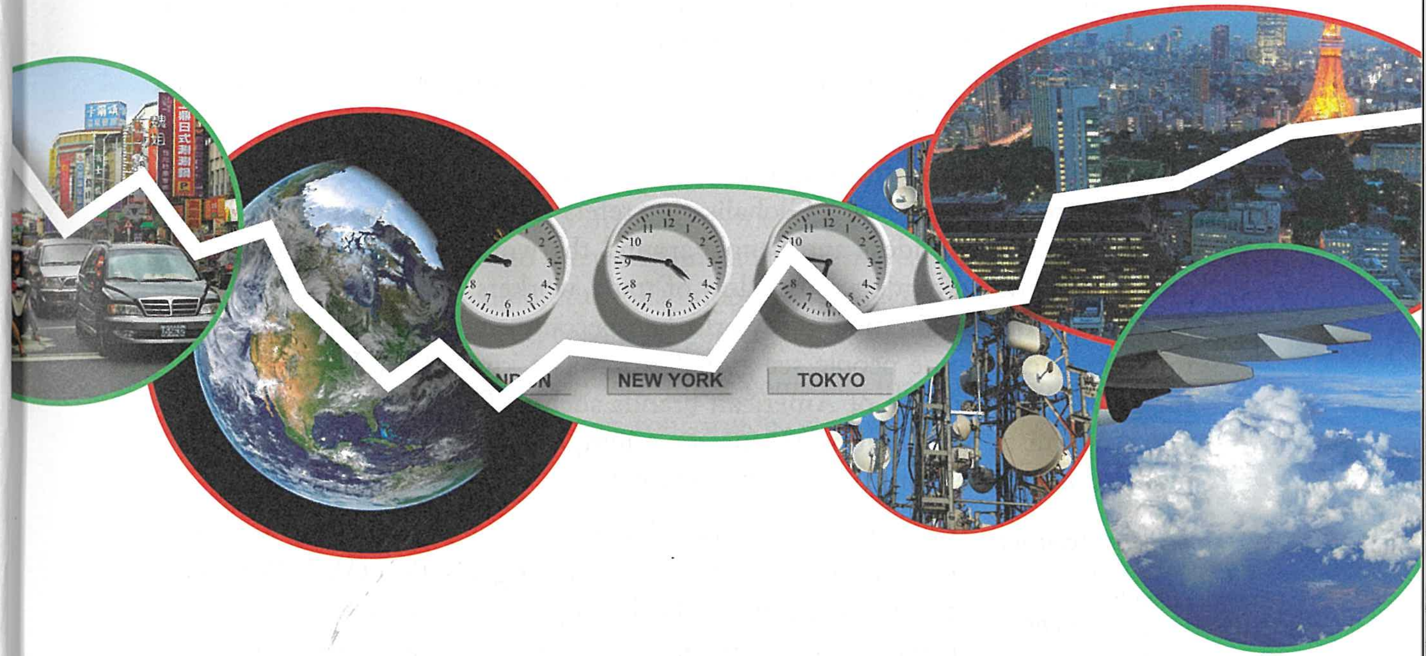
# Global Interdependence

# 1




## Chapter concepts and skills

- *the linkages between economies, including trade, investment, tourism and immigration*
- *the patterns and trends in global trade*
- *the concept and determinants of international competitiveness*
- *the concept and extent of globalisation*
- *the factors affecting globalisation*
- *the economic effects of globalisation*
- *apply economic reasoning to analyse issues and events in relation to Australia's international transactions*
- *use evidence found in economic information and data to justify a conclusion.*

you drink, your TV set, your laptop, your iPad, the bicycle you ride and probably the family car. All of these are imported goods, but many of them will have used Australian resources in their manufacture.

International tourism has grown in importance due to improvements in transport and communications and ranks fourth (after fuels, chemicals and automotive products) in global exports. Tourism now accounts for 30 per cent of the world's exports of commercial services. It is interesting to note that tourism is the main source of foreign exchange for one-third of developing countries and one-half of less developed countries (LDCs). Tourism has also become an important industry in Australia. Personal travel services (overseas tourists coming to Australia) is the 5th ranked export, while Australian tourists traveling to overseas destinations is Australia's highest ranked import.

The Australian economy has throughout its history relied on foreign investment to supplement its domestic savings to help fund its economic development. The recent mining boom would not have been possible without foreign investment. Net inflows of foreign investment in Australia were valued at $91 billion in 2018, while net outflows of Australian investment abroad were valued at $47 billion. The importance of foreign investment cannot be underestimated - foreign net flows account for anywhere between 10 and 20 per cent of Australia's total investment requirements. Australia is also a multicultural nation. Immigration has been an important source of skilled labour and has helped to boost Australia's population growth. Twenty-eight per cent of Australia's population were born overseas. The world economy has become more integrated than it ever was through improvements in communications, transport and the application of the Internet.

Australia is an outward-looking country that is strongly engaged with the rest of the world. Australia has a number of globally significant industries:

- agricultural products - top 15 exporter in the world;
- international tourism - 11th largest in the world;
- fuels and mining - 4th largest exporter in the world;
- foreign students - 3rd largest exporter in the world; and
- investment fund assets - 3rd largest in the world

Australia also plays an active role in a wide variety of global and regional groups. Some of these include:

- The United Nations (UN);
- The World Trade Organisation (WTO);
- Group of 20 major economies (G20);
- Association of South East Asian Nations (ASEAN); and
- Asia Pacific Economic Cooperation (APEC).

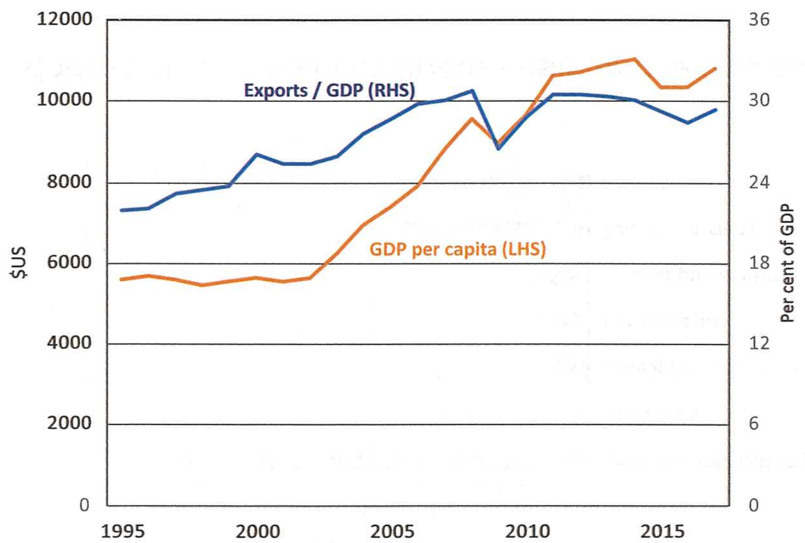
## Patterns and trends in global trade

One of the key features of the past 50 years has been the rapid growth of world trade. Since 1995, world exports have increased by over 350 per cent, while world GDP has approximately doubled. This illustrates the spectacular pace of globalisation. Faster growth in trade is synonymous with faster world economic growth. China joined the World Trade Organisation in 2002 and in the space of a decade overtook the United states to become the world's leading exporter. This has had a major effect on many countries, especially Australia. In periods when trade has fallen, world growth has slowed.

The positive relationship between trade and growth is illustrated in figure 1.2. This graph shows that a rising share of world trade in GDP has been accompanied by rising per capita GDP. World exports as a percentage of GDP have increased from around 21 per cent in 1995 to 30 per cent by 2017. GDP per capita has experienced an even faster rate of increase - doubling over this period. Economists believe that increased trade intensity is an important catalyst for higher real incomes and living standards.

Why has world trade grown so fast? It is partly due to the success of world organisations such as the World Trade Organisation (WTO), the International Monetary Fund (IMF) and the World Bank in promoting the liberalisation of world trade. It is also due to improvements in transport and communication which has drastically lowered the costs of international commerce. Trade is seen as an 'engine of growth'. Specialisation and exchange is the cornerstone of all modern

### Figure 1.2 World income and trade




*Trade plays a crucial role in driving economic growth, development and job creation around the world.*

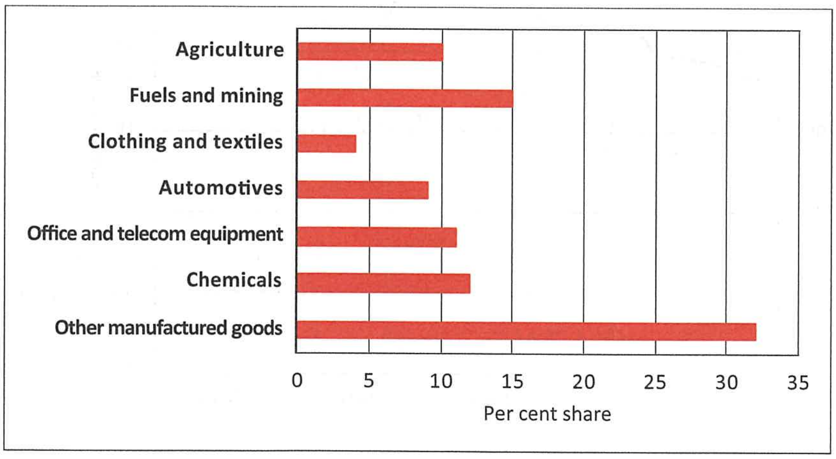
economies and is the catalyst for raising living standards. For most economies, including Australia, trade as a proportion of GDP has been increasing. Economies are becoming more open to trade and investment and as a result, economic growth and living standards have accelerated.

International trade can be broadly distinguished between trade in goods (merchandise) and services. The bulk of international trade concerns physical goods (77 per cent), while services account for a much lower share (23 per cent). This makes sense given that goods are generally easier to trade than services. Many services are in fact non-tradable. For example, it is not possible to export a haircut or a restaurant meal. World trade in goods has increased dramatically over the last decade, rising from less than US$10 trillion in 2004 to more than US$17.7 trillion in 2017. Trade in services has more than doubled between 2004 and 2017 - from just above US$2 trillion to US$5.3 trillion.

| World Merchandise Exports 2017 | |
|---|---|
| Manufacturing | 70% |
| Fuels & Mining | 15% |
| Agriculture | 10% |
| Other | 5% |

Merchandise is divided into three main categories: agriculture, mining and fuels, and manufactured goods. Trade in manufactured goods dominates merchandise trade accounting for 70 per cent. Figure 1.3 shows some of the major merchandise product groups exported in the world. Important categories in manufactured exports are chemicals (12%), office and telecom equipment (11%) and automotives (9%). Trade in services comprises transport, travel and commercial services. Commercial services includes categories such as insurance, telecommunications, financial services and construction and accounts for half of all services trade. Tourism in fact, ranks third as an export category after fuels and chemicals and ahead of food and automotive products. In many developing countries, tourism ranks as the major export sector.

## Figure 1.3 World merchandise exports by major product group



| World Exports by Region & Selected Country | | | | |
|---|---|---|---|---|
| Region/Country | 1983 | 1993 | 2003 | 2017 |
| North America | 16.8 | 17.9 | 15.8 | 13.8 |
| United States | 11.2 | 12.6 | 9.8 | 9.0 |
| Canada | 4.2 | 3.9 | 3.7 | 2.4 |
| South & Central America | 4.5 | 3.0 | 3.0 | 3.4 |
| Europe | 43.5 | 45.3 | 45.9 | 37.8 |
| Germany | 9.2 | 10.3 | 10.2 | 8.4 |
| Netherlands | 3.5 | 3.8 | 4.0 | 3.8 |
| France | 5.2 | 6.0 | 5.3 | 3.1 |
| United Kingdom | 5.0 | 4.9 | 4.1 | 2.6 |
| Africa | 4.5 | 2.5 | 2.4 | 2.4 |
| Middle East | 6.7 | 3.5 | 4.1 | 5.3 |
| Asia | 19.1 | 26.0 | 26.1 | 34.0 |
| China | 1.2 | 2.5 | 5.9 | 13.2 |
| Japan | 8.0 | 9.8 | 6.4 | 4.1 |
| India | 0.5 | 0.6 | 0.8 | 1.7 |
| Australia & NZ | 1.4 | 1.4 | 1.2 | 1.6 |

*World trade is dominated by the largest economies - China, the United States and Germany. These three countries account for 30% of world exports. China has emerged rapidly to become the world's largest exporter - from 1 per cent of world exports in 1983 to 13 per cent in 2017. Europe is still the dominant region for exports, but will soon be overtaken by Asia.*

*International Trade Statistics 2017*

**Figure 1.4 World exports by region and country**

Not surprisingly, the countries that dominate world trade are the largest economies - China, the United States, and Germany. These three countries account for 30 per cent of world merchandise exports. China is the world's largest exporter, while the United States is the largest importer. The three largest exporters of commercial services are the United States, United Kingdom and Germany. Figure 1.4 provides a breakdown of world exports by region between 1983 and 2017. The most notable change is the rapid emergence of China - from 1 per cent of world exports in 1983, to 13 per cent in 2017. At the same, Japan's relative importance has slipped, its share of world exports halving over this period. While Europe is still the dominant region for exports, accounting for 38 per cent, Asia's share has increased significantly over the period, from 19 per cent in 1983 to 34 per cent in 2017.

Remember that it is individuals (both firms and households) that engage in trade, not countries. People trade because it is advantageous. Trade enables people to consume a greater quantity and variety of goods and services. Trade results in lower prices for consumers and higher prices for producers. When a country exports its goods and services, domestic producers gain from higher prices and greater production. When a country imports, domestic consumers gain from lower prices and greater consumption. Cross-border trade is no different than trade in a local market, with one exception - most countries have their own currency and so an exchange rate needs to be established before trade can take place.

There are a number of factors that affect economic transactions between different economies:

- the exchange rate - movements in the exchange rate affect the price of exports and imports. For example, if the Australian dollar ($A or AUD) falls in value (a depreciation), Australia's exports become cheaper to overseas buyers, while imports increase in price to Australian buyers;
- world economic growth - Australia's exports are dependent on foreign demand. Increased economic growth in foreign countries will increase the demand for Australia's exports. China and Japan, for example, are our most important customers for our mineral and energy resources. If their economies grow, then the demand for our resources increases;
- domestic economic growth - Australia's imports are determined by domestic economic activity. Higher economic activity in Australia raises domestic income which increases demand for imported consumer goods and services while increased investment will increase capital goods imports;
- relative inflation rates - if Australia's inflation rate is greater than our trading partners it will reduce the competitiveness of domestic goods and increase the competitiveness of foreign goods;
- relative interest rates (the interest rate differential) - if interest rates in Australia are higher than other countries, especially the United States, then financial capital will flow into the Australian economy; and
- productivity & cost efficiency - the efficiency of domestic firms relative to foreign firms will determine their success in the global market. Productivity improves cost efficiency by increasing output per worker.

**Global Value Chains - today, most goods and a growing share of services are "made in the world"**

*World trade, investment and production are increasingly organised around global value chains (GVCs). A value chain is the full range of activities that firms engage in to bring a product to the market, from conception to final use. Such activities range from design, production, marketing, logistics and distribution to support to the final customer. They may be performed by the same firm or shared among several firms. The growth of GVCs has increased the interconnectedness of economies. It has been estimated that more than half of world trade in goods and services takes place within GVCs.*

*The tendency of countries to specialise in particular stages of a good's production (known as vertical specialisation), has created new trade opportunities, especially for small developing countries. As a result, world trade in intermediate goods, capital goods and services has grown with the rise of vertical specialisation. The expansion of the operations of multinational enterprises (MNEs) through foreign direct investment (FDI) has been a major driver of the growth of GVCs. Participation in GVCs contributes to economic growth through the gains that firms achieve from specialisation and improved productivity (access to new technology and knowledge).*

*Source: OECD Interconnected Economies*

## International competitiveness

International competitiveness has become a popular term with the advent of globalisation. The OECD defines a nation's competitiveness as 'the degree to which a country can produce goods and services which meet the test of international markets, while simultaneously maintaining and expanding the real incomes of its people over the long term'. This definition highlights the importance of being able to compete in international markets.

There are several organisations that produce annual competitiveness reports:

- the World Economic Forum (WEF), and
- the International Institute for Management Development (IMD)

For more than three decades, the World Economic Forum's annual Global Competitiveness Reports have studied and benchmarked the many factors underpinning national competitiveness. This organisation defines competitiveness as '*the set of institutions, policies, and factors that determine the level of productivity of a country*'. What are the key determinants that drive productivity and competitiveness? From the early days of economics, Scottish economist Adam Smith emphasised the importance of specialisation and division of labour. Economists believed that investment in physical capital and infrastructure was crucial to the growth process, while new growth theory focuses on the role of education and training and technological progress. The WEF base their competitiveness index on what they call the 'twelve pillars of competitiveness' - a fairly comprehensive list of key factors that promote efficient resource allocation, productivity, innovation and long term growth. A key criticism of the WEF index is that it is compiled from an opinion-based survey rather than on actual 'hard' economic data.

The IMD is a top-ranked global business school based in Switzerland which also publishes an annual world competitiveness ranking. IMD defines competitiveness in terms of the ability of nations to create and maintain an environment which sustains the competitiveness of enterprises. The IMD competitiveness report is arguably a more accurate and reputable measure than the survey based index produced by the WEF. The IMD focuses on four main factors that are seen as the drivers of competitiveness:

- economic performance - domestic economy, international trade, inflation and unemployment;
- government efficiency - public finance, fiscal policy, business legislation, institutional framework;
- business efficiency - productivity, labour market, finance, management practices; and
- infrastructure - basic infrastructure, technological infrastructure, health, education.

**The 12 Pillars of Competitiveness (World Economic Forum)**

1. Institutions: the legal and administrative framework within which individuals, firms, and governments interact.
2. Infrastructure: extensive and efficient infrastructure such as a well-developed transport and communications network and efficient electricity supplies.
3. Macroeconomic stability: low inflation, low unemployment.
4. Health and primary education: primary education is the foundation for all subsequent training; Investment in the provision of health services is critical to maintain an active & fit workforce.
5. Higher education and training: increases the quality of the workforce.
6. Goods market efficiency: competitive markets lower costs and promote improvements in productivity.
7. Labour market efficiency: labour market flexibility enables workers to shift from one economic activity to another rapidly at low cost.
8. Efficient financial markets: economies require sophisticated financial markets that can make capital available for private-sector investment.
9. Technological readiness: Information and communication technology (ICT) access and usage are key factors affecting a countries' overall technological readiness.
10. Market size: large markets allow firms to exploit economies of scale.
11. Business sophistication: the quality of a country's business networks and supporting industries.
12. Technological innovation: requires sufficient investment in research and development (R&D).

Notice that these factors are not dissimilar to the '12 pillars of competitiveness' and are a simpler and better way to think about the determinants of competitiveness. Notice also that both the government and the private sector are important in determining a country's international competitiveness. Figure 1.5 compares the rankings of each organisation's competitiveness report for 2018. It is not surprising that eight of the top twelve ranked countries are common to both lists: United States, Singapore, Hong Kong, Switzerland, the Netherlands, Denmark, Sweden, and Canada. Australia was ranked 14th by IMD and 19th by the WEF. What is also interesting is the close correlation with the GDP per capita ranking.

Australia's international competitiveness affects our international trade and hence our national production, employment and income. A fall in our competitiveness implies that goods and services produced in Australia have difficulty finding buyers in both foreign and domestic markets. Competitiveness matters because it can affect a country's standard of living. The ultimate economic objective for any country is to improve the economic welfare or living standard of its inhabitants. Improving competitiveness implies that a country can increase its national income. The competitiveness of a country's goods and services depends on a large number of factors, but some of the key economic determinants are:

- changes in labour productivity due to factors such as technology, education and training;
- changes in a country's price level relative to its trading partners;

| Ranking | WEF Global Competitiveness Index | IMD World Competitiveness Yearbook | GDP per capita ($US) 2017 |
|---|---|---|---|
| 1 | United States | United States | Luxembourg |
| 2 | Singapore | Hong Kong | Norway |
| 3 | Germany | Singapore | Switzerland |
| 4 | Switzerland | Netherlands | Iceland |
| 5 | Japan | Switzerland | Qatar |
| 6 | Netherlands | Denmark | Denmark |
| 7 | Hong Kong | UAE | Sweden |
| 8 | United Kingdom | Norway | Australia |
| 9 | Sweden | Sweden | Singapore |
| 10 | Denmark | Canada | Netherlands |
| 11 | Finland | Luxembourg | United States |
| 12 | Canada | Ireland | Canada |
| ... | *(Australia 14th)* | *(Australia 19th)* | *(Australia 8th)* |

**Figure 1.5 International competitiveness rankings, 2018**

- changes in a country's wages relative to its trading partners; and
- changes in the exchange rate.

Most statistical indicators of international competitiveness try to reflect these changes by using price measures. Two of the more commonly used measures are a nation's real unit labour costs and the value of its exchange rate. Real unit labour costs reflect changes in a country's wages relative to its productivity. Productivity measures how much output can be produced from a given input, such as labour. It is usually measured by dividing total production (GDP) by number of hours worked. An increase in productivity will increase competitiveness. Real unit labour costs will fall if either productivity rises or if wage costs fall. This will cause an increase in competitiveness. To compare the value of Australia's exchange rate with other countries it is important to use a trade weighted exchange rate rather than a single rate such as the US dollar. Australia's trade-weighted index (TWI) measures the change in the value of the Australian dollar relative to its major trading partners. The real TWI takes into account changes in Australia's inflation rate relative to trading partners. If the real TWI falls (a depreciation) then this implies an improvement in competitiveness since the price of Australia's exports to overseas buyers will fall.

Figure 1.6 shows changes in Australia's real unit labour costs and the real TWI since 2002. Between 2002 and 2009 real unit labour costs (RULC) declined by 6 per cent which had a positive effect on Australia's international competitiveness. Since 2016, real unit labour costs have fallen quite sharply. The real TWI experienced a strong appreciation from 2002 to 2013 - increasing by 65 per cent. This was

*Australia's international competitiveness improves if either the real Trade Weighted Index (TWI) falls and/or if real unit labour costs fall.*

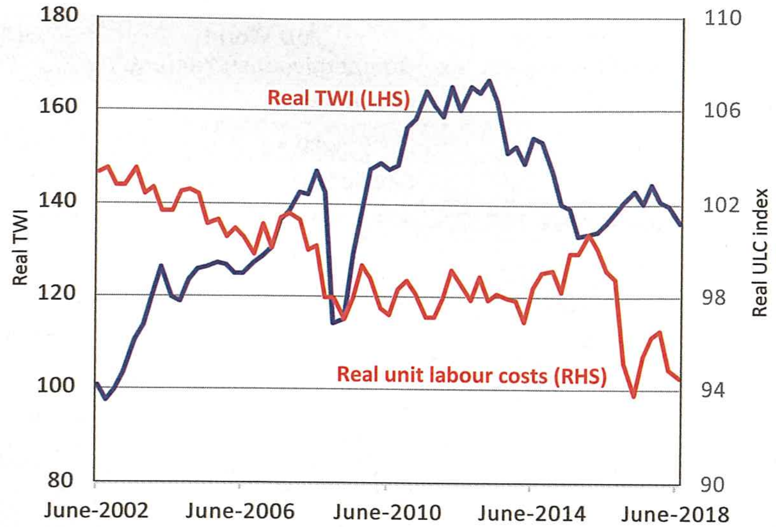



**Figure 1.6 Measures of international competitiveness**

due to the mining boom and the increased demand for Australian commodities (esp. iron ore and coal) by China. An appreciation reduces the competitiveness of Australia's exports by increasing their price to foreign buyers. In 2009 there was a sharp depreciation in the real TWI due to the global financial crisis. But this was a minor hiccup, with the real TWI increasing again quickly to reach its post float high in 2013. When the mining boom came to a sudden end in 2013, commodity prices fell drastically and the real exchange rate fell from its 'dizzy' heights. Between 2013 and 2018, the real TWI depreciated by around 20 per cent, boosting the competitiveness of the traded goods sector.

A number of novel indexes have been developed to help compare the relative cost of goods in different economies. These indexes select a uniform product that is sold in most countries and converts the local price into a standard currency such as the US dollar. Examples include the 'Big Mac' index (McDonalds hamburger) and the 'iPad' index (Apple). These indexes are useful in determining whether an exchange rate is under or overvalued. The most famous of these is the Economist Magazine's Big Mac index, which is illustrated in figure 1.7 (based on prices in July 2018). According to the Purchasing Power Parity (PPP) theory, the same product should sell for the same price in different countries, if converted to a common exchange rate. The first column of figure 1.7 lists the price of a Big Mac in local currency. Dividing this price by the actual exchange rate in the second column gives the price in US dollars, shown in the third column. For example, in Australia a Big Mac sells for A$6.05 which equals US$4.51. In July 2018 the exchange rate was $1US = A$1.34 or $A1 = $US0.75. The table shows the wide disparity in the price of a Big Mac measured in US dollars - from $2.10 in Malaysia (less than half the US price) to $6.54 in Switzerland.

*PPP - implies that exchange rates are determined by the value of goods that currencies can buy.*

| Country | Big Mac in local currency | Exchange rate ($1US) July 2018 | Big Mac in $US | Implied PPP of $US | % Over or Under Valued |
|---|---|---|---|---|---|
| Australia | A$6.05 | 1.34 | 4.51 | 1.10 | -18 |
| Britain | £3.19 | 0.75 | 4.23 | 0.58 | -23 |
| Canada | C$6.65 | 1.31 | 5.07 | 1.21 | -8 |
| China | Yn20.5 | 6.62 | 3.10 | 3.72 | -44 |
| Euro Area | €4.04 | 0.85 | 4.74 | 0.73 | -14 |
| Japan | ¥ 390 | 111.25 | 3.51 | 70.78 | -36 |
| Malaysia | Myr 8.45 | 4.02 | 2.10 | 1.53 | -62 |
| New Zealand | NZ$6.20 | 1.46 | 4.23 | 1.13 | -23 |
| Singapore | S$5.80 | 1.35 | 4.28 | 1.05 | -22 |
| Sweden | Kr 51 | 8.75 | 5.83 | 9.25 | +6 |
| Switzerland | Fr 6.50 | 0.99 | 6.54 | 1.18 | +19 |
| Russia | R 130 | 62.14 | 2.09 | 23.59 | -62 |
| United States | $5.51 | 1.00 | 5.04 | 1.00 | 0 |

*According to the purchasing power parity (PPP) theory, the same product should sell for the same price in different countries. This table shows a wide disparity in the price of a Big Mac measured in US dollars - from $2.10 in Malaysia to $6.54 in Switzerland.*

**Figure 1.7 The 'Big Mac' index**

We can use the data to derive some interesting results. If we divide the actual Australian price of the Big Mac ($6.05) by the US price ($5.51) we get the implied PPP exchange rate. This suggests that US$1 should equal A$1.10 or equivalently A$1 should equal US$0.91. This suggests that Australia's exchange rate in July 2018 was undervalued by 18 per cent. When you compare actual exchange rates in the table with the implied PPP rate, you will see that most currencies are trading well below their implied value, meaning that they are undervalued. For example a 'Big Mac' in Malaysia is 62 per cent cheaper than in the US. only two currencies in the table were overvalued - Switzerland (30 per cent more expensive) and Sweden (+6 per cent). It is important to remember that PPP is meant to be a long term indicator showing where currencies might trend in the future.

Why do the prices in the Big Mac index vary so widely once converted into a common currency? It is basically due to differences in the costs of producing a Big Mac across countries. Prices will reflect the cost of key inputs such as raw materials and wages. Real wages are determined by labour productivity. A country that is relatively more productive at producing tradable goods will have higher wages for workers in that sector. This will drive up prices and wages in the non-tradable sector, including the fast food industry. This is why the price of a Big Mac is higher in countries such as Australia, Canada and Europe and lower in China, Indonesia and South Africa.

A better guide to show purchasing power parity would be to compare the prices of a good which did not reflect differences in input costs, for example a uniform product such as the Apple iPad or Apple iPhone. The official price for an iPad in Australia in November 2018 was A$469 while in the United States the price was $329. The implied PPP of the US dollar is 1.425 (469/329) which suggests that the implied exchange rate of the Australian dollar should be US$0.70. The actual exchange rate was A$1 = $US0.72. This suggests that the Australian dollar is very close to its implied PPP value. What if we compare the prices of the iPhone X. In the United States it sells for US$999, while in Australia it sells for $1629. This implies that A$1 should equal US$0.61! This seems odd given that the iPad price difference is close to the PPP value. Perhaps Apple is taking advantage of the popularity of the iPhone in Australia? There are only three countries where the iPhone has 60 per cent or more of the market - Japan, the United States and Australia. This means that Apple Can sell its iPhone at a premium price in these markets.

## Globalisation

Globalisation is one of the defining trends of the 21st century. It is discussed everywhere from political and business circles to the ordinary person in the street. The term globalisation generally refers to the opening of international borders to the flows of trade, investment, immigration, information and technology. The many, substantial benefits of globalisation include higher average incomes, greater innovation, richer cultural exchanges and improved standards of living around the world. Globalisation has also been blamed (incorrectly) for many of the world's problems including climate change, world poverty and environmental degradation.

Globalisation has in fact been responsible for creating unprecedented prosperity. The evidence for globalisation is seen in the ever expanding trade in goods and services, foreign investment and people. It has been propelled by cheaper and faster transportation, more innovative information technology, fewer or lower trade barriers, and better economic management. Joseph Stiglitz, an economist and winner of the Nobel Prize defines globalisation as:

> *"the closer integration of the countries and peoples of the world brought about by the enormous reduction of costs of transportation and communication, and the breaking down of artificial barriers to the flows of goods, services, capital, knowledge, and people across borders".*

There are many indicators that illustrate how goods, capital, and people have become more globalised:

- the value of exports (goods and services) as a percentage of world GDP increased from 20 percent in 1990 to 29 percent in 2017;
- since 1990, inflows of foreign direct investment (FDI) have increased by a factor of nine - from US$196bn in 1990 to US$1957bn in 2017;

- the number of internet subscribers per 100 people has increased from 0.4 in 2000 to 14 in 2017;
- the number of mobile phone subscriptions per 100 people has increased from 12 in 2000 to 104 in 2017 (a factor of 9); and
- the number of international tourist arrivals has doubled between 1990 and 2017.

The key measures of globalisation that most economists focus on are trade in goods and services and financial capital flows. Trade has been the 'engine of globalisation'. Since 1990, the volume of world trade has grown at twice the rate compared with the growth of world GDP. The most commonly used measure of a country's trade openness is the ratio of a country's trade to GDP. This ratio, has on average, increased quite markedly across all groups of economies, including both developed and developing countries. It represents a quick and simple measure of a country's level of integration with the rest of the world. Research has shown that those economies that increase their trade openness over time experience faster rates of economic growth. Between 1990 and 2017, world exports as a proportion of GDP have increased from 20 per cent to 29 per cent. Notice the dramatic increase in trade intensity for countries such as Thailand, Vietnam and Korea. For many countries

## Figure 1.8 Indicators of globalisation

| Indicators | 1990 | 2000 | 2010 | 2017 |
|---|---|---|---|---|
| **Economic**: | | | | |
| Exports of goods and services (% GDP) | 19.6 | 25.7 | 28.8 | 29.1 |
| High income countries % GDP | 19.8 | 25.4 | 29.4 | 30.5 |
| Low income countries % GDP | 12.4 | 17.8 | 23.4 | 20.1 |
| FDI net inflows, $US billions | 196 | 1319 | 1863 | 1957 |
| High income countries, $US billions | 175 | 1176 | 1253 | 1422 |
| Low income countries, $US billions | 0.6 | 2 | 15 | 15 |
| **Social** | | | | |
| Fixed Broadband Subscribers, per 100 people | .. | 0.4 | 8 | 14 |
| High income countries, per 100 people | .. | 1.4 | 26 | 32 |
| Low income countries, per 100 people | .. | .. | 0.1 | 0.8 |
| Mobile Phones, per 100 people | 0.1 | 12 | 76 | 104 |
| High income countries, per 100 people | 1.0 | 44 | 110 | 125 |
| Low income countries, per 100 people | 0.0 | 0.3 | 30 | 62 |
| International Tourist Arrivals, millions | 524 | 677 | 956 | 1245 |
| High income countries, millions | 377 | 457 | 564 | 749 |
| Low income countries, millions | 5 | 6 | 12 | 16 |

*Source: World Bank*

| Exports as % of GDP | | |
|---|---|---|
| | 1990 | 2017 |
| World | 20 | 29 |
| Australia | 15 | 21 |
| China | 16 | 20 |
| Thailand | 34 | 68 |
| Vietnam | 36 | 101 |
| Korea | 26 | 43 |

of East Asia, trade has been the pathway to achieve rapid economic development. Exposure to trade provides the incentive to improve productivity and cost competitiveness.

The second main indicator of globalisation is the growth in foreign direct investment. Trade in financial capital is a more recent phenomenon than trade in goods and services. This is because international financial transactions were relatively regulated in most economies until the 1990s. The opening up of domestic economies to foreign direct investment is an important part of modern globalisation and has seen the significant growth in the role of the multinational firm. Multinationals are now accounting for an ever larger share of global trade.

Many people think that globalisation is a relatively recent phenomenon. The two modern waves of globalisation occurred over the past 150 years. The earlier wave began around the middle of the nineteenth century and ended with the beginning of World War I (1870 - 1913). This wave of international integration was fueled by colonial expansion and the onset of the industrial revolution. The second wave of globalisation began after the Second World War and extended to the present day (1950 - present). Both episodes were characterised by strong growth in trade and living standards (GDP per capita). The period of history between these waves was a period of economic upheaval with the World Wars and the Great Depression of 1930. This was an era of anti-globalisation, during which countries pursued protectionist policies which slowed world growth and development. Some analysts believe that the period since the 1980s could be interpreted as the start of a new golden age of globalisation, after the setbacks from  the OPEC oil shocks and the Vietnam War. This 'third' wave coincides with a number of important global events - the end of the Cold War (the collapse of Communism); the birth of the Internet and the creation of the World Trade Organisation (WTO). The result is that in the past 30 years the pace and scale of globalisation has accelerated.

## Causes of globalisation

There have been a number of important drivers or causes of the current era of globalisation. The first has been the liberalisation of markets to the flow of goods, services and investment. This process began after World War II with the establishment of a number of United Nations organisations, including the GATT, the International Monetary Fund (IMF) and the World Bank. Chief of these was the GATT - the General Agreement on Tariffs and Trade. This was set up in 1947 with the aim of reducing barriers to trade to increase general living standards and promote full employment. Originally, the GATT was supposed to become a full international organization like the World Bank, however it remained an agreement until it was superseded by the WTO in 1995. Since 1990 world tariff rates have

**International agencies fostering globalisation**

*The World Trade Organisation (WTO) - the successor or 'son of GATT' was established in 1995 and is the only international organization dealing with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible. It does this by administering trade agreements, acting as a forum for trade negotiations and settling trade disputes.*

*The International Monetary Fund (IMF) - is an organization of 186 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. The IMF was established at the end of World War II with the responsibility of overseeing the international monetary system to ensure exchange rate stability and encouraging members to eliminate exchange restrictions that hinder trade.*

*The World Bank - was also established in 1944 with the purpose of reducing world poverty by promoting global economic development. It does this by providing low or no interest loans and grants for economic and social development projects to developing countries that have limited access to international credit markets.*

fallen from an average of 29 per cent to below 8 per cent. Today average tariff rates are around 5 per cent in high income economies and 10 per cent in developing countries. Regional trading groups (or trading blocs) such as the European Union, NAFTA and ASEAN have also flourished and have encouraged the expansion of free trade by reducing or eliminating trade barriers.

A second key factor driving recent globalisation has been technology. Advances in transport and communication have resulted in 'the death of distance'. Transport costs and travel time have been drastically cut helping to boost the volume of merchandise trade and increase tourist travel to record numbers. Advances in information technology and the internet have enabled the growth of trade in services. Many services that were once thought of as non-tradable are now being outsourced to countries such as India - business services such as accounting, marketing and IT support. India has now become the world's leading exporter of IT services.

Multinational corporations have also played an important role in promoting globalisation. Multinational corporations (MNCs) are very large firms with headquarters in one country and subsidiaries in one or more other countries. These firms establish production and/or retail and distribution facilities in other countries. Think of major global firms such as General Electric, Apple, Nike and Microsoft from the United States, Shell and Vodafone from the United Kingdom, Toyota and Sony from Japan, Samsung from Korea, Nestle from Switzerland and Volkswagen from Germany. Even Australia has several MNCs, including BHP and Rio Tinto. Over the last 40 years, the number and size of multinational corporations has increased dramatically. In 1970, there were just 7,000 MNCs, whilst today there are over 100,000 parent companies operating with around 900,000 subsidiaries or affiliates in almost all industries and countries in the world. These companies play an increasingly major role in the world economy. Multinational corporations account for around a quarter of global GDP.

Why do multinational firms expand into foreign markets? Basically to increase their sales, market share and profits. To increase sales to a foreign market a firm has a choice of either exporting to the foreign location or establishing a subsidiary through foreign direct investment. Foreign direct investment (FDI) occurs when a firm in one economy acquires at least 10 per cent ownership of a foreign firm. Foreign direct investment has become an important link in the process of globalisation. In developed economies, FDI tends to be associated with mergers and acquisitions of foreign companies. In developing economies FDI is more associated with the construction of new facilities and is known as 'greenfield' investment.

## The effects of globalisation

Globalisation has become a controversial issue. On one side are the economic rationalists who argue that globalisation will improve economic welfare. On the other side are the critics who argue that globalisation while creating benefits for some, imposes costs on poorer economies and on disadvantaged workers. They argue that globalisation is simply making the rich richer and the poor poorer. First lets focus on the arguments against globalisation. Meetings of the WTO and other global groups such as the G20 are often plagued by violent demonstrations against free trade. Globalisation is seen as favouring the richer, developed nations of the world at the expense of the less developed countries. Global poverty has not been reduced and income inequality around the world appears to have increased. Anti-globalisers argue that free trade results in job losses in less competitive economies. By erecting barriers to trade such as tariffs, local jobs can be protected against unfair foreign competition. Free trade is also seen as leading to greater environmental damage due to increased industrialisation. Some argue that globalisation destroys cultural diversity with local markets being overrun by global brands. The recent increase in global financial flows is also seen as the cause of financial crises in many developing economies.

How do the advocates of globalisation respond to the critics? Most economists understand the economic case for free trade and see the modern form of globalisation as part of this process. The case for trade was put succinctly by the WTO Director (General Mike Moore). He regards trade as an important ingredient to improved living standards:

> *"Trade works its wonders in many ways. Higher exports pay for goods and services that are more cheaply priced abroad. The need to compete in world markets forces companies to become more efficient. And exporting firms provide good, high paying jobs...Imports too bring many benefits. Cheaper food and clothing for working families. Cheaper and better cars and electronic goods. Cheaper inputs to make businesses more competitive. And last but not least, new technologies and greater competition, both of which boost economic growth."*

There is substantial evidence that as countries 'globalise' their people benefit, in the form of access to a wider variety of goods and services, lower prices, more and better-paying jobs, improved health, and higher overall living standards. The

| Arguments for | Arguments against |
|---|---|
| It provides access to a wider variety of goods and services | It results in higher unemployment among low-skilled workers |
| It lowers prices | It entrenches the use of child labour |
| It provides more and better-paying jobs | It lowers wages |
| It increases competition & efficiency | It destroys local cultures |
| It reduces global poverty | It worsens poverty |
| It increases economic growth | It erodes democracy |
| It increases overall living standards | It is unfair to developing countries |
| It has enabled developing economies to access foreign investment | Volatile capital flows have destabilised developing economies |
| It increases multiculturalism | It increases environmental damage |

**Figure 1.9 Effects of globalisation**

evidence shows that over the past 30 years, as the number of countries engaging in globalisation has increased, the percentage of people living in extreme poverty (defined as living on less than $1 per day) has been cut in half.

A core element of globalisation is the expansion of world trade through the elimination or reduction of trade barriers, such as import tariffs. Greater imports offer consumers a wider variety of goods at lower prices, while providing strong incentives for domestic industries to remain competitive. The East Asian miracle is testament to the success of export led growth. Producing for the world market promotes efficiency and enhances national competitiveness. Open economies lead to more jobs, higher wages and better standards of living. Greater openness can also attract foreign direct investment (FDI), which helps to boost domestic production and employment and is an important source of new technologies - thus promoting higher productivity. Foreign direct investment (FDI) is a key element in international economic integration. FDI creates direct, stable and long-lasting links between economies. It encourages the transfer of technology and know-how between countries, and is also an additional source of funding for investment

Globalisation unites people around the world by promoting a common culture. The more economically interdependent the world becomes, the more people will trade and communicate with one another. This leads to inherent stability and the promotion of world peace. Notice that the most politically unstable and violent time of the 20th century was the period between 1914 and 1945. This was the period of 'protectionism' when globalisation went underground.

*"It has been said that arguing against globalisation is like arguing against the law of gravity." (former UN Secretary General Kofi Annan)*

Free trade does create winners and losers. However the winners gain more than the losers, so that it is possible to compensate the losers and result in a net gain for the economy. It is a similar argument to the effects of technological change. Technology imposes costs on some sections of the community but also leads to net gains. Should the world stop the advance in technology? Of course not. Research carried out by the World Bank found that since 1980, globalisation has contributed to a reduction in poverty as well as a reduction in global income inequality. They found that in 'globalising' countries in the developing world, income per person grew three-and-a-half times faster than in 'non-globalising' countries' during the 1990s. In general, they concluded that 'higher growth rates in globalising developing countries have translated into higher incomes for the poor.'

More recently, the election of President Donald Trump in the United States as well as the UK voting to leave the European Union (Brexit) signal that the world maybe moving away from globalisation. A new political climate is developing in which trade liberalization is increasingly unpopular. The IMF believes that the failure to support displaced workers and others affected by globalisation has encouraged protectionist sentiment in many countries. To prevent the world from slipping into a new protectionist era, governments should not only focus on economic growth but also on reducing inequality.

It is prudent to conclude the discussion of the globalisation debate with a quote from one of the world's leading economists, and Nobel Prize winner, in the field of economic development, Amartya Sen:

> *"Over thousands of years, globalisation has contributed to the progress of the world, through travel, trade, migration, spread of cultural influences, and dissemination of knowledge and understanding (including of science and technology). To have stopped globalisation would have done irreparable harm to the progress of humanity."*

## Worksheet 1

1. What are the key elements in the definition of globalisation?
2. Why do open economies grow faster?
3. Describe the main linkages between economies.
4. Why has world trade gown so fast?
5. Describe some of Australia's globally significant industries.
6. Why is merchandise trade much larger than trade in services?
7. Explain why there is a positive relationship between trade and economic growth.
8. What were the three largest categories of world exports in 2017?
9. Describe the main types of services that are traded.
10. Manufactured goods account for ____ % and services ____ % of world trade.
11. Which three countries are the world's leading exporters?
12. Explain why China has become the world's largest exporter.
13. Explain how a depreciation will affect a country's trade?
14. How does world economic growth impact on Australia's trade?
15. How will an increase in productivity affect Australia's trade?