TOPIC 1

THE GLOBAL ECONOMY

Focus

The focus of this study is the operation of the global economy and the impact of globalisation on individual economies.

Skills

Topic 1 skills questions can ask you to:

- Analyse statistics on trade and financial flows to determine the nature and extent of global interdependence
- Assess the impact on the global economy of international organisations and contemporary trading bloc agreements
- Evaluate the impact of development strategies used in a range of contemporary and hypothetical situations

Issues

Topic 1 economic issues questions can ask you to:

- Examine the effects of globalisation on economic growth and the quality of life, levels of unemployment, rates of inflation and external stability
- Assess the potential impact on the environment of continuing world economic development
- Investigate the global distribution of income and wealth
- Assess the consequences of an unequal distribution of global income and wealth
- Discuss the effects of protectionist policies on the global economy

Topic 1

Introduction

This section (chapters 1 to 3) covers HSC Topic 1 *The Global Economy* and focuses on the structure of the global economy and the key features of globalisation. To understand the Australian economy we need to start with a global perspective. Topic 1 is critical to the rest of the course because it provides the overall perspective for when we later examine other topics such as Australian economic issues and policy.

Chapter 1 provides an overview of the global economy. It discusses the main components of the global economy – international trade, international flows of finance and investment, and the role of technology and people movements in strengthening links between individual economies. These links are highlighted with a review of international and regional business cycles.

Chapter 2 examines the main economic theory that underpins globalisation – the concept of free trade and the economic benefits that trade brings. Chapter 2 then examines the reasons for countries restricting trade and protecting their own industries and how recent years have seen many international agreements to reduce barriers to trade. This chapter concludes with a look at the role of international organisations and government economic forums in managing the global economy.

Chapter 3 examines the divisions within the global economy. Understanding the gaps in the living standards between rich and poor nations is essential to an analysis of the global economy. This chapter looks at the distinction between economic growth and economic development. It discusses the main categories into which different economies are grouped and examines the global and domestic factors that contribute to inequality. Chapter 3 also discusses the impacts of globalisation on economic development.

Topic 1 concludes with case studies of Brazil and Indonesia. Understanding the impacts of globalisation on individual economies is an important complement to any analysis of globalisation at the global level and is a requirement of the HSC Economics Course.

Brazil is one of four largest emerging economies in the world and is the major economy of the Latin American region – a region of the world Australians often know little about. Like Australia, Brazil is a major commodity exporter, but unlike Australia it has recently experienced severe recession. Brazil has grappled with globalisation and many of its experiences highlight the opportunities and challenges of increased economic integration.

Indonesia is the largest emerging economy of South-East Asia – a region that experienced rapid industrialisation and improvements in economic development in recent decades despite major international economic disturbances. The increasing linkages between Indonesia and Australia make understanding the Indonesian economy especially valuable for future Australian economists.

The case studies may complement another country that you choose to study. You may decide to compare the impacts of globalisation on these two economies or you may choose to make either Brazil or Indonesia your case study in 2018.

1 Introduction to the Global Economy

1.1 The global economy

The study of Economics has traditionally focused on how individual economies operate. While countries have always traded with each other, economic theories have generally assumed that economies operate separately from each other and that the structure and performance of economies is mainly the result of local developments and influences.

This way of looking at Economics no longer describes the real world. Today we live in a **global economy** – where the economies of individual countries are linked to each other and changes in a single economy can have ripple effects on others. In the industrialised world for example, the value of what many countries buy and sell from overseas is greater than half of the country's economic output. When conditions in the global economy change these changes can have an impact on the economies of far-flung countries almost immediately.

In many respects there is nothing new in the fact that major economic developments can have impacts across the world. For example, the Great Depression of the 1930s had a global impact with many countries experiencing a severe economic downturn. The level of trade and integration between the economies of European nations a century ago was so strong that many observers doubted that these nations would ever go to war against each other. In fact the level of trade between the world's leading economies has only recently surpassed its level in the decades prior to World War I, as countries have dismantled the trade barriers that were raised after World War I and the Great Depression.

On the other hand, economies are more closely integrated now than at any previous time. The linkages between economies are stronger and more far-reaching than ever before. There are few aspects of life that have not been affected by the waves of global influences washing across the world. This is especially the case in a small economy such as Australia which has embraced the global economy and pursued policies to integrate its economy with those of its region and around the world.

Globalisation refers to the integration between different countries and economies and the increased impact of international influences on all aspects of life and economic activity.

In the past two decades the term **globalisation** has become a dominant economic political and social theme. Globalisation is the integration between different countries and economies and the increased impact of international influences on all aspects of life and economic activity.

Unlike many previous times in world history when the influence of one country has been almost entirely one-way, globalisation in recent decades has involved layers of influences in all directions. Although the United States is still unrivalled as the leading world economy its power is increasingly constrained by many other faster-growing economies in Asia.

There are many dimensions to globalisation and there are many statistics that can be used as measures of globalisation. For example, some indication of the extent of globalisation

can be gained from examining the proportion of television programming taken by shows produced overseas or the influence of global fashions on what people wear in countries such as Australia. These would be classified as social or cultural indicators of globalisation.

Globalisation is also a phenomenon with increasing impacts on politics. The United Kingdom's "Brexit" from the European Union and the election of Donald Trump as US President on an anti-free trade platform were both examples of rising public opposition to globalisation, with perceptions that it reduces national sovereignty and contributes to inequality. The impacts of globalisation are discussed in detail in chapter 3 of this textbook.

From an economic point of view the major indicators of integration between economies include:

- international trade in goods and services
- international financial flows
- international investment flows and transnational corporations
- technology transport and communication
- the movement of workers between countries.

Each of these indicators provides an insight into the way in which economies are now linked to each other and the extent to which a global economy is emerging.

"Ensuring that the fruits of globalisation are enjoyed by all is an urgent task for every country in the world, both rich and poor. But globalisation is having other effects, especially on people's aspirations, that are forcing us to rethink our approach to development.

The Sustainable Development Goals, adopted by 193 states in 2015, are wildly aspirational in their vision of a world without poverty and hunger, safe from threats like environmental and social disasters.

Everywhere I go I see that ambition with my own eyes.

As President of the World Bank Group, I've travelled to 6 continents and met people from most of our 189 member countries. In almost every country, I see people on their cell phones and computers. The internet and social media allow them to know exactly how everyone else lives. To some extent that's been possible for a long time through newspapers and television.

The difference is that now someone in Butare, Rwanda can Facebook message their cousin in Kigali and become immersed in detail about life 80 miles away. Both of them can talk every day with a friend studying in Paris, and learn about life 4000 miles away. Depending on connectivity, which happens to be excellent throughout Rwanda, they can send emails, pictures, videos, snaps, tweets and texts back and forth at lightning speed.

Knowing exactly how everyone else lives, in their own countries and abroad, is leading to a convergence of aspirations."

– Jim Yong Kim, President of the World Bank Group
"Rethinking Development Finance", 11 April 2017
Speech presented in London, United Kingdom.

1.2 Globalisation

Trade in goods and services

International trade in goods and services is an important indicator of globalisation because it is a measure of how goods and services produced in an economy are consumed in other economies around the world. Trade in goods and services has grown rapidly in recent decades, increasing from US$6.2 trillion (37 per cent of global output) in 1987 to over US$41.7 trillion (53 per cent of global output) in 2017. The size of the **Gross World Product (GWP)** – the aggregate value of all goods and services produced worldwide each year in the global economy – is now over fifty times its nominal level in 1960, but the volume of world trade has grown to 125 times its 1960 level.

Gross World Product (GWP) refers to the sum of total output of goods and services by all economies in the world over a period of time.

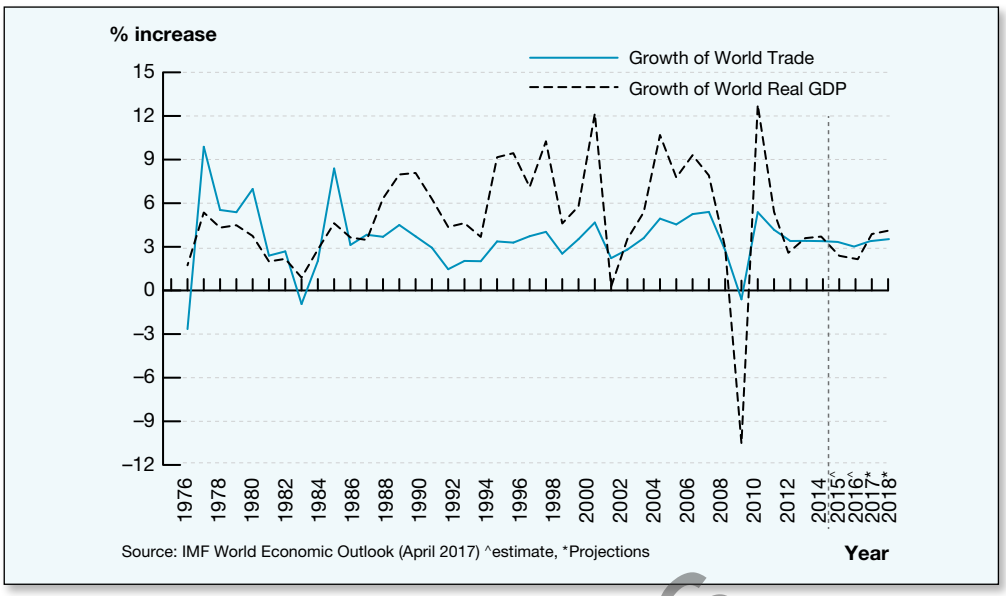


Figure 1.1 – Gross World Product and world trade

Annual growth in the value of trade has generally been around twice the level of world economic growth as shown in figure 1.1. During economic downturns however, such as in the mid-1970s, early 1980s, early 2000s and again in the late-2000s, the growth of global trade has contracted faster than world economic output highlighting the **greater volatility** of trade compared with Gross World Product. The WTO has forecast that global trade growth could range from between 2.1 per cent to 4 per cent for 2018 until the end of the 2010s. This will be driven by stronger global economic growth and offset somewhat by government policies (such as the UK's withdrawal from the European Union).

World Trade Organisation (WTO) is an organisation of 164 member countries that implements and advances global trade agreements and resolves trade disputes between nations.

The high volume of global trade reflects the fact that economies do not produce all the items they need, or they do not produce them as efficiently as other economies, and have to import goods and services. Global trade has also grown strongly in recent decades because of new technology in transport and communications, which have reduced the cost of moving goods between economies and providing services to customers in distant markets. Over the same period, governments have encouraged trade by removing barriers and joining international and regional trade groups such as the **World Trade Organisation (WTO)**, European Union (EU), and the Association of South-East Asian Nations (ASEAN). These developments have been a major force behind increasing global trade.

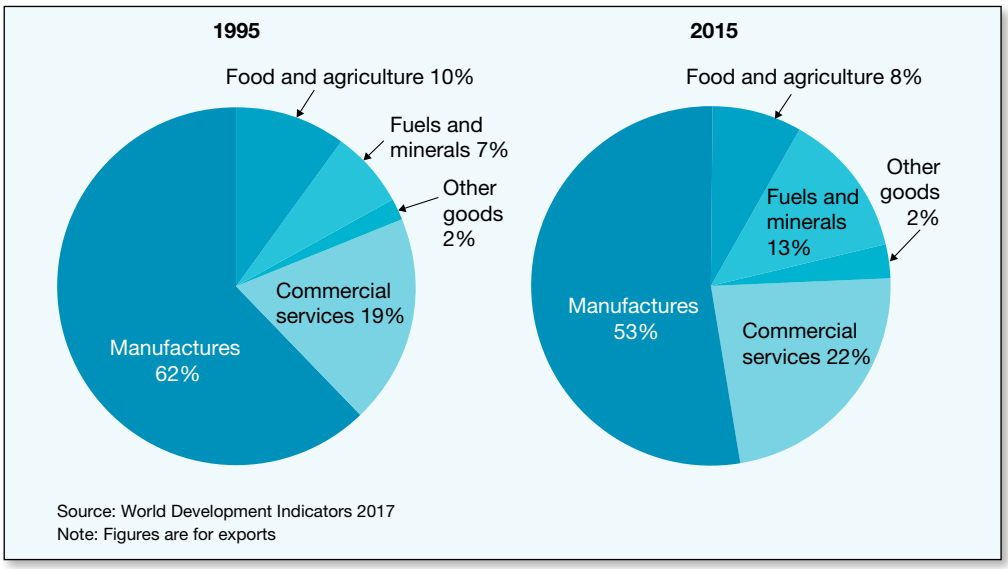


Figure 1.2 – Composition of global trade, 1995 and 2015

The mix of what goods and services are traded, known as the **composition of trade,** can have an impact on individual economies. As shown in figure 1.2 on page 8, global trade used to be dominated by manufactured goods, such as vehicles, clothing and electronic goods. In the long term it is expected that trade in services like finance and communication services will be the fastest growing category because while services make up two-thirds of global output they still make up just one-quarter of global exports. Countries such as Australia are expected to benefit from this growth, because countries with highly educated workforces are best positioned to compete in growing global markets for services.

The **direction of trade flows** has changed in recent decades, reflecting the changing importance of different economic regions. Between 1995 and 2015 high-income economies (concentrated in North America and Western Europe) saw their overall share of global trade fall from 82 per cent of world merchandise exports to 68 per cent, as shown in figure 1.3. Over the same period the fast growing economies of East Asia and the Pacific region (which includes China, Indonesia and Vietnam) experienced the most rapid increase in trade with their share of global trade surging from 7 per cent to 18 per cent.

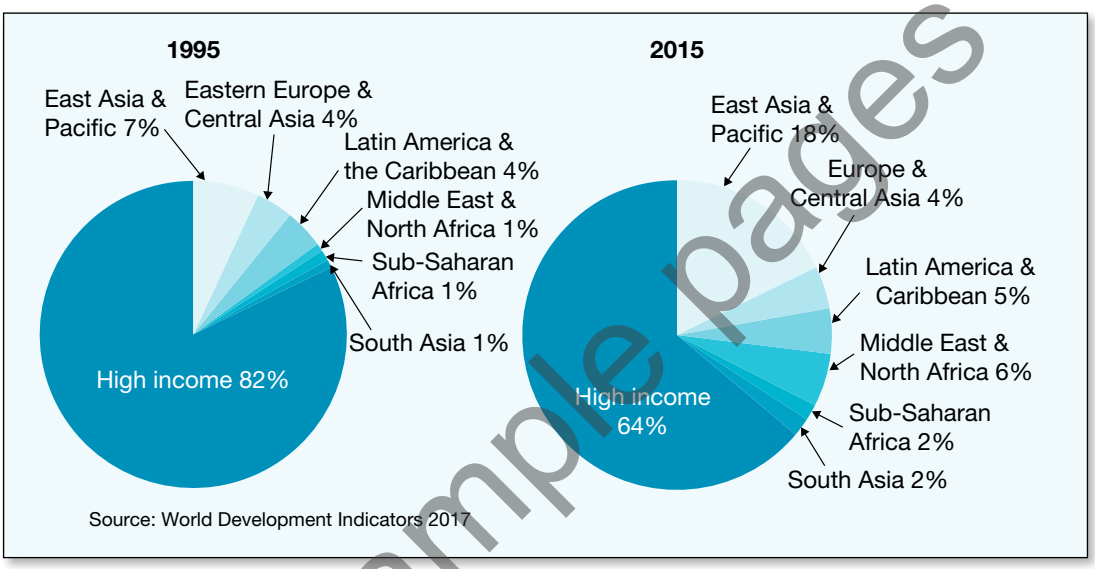


Figure 1.3 – Share of world's merchandise exports by region, 1995 and 2015

Trends in the direction of trade can also have an impact on individual economies. For example, with the Chinese economy playing an increasingly important role in global trade, other economies have placed an increased priority on their trade relationships with China. China's economy has grown rapidly in recent decades, and despite a more recent slowdown, this still points towards an expanding market for exports in future years. Countries such as Australia may respond by preparing for a larger trading relationship with China through encouraging students to learn Mandarin at school, negotiating trade agreements with China, and increasing investment in domestic industries whose goods and services are in greatest demand from China.

reviewquestions

1. Explain TWO reasons for the increase in trade in goods and services in the global economy.
2. Describe trends in the composition and direction of trade flows in the global economy.
3. Discuss the impacts of changes in global trade flows on economies.

Financial flows

International finance now plays a leading role in the global economy. Because finance is crucial to so many aspects of how modern economies work, the globalisation of finance has had a major impact in terms of linking economies around the world. Finance is the most globalised feature of the world economy because money moves between countries more quickly than goods and services or people.

International financial flows have expanded substantially following financial deregulation around the world, which in most countries occurred in the 1970s and 1980s. Controls on foreign currency markets, flows of foreign capital, banking interest rates and overseas investments in share markets were lifted. Technological change also played an important role. New technologies and global communications networks have linked financial markets throughout the world allowing events in major international markets such as New York, Tokyo, London and Hong Kong to produce immediate results.

While there is no single measure of international financial flows all have shown a dramatic increase during the globalisation era. Figure 1.4 shows the growth of exchange-traded derivatives, which are a major instrument in global financial markets. After falling significantly in 2008 because of the global financial crisis, financial flows have recovered strongly. Exchange-traded derivatives have fluctuated around US$65 trillion throughout the mid-2010s, but at the beginning of 2017 reached almost US$85 trillion (surpassing the size of Gross World Product).

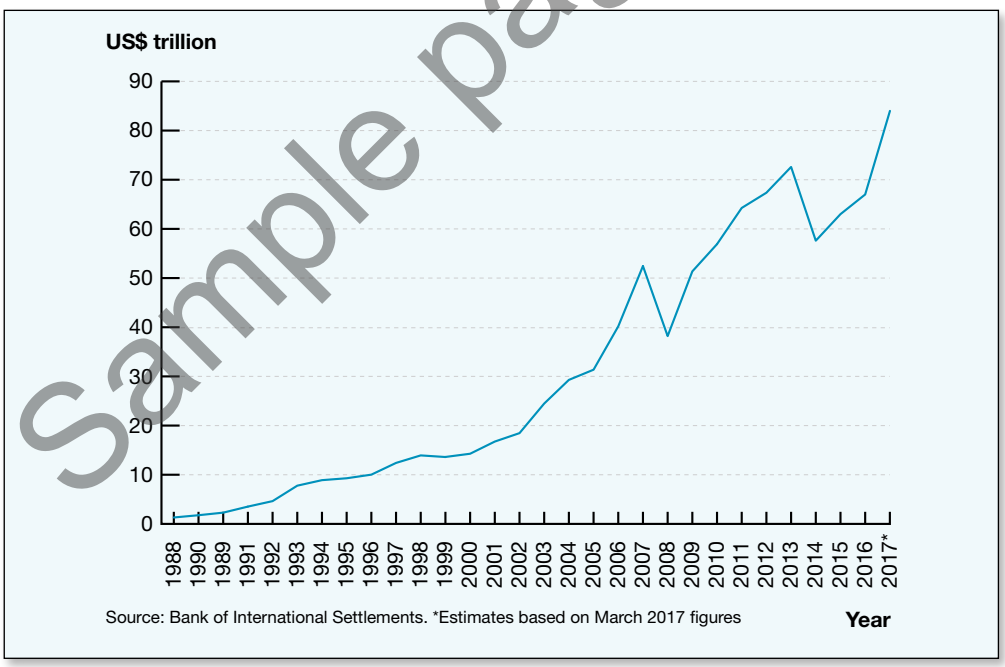


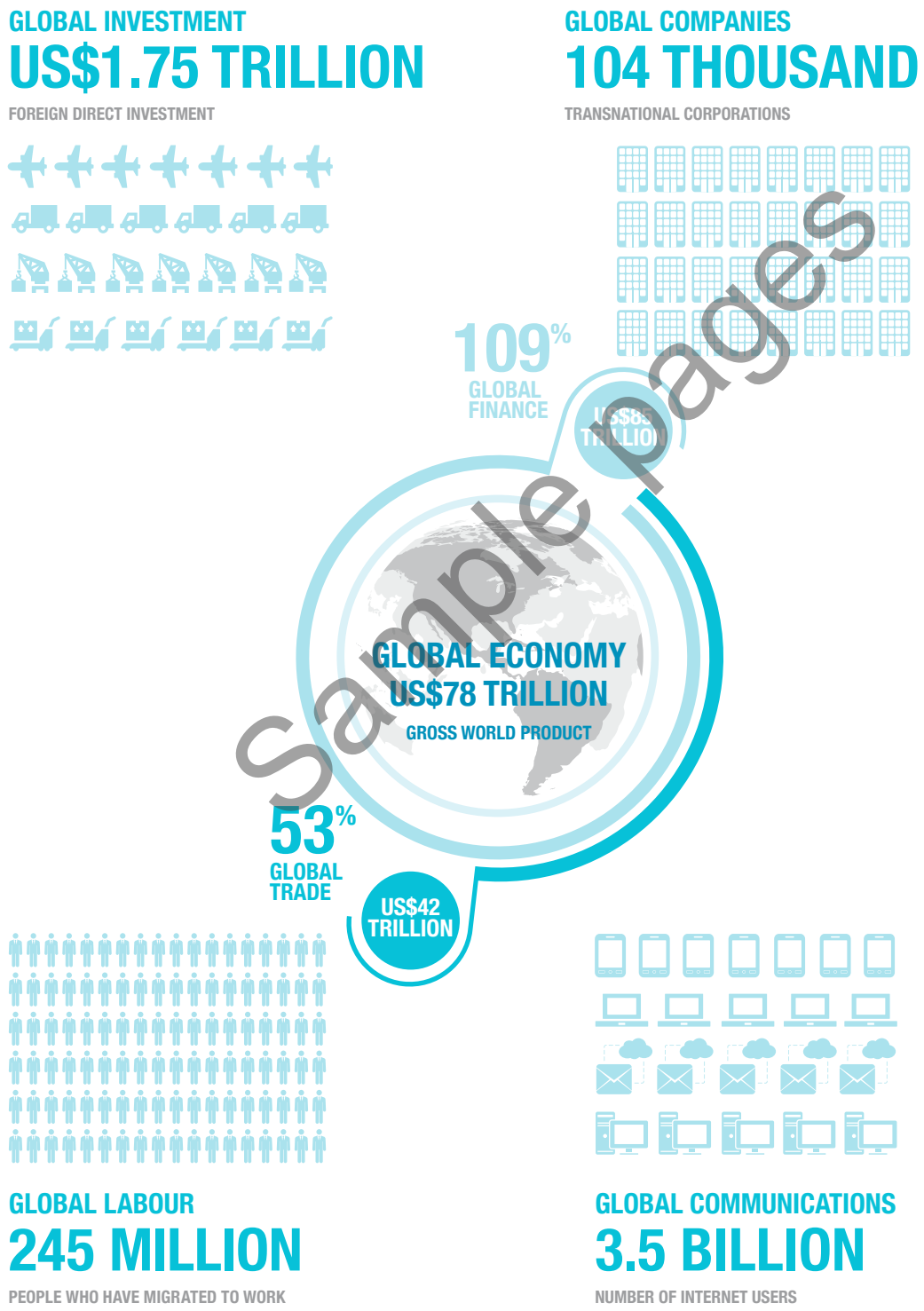
Figure 1.4 – The growth of global financial flows: exchange-traded derivatives

An important feature of international finance is **foreign exchange markets** (or forex markets), which are networks of buyers and sellers exchanging one currency for another in order to facilitate flows of finance between countries. Foreign exchange markets have experienced extraordinary growth in recent years with average daily turnover reaching almost US$5.1 trillion in 2016, up from US$4.0 trillion in 2010. The value of a currency is expressed in terms of another currency and is known as the **exchange rate** between two currencies. As will be discussed in chapter 5, most countries determine the value of their currency through the interaction of the forces of supply and demand in foreign exchange markets.

Speculators are investors who buy or sell financial assets with the aim of making profits from short-term price movements. They are often criticised for creating excessive volatility in financial markets.

The main drivers of global financial flows are **speculators and currency traders** who shift billions of dollars in and out of financial markets worldwide to undertake short-term investments in financial assets. Based on data from the Bank of International Settlements'

Triennial Survey of foreign exchange transactions, only a small share is for "real" economic purposes such as trade and investment. The vast majority is for speculative purposes – to derive short-term profits from currency and asset price movements – or for technical purposes, such as hedging against future exchange rate movements and swapping funds between currencies. International investment banks and hedge funds, often based in the United States, are generally responsible for most of these transactions. The aim of these transactions is to either gain from short-term movements in asset prices – namely currency and share price fluctuations – and to generate profits, or to hedge against future movements and minimise the risk of losses.



SOURCES: World Bank, International Monetary Fund, Bank of International Settlements, International Telecommunications Union, United Nations Conference on Trade and Development.

The main benefit of greater global financial flows is that they enable countries to obtain funds that are used to finance their domestic investment. In particular, investors in countries with low national savings levels would not otherwise be able to obtain the necessary finance to undertake large-scale business and investment projects if their economy were closed off to global financial flows. In this regard, global financial flows may enable a country to achieve higher levels of investment (and therefore economic growth) than would otherwise have been possible if finance from overseas were not available.

International Monetary Fund (IMF) is an international agency that consists of 189 members and oversees the stability of the global financial system. The major functions of the IMF are to ensure stability of exchange rates, exchange rate adjustment and convertibility.

However, changes in global financial flows can also have significant negative economic impacts. Speculative behaviour can create significant volatility in foreign exchange markets and domestic financial markets. This is because speculators are often accused of acting with a herd mentality, meaning that once an upward or downward trend in asset prices is established it tends to continue. Speculative activity has been blamed for large currency falls and financial crises in East Asia in 1997, Argentina in 2002 and the pound in mid-2016 following the "Brexit" referendum result for the UK to leave the European Union. As discussed further in chapter 2, the **International Monetary Fund (IMF)** is responsible for the overall stability of the global financial system. Its objective is to stabilise individual economies experiencing currency crises or financial turmoil in order to prevent flow-on effects to other economies.

reviewquestions

1. Account for the trends in international financial flows during the globalisation era.
2. Examine the role of speculators and currency traders in global financial markets.
3. Discuss the impact of global financial flows on economies.

Investment and transnational corporations

Foreign direct investment (FDI) refers to the movement of funds between economies for the purpose of establishing a new company or buying a substantial proportion of shares in an existing company (10 per cent or more). FDI is generally considered to be a long-term investment and the investor normally intends to play a role in the management of the business.

Another indicator of globalisation is the rapid growth of investment between countries over the past two decades. Since the late-1970s in particular, the global economy has witnessed rapid growth in movements of capital. While there are similarities in the growth of global finance and global investment, the two concepts can be distinguished by describing the shorter-term, speculative shifts of money as finance and the longer-term flows of money to buy or establish businesses as investments.

One measure of the globalisation of investment is the expansion of **foreign direct investment (FDI),** which involves the movements of funds that are directly invested in economic activity or in the purchase of companies. Reforms in developed and developing countries led to a surge in FDI flows from the 1980s onwards. Figure 1.5 demonstrates the dramatic increase in FDI flows over the past three decades. FDI flows are strongly influenced by the level of economic activity. The global recession in the late-2000s saw FDI flows fall significantly and this has continued across the early 2010s due to ongoing policy uncertainty and geopolitical risks. However, FDI flows have recovered, reaching US$1.75 trillion in 2016, 30 per cent more than two years earlier. The United Nations Conference on Trade and Development (UNCTAD) however remains optimistic that FDI flows will increase throughout the end of the 2010s, and the global FDI flows will surpass US$1.8 trillion – a level not seen since the global economic crisis in 2008–09.

FDI flows have traditionally favoured developed nations. With greater industrial capacity and larger consumer markets, economies in Europe, North America and Japan were the natural destination for foreign investment during the globalisation decades of the 1990s and most of the 2000s. But this dominance is now changing, with the share of FDI destined for developing and other economies increasing from a quarter of the global

total to over half in recent years. From the early to mid-2010s, developing and other countries have received almost or more than half of FDI inflows, spurred by the growth of developing countries such as China, India, Brazil and Mexico. However, in 2016 these economies saw a short-term decline of 14 per cent in FDI inflows, from a combination of lower commodity prices, weaker domestic performance and general global uncertainty. At the same time, FDI flows to developed economies increased by more than 5 per cent to surpass US$1 billion in 2016 (particularly to North America). This level is expected by UNCTAD to remain steady throughout the end of the 2010s (especially as prospects and FDI inflows into Europe recover).

Developing and transitional economies are also significantly increasing their share of FDI outflows. In 2014 these economies contributed 35 per cent of global FDI funds compared to 13 per cent in the mid-2000s. Furthermore, developing Asia became the largest regional provider of global FDI funds. However this trend reversed in the mid-2010s as developed countries increased their investment overseas by 33 per cent (from 61 per cent in 2004 to 72 per cent in 2016 of global FDI outflows). This was largely driven by investment from European economies, which had experienced decline in FDI outflow in the early 2010s.

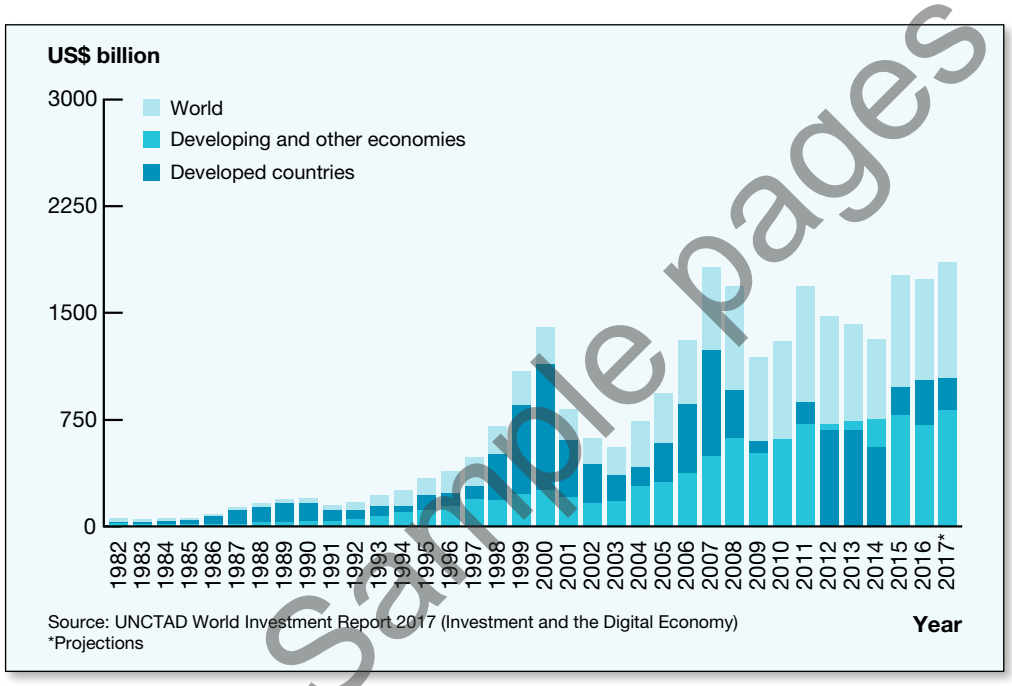


Figure 1.5 – Total world FDI inflows

Transnational corporations (TNCs) play a vital role in global investment flows. Often, they will have production facilities in countries around the world, sourcing inputs from some countries, doing most of the manufacturing in another country, and doing other packaging and marketing tasks in another country.

Transnational corporations (TNCs) are global companies that dominate global product and factor markets. TNCs have production facilities in at least two countries and are owned by residents of at least two countries.

As TNCs such as Apple, Shell and Toyota establish or expand production facilities in a country, they bring foreign investment, new technologies, skills and knowledge. Because of the capital and job opportunities they bring, governments often encourage TNCs to set up in their country through supportive policies like subsidies or tax concessions. Since the early 1990s, the number of TNCs has grown from 37,000 to 104,000 and the number of affiliates to TNCs has grown from 170,000 to over 1,116,000. Since the mid-2010s, foreign affiliates of TNCs employ over 79 million people globally. As TNCs continue to increase in both volume and significance, there has been an associated increase in cross-border cartels between large corporations, which reduces competition in economies and disadvantages local consumers. The OECD reports that 240 cross-border cartels were penalised between 1990 to the mid-2010s, with a financial impact of US$7.5 trillion. The number and effect of undetected cartels throughout this same period is unknown, but is expected to be similarly significant.

A significant cause of the growth of international investment is the increased level of international mergers and takeovers. During recent years, there has been a spate of mergers between some of the world's largest corporations – most recently between casual restaurants Burger King and Tim Hortons, pharmaceutical companies Johnson & Johnson and Actelion, technology and communications giants AT&T and Time Warner, snack companies Kellogg's and Pringles, mining companies Glencore and Xstrata and between other major companies in the resources, healthcare, and financial services industries. These mergers have seen the formation of companies worth hundreds of billions of dollars and reduced the number of truly global companies in different product markets. In 2007, cross-border mergers and acquisitions (M&As) reached a record level of US$1.6 trillion, as shown in figure 1.6. International mergers and acquisitions typically move in line with changes in global economic conditions – investment falls when economic growth is lower. In 2016, mergers and acquisitions rose by 18 per cent from the year before to reach US$869 billion, their highest level since the global economic downturn, largely driven by increased growth and investment from developed economies.

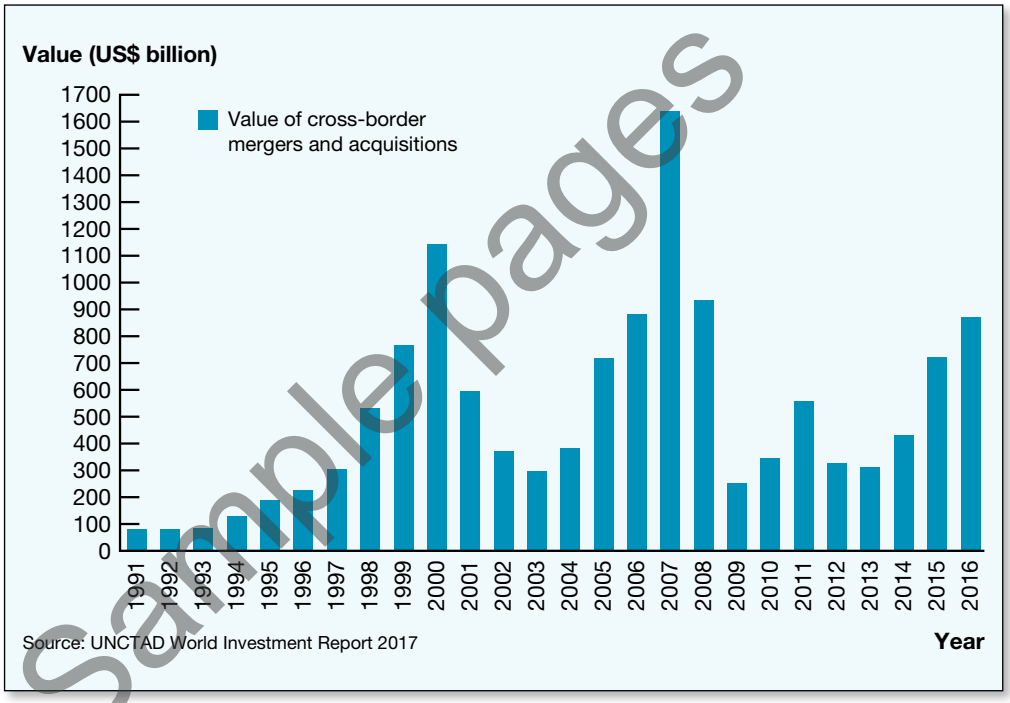


Figure 1.6 – Cross-border mergers and acquisitions

In overall terms most investment still comes from domestic sources. Foreign direct investment typically accounts for less than 20 per cent of total investment, meaning that over 80 per cent of investment still comes from within national economies.

reviewquestions

1. Distinguish between global financial flows and global investment flows.
2. Outline trends in the growth and direction of FDI flows.
3. Explain the role that transnational corporations play in global investment flows.

Technology transport and communication

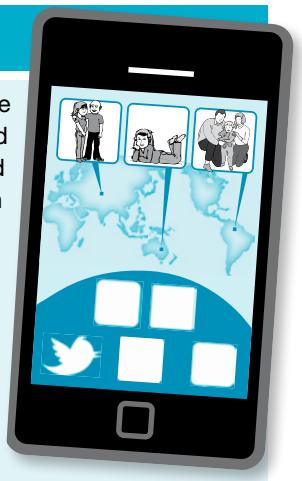
Technology plays a central role in globalisation. In part, this is because technological developments facilitate the integration of economies. Consider the following examples:

- Developments in freight technology such as standardised shipping containers (containerisation), cargo tracking and more efficient logistics systems facilitate greater trade in goods.
- Cheaper and more reliable international communications through high-speed broadband allows for the provision of commercial services to customers around the world. The proportion of the global population that uses the internet has increased from 6 per cent in the early 2000s, to over 43 per cent in the late-2010s.
- In finance and investment, technology plays a key role in facilitating globalisation through the powerful computer and communications networks that allow money to move around the world in a fraction of a second.
- Smartphones and mobile internet access are fundamentally changing the structure of many industries, from retail and transport sectors to education, leisure and professional services. Technology is causing disruptive change to the structures of many of these industries as huge populations embrace online technologies. The number of mobile phone subscriptions is now almost 7.2 billion, which is roughly equal to the number of people in the world.
- Advances in transportation such as aircraft and high-speed rail networks allow greater labour mobility between economies, as well as increased accessibility to tourism and travel for consumers.

In these ways, technology is the ultimate driver of globalisation because it allows integration at a depth unthinkable in previous decades and centuries. Economies that adapt to new technologies rapidly also tend to be the economies that are most closely integrated with other economies in their region or around the world.

Another way technology influences globalisation is as a driver of growth in trade and investment. For the leading technology innovators and exporters technology represents a major trade opportunity. The United States earns substantial export revenues from its global leadership in many areas of new technologies. An analysis of the income flows from technology transfers between countries shows that the United States receives half of the royalties and licence fees from the world's technology transfers and that most of the remaining gains are shared amongst a small group of developed economies.

SOCIAL MEDIA AND GLOBALISATION



Social media has accelerated globalisation at many levels. By creating new online communities, social media platforms such as Facebook, Instagram, Google+ and Twitter connect individuals on an unprecedented scale. Of all internet users, around three quarters are active on social media. Facebook, for example, claims 1.9 billion members out of an internet user population of over 3 billion.

Although social media is contributing to "cultural globalisation", it is also having major economic impacts. Large companies must now consider social media as part of their global marketing efforts. Firms may use professional networks like LinkedIn to source the best talent from global labour markets. Google Chief Economist Hal Varian has even suggested that word search data for terms like "unemployment benefits" and "holidays" could be used to predict trends in consumer confidence and economic conditions.

Social media is also itself a global business opportunity. Google earned over US$66 billion in 2014 mostly from advertising revenue. LinkedIn was was bought by Microsoft in 2016 for US$28.1 billion, six times its value after it was floated in 2011. Facebook acquired WhatsApp for US$19 billion in 2014 and Microsoft paid US$8.5 billion for Skype Communications to expand its new media operations. Apple Computer has become the world's most valuable company by selling the phones, tablets and laptops through which people access social media. Like most new trends, social media's growth is unpredictable but it is re-shaping the economics of many industry sectors beyond media and telecommunications.

Other countries rely on importing technology from these leading countries with the hope that over time as they adopt new technologies they can become innovators and develop their own technology exports as countries like India, South Korea and Israel have done in recent years. Trade, therefore, spreads new technologies. Because innovation is an ongoing process, the leading country can often retain its technological superiority for a long period of time.

Business corporations that play a leading role in developing new technologies will often move directly into overseas markets in order to sell their products and services direct to local buyers. For example, leading information and communications technology corporations such as Google, Oracle and IBM all have extensive global operations. These corporations bring extensive know-how into a new market and will often invest substantially in the new countries that they enter particularly in education and training. In this way technology drives increased foreign investment.

The internet is the communications backbone that links businesses, individuals and nations in the global economy. This not only allows greater communication within and between firms, but reduces business costs that have in the past been a barrier to integration between economies. The World Information Technology and Services Alliance (WITSA) estimated that since the mid-2010s the global marketplace for information and communications technology has been worth almost US$5 trillion. The surge in worldwide internet usage to over three billion users highlights the rapid spread of technologies across countries in recent years and the increasingly interconnected nature of the global economy. Figure 1.7 shows the number of internet users in selected countries.

Figure 1.7 – Internet users in selected countries

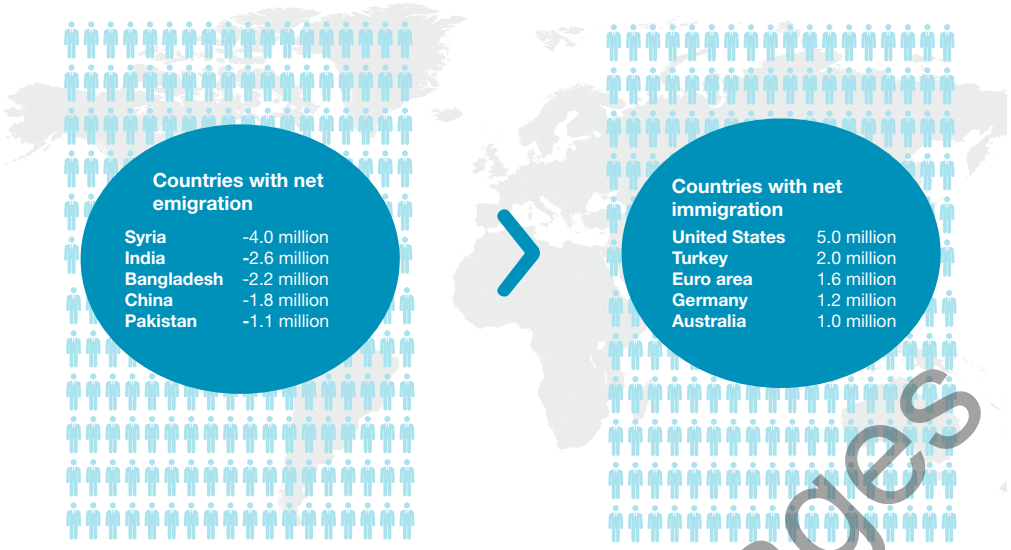
International division of labour and migration

Migration is the movement of people between countries on a permanent or long-term basis, usually for 12 months or longer.

Labour markets differ from markets for goods and services, finance and investment, in that they are far less internationalised. While money can move around the world in fractions of a second, goods and services can move in days and investments can be made in weeks, people do not move jobs quite as freely. In fact in recent years the industrialised world has become more restrictive about immigration of people from poorer countries.

Nevertheless, more people than ever before are moving to different countries to take advantage of the better work opportunities that other countries offer. The World Bank estimates that there are around 245 million people (almost triple the 85 million people in 1990 and over 3 per cent of the world's population) who have migrated to work in different countries in the world, and that rising labour supply pressures and income inequalities could increase this level. Labour migration into Organisation for Economic Co-operation and Development (OECD) member countries fell because of reduced job

opportunities during the late-2000s, but according to the International Migration Outlook, migration has started to pick up again, driven largely by the European Union, United States and Australia. While there are strong economic and financial motivations for migration, political unrest and conflict are also a significant factor driving movements, as is evident by the countries shown in figure 1.8.



Source: World Development Indicators 2017

Figure 1.8 – Net migration by region and country (over past five years)

The movement of labour between economies appears to be concentrated at the top and bottom ends of the labour market. At the top end, highly skilled workers are attracted towards the richest economies such as the United States and the largest European economies because of the higher pay and better opportunities available in these countries. The OECD has reported that the proportion of migrants leaving developing countries who move to high-income economies has increased from 36 per cent to 51 per cent in the past two decades. Smaller advanced economies such as Australia and New Zealand suffer from a "brain drain" of some of their most talented and skilled workers, who are attracted to other countries by greater rewards. In effect, there is a global market for the most highly skilled labour.

At the bottom end of the labour market, low-skilled labour is also in demand in advanced economies where it may be difficult to attract sufficient people born locally to do certain types of work. Jobs that only require basic skills (and perhaps do not require any language skills) are often filled by migrants – in the United States by migrants from Latin America; in European countries, by migrants from Eastern Europe and Africa; in richer Asian countries by migrants from poorer Asian nations.

These trends in migration reflect an **international division of labour** whereby people move to the jobs where their skills are needed while the globalisation of the labour market is increasing but there are still significant barriers to working in other countries. These barriers include immigration restrictions, language, cultural factors and incompatible educational and professional qualifications. Most people would prefer to stay in the country of their birth, where their family and friends live, and where they are most familiar with he language and culture. Against this preference, domestic instability and geopolitical turmoil may force people to flee their countries (refugees are estimated to represent up to 10 per cent of total migration worldwide).

International division of labour is how the tasks in the production process are allocated to different people in different countries around the world.

The international division of labour is also evident from another aspect of the world economy – the shift of businesses between economies, rather than the shift of people. Just as people may move countries in search of the best job opportunities, corporations shift production between economies in search of the most efficient and cost-effective labour.

BRAIN DRAIN OR BRAIN GAIN?

Around 245 million people worldwide have migrated because of work. The proportion of these "economic migrants" who are highly skilled heavily outnumbers those who are low-skilled in almost all countries. In some countries like Haiti and Jamaica, more than 80 per cent of their skilled labour force has moved overseas. Not even high-income countries are immune to the brain drain problem, with Hong Kong and Ireland losing between one-third to one-half of their college graduates.

Brain drains have traditionally been perceived as a negative outcome for an economy in terms of both development and welfare. High levels of skilled labour emigration increase the technological gap between developed and developing countries as human capital flows towards more advanced economies and the source country may experience shortages of particular workers. It is also suggested that high-skilled migrants may contribute to fiscal imbalances if they leave and do not pay income taxes to "repay" their publicly subsidised education.

On the other hand, economies experiencing outwards migration can benefit from remittance inflows, interconnected business networks and increased sharing of technological developments. The World Health Organisation (**WHO**) and the European Union have launched a project, From Brain Drain to Brain Gain – Supporting WHO Code of Practice on International Recruitment of Health Personnel for Better Management of Health Worker Migration. The program aims to manage and improve the flow of health workers from developing economies in Sub-Saharan Africa and Asia to maintain health standards and ensure that source countries retain some ability to deal with potential medical crises.

Sources: IZA World of Labor; WHO Health Workforce Alliance and the Health Workforce Department

In a globalised business environment, many producers operate what is sometimes called a global supply chain, with production facilities in several countries. The process called "offshoring" allows companies to shift production between countries to reduce costs. This results in the development of export-oriented economies that can compete on the basis of their abundance of low wage labour. While offshoring has been occurring for decades, particularly for labour-intensive manufacturing processes, recent years have also seen services functions such as IT support, data management and accounting move to more competitive locations to reduce costs.

The international division of labour reflects the economic concept of "comparative advantage" that is discussed in chapter 2. Essentially, this theory states that economies should specialise in the production of the goods or services that they can produce at the lowest opportunity cost. Developing economies have a large population of workers with only basic labour skills and education levels giving them a comparative advantage in labour-intensive manufacturing. Advanced economies have generally shifted away from labour-intensive manufacturing to focus on specialised service aspects of the economy that use more highly skilled workers who are in greater supply in advanced economies.

reviewquestions

1. Explain the role of innovations in technology communications and transport in driving the process of globalisation.
2. Outline key trends in migration in recent years.
3. Explain how migration and offshoring reflect an international division of labour between different economies.

1.3 The international and regional business cycles

The level of economic activity in individual economies is never constant (that is, never in a state of equilibrium). Economic growth usually moves in cycles – in other words, instead of sustaining a steady rate of growth from year to year, most economies go through periods of above average growth that then lead into a period of below average growth. These ups and downs of the **business cycle** (that is, the general level of economic activity) are caused by changes in the level of aggregate supply and demand. This is shown in figure 1.9, which also reveals that over time, economies usually experience an overall trend of growth in output (measured by increases in **Gross Domestic Product**).

Business cycle refers to fluctuations in the level of economic growth due to either domestic or international factors.

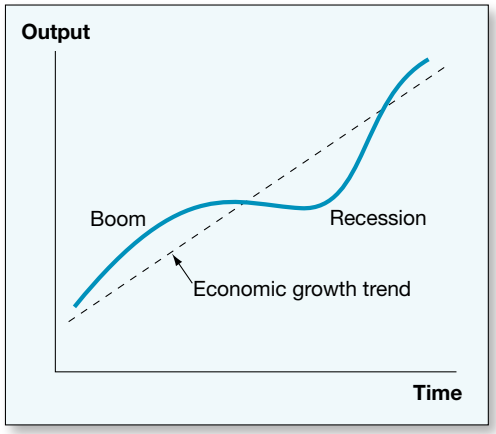


Figure 1.9 – The business cycle

Gross domestic product (GDP) is the total market value of all final goods and services produced in an economy over a period of time.

Just as individual economies experience stronger and weaker periods of economic growth, so too does the global economy. This ebb and flow of world economic growth is known as the **international business cycle,** which refers to the changes in the level of economic activity in the global economy over time. Although the levels of economic growth each year often differ greatly between countries, for most countries economic growth is stronger when the rest of the world is growing strongly and weaker when other countries are experiencing a downturn. The extent of synchronisation of economic growth levels across individual economies is highlighted by the extent to which the downturn of the late-2000s in the United States spread to other advanced industrialised economies and resulted in the biggest global recession since the Great Depression of the 1930s. It resulted in the largest fall in world trade in more than six decades, highlighting the relationship between trade and economic growth.

International business cycle refers to fluctuations in the level of economic activity in the global economy over time.

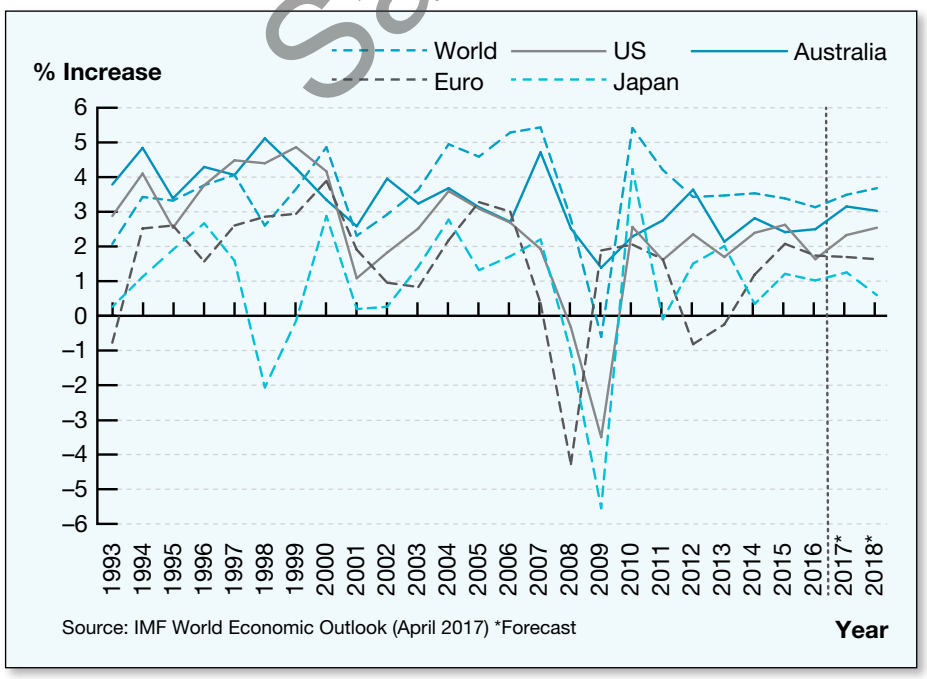


Figure 1.10 – Economic growth performance of major economies

Figure 1.10 on page 17 highlights the strong relationship between the economic growth performances of the world's major economies. The United States, the Euro Area economies, Japan and Australia all experienced a long period of moderate growth during the 2000s, followed by a sharp collapse in growth in the late-2000s. Each of these advanced economies has struggled to improve its economic growth across the 2010s due to a variety of factors, including persistent global uncertainty, volatile commodity prices and a moderation of growth for the emerging economies. As a small open economy, the Australian economy is particularly affected by economic growth rates overseas. Research by the Reserve Bank of Australia (RBA) has found that 63 per cent of changes in the level of output in Australia can be explained by the changes in interest rates, growth levels and inflation rates in the Group of Seven (G7) largest industrialised countries. This means that for Australia, domestic factors have less influence than international factors on economic growth in any given year.

The transmission of economic conditions from one country to another is made more immediate by the increased integration of economies during the globalisation era:

- **Trade flows**: If there is a boom or recession in one country, this will affect its demand for goods and services from other nations. The level of growth in an economy will have flow on effects on the economic activity of its trading partners. During the global downturn in the late-2000s, it was estimated that more than 25 per cent of the decline in US growth transmitted to other economies.
- **Investment flows**: Economic conditions in one country will affect whether businesses in that country will invest in new operations in other countries, affecting their economic growth. In the early 2010s, for example, one of the factors limiting the growth of foreign direct investment (FDI) inflows to developing countries was the weak economic growth performance in Europe and the United States.
- **Transnational corporations**: Transnational corporations (TNCs) are an increasingly important means by which global upturns and downturns are spread throughout the global economy. The 2017 UNCTAD World Investment Report found that in 2016, growth in TNC assets and sales were valued at over US$150 billion, and higher for their foreign affiliates compared to their domestic entities.
- **Financial flows**: Short-term financial flows also play an important role in transmitting the international business cycle. A 2016 paper by leading economists in the European Union titled "International business cycle synchronisation: the role of financial linkages" concluded that countries with strong financial integration will experience an increase in financial flows between themselves, especially in response to common external shocks. This was experienced in mid-2016 when the "Brexit" referendum result saw increased financial flows between the other advanced economies.
- **Financial market and confidence**: Consumer confidence and the "animal spirits" of investors are constantly influenced by conditions in other countries. This is highlighted by the strong correlation between movements in share prices of the world's major stock exchanges – that is, they tend to go up and down at the same time. Events that threaten global stability – such as an increased risk of war, sovereign debt default or the collapse of a major business – can spark an immediate downturn in share values. As both emerging and advanced economies incur more debt to fund financial and investment flows, there is concern about the risks to financial stability. Historically, high leverage has impeded growth over time. The 2017 Bank of International Settlements forum noted that global corporate debt in particular had increased by 16 per cent since the late-2000s to reach almost 130 per cent of gross world product.
- **Global interest rate levels:** Monetary policy conditions in individual economies are increasingly influenced by interest rate changes in other countries. If strong economic growth makes it necessary for the central bank to increase interest rates in the United States, this places pressure on central banks in other economies to follow suit. Furthermore, higher interest rates in a major economy will make borrowing more expensive for emerging and developing economies. The World Bank's *Global Economic Prospects* report predicted in 2017 that as the Federal Reserve increases interest rates in response to a recovering US economy, from the mid to late-2010s, this would reduce investment into emerging economies by up to 1.8 per cent of GDP, slowing their growth.

- **Commodity prices:** Global prices of key commodities such as energy, minerals and agricultural products play a critical role in the general level of inflation in the world economy and therefore have an effect on investment, employment, growth and other features of the international business cycle. Oil prices are particularly significant due to their role in the transport of many goods and services. An economic analysis conducted by the World Bank in the mid-2010s concluded that while lower oil prices result in an expansion in global GDP, there are winners and losers. Oil-exporting countries experience slower growth due to reduced revenues, especially economies in the Middle East, which also face security and other structural challenges. In contrast, emerging economies in the Pacific, East and South Asian regions benefit from improved fiscal and current account balances, due to their manufacturing-based economies and reliance on imported oil supplies.
- **International organisations**: International forums such as the Group of Twenty (G20) or Group of Seven (G7) can play an important role in influencing global economic activity. Discussions of global economic conditions at summit meetings mean that the G20 or G7 can act as the unofficial forum coordinating global macroeconomic policy especially during periods of economic uncertainty. The OECD Business and Financial Outlook 2017 emphasised the significance of international organisations imposing stricter regulations on bribery and corruption and cross-border tax minimisation strategies, which otherwise pose risks for economic growth and inequality.

Nevertheless, it is important to note that despite these linkages, the pattern and the pace of economic growth differs between countries. Even countries that are at similar stages of economic development, such as the United States and European economies, experience differing levels of economic growth. Despite the global linkages described above, many of the factors that influence the business cycle differ between economies:

- **Interest rates** have a significant impact on the level of economic activity, and interest rates differ between countries (or regions, in the case of European countries that share a common interest rate policy). Higher interest rates will dampen economic activity while lower interest rates will stimulate economic activity.
- Government **fiscal policies** also have a significant effect upon the level of economic growth in the short to medium term. If a government in one country raises taxes while the government in another country cuts its taxes, economic growth is likely to move in opposite directions in those two countries.
- **Exchange rates** differ between countries and impact on the level of trade competitiveness and confidence within economies. In turn, these factors will influence the level of economic growth. The Bank of International Settlements 2016 Annual Report notes that exchange rates are having an increased impact on domestic economies, particularly in the past decade as government policy has less ability to target economic shocks.
- **Structural factors** differ between economies. For example, countries have different levels of resilience in their financial systems; different levels of innovation and takeup of new technologies; different attitudes towards consumption and savings; different population growth rates and age distribution; different methods of regulating labour markets, educating and training employees and regulating businesses. These structural factors influence the competitiveness of economies and their level of growth.
- **Regional factors** between economies differ. Some economies are closely integrated with their neighbours and are therefore very influenced by the economic performance of their major trading partners. For example, geopolitical instability in countries like Egypt, Turkey and Yemen has held back economic growth in other Middle Eastern economies throughout the 2010s. Other economies may be less influenced by changing growth in a specific region.

FACTORS THAT *STRENGTHEN* THE INTERNATIONAL BUSINESS CYCLE

Trade flows
Investment flows & investor sentiment
Transnational corporations
Financial flows
Technology
Global interest rates
Commodity prices
International organisations

FACTORS THAT *WEAKEN* THE INTERNATIONAL BUSINESS CYCLE

Domestic interest rates
Government fiscal policies
Other domestic economic policies
Exchange rates
Structural factors
Regional factors

In summary, there is an international business cycle and when there is a substantial economic downturn such as in the mid-1970s, the early 1990s and the late-2000s, this downturn is shared across almost all countries. However, the factors influencing individual economies differ and the level of world economic growth is one of several factors that influence economic conditions.

Regional business cycles

Regional business cycles are the fluctuations in the level of economic activity in a geographical region of the global economy over time.

Similar to the international business cycle, the term **regional business cycle** refers to the changes in economic activity in a particular region. In the same way that countries' activity can be affected by global changes, they can also be affected by regional changes. While changes in the US economy will have ripple effects around the world, they can have more pronounced impacts in **North America,** on the nearby Canadian and Mexican economies because of their integration through the North American Free Trade Agreement. Likewise, many of the 28 economies of the **European Union** (27, after the departure of Britain) are influenced by activity levels in Europe's largest economies – Germany and France.

In the **East Asian region**, economic conditions are dominated by the influences of China and Japan – the world's second- and third-largest economies. While the regional business cycle in Asia has been weaker than in other regions, it has strengthened in recent years because of increased integration between Asian economies. On the other hand, as China and Japan both experienced a slowdown in recent years, the region continued to experience stable growth due to moderate upswing elsewhere in the region.

Other regions around the world have a higher proportion of developing or low income countries and they tend to be less regionally integrated. In **Sub-Saharan Africa,** for example, many economies such as Chad, Uganda and Sierra Leone are dependent on high-income economies for more than 80 per cent of their exports, and are therefore as likely to be influenced by conditions in the world economy as they are by neighbouring African economies. In the **South Asia and Latin American regions,** regionally dominant economies such as India and Brazil respectively play a key role alongside influences from outside the immediate region. The moderate growth forecast in both these economies for the end of the 2010s (primarily driven by government reforms and monetary easing) will be a key contribution to an upswing in their respective regions.

While regional business cycles tend to be dominated by the largest and most globalised economies, it is also important to recognise the complexity of conditions at the regional level. Throughout the 2010s economic conditions in large European economies like France and Italy were weakened by financial turmoil in the relatively small economy of Greece. Similarly, the East Asian financial crisis of the late 1990s was triggered by a substantial depreciation of the Thai Baht. In Latin America in the early 2000s problems in Argentina quickly became a regional crisis. Geographical tensions among Russia and Ukraine in the mid-2010s reduced growth, trade and economic policy across **Europe and Central Asia**. In this way, smaller economies can affect the performance of regional economies even if they are not dominant economies or strongly integrated.

Clearly, regional business cycles can be quite different from patterns in global economic activity with some regions performing more strongly than others and fluctuating more independently from other regions. However, regional cycles are also part of the phenomenon of globalisation because they result from increased cross-border integration. Ultimately, the business cycles of different regions interact in complex ways to drive the level of economic activity around the world.

reviewquestions

1. Define the terms *international business cycle* and *regional business cycle*.
2. Using examples from specific countries or regions describe recent trends in the international business cycle and regional business cycles.
3. Outline the factors that strengthen and weaken the relationship between the economic cycles of individual economies.

chapter summary

1. **Globalisation** refers to the integration between different countries and economies leading to the increased impact of international influences on all aspects of life and economic activity.
2. The **global economy** is a way of describing the activities of all the economies of the world as a whole reflecting the fact that they are now increasingly linked together into one larger economic system.
3. **Gross world product** is the sum of the total output of goods and services produced by all economies in the world over a given period of time.
4. The growth of **world trade** is an important indicator of the extent of globalisation. World trade has increased at around double the rate of world economic growth over the past half century.
5. The pattern and direction of world trade has changed to reflect the increasing importance of advanced technology and services and the growth of the Asia Pacific region.
6. The process of globalisation has occurred most rapidly in global finance which faces few barriers and is driven mostly by speculative activity (that is, investors seeking to make short-term profits out of fluctuations in exchange rates, interest rates and other financial indicators).
7. **Foreign direct investment (FDI)** is the injection of funds into an economy to establish a new business or purchase an existing business. FDI flows are driven by **transnational corporations (TNCs)** and often involve the transfer of technological innovations between economies.
8. **Technology, transport and communication** have driven increased economic integration by facilitating linkages between businesses individuals and nations in the global economy.
9. Globalisation has also contributed to the **international division of labour** in part because of the migration of workers to countries where jobs are plentiful or better paid, and also because of the shift of business between economies in search of the most efficient and cost-effective labour.
10. The concept of **international and regional business cycles** refers to the extent to which economies tend to experience a similar pattern of boom, downturn and recovery at similar times. Although the shape and the length of the business cycle differs from one economy to the next, the level of economic growth between different economies is closely related, and recessions and booms tend to occur around similar times.

chapterreview

1. Explain what is meant by *globalisation* using recent trends to illustrate your answer.
2. Describe the role of trade flows in globalisation.
3. Summarise recent changes in the direction and composition of international trade in goods and services.
4. Explain how technology drives growth in trade of goods and services.
5. Explain the difference between *investment flows* and *financial flows*.
6. Outline the role of foreign exchange markets in international financial flows.
7. Discuss the role played by transnational corporations (TNCs) in globalisation.
8. Discuss the impact of globalisation on the international division of labour.
9. Explain how changes in the level of economic growth in one economy can impact upon economic growth in other economies.
10. Examine the performance of an individual economy over the past decade. Discuss the extent to which this economy's performance has reflected world economic growth trends and the extent to which it has differed. Identify factors that might explain these similarities and differences.