Unit 18

THE NATION AND THE WORLD ECONOMY

OUTLINE

A. Introduction
B. Measuring Globalization
C. Specialization and Trade
D. The role of policies and institutions

A. Introduction

The Context for This Unit

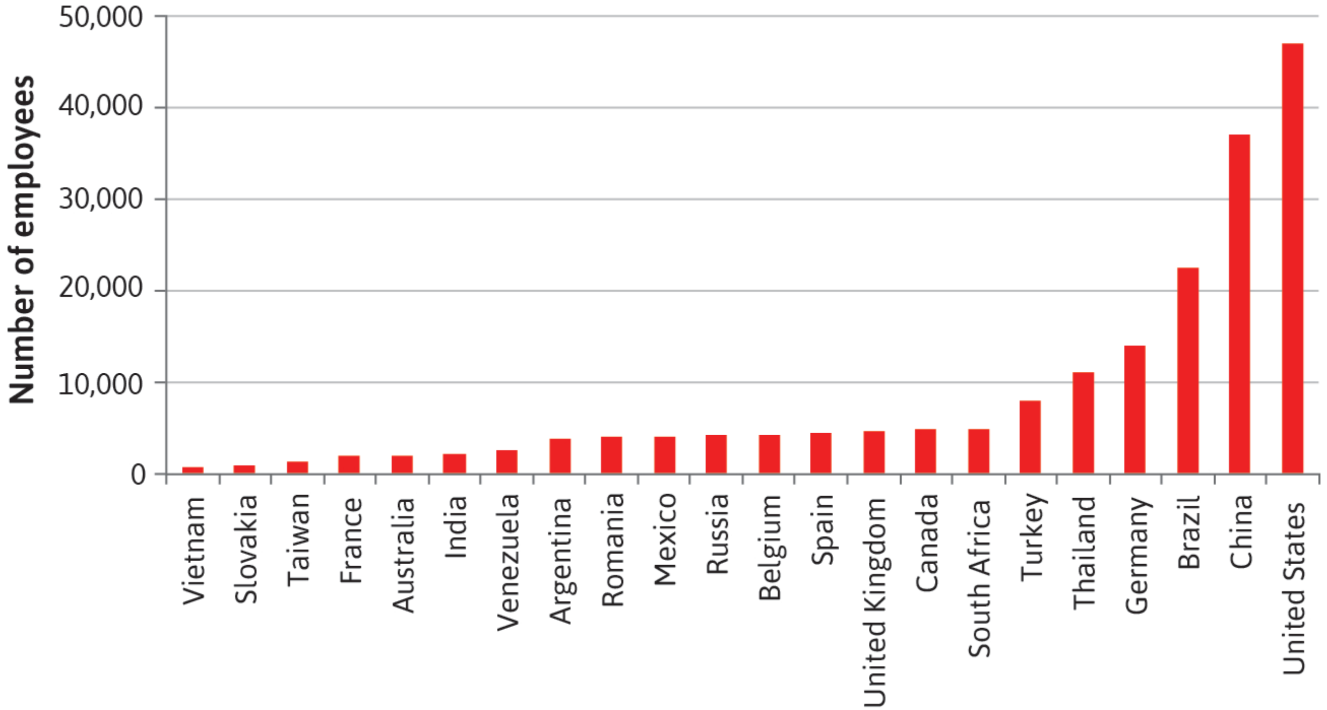
Exchange between parties can be mutually beneficial but conflicts arise over how these gains are distributed. (Units 5-9)

When goods/services, people, and financial assets can cross national boundaries, new factors are involved.

- How can governments influence trade?
- What affects the distribution of gains from trade?
- When can globalization be detrimental to growth?

This Unit

Globalization: A process by which the economies of the world become more integrated by the freer flow across national boundaries of goods, investment, finance, and labour.



Offshoring is an important aspect of globalization.

This Unit

Use models and concepts from previous units to explain the effects of globalization on:

- International markets for goods and services (trade)
- International capital markets (flows of savings and investment)
- International labour markets (migration)

B. Measuring Globalization

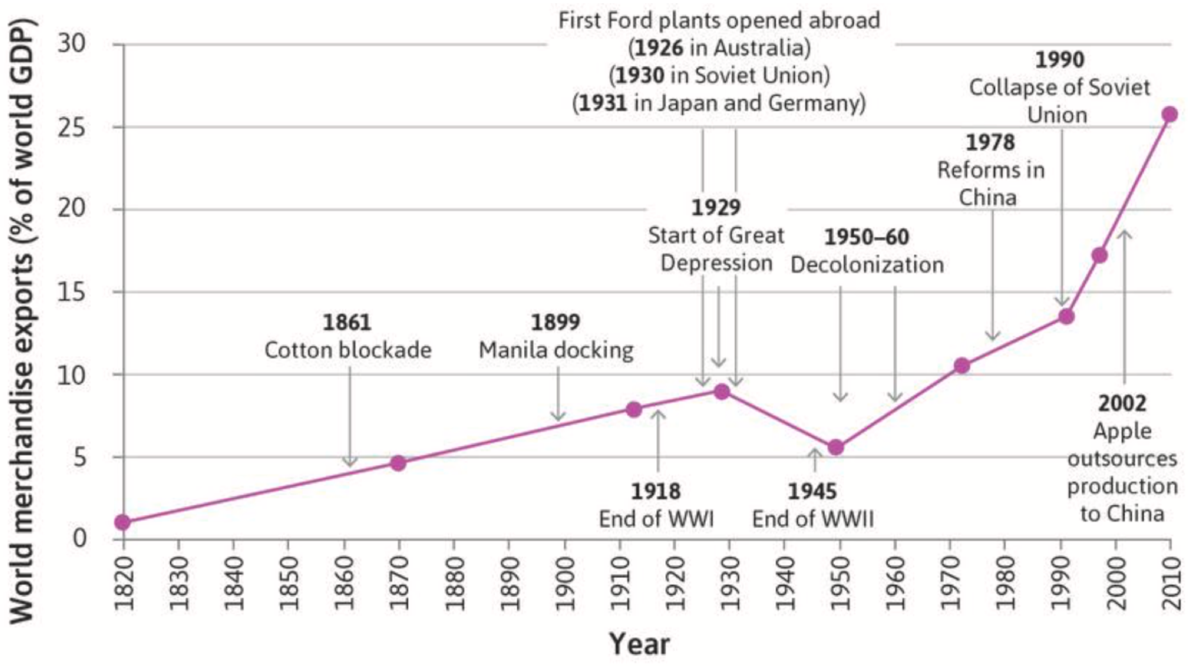
Integration of Goods Markets

Merchandise trade: Tangible products that are physically shipped across borders.

Common measures of globalization:

1. Imports/exports/total trade as a share of GDP

- Clear upward trend in amount of trade worldwide (except from 1914-1945), with sharp acceleration from 1990s onwards.



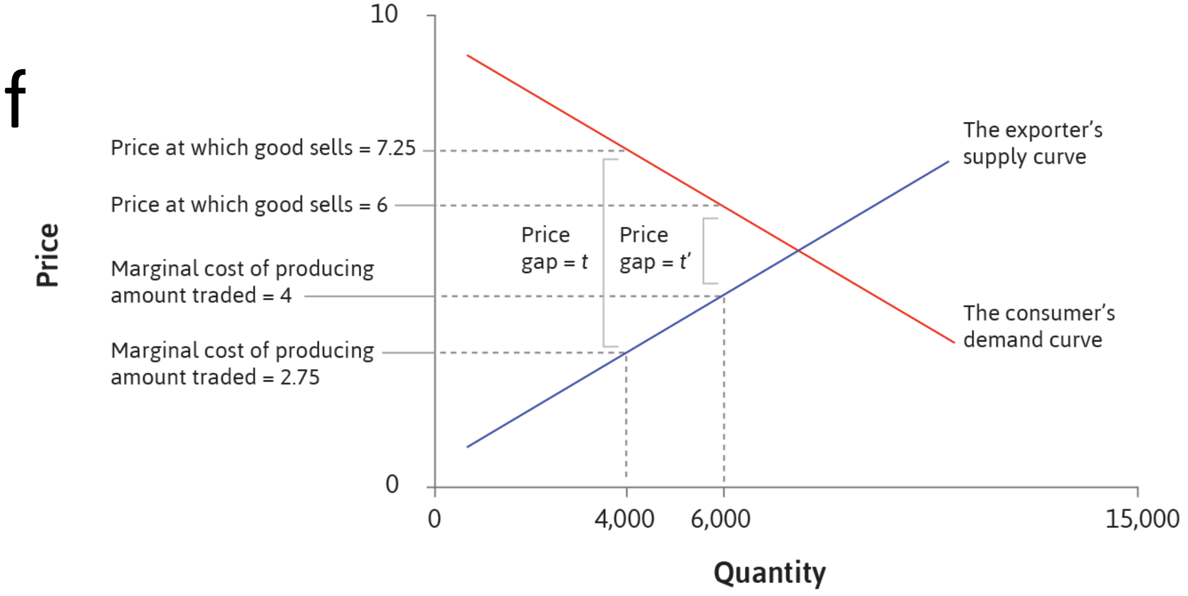
Integration of Goods Markets

2. Reduction in trade costs (price gaps) between countries

- **Law of One Price** should hold if there are no transport costs or barriers to trade.

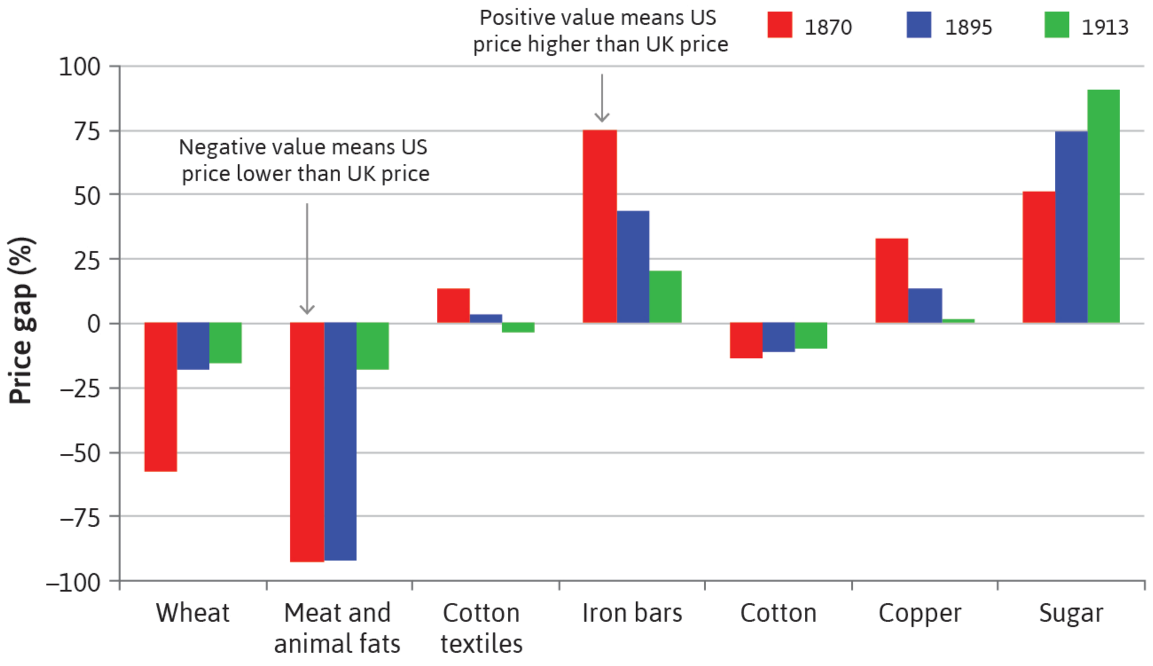
Price gap: Difference in the price of a good in the exporting and importing country.

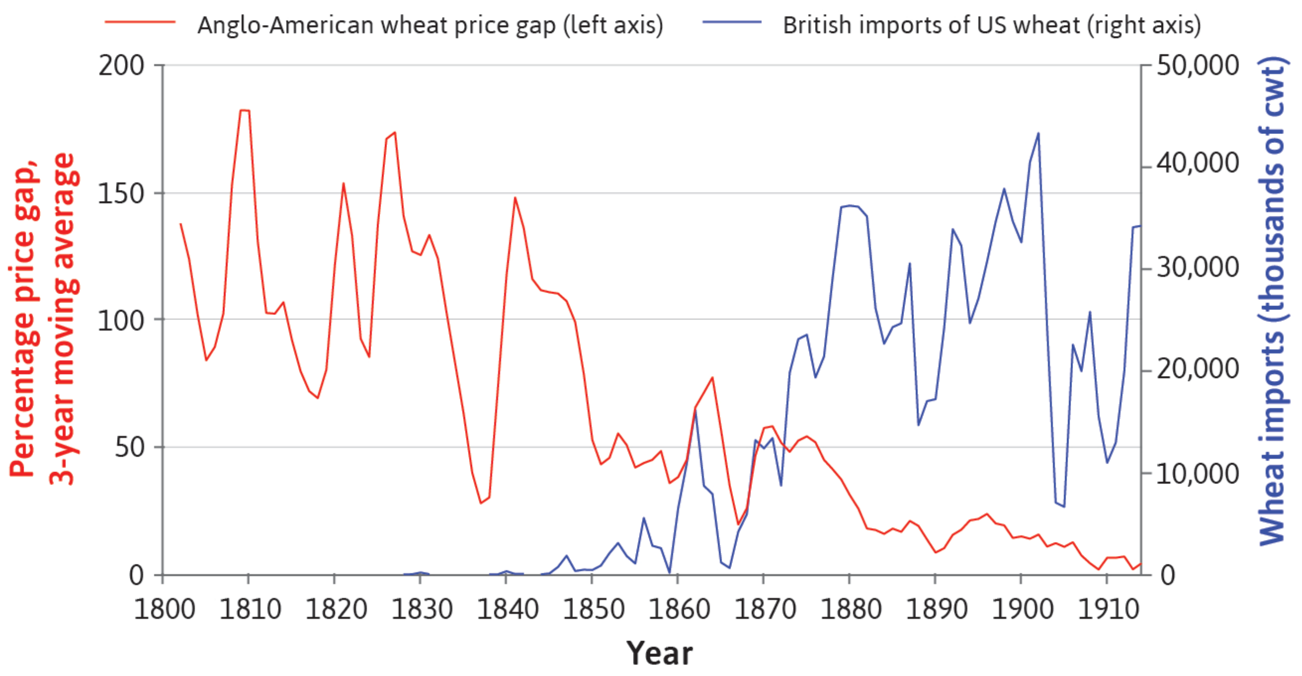
Due to **arbitrage**, in competitive equilibrium the price gap should equal the sum of all trade costs.



Evidence of globalization of goods

Price gaps between countries have generally declined over time, while the volume of goods traded has generally increased.





Trends in globalization of goods

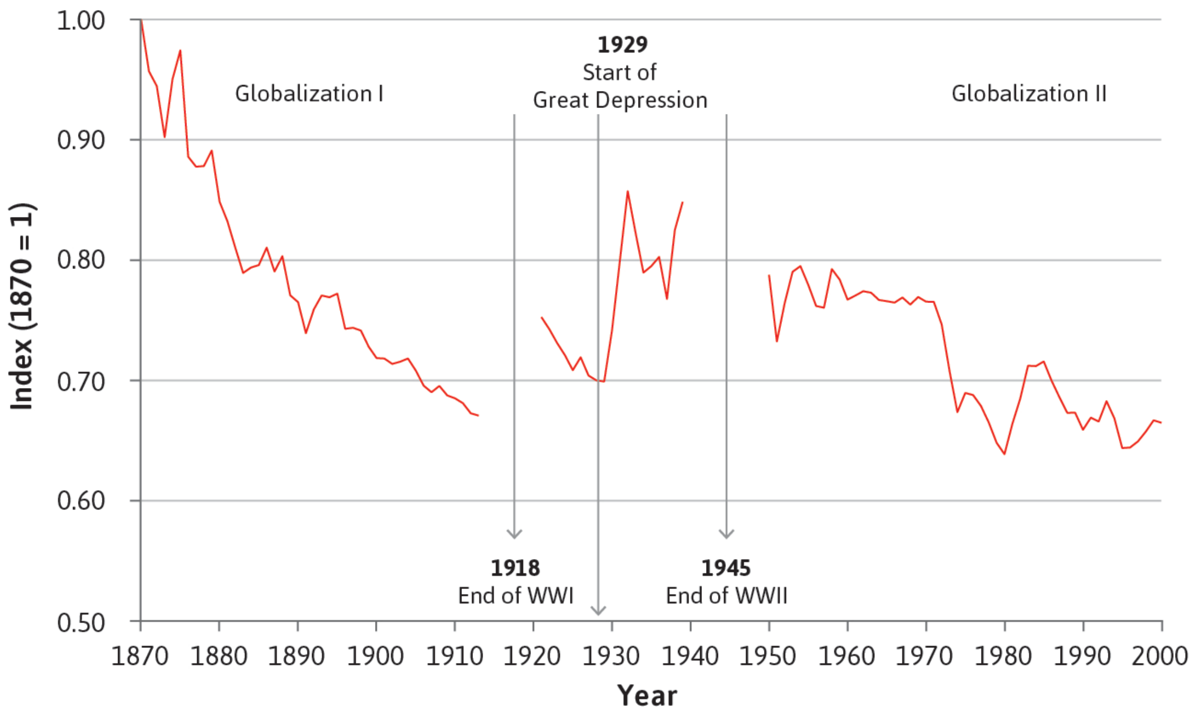
Two separate periods of increasing global economic integration:

Globalization I: before 1870 until 1914

Globalization II: the end of the Second World War until now

Deglobalization: increasing trade costs during the Depression.

Partly due to protectionist policies aimed at protecting domestic employment (**tariffs** and **quotas** on imports).



Integration of Capital Markets

Countries lend and borrow from each other to finance investment.

The **balance of payments** records the sources and uses of foreign exchange, which include:

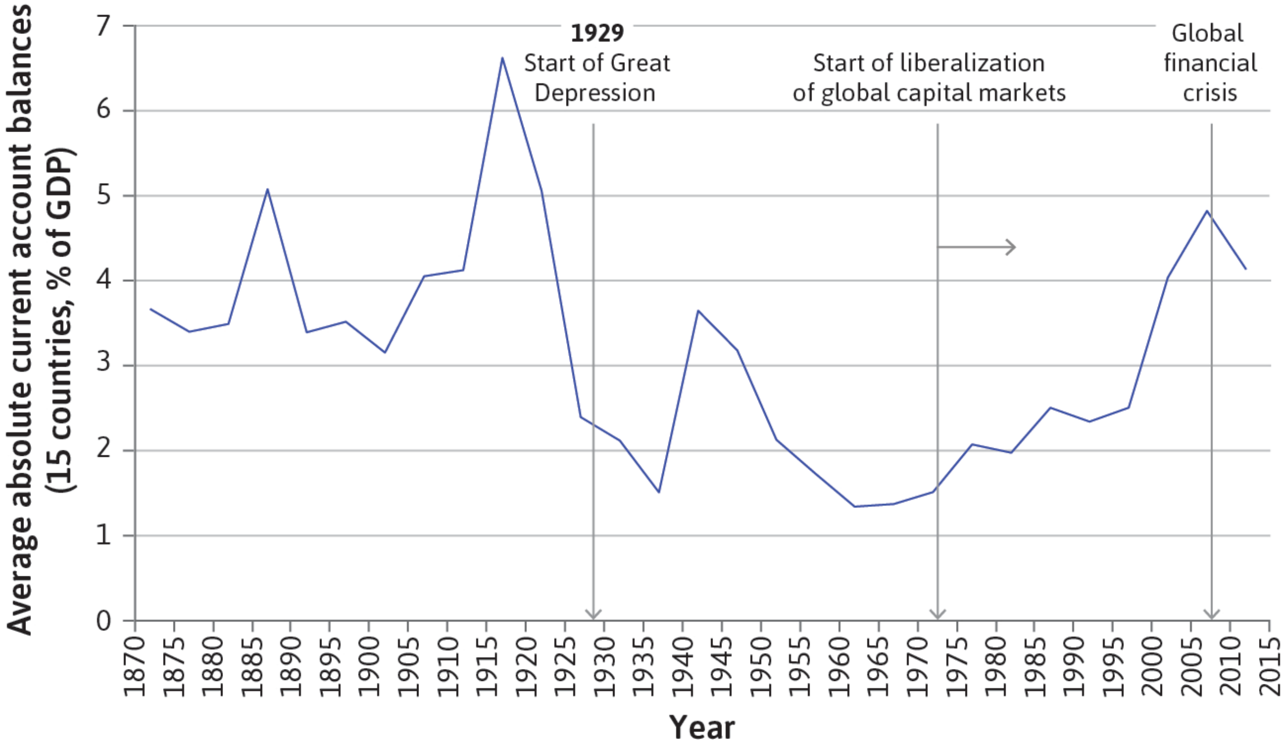
- **Portfolio investment**: buying foreign stocks/bonds
- **Foreign direct investment**: ownership of foreign physical assets

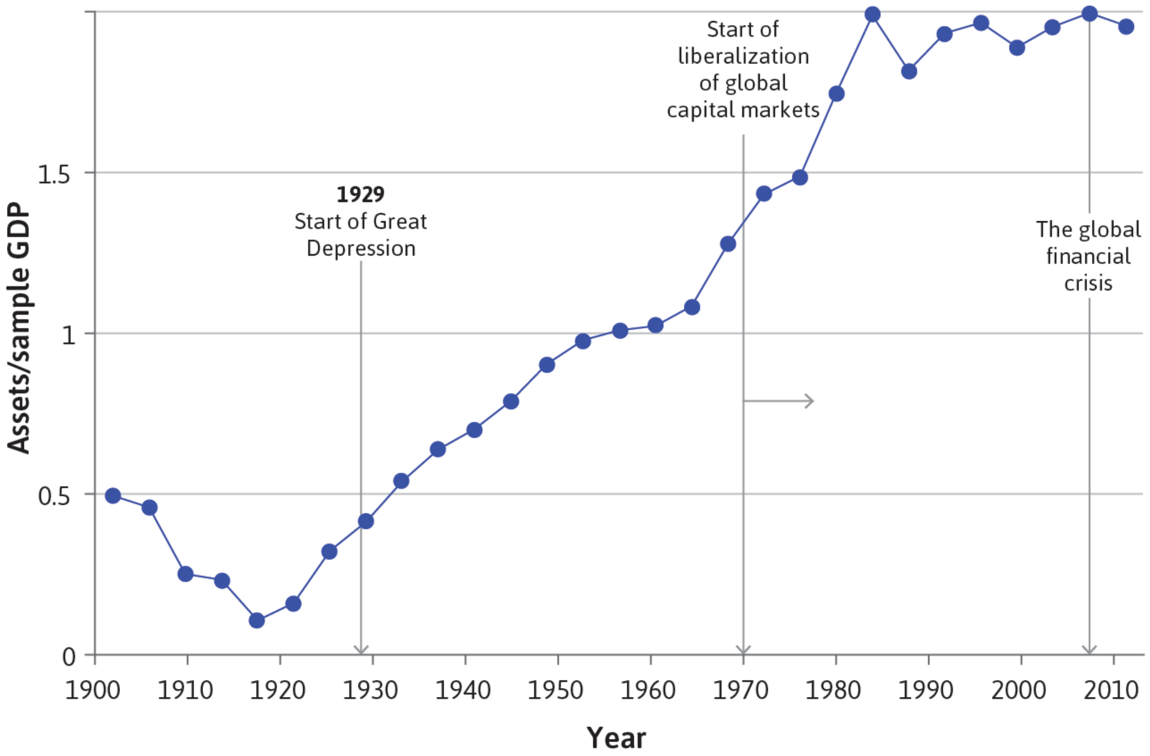
Current account (**CA**) = **exports** – **imports** + **net investment**

CA deficit: Country is borrowing (receiving **net capital flows**)

CA surplus: Country is lending (net capital outflow)

Trends in globalization of capital markets



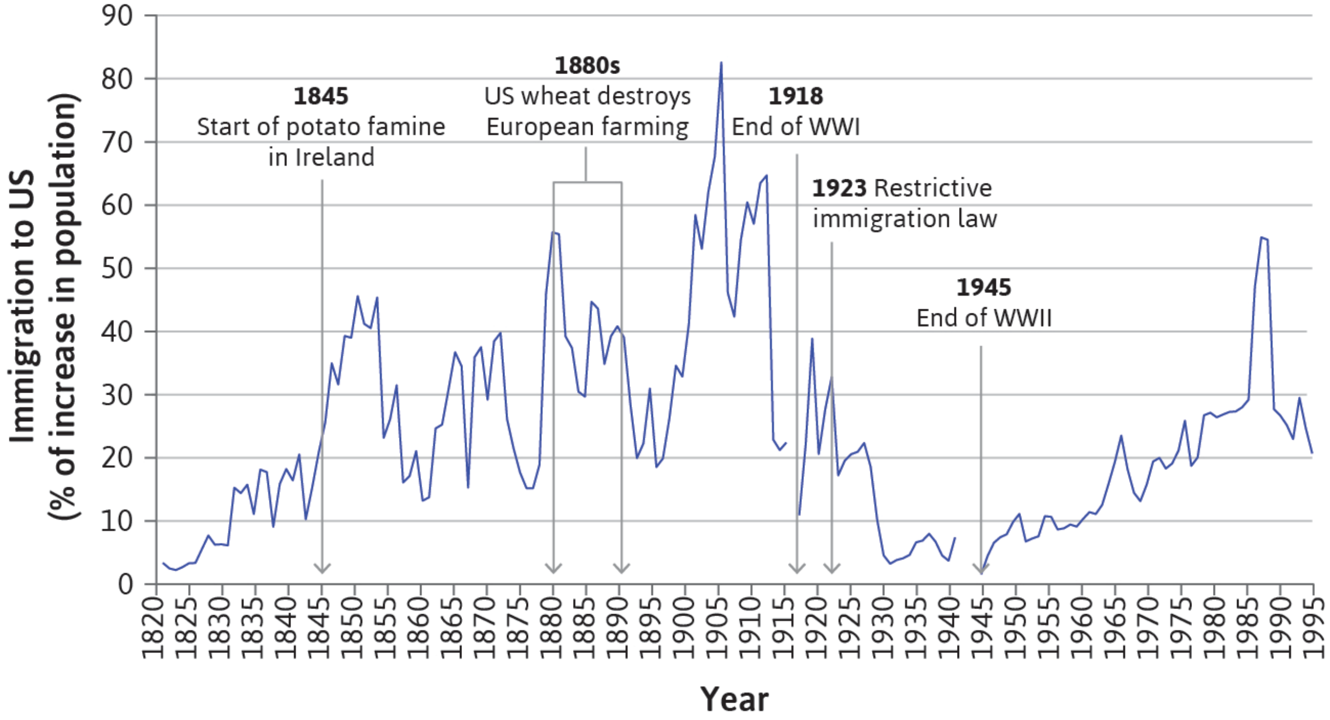


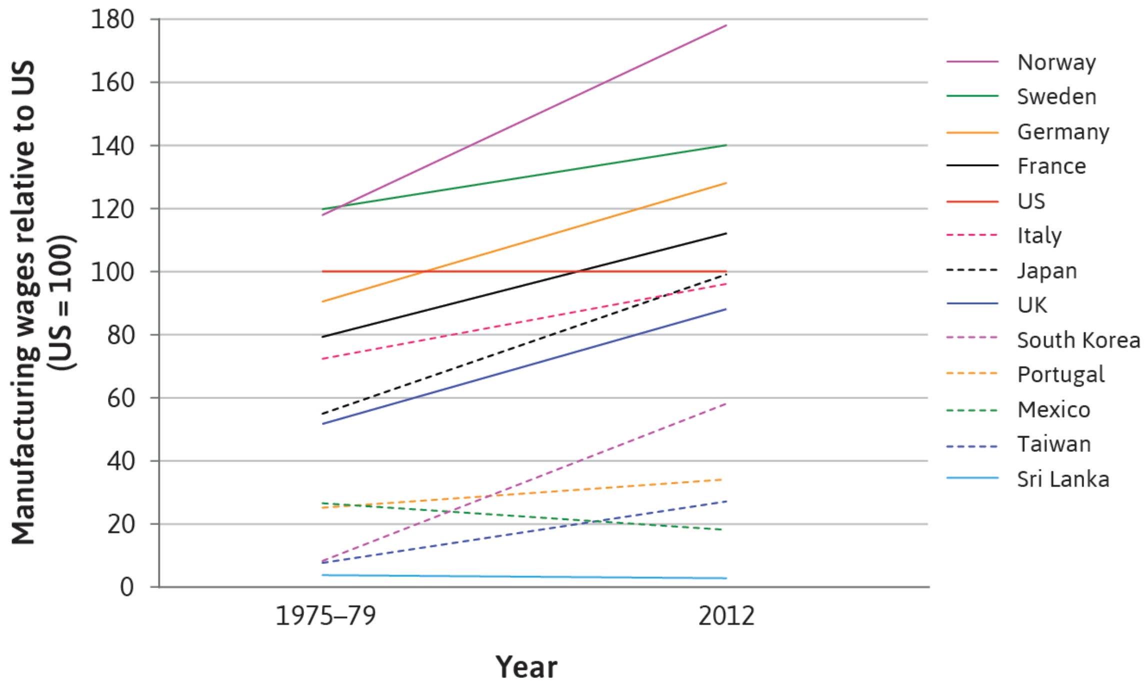
Historically, increased trade resulted in larger CA imbalances.

(Countries that trade more also tend to borrow and lend more)

International asset holdings increased over the 20th century.

Integration of labour markets?





Fewer advances in labour market integration than goods or financial market integration due to immigration barriers. Wages still differ across countries due to migration costs.

C. Specialization and Trade

Specialization

Increased globalization means that most nations engage in both specialization and trade.

Specialization: when an entity produces a narrower range of goods than it consumes, acquiring the rest through trade.

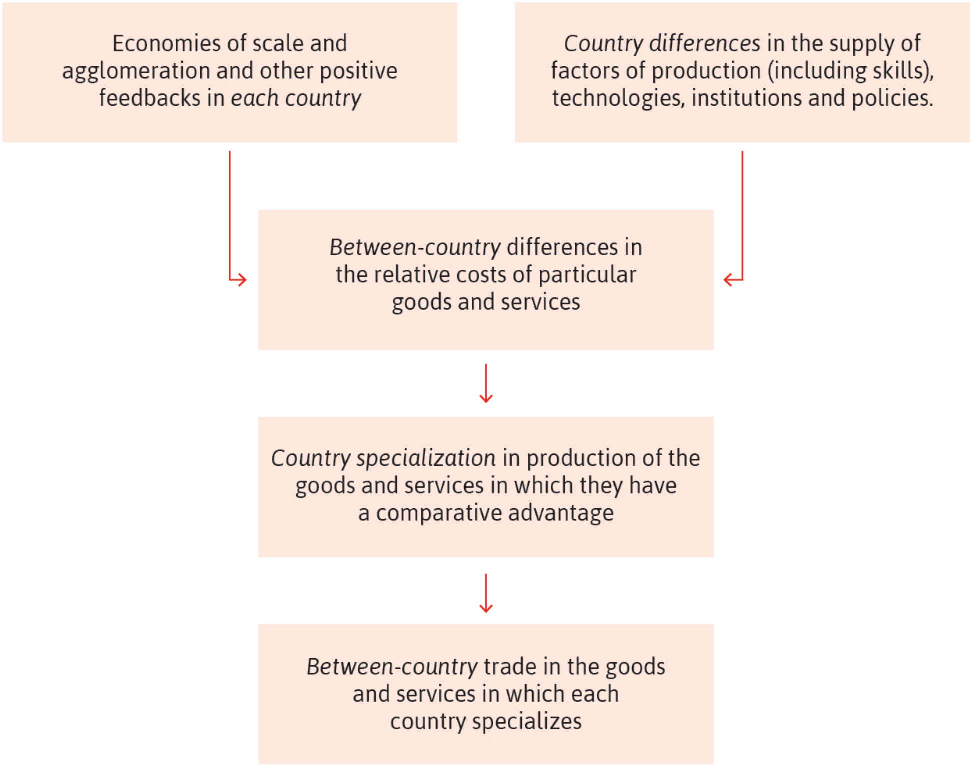
Reasons for specialization include:

- **Comparative advantage** in producing particular goods
- **Economies of agglomeration** – cost reductions from locating close to other firms in similar industries
- Economies of scale – cost advantages from producing more

Comparative Advantage

Absolute advantage: uses fewer inputs to produce a good

Comparative advantage: greatest absolute advantage, or least productivity disadvantage (comparatively better)

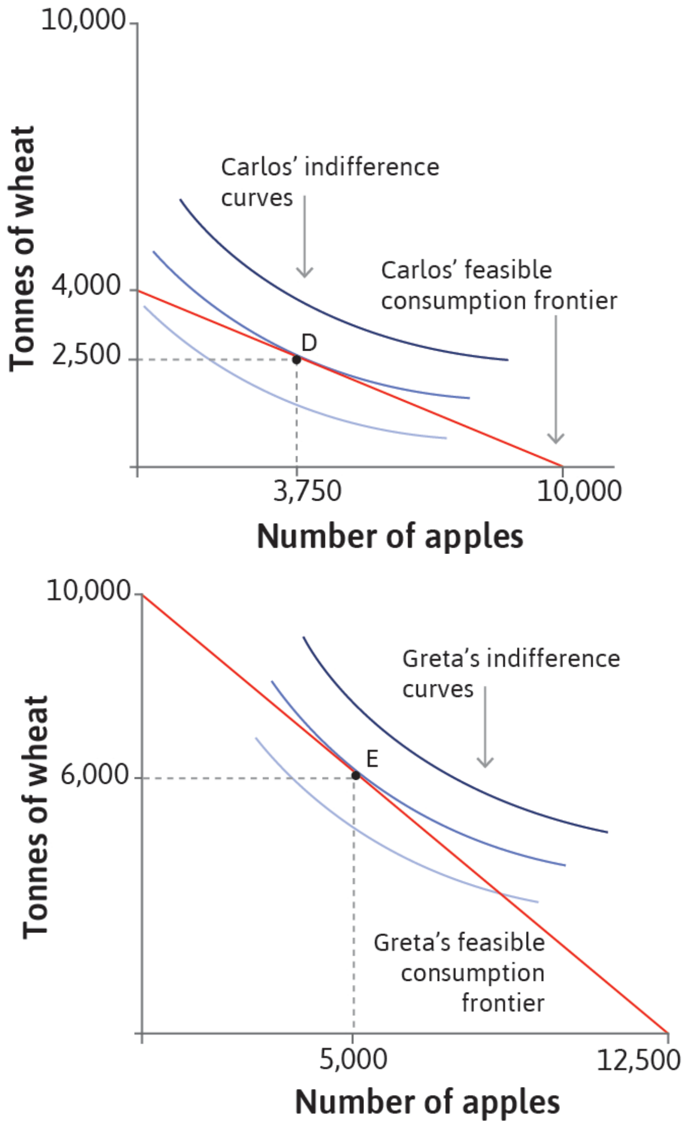


Trade can be mutually beneficial when both parties specialize in the good in which they have a comparative advantage.

Comparative Advantage: Example

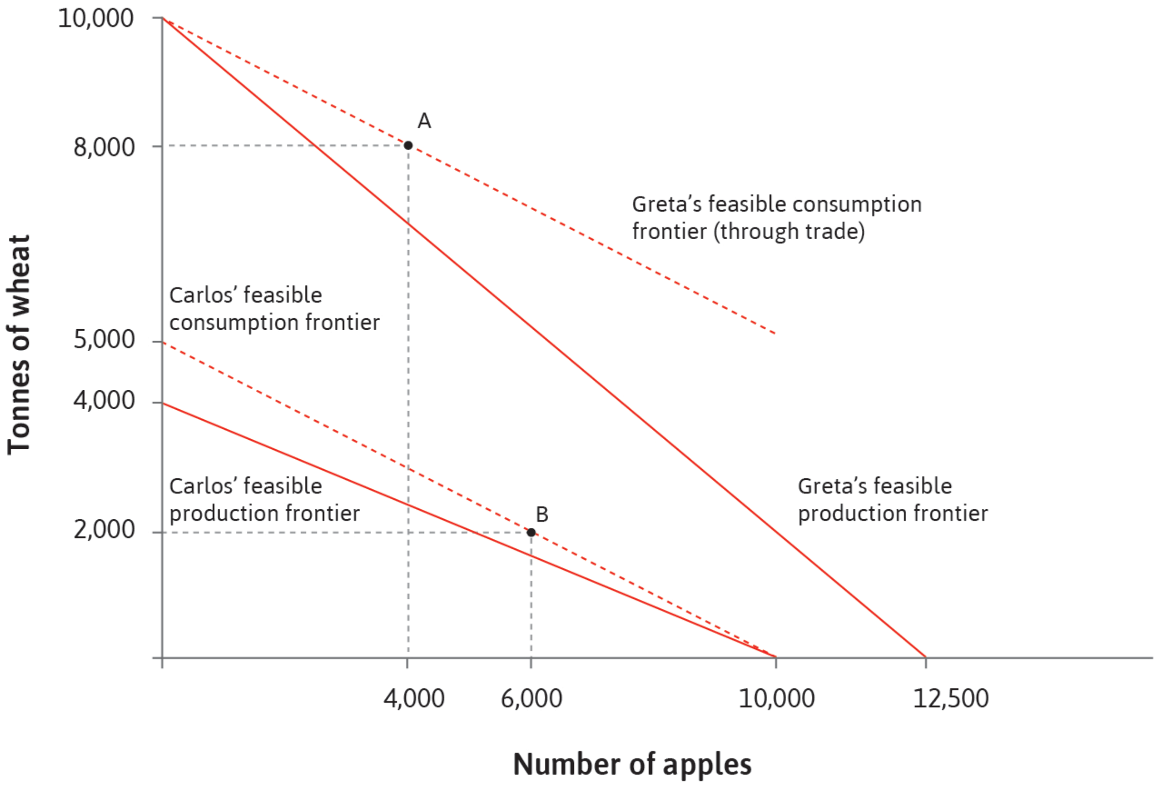
- Greta lives on Wheat Island and Carlos lives on Apple Island.
- Greta has an absolute advantage in producing apples and wheat.
- Carlos has a comparative advantage in producing apples.

In the absence of trade, the feasible consumption frontier = feasible production frontier (they can only consume what they produce).



Comparative Advantage: Example

- With trade, Carlos specializes in producing apples and Greta specializes in producing wheat.
- Both of their consumption frontiers are above their production frontiers, so they are both better off.



The relative price of apples to wheat depends on each person's **bargaining power** and **reservation option**.

Winners and Losers: Short Run

Opening trade increases countries’ consumption possibility sets, but conflicts of interest emerge between and within countries.

Winners and losers from trade depend on the relative scarcity of factors e.g. skilled/unskilled labour, capital:

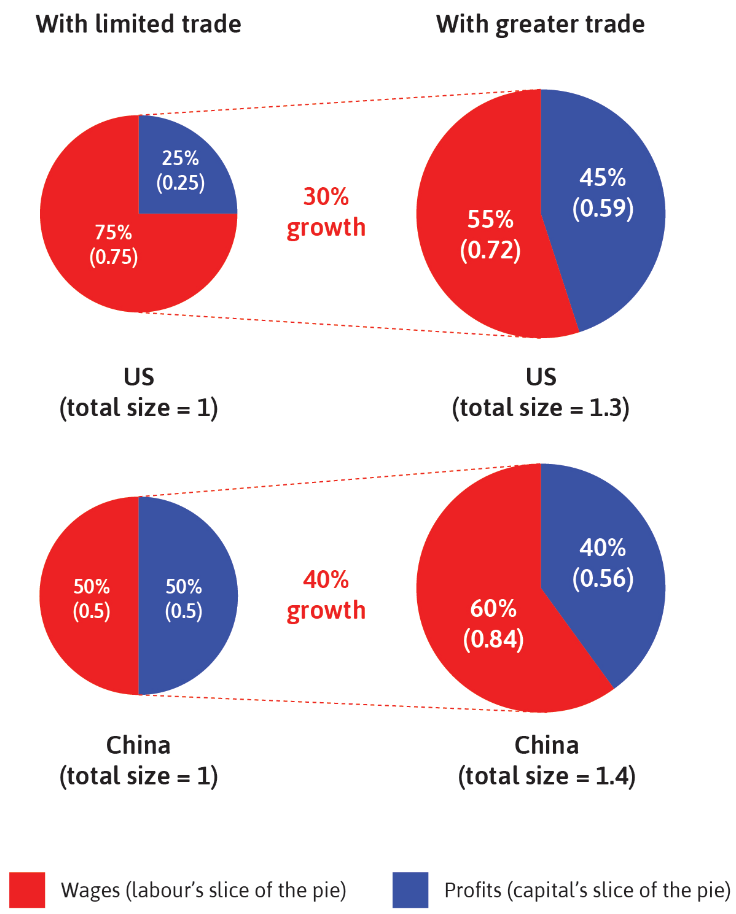
- Relatively abundant factors within a country are relatively cheap, and gain when trade raises their price towards the world average.
- Conversely, the price of relatively scarce factors falls towards the world average due to trade.

Hypothetical example

There are 2 goods: passenger aircraft (capital-intensive) and consumer electronics (labour-intensive).

The US is relatively capital abundant, whereas China is relatively labour abundant -> specialization according to factor endowments.

- Winners in the US: Owners of capital -> inequality should rise
- Winners in China: Workers (higher wages) -> inequality should fall

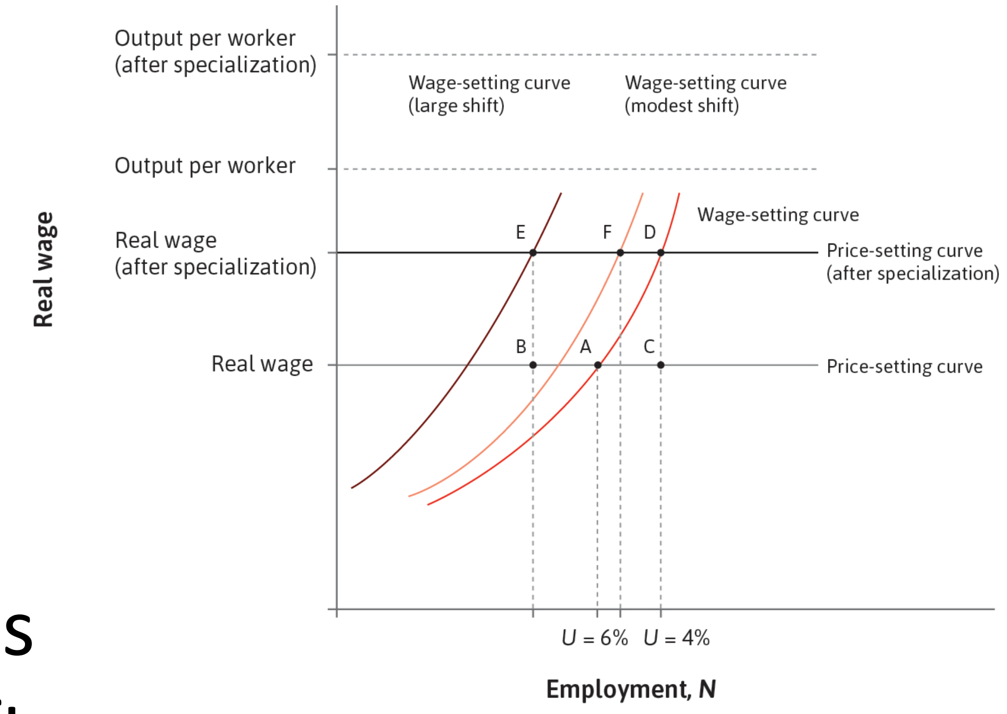


Winners and Losers: Long Run

Specialization according to comparative advantage has similar labour market effects as technological progress.

Increased productivity shifts the price-setting curve upwards:

- In the short run, jobs are destroyed.
- In the medium run, growth in export industries creates new jobs.
- Long-run adjustment process depends on how much wage-setting curve shifts.



D. The role of policies and institutions

The power of governments

Governments have additional powers over their national boundaries (compared to within their nation):

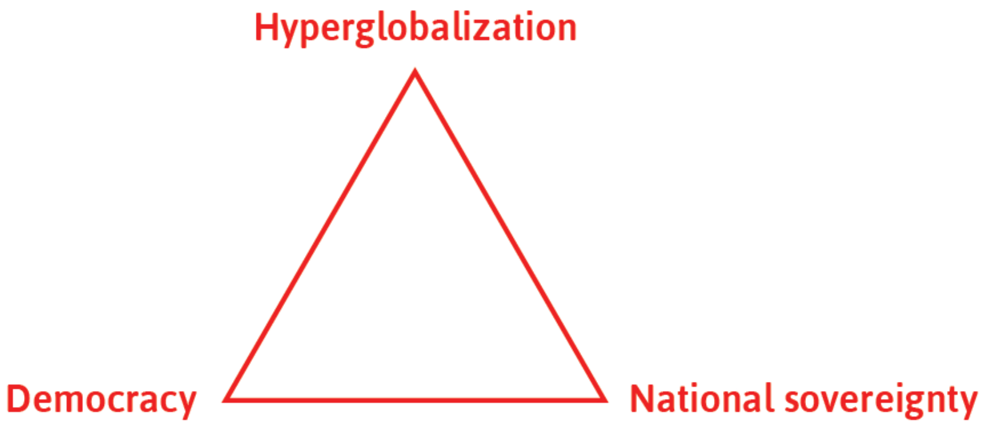
- Imposition of tariffs: Taxes on imports effectively discriminate against foreign-produced goods.
- Immigration policies: Regulate the movement of people between nations that is not possible within nations.
- Capital controls: Limits on the ability of individuals or firms to transfer financial assets among countries.
- Monetary policies: Affect the exchange rate hence the relative price of imported and exported goods.

Rodrik's Trilemma

One argument against globalization is that nations must give up some sovereignty or democracy.

Rodrik's Trilemma states it is impossible for countries to simultaneously achieve:

- **Hyper-globalization** - no political or cultural barriers to the flow of goods and investment
- Sovereignty – pursue the policies that it chooses
- Democracy – liberty and equality



Rodrik’s Trilemma: Summary

If we have	then	and as a consequence	
National sovereignty (limited global governance) and Democracy	Effective national economic policies of stabilization, environmental protection and redistribution require	limits on labour and capital mobility, the opposite of hyperglobalization	**Hyper-globalization**
Hyperglobalization and National sovereignty (limited global governance)	Hyperglobalization policies are unpopular with voters because they increase economic insecurity and weaken labour rights and environmental protection and	hyperglobalization can only survive if democracy does not	**Democracy**
Hyperglobalization and Democracy	Demands for global governance (e.g. labour standards, global environmental protection, tax treaties, coordinated macro policies) that compromise nationally differentiated policies mean that	effective global governance is inconsistent with complete national sovereignty	**National sovereignty**

Trade and Growth

Globalization can promote growth:

- Competition with foreign firms accelerates the rate of technological progress
- Economies of scale due to foreign demand allows for lower-cost production, which benefits workers, owners, and buyers

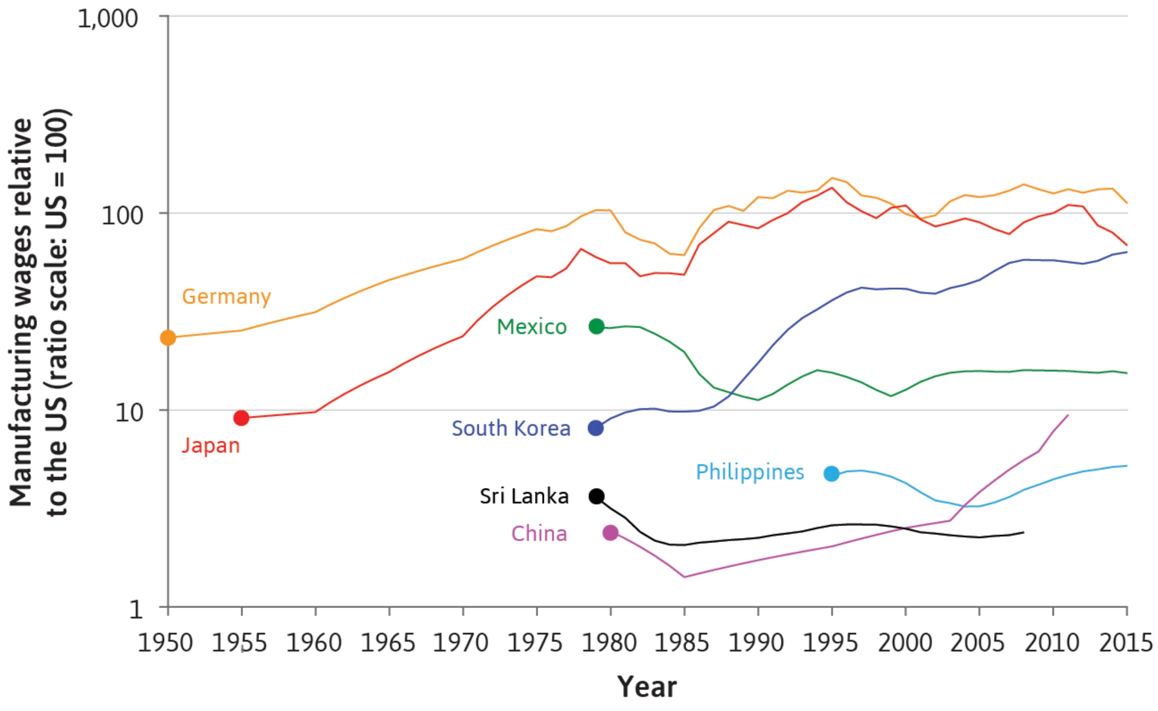
Globalization can also prevent growth:

- Disadvantageous specialization – specializing in low-innovation sectors can slow growth
- **Learning by doing** in **infant industries** – may need temporary tariff protection

Globalization and economic performance

Some countries have benefitted more from globalization than others. Economic success depends on how well policies have managed growth due to economic integration.

- During industrialization, Germany and the US achieved high economic growth despite high manufacturing tariffs.
- Scandinavian countries prospered through openness, with policies that help displaced workers.



Summary

1. Economies have become more integrated over time
- Specialization and trade can be mutually beneficial
- Winners and losers in the short run, both within and between countries, depending on relative factor abundance
- All parties can benefit in the long-run with good policymaking

2. Globalization brings new policy challenges
- **Rodrik's Trilemma** shows policymaker's tradeoffs
- Long-run success depends on policies that promote growth

In the next unit

- More about inequality
- Costs and benefits of inequality
- Policies that address inequality