OCR Economics A-level

Macroeconomics

Topic 4: The Global Context

4.3 Globalisation

Notes

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Characteristics of globalisation:

Globalisation is the ever increasing integration of the world's local, regional and national economies into a single, international market.

It involves the free trade of goods and services, the free movement of capital and labour and the free interchange of technology and intellectual capital.

With the spread of globalisation came more trade between nations and more transfers of capital including FDI (foreign direct investment). Moreover, brands developed globally and labour has been divided between several countries. There is more migration and more countries participate in global trade, such as China and India, as well as higher levels of investment. Additionally, countries have become more **interdependent,** so the performance of their own country depends on the performance of other countries. This could be seen in 2008 and 2009, when the effects of the global credit crunch spread across the globe.

Factors contributing to globalisation in the last 50 years

Trade in goods:

- Developing countries have acquired the capital and knowledge to manufacture goods. The efficient forms of transport make it easier and cheaper to transfer goods across international borders. Some developing countries have the cost advantage of cheaper labour, so MNCs move their production abroad. This causes developed countries to trade with these developing countries, so they can access the same manufactured goods.

Trade in services:

- For example, the trade of tourism, call centre services, and software production (particularly from India) has increased from developing countries to developed countries.

- **Trade liberalisation:**

    - The growing strength and influence of organisations such as the World Trade Organisation (WTO), which advocates free trade, has contributed to the decline in trade barriers.

- **Multinational Corporations (MNCs):**

    - MNCs are organisations which own or control the production of goods and services in multiple countries. They have used marketing to become global, and by growing, they have been able to take advantage of economies of scale, such as risk-bearing economies of scale. The spread of technological knowledge and economies of scale has resulted in lower costs of production.

- **International financial flows:**

    - For example, the flow of capital and FDI across international borders has increased. China and Malaysia have financed their growth with capital flows. Also, the foreign ownership of firms has increased. There has been more investment in factories abroad.
    - The removal of capital controls has facilitated this increase.

- **Communications and IT:**

    - The spread of IT has resulted in it becoming easier and cheaper to communicate, which has led to the world being more interconnected. There are better transport links and the transfer of information has been made easier. This is sometimes referred to as the 'death of distance'.

- **Containerisation:**

    - This has resulted in it becoming cheaper to ship goods across the world. This causes prices to fall, which helps make the market more competitive. Containerisation means that goods are distributed in standard sized containers, so it is easier to load and cheaper to distribute using rail and sea transport. This helps to meet world demand. Cargo can be moved twenty times as fast as before, economies of scale can be exploited and less labour is required.
    - However, it is mainly MNCs which have been able to exploit this, and it could result in some structural unemployment.
    - This video provides a good background to containerisation https://www.youtube.com/watch?v=Gn7IoT_WSRA

International Competitiveness:

International competitiveness is the ability of a nation to compete successfully overseas and sustain improvements in real output and living standards.

Countries who are internationally competitive will benefit from globalisation as they can access wider markets. International competitiveness can be measured by relative unit labour costs and relative export prices.

Countries can compete with price and non-price competitiveness. For example, the quality of goods and services and the rate of innovation can change how competitive a country is.

How countries achieve international competitiveness

- **Productivity**

  The more productive the country becomes in the production of a good or service, the lower its cost per unit and the cheaper it can supply the good on the international market. They can also produce more per hour with the same quantity of resources, which makes them more efficient. This increases international competitiveness.

- **Unit labour costs**

  Unit labour costs form a significant part of the production costs of a firm, especially if it manufactures goods, rather than being in the services sector. In China, unit labour costs have been low, especially because of the large population which increases the supply of labour. This has made them highly competitive in the manufacturing sector. However, the rise of the middle class in China has meant workers have been demanding higher wages recently.

- **Exchange rates**

  A lower real exchange rate means goods are more competitive. This is because exports are relatively cheaper.

- **Product quality**

  If a good is renowned for being of a good quality, such as German cars, they are likely to have a more inelastic demand, since consumers are attracted to the reputation. This makes the country more competitive in a market.

- **Regulation**

  Excessive regulation (red tape) can make it hard for firms to invest, and it could raise their average costs of production. The UK government has established the 'Red Tape Challenge', which aims to simplify regulation for businesses, so it is cheaper and easier to meet environmental targets and create new jobs. It should help to encourage investment and innovation, so domestic firms can become more internationally competitive.

  In France, there are excessive employment laws that make it hard for small enterprises to compete.

- **Rate of innovation**

  This is calculated by the proportion of GDP invested in new capital. If a country innovates more, they are likely to develop new, more advanced technology that can help them become more competitive. It could increase the quality of the goods and services produced.

  It could be argued that non-price factors such as availability, reliability, quality, design and innovation are more important than price factors.

  Other factors determining international competitiveness include the ability to attract FDI, tax rates, ability to attract skilled labour from abroad and labour market flexibility.

The distinction between absolute and comparative advantage

A country has **absolute advantage** in the production of a good or service if it can produce it using fewer resources and at a lower cost than another country.

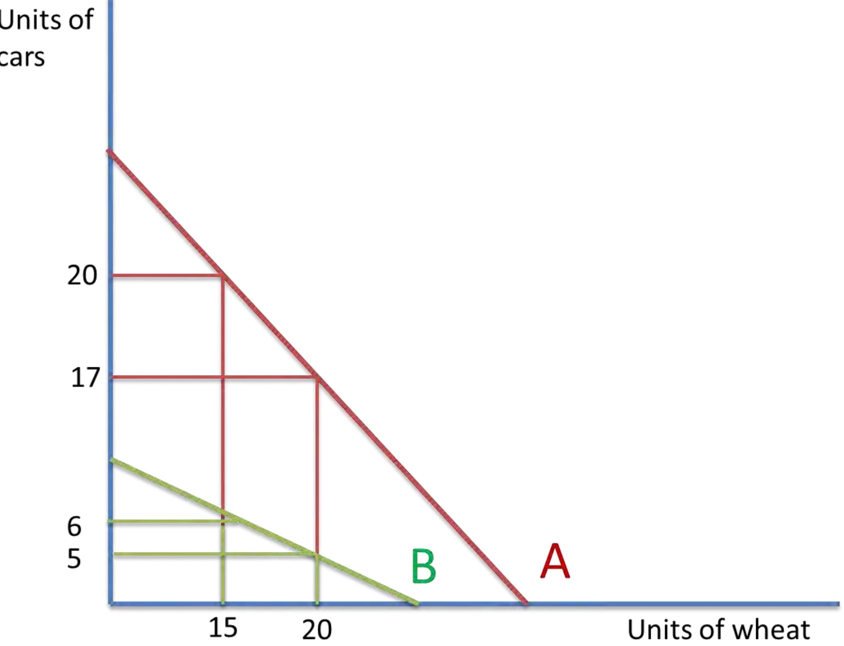
Comparative advantage occurs when a country can produce a good or service at a lower opportunity cost than another country. This means they have to give up producing less of another good than another country, using the same resources.

Opportunity cost ratios to illustrate the gains from trade derived from absolute and comparative advantage

Countries can specialise where they have comparative advantage. This increases economic welfare. By specialising and exploiting their comparative advantage, countries can increase world output.

Country A can produce 30 units of wine and 10 units of wheat with their resources, and country B can produce 32 units of wine and 20 units of wheat. It can be seen that country B has an absolute advantage in producing both products (it can produce more of both with the same resources). The greatest difference between the productions is with wheat, so country B should produce wheat and country A should produce wine.

The opportunity cost of production is reflected in the gradient of the PPF. If more of one good is produced, less of the other good can be produced.



From the diagram, it can be seen that to increase production of wheat by 5 units, A has to give up 3 units of cars (20 to 17). However, B only gives up 1 unit of cars (6 to 5). Therefore, B has a lower opportunity cost of producing wheat, so B should produce wheat. For each unit of wheat, the opportunity cost ratio for A is 3/5, whilst for B it is 1/5.

The measurement of the terms of trade

The terms of trade measures the volume of imports an economy can receive per unit of exports. It is calculated by the index price of exports over the index price of imports. Terms of trade above 100 are improving, whilst those below 100 are worsening. An example calculation is:

- The index price of exports increases by 15%. The index price of imports increases by 20%. The terms of trade are (115/120) x 100 = 95.83. This means that the terms of trade has reduced, so the economy gets fewer imports per unit of exports.

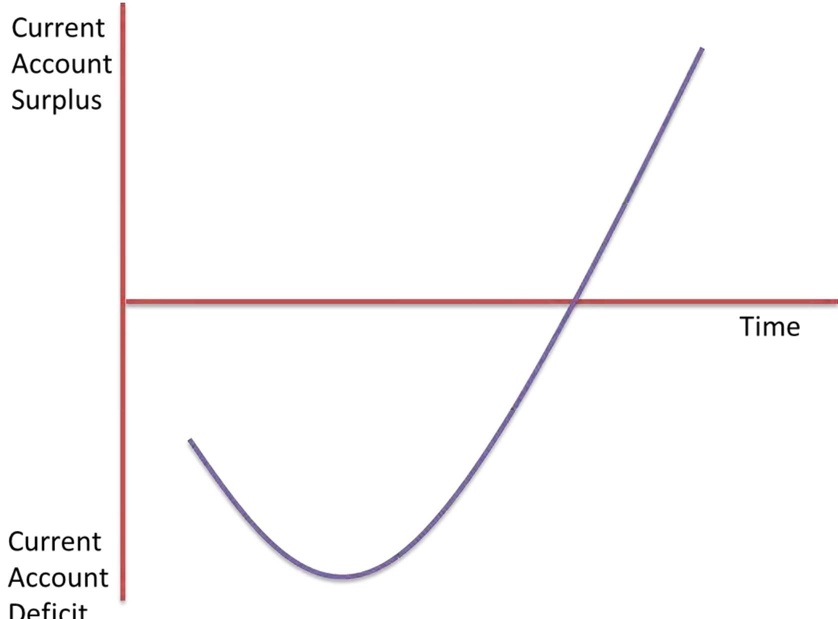
The determinants of the terms of trade, including Heckscher-Ohlin theory

The Heckscher-Ohlin model (H-O model) suggests that countries produce and export goods which need abundant resources, and import goods which need resources in short supply.

Essentially, the different factor endowments in each country determine what a country imports or exports. The model assumes that labour and capital is able to flow freely between sectors, that the quantity of labour and capital in each country varies, that in the long run technology is the same among countries and that tastes are the same.

Marshall-Lerner condition and the J-curve effect

The Marshall-Lerner condition states that a devaluation in a currency only improves the balance of trade if the absolute sum of long run export and import demand elasticities is greater than or equal to 1.



The J-curve effect occurs when a currency is devalued. Since devaluing the currency causes imports to become more expensive, at first the total value of imports increases, which worsens the deficit. Eventually, the value of exports decreases, which leads to a reduction in the trade deficit.

When the currency is devalued, there may be a time lag in changing the volume of exports and imports. This could be due to trade contracts and the price inelasticity of demand for imports in the short run, whilst consumers search for alternatives. In the long run, consumers might start purchasing domestic products, for example, which helps improve the deficit.

Evaluate comparative advantage as an explanation of global trade patterns

The theory of comparative advantages assumes a perfectly competitive market. In reality, this is likely to be different, which results in the full benefit of specialisation not happening. Specialising fully could also lead to structural unemployment, since workers might not gain the transferable skills they need to change between sectors, or they are simply unable to change.

Comparative advantage does not consider the exchange rate when considering the cost of production for both countries. Therefore, if the price of one good increase, it is more worthwhile producing that good, even if the country has a comparative advantage in the other good.

Countries can develop an advantage in the production of a good, such as Vietnam in the production of coffee. It is the largest coffee supplier to the UK and, over the last 30 years, it has become one of the world's largest coffee producers. During this period, Vietnam's market share increased from 1% to 20%.

Impacts of globalisation and global companies on:

Individual countries

There could be trade imbalances between countries. For example, the US runs a large current account deficit with China, who has a large current account surplus.

There could be imbalances and inequalities in consumers' and countries' access to health, education and markets.

Within individual countries, there could be income and wealth inequalities if the benefits and costs of globalisation are not evenly spread. This is evident in China, where the population in the rural and urban areas have vastly different levels of income and living standards.

Culture could spread across the globe. Some might say this has weakened culture and that there has been a loss of cultural diversity due to global brands. However, others will argue that the spread of culture has been positive and helped to improve their quality of life.

If firms are operating in a competitive global environment, infant industries might find it hard to compete, so they are forced out of the market. This might be to the detriment of developing countries who may have less developed or smaller industries. Also, the supernormal profits of large firms might be eroded away, which could limit the amount of investment in R&D, and therefore long term economic growth.

Governments

Some governments might lose their sovereignty due to the increase in international treaties. Individual states would find it hard to resist the force of them, and if countries become members of organisations, they will have to abide by their rules.

Producers and consumers

Consumers and producers can earn the benefits of specialisation and economies of scale as firms become larger.

Firms operate in a more competitive environment, which encourages them to lower

their average costs and become more efficient. Producers can also make their average costs lower by switching production to places with cheaper labour. The spread of technology has resulted in firms being able to employ the most advanced machines and production methods.

Globalisation leads to a general increase in world GDP, which increases consumer living standards and helps lift people out of absolute poverty. However, it is hard to calculate the proportion of growth which was due to globalisation.

This rise in average consumer incomes could offset some of the lower costs of production for firms. This is especially due to increased demand from China, which has contributed to the increase in price of commodities, and therefore pushed up the price of raw materials.

Some consumers gain more from globalisation than others. Globally, there are fewer people in extreme poverty, but this has not been the case in Sub-Saharan Africa. There could be increased inequality. Oxfam research in 2015 suggested that 1% of the world own more than the rest of the world (more information here http://www.bbc.co.uk/news/business-30875633).

Consumers could take advantage of a wider range of goods and services because of the increased availability of goods and services. However, some services might become homogenised, such as hotels.

Workers

Workers can take advantage of job opportunities across the globe, rather than just in their home country.

However, there could be structural unemployment. For example, in the UK after the collapse of the ship building and mining industries, there was a lot of structural unemployment. This is because it was more efficient for manufacturing to occur abroad, so production shifted to lower labour cost nations.

However, it could be argued that countries would have had the change from agriculture to manufacturing to services anyway, and globalisation simply sped it up.

When production shifts to lower labour cost countries, the creation of jobs could be seen as either beneficial or harmful. On one hand, MNCs could be exploiting their labour and providing poor working conditions in, for example, sweatshops. On the other hand, working in a sweatshop might provide a higher, more stable income than any alternatives, such as agriculture.

The environment

Although industrialisation and increased consumer living standards might lead to more pollution through increased production and increased car use, consumers might show more concern towards the environment as their average incomes increase.

Some of the negative impacts on the environment could include deforestation, water scarcity and land degradation.

Impact of emerging economies

The collapse of communism has meant that more countries, especially developing countries, are participating in world trade.

International trade is arguably more important for developing countries than developed countries. It contributes towards 20% of LDC economies compared to 8% of the US economy.

Between 1995 and 2005, India's share of textiles and clothing fell from 35% in 1995 to 16% in 2005. Instead, India's manufacturing sector seems to produce more engineered goods than clothing and textiles. This has resulted in UK manufacturers selling fewer manufactured goods abroad.

China and India are important for African infrastructure. They have invested in their infrastructure in exchange for natural resources.

Both China's and India's share in agriculture, mining and fuel has declined. Both countries are important in the Euro area, with trade and financial relations. China is a main import source, whilst both are important for capital.