry Page and Sergey Brin stated, *"Google is not a conventional company. We do not intend to become one...We have also emphasized an atmosphere*

---

[6] It refers to a region in southern part of San Fransisco, California. A lot of computer companies and computer chip manufacturers reside there. In fact, the name 'Silicon' derives from the silicon material that used in computer chips. It is the technology center of the U.S. Current occupants of Silicon Valley, i.e., Apple, Alphabet, Cisco, HP, Intel, and Oracle. Read more: http://www.businessdictionary.com/definition/Silicon-Valley.html

[7] IPO (Initial Public Offering) is the term used when a private company presented their stock to the public for the first time. While it is more common for IPOs to announced by small, young companies who want to increase their capital, IPOs can also declare by larger privately owned companies, for public trade purpose. Google, Inc announced their IPO on 19 August 2004.
Read More: https://www.investopedia.com/terms/i/ipo.asp

of creativity and challenge, which has helped us provide unbiased, accurate, and free access to information for those who rely on us around the world." (Google, n.d).

The statement shows that Google, Inc is not your usual company, and it is right in the matter of how the shareholders hold a voice in the decision-making process. Google, Inc did not implement that rules. To create the atmosphere of creativity and innovation, the final decision taker will be the two founders. This policy was made to make sure the independence of the company itself is well-guarded. With this, the decision would not hinder by corporate interest of shareholders. They make it clear that Google, Inc is their company. Shareholders could buy into it, but they would not have a voice (Helft, 2014). Not only that, but the statement also underlining the vision of the company, which is to create free access to information for people around the world. Google, Inc strive to serve people by providing useful and accessible information that available for everyone, in the hope that the data can be used to improve the lives of people (Google, n.d).

It remains the same even after Google slimmed down under the parent company named Alphabet. Alphabet, Inc. formally established on 2 October 2015. Larry Page describes Alphabet as a group of companies. It include Google (include YouTube, Android, Google Maps, etc); Life Science (focused on medicine and health issues); Calico (concentrate on age-related disease); Fiber (a high speed internet company); Nest (home-based internet devices company); Google Ventures, Google Capital, and Google X (Alphabet's incubator, focused on fund, investment, and innovation) (Sanders, 2015).

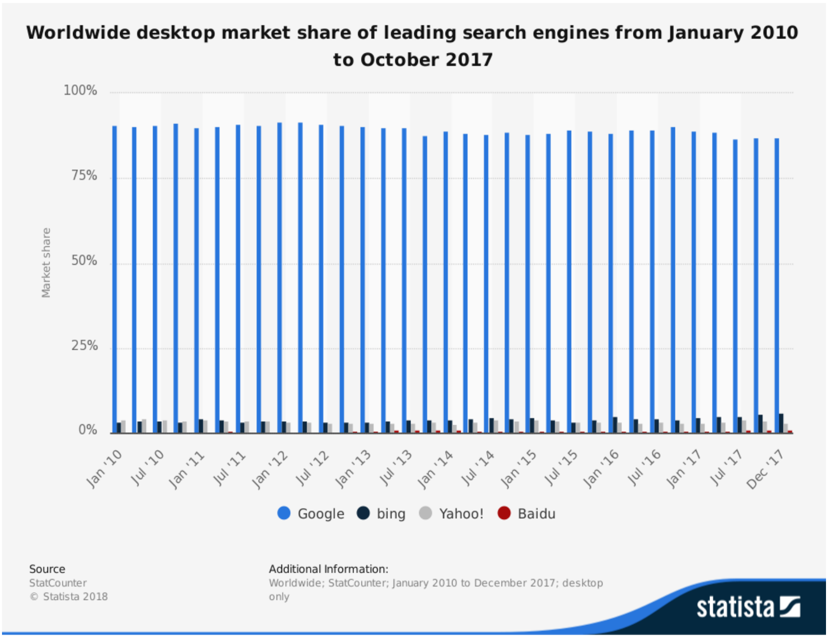
3. Worldwide Influence of Google/Alphabet, Inc.

It is already briefly mentioned in previous sub-bab that Google (it's internet-based product and search engine) is already part of our daily lives. Whenever we come across a question, no matter how complicated or simple it is, we immediately put out our phone and search for the answer on the internet rather than thinking about it first. It is like our phone, or the internet specifically, becomes our answering avatar and our memories' external hard drive. In the times before internet exists, there are several options in which you can use to answer series of questions, for example, asking other people for advice, or finding the answer through books. Whichever it is, it was undoubtedly will consume more time and of course, more complicated. But the answer for everything is straightforward in today's world: Google it (Thompson, 2016).

The latest study, from academics at the Universities of California and Illinois, found that the current society has developed a heavy reliance on the internet, and it is slowly altering the way we think and remember. It is so much easier to look it up online for the answer rather than have to think it first or search it in the book. In the end, people more likely to give up remembering certain things as we can find the answers online. The researchers called it "cognitive offloading." The internet slowly becomes our virtual brain, as they think and remember things for us. Benjamin Storm, the study's lead author, stated that it makes people have a hard time to remember something in long-term, and while we might recall something on our own, we choose not to bother (Thompson, 2016).

As Storm stated, while our brain still has the actual capability to think and remember things, we do not bother, as it is easier to surf the web for the answer. That is why every day, many people across the globe use the search engine to answer a different question in their lives. Look at the figure below.

Figure ٢.١ Worldwide desktop market share of leading search engines from January 2010 to October 2017



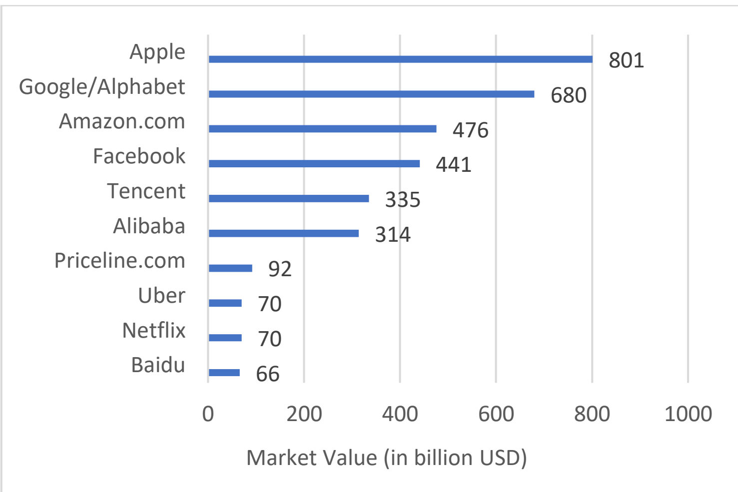
Source: StatCounter (2018)

The statistic indicates that among ‘the-most-commonly-used' search engines, Google shows the overwhelming presence in the term of market share.

Ever since its foundation in 1998, Google held a dominant position in the search engine market, maintaining an 87.1 percent market share in December 2017. It was far surpassing its competitors, with bing holding 5.82 percent, Yahoo! With 2.98 percent, and Baidu with 0.86 percent (StatCounter, 2018).

Beside of its use as a search engine, Google also expanded its company and has been producing many free internet-based products or services which handy to use, such as mail (Google Mail), productivity tools, enterprise products, mobile devices, etc. Because of this, Google received one of the highest tech company revenues in 2017, with approximately US$ 110 billion (StatCounter, 2018).

Figure ٢.٢ Market capitalization of the biggest internet companies worldwide as of May 2017



Source: Kleiner Perkins Caufield & Byers; Capital IQ (2017)

Since the end of 1990, few notable internet companies have flourished into internationally successful internet companies, such as few American companies, i.e., Google, Inc., Amazon (founded in 1994), eBay, Inc (founded in 1995), and the Chinese company Alibaba (founded in 1998). Holding the unbeatable first place of most substantial internet companies worldwide at present is Alphabet, the parent company of Google. The statistic shows the market value of the top internet companies across the globe as of May 2017. Google, Inc, as the leading power of search engine market, had a market value of US$ 680 billion, and currently is the number one search engine in the world. As of December 2016, it is the most visited multi-platform website in the U.S, with the total amount of visitors US$ 247 million in that month alone (Kleiner Perkins Caufield & Byers; Capital IQ, 2017).

The data speak for itself. The existence of the internet, or in this case, Google, is huge in helping people lives. Not only search engines, but Google also produced many kinds of free services and software that easy to use, even providing the accessible and wide range of information. If we look into how people perform their task every day, we can see many of them use Google's products. To watch video you can use YouTube; to find someplace that you have yet to know, you can use Google Maps; to communicate with friends, family, or co-worker, you can use Google Mail, Google Allo, or Google Duo; to help you with your works you can use Google Docs, Sheets, Slides, and Drives; and it is almost unavoidable to see Android phones, or Chromebook in our daily lives among people around us. So, it is easy to found Google's traces in small things we do, and we accept it as a given thing.

It is almost interesting on how the users turn from consumers of Google product's, into their commodities that makes the company flourishing more every day.

D. The Needs for International Investment Regime

A study by Global Justice Now, discovered that by 2015, the corporations have the dominant position among the top 100 economic powers in the world. It is recorded that 69 seats out of the 100 placed by big companies from all over the world, such as Walmart, Royal Dutch Shell, Exxon Mobil, Volkswagen, Toyota Motor, Apple, etc. (Green, 2016). It verified the increasing power of the corporation in the global economy.

Following the fact above, MNC's business activity starts to dominate the world is not an understatement anymore. The effort to liberalize trade and investment has given the MNC more opportunity to expand more. Like already explained before, the function of global trade regime is to reduce the tariff and non-tariff barriers, enable a country to conduct trade negotiation and practices with their partner in freer and more organized manner. Consistent with the interpretation of economic globalization by McGrew (2005), it perceived as a process of a single, global economy. By this, it means that the actors of economic activities across the globe are no longer move in units anymore but instead move collectively under the same trade regime. Therefore, it is safe to assume that the principles, rules, and regulation implemented by the WTO is hugely influencing the trade policies of many countries, and consequently the incentives for FDI as well. Like, for example in the case of the U.S imposed a Voluntary Export Restraint (VER)[8] to Japan.

This case is about how Japanese automobile manufacturers have to produce their product in the U.S in 1981, due to the imposition of VER, which limits the number of the product that can be exported by a country (World Trade Organization, 1996). The WTO did not vote against the imposition of VER because VER is unprohibited under the Anti-Dumping Agreement[9]. WTO agreement allows the act against dumping as long as there is actual damage to the competing domestic industry. The permission for implementing action against dumping is stated in GATT (Article 6) (World Trade Organization, 2017). The GATT (Article 6) is a part of global trade regime enforced by WTO, under the principle of "safeguards and contingent trade measures."

In the case of VER, Japan's automobile company built a manufacturing facility/factory in the U.S, so they did not have to export goods, but instead made them from the inside of the U.S itself. By the institutionalization theory by Mats Forsgren, MNC can ‘adapt' to its surrounding. Like in the VER case of Japan-U.S, Japan's company need to abide by the existing rules, agreement, or policy, but it does not mean MNC will not attempt another way to gain profit. The ability of MNC to ‘manipulate' the situation to blow in their direction showing the difficulty to govern this almost state-less actor.

---

[8] VERs is a self-imposed trade restriction and made by importing country to protect its domestic businesses. Japan imposed a VER on its automobile exports to the U.S, as the result of American pressure in the 1980s. Read more: https://www.investopedia.com/terms/v/voluntary_export_restraint.asp#ixzz50b5wa9FT

[9] This agreement allows a country to take measures against dumping. Dumping is an occurence when a company exporting products in lower price than the price charged in the home country. See : Cohn (2008), Global Political Economy : Theory and Practice Fourth Edition.

Bonnitcha, Poulsen, & Waibel (2017) argued that there are many discussion regarding trade, finance, production treaties and agreement, but the debate about investment treaties and cooperation did not begin until recent years. Most of the conventions only discussed by mid-level government officials, but it barely gains attention. Seeing on how investment act as the primary actor of the global economy recently it is rather strange that it the arbitration is almost unnoticeable. Unlike the international trade regime, which has a long history and close relation with political scientist and economist, the comprehension of investment treaty regime processed in a rather slow manner.

Most investment treaties are bilateral and mostly only deal with investment protection. Though, some of them involve more than two parties and issues, such as North American Free Trade Agreement (NAFTA). In latest years, the investment treaty regime started to move toward multi-issue and pluralism agreements. It enables two or more parties to address multiple issues at the same time. For example, there are many arrangements to take a comprehensive protection measure against investor. It discussed by several countries at once within Trans-Pacific Partnership (TPP), or Regional Comprehensive Economic Partnership (RCEP). There is also discussion of an investment treaty between two supranational actors like the U.S and EU within the negotiation of Transatlantic Trade and Investment Partnership (TTIP) (Bonnitcha, Poulsen, & Waibel, 2017).

Despite that, there are difference between treaty regime and international trade regime. Unlike international trade regime with WTO as its leading organization, the investment treaty did not have international organization who can monitor the activity of the member parties. It decided upon by the participants, and it depends heavily on the observation from another participant to ensure the correct implementation of agreed rule and regulation. So, in the case, if one of the countries violate the agreement, it is hard to put a penalty on it, as there are no reliable institution to enforce that. The absence of institution not only caused difficulty in dispute settlement but also makes it seem fragile and unstable. But even so, these facts did not conclude that the investment cannot be governed in the future. It is just with the situation right now, international investment regime may need some time before it can be formally established.