Economic Globalization and Its Consequences

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Defining Globalization

Globalization is the process by which nationality and geographic location become increasingly irrelevant for economic activities.

What exactly does that mean?
What is the evidence of this process?
Which factors drive this process?
How should businesses respond to it?

Types of Globalization

- **Economic Globalization**: the process advancing the integration of the world economy through trade and investment.
  ➡ How does it work?

- **Cultural Globalization**: the process by which tastes and preferences of individuals become more similar across countries (e.g., Nintendo? Hollywood movies? McDonald's? or Sushi?).
  ➡ Should we care about it? Is this desirable or not?

- **Political Globalization**: countries care about their neighbours' actions because of (negative) spillover effects.

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Types of Economic Globalization

- Globalization of **consumption**: the nation in which a product was made becomes independent of the nationality of the consumer.

  ➡ **International Trade**

- Globalization of **production and ownership**: the nationality of the owner and controller of productive assets is independent of the nation housing them.

  ➡ **Foreign Direct Investment**

Globalization of Consumption

People have a **preference for variety**.

➡ If each nation produces a number of varieties of goods proportional to its size, a Canadian consumes foreign products in proportion to the economic size of the originating country. Since Canada's share in world output is only about 3%, only 3% of goods consumed in Canada would be domestically produced.

➡ In a fully "globalized" world, consumption patterns will *not* depend on similarity in culture, language, or institutions, and they will also *not* depend on geographic proximity or trade relations.

Globalization of Production and Ownership

Location choice depends on **comparative advantage** (lower per-unit production cost) in a given location. Countries tend to specialize in activities. International "outsourcing" of production allows companies to reap the full benefits of an integrated world economy.

If there is no **"home bias" in ownership**, Canada's assets would be owned by foreigners at the same proportion as foreigners own all world assets. Consequently, only about 3% of Canadian assets would be owned by Canadians, and Canadian firms would have roughly 97% of their total assets overseas.

The Gains from Trade

➡ Trade Leads to Specialization of Countries

- **Technological Differences**: Some countries are more productive than others. Diffusion of new technology is slow. Ricardo's Theory of Comparative Advantage implies that countries will trade even when one country has higher productivity in all industries.
- **Factor Endowments**: Countries are differently endowed with capital, different types of labour, land, and natural resources.
- **Increasing Returns to Scale**: Per-unit costs may fall with output or cumulative output. Companies may benefit from agglomeration effects and other positive "spillovers." Concentration and specialization of production will be beneficial.

Gains from Foreign Investment

➡ Why do Multinational Enterprises exist?

➡ Because MNEs internalize ownership advantages.

- **Technological Advantage**: protection of intellectual property.
- **Consumer Recognition Advantage**: brand names, company recognition, positive “source effect”.
- **Market/Location Advantage**: local knowledge, delivery logistics.
- **Input/Sourcing Advantage**: superior ability to source inputs.

Liberty, Markets, and Market Failure

- People and companies trade with each other across borders because this is their choice and it is to their advantage. Interfering in trade relations limits freedom.
- Companies which compete with rivals for customers and workers worry about their reputation for quality and social responsibility. Functioning markets express consumer preferences, not company preferences. Globalization generally increases competition.
- When markets fail, governments have an obligation to intervene (e.g., by setting environmental standards).

Does globalization harm the poor?

Accusations:

1. Globalization displaces low-paid workers at home and drives down wages by raising unemployment.
2. Globalization shifts jobs to poor countries where workers are paid much less than the displaced workers in rich countries.

Responses:

1. Freer trade raises living standards in both rich and poor countries.
2. Workers in poor countries are better off because they have chosen to work for a (usually better-paying) foreign company rather than a (lower-paying) domestic company.

3. While displaced rich-country workers are initially worse off, most of them will eventually move to other jobs.

4. Unemployment rates are neither higher nor lower in an open economy compared to a closed economy.

5. Because imports and exports must balance in the long run, "moving jobs abroad" in one industry must be matched by an increase in production in another industry at home. New jobs at home are often high-skilled jobs.

6. Empirically, investment abroad does not displace exports (and jobs). Production abroad often requires inputs from the home country, and increases trade among affiliates of multinationals. As a result, exports tend to increase along with foreign investment.

But what about child labour? Or the environment?

- Stopping imports from countries with child labour may do more harm than good. Less trade means less growth and more poverty. Trade barriers may simply drive children from producing for export to producing goods for domestic consumption; they still may not go to school instead. In the long run, the best way to combat child labour is to combat its source: poverty.
- With increased FDI, will environmental polluters move from rich high-standard countries to poor low-standard countries, resulting in a "race to the bottom"? Is free trade good or bad for the environment? Evidence: open economies grow faster than closed economies, and richer countries implement higher environmental standards.

Does globalization widen income inequality at home?

- Increased trade does indeed seem to raise income inequality somewhat. Wages for low-skilled jobs have stagnated, but wages for high-skilled workers have increased significantly.
- However, the effect from increased trade is overshadowed dramatically by the inequality-raising effect from skill-biased technological change.
- The negative effects from trade and technology are compensated by better education of new workers and retraining of low-skilled workers.

Does globalization widen the income gap between rich countries and poor countries?

- Empirical fact: trade is good for economic growth, and with few exceptions increases in per-capita income of the poor has not fallen behind overall increases in per-capita income in developing countries.
- Poverty is worst where growth is low (Africa) and is much reduced where growth is high (East Asia). Between 1975 and 1995, the per-capita income gap between the U.S. and China has fallen from 19 to 6; however, Africa's income gap has increased from 12 to 19.
- Wage differentials also reflect differences in productivity.

If not globalization, then who or what is responsible for the scandalous level of poverty in this world?

- **Rich countries:** • trade rules exclude goods from poor countries (e.g., textiles, agricultural products) • protection of intellectual property rights may exclude poor countries from accessing technology (e.g., cheap generic drugs to combat HIV) • over-protection of banks encourages reckless lending and thus contributes to financial crises in poor countries
- **Poor countries:** many problems are indeed home-made • corruption • incompetence and patronage • lack of legal protection of people and property • lack of women's rights • tribal warfare • non-democratic political systems

Globalization Example: The GM LeMans

- design: Germany
- components: Japan, Taiwan, Singapore
- assembly: Korea
- advertising campaign: Britain

Empirical Evidence: International Trade

1. World exports have consistently grown more than world GDP (output) during the Post-war period. During the last 45 years world merchandise output multiplied by a factor of 5.5 while trade multiplied by a factor of 14.
2. Trade in manufactured goods still accounts for about half of all trade and it grew rapidly in the 1990's.
3. Trade in services (software, insurance, banking, etc.) is increasing its share in total trade and is becoming increasingly important.

Empirical Evidence: Foreign Direct Investment

1. FDI has increased dramatically. Between 1984 and 1998, total flow of FDI from all countries increased by 900%, while world trade grew by 121%, and world output by 34%.
2. By 1998, the global FDI stock has exceeded US$4.0 trillion (more than 1/2 the size of the U.S. economy)
3. 45,000 parent companies had 280,000 foreign affiliates.
4. About 80% of world FDI is between developed countries.
5. About 80% of FDI into Canada comes from the U.S., and another 10% from the UK.

Counter Evidence: Is the World a Global Village?

- Nations and geography still matter.
- Consider the leading multinationals. With few exceptions (Nestle), they have a home-country bias in both their assets and sales (sales at home are a higher % of total sales than home GDP as a % of world GDP).
- Consider the large automobile-MNEs in the US. Deborah Swenson has analyzed data on the percentage of inputs originating in the US and the percentage of shipments remaining in the US. For the ‘Big 3’, 95% of inputs are domestic and 92% of shipments remain in the US. For foreign assemblers, 67% of inputs and 88% of shipments are domestic.

Counter Evidence (II)

- FDI outside of the home country is regionally clustered (especially taking into account economy sizes): Japan is the principal investor in Korea and other Asia-Pacific areas. Germany dominates investment in Eastern Europe. The United States dominate investment in the rest of the Americas.
- Affiliates of US MNEs in Europe sell most of their products (on average 60%) in the country in which the affiliate is located.

Driving Forces of Globalization

1. **Advances in Transportation Technology**: the "shrinking globe"; air travel; container ships and tankers; more roads.
2. **Improvement in Communication Technology**: coordination of activities around the world is getting easier; the Internet.
3. **Lower Barriers to Trade**: NAFTA, GATT and the WTO; the Most-Favoured Nation (MFN) Principle.
4. **Lower Barriers to Investment**: The National Treatment (NT) Principle ensures non-discrimination against foreign companies
5. **Integration of Financial Markets**: High level of international capital mobility; increased market transparency.

Driving Forces of Globalization (continued)

6. **Convergence in Tastes:** As per capita incomes have converged among the OECD nations (Europe, North America, Japan), this has promoted more similar buying patterns, making goods produced abroad more attractive than they were before. Greater similarity in buying patterns may also emerge from increased travel, migration, and international media. For example: With the exposure to new cuisines, Americans are sprinkling an average 3.1 pounds of spices onto food annually, nearly a pound more than a decade ago.

How Should Businesses Respond to the Challenge of Globalization?

- **Rationalization**: the reorganization of production by product or process in different countries to exploit location advantages (see: gains from trade).
  - **Consolidation**: shutting down of inefficient production lines in some plants and boosting of production capacity of efficient production lines in other plants
  - **Specialization**: dedication of production plants to individual products or processes.
- **Fragmentation**: Duplication of production lines in different geographic locations to address local differences in consumer behaviour or exploit proximity advantages.

Globalization: Strategic Responses

- **Global Strategy**: In response to high cost pressures, centralize production and functions in the most suitable location(s) in order to exploit economies of scale. Sell a “global product”.
- **Multidomestic Strategy**: In response to high demand pressures, establish self-reliant operations in many countries with little global integration. Sell a “local product”.
- **International Strategy**: A mixture of the previous two strategies with a strong headquarter (e.g., for R&D), strong global integration, but some duplication of functions in individual countries or regions.

Globalization: Operational Modes

- **Exporting**
- **Licensing and Franchising**
- **Subsidiary**
  - Buying an existing “brownfield” operation.
  - Establishing a new “greenfield” operation.
- **Joint Ventures**
- **Strategic Alliances**

Globalization: Practical Challenges

- **Different Legal and Tax Environments**: ownership rules tax rates, double taxation, government incentives
- **International Finance**: different currencies, exchange rates, hedging against currency risk.
- **International Marketing**: consumers have different preferences, different levels of sophistication and purchasing power, different social context.
- **Organizational Integration**: different languages, different business culture.

Political Globalization And The Westphalian Principle

- The 17th-century Peace of Westphalia, which ended the 30-Years War, established the rule that states may do whatever they like (such as imposing the sovereign’s religion) within their borders—only external relations are the proper concern of the international community.
- Under which conditions are we willing to interfere in the internal affairs of a sovereign state? In reality, the Westphalian Principle is eroding.

The Westphalian Principle (II)

- What about spillover effects? Violations of human rights generate refugee streams. Violations of environmental standards spill across borders through pollution (e.g., acid rain, global warming).
- How strong is the (economic and/or political) rationale for harmonizing standards such as labour laws, environmental protection, or human rights?
- What can we do to coordinate activities and protect standards?
- Isolationism is not an option. Globalization is a reality.