Topic one: The Global Economy

Global economy: Where the economies of individual countries are linked to each other through globalisation and changes in a single economy can have ripple effects on others.

Gross world product: Refers to the aggregate value of goods and services produced in the global economy over the course of the business cycle

Globalisation: Refers to the process of increased economic convergence between nations on the basis of finance, labour, investment, technology and trade.

Trade: The volume of world trade has grown to over 40 times its 1950 level, with exports between developing economies growing by more than 650% from 2000-2011 according to the World Bank. Trade intensity has also increased – from 38% of GWP in 1990 to 70% in 2009 reflecting how economies do not produce all the items they need, or not as efficiently as other economies, and thus have to import these goods and services. Comparative factor endowments mean countries specialising in their production by allocating resources towards the most profitable export sectors. One third of trade involve intermediate goods – there is an increase in vertical specialisation.

Finance: Money is highly liquid between countries especially with advances in technology alongside with deregulation of FOREX markets. Foreign exchange markets (FOREX) are characterised by networks of buyers and sellers (Speculators) exchanging one currency for another. They allow countries to obtain funds used to finance their domestic investment for economic growth, especially in Australia, where savings among consumers are low.

Investment: An indicator of globalisation has been the rapid growth of investment – 6 times its 1995 level, currently $US 2 trillion. TWO TYPES:

- Foreign Direct Investment (FDI): 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% or more).

Transnational corporations expand to countries with favourable markets and bring FDI, technology, skills and employment opportunities. As such they have been encouraged by governments through tax incentives and less restrictions.

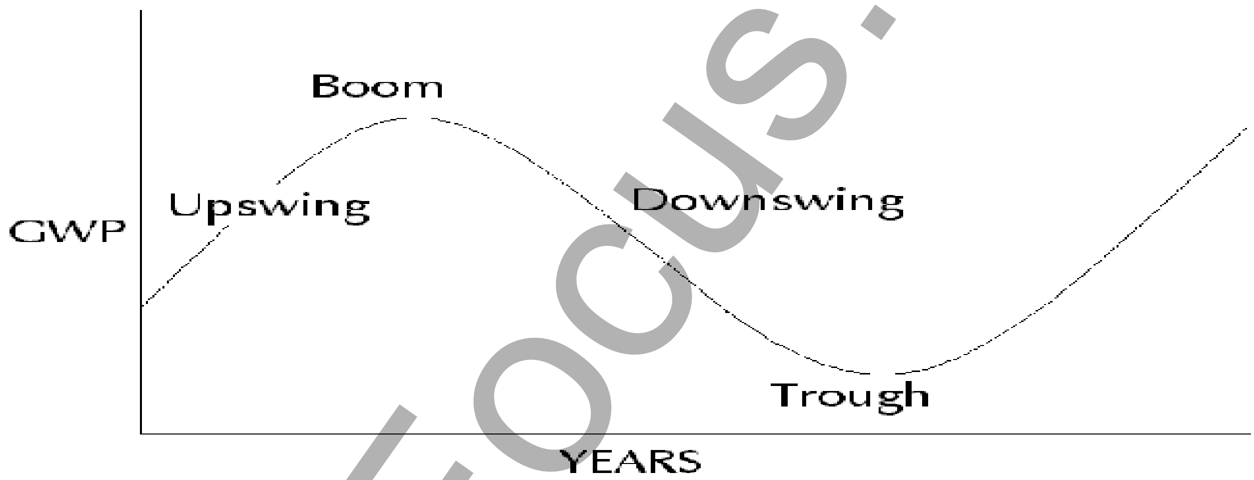
- Portfolio investment: Purchase of equity (shares) on a smaller scale (under 10%) for the sole purpose of deriving income.

Technology: The ultimate drive of globalisation as it allows economic convergence. Allows for contract creation throughout the global economy

Labour: Economies have been able to resolve failures in the labour market through globalisation. Labour movement is concentrated at the top and bottom ends of the labour market in advanced economies. Globalisation through technology has allowed for greater geographical mobility, and has contributed to the brain drain.

<u>The international business cycle:</u> Fluctuations in the level of economic activity and GWP (growth) in the global economy over time.

Expansion/upswing	Peak/Boom	Downswing/Recession	Trough
Increase in output Rise in consumer demand, demand for resources, and investment.	Increase in inflation – unsustainable growth. Lack of supply Demand>Supply	Decrease in output. Fall in consumer demand, demand for resources, and investment. Increased unemployment	Bottom of the cycle where unemployment peaks as demand and output reach their lowest levels



Factors that affect the international business cycle

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. i.e Australia sells raw materials to manufacturing nations to make manufactured goods. If nations such as Japan and China cannot export goods to the United States then Australia's exports to China and Japan will fall, export income will decline, economic growth will slow and Australia will have a reduced standard of living.	**Financial market and confidence:** Consumers confidence and the herd mind of investors are influenced by conditions in other countries. Thus there is a strong correlation between movements in share prices and demand. They tend to go up and down at the same time. **Transnational Corporations (TNCs)**: Highlight how global upturns and downturns are spread. i.e Toyota reduced marketing operations in 2011 as earthquakes and tsunamis in Japan impacted the company economically.
Investment flows: Stronger economic conditions in one country will make it more likely businesses in that country will receive investment in new operations from other nations.	**Exchange rates** differ between countries and impact on the level of trade competitiveness and confidence within economies.

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

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

Free Trade And Protection

Free trade is a situation where there are no artificial barriers to trade that restricts the exchange of goods and services between countries imposed by domestic governments. It allows for the fastest levels of growth, free exchange of goods and services, however, there is no shielding for domestic producers from foreign competitors.

Advantages of Free Trade	Disadvantages of free trade
Countries can obtain the goods and services they cannot produce themselves or in insufficient quantities to satisfy domestic demand	A rise in short term (structural) unemployment may be experienced as some domestic businesses struggle to compete with imports. This corrects itself in the long term as the economy redirects resources to areas of comparative advantage.
Better living standards as a result of lower prices, increased quantities and increased variety. The opening up of global markets leads to increases in real income.	Increased domestic economic instability from international trade cycles, as economies become dependent on global markets. Due to narrow export bases economies may face the Dutch Disease.
Efficient allocation of resources since countries will specialise in goods they have a comparative advantage in. Economies are also able to become internationally competitive with free trade as factor market prices aren't increased artificially, in light of the rise in resource complementation and vertical specialisation.	Surplus production may be dumped on the domestic Australian market for unrealistically low prices.

Reasons For Trade

Factor endowments: The amount of labour, land, money and entrepreneurship that could be exploited for manufacturing within a country. Factor endowments can only be limited to the four factors of production

They are determined by:

- Geographical features such as climactic conditions and natural resources
- Economic development, size and quality of the workforce and access to capital
- Entrepreneurial skills and the freedom to pursue entrepreneurial activities.

If economies specialise in production based on comparative advantages, economies of scale will be achieved as scarce resources are allocated in an efficient manner.

The Principles Of Absolute And Comparative Advantage

Absolute advantage: An economy is said to have an absolute advantage if it can produce a particular good or service in greater quantity than other economies with the same amount of resources.

Comparative advantage: A country has a comparative advantage in the production of a good or service if it can produce it relatively more efficiently (with a lower opportunity cost) than other countries can.

The Reasons For Protection

Protection can be defined as any actions by national governments that will give an artificial competitive advantage to domestic producers over foreign producers.

The infant industry argument: New industries face difficulties and risks in their early years. They have not had time to establish economies of scale. Therefore they need protection in the short term from overseas competition which will allow them to become efficient as well as internationally competitive. However, these firms remain inefficient if protection remains in the long term due to the lack of international competition and pressure to improve productivity and reduce costs.

Domestic employment: If protection levels are reduced, the level of unemployment would rise - there would be in the short run an increase in structural unemployment. Extensive and expensive retraining schemes would be required. So in the short run the tendency is to increase protection. However, in the long run reductions in protection levels has the potential to create more jobs. Since protection diverts resources away from efficient firms, the misallocation of resources will reduce the economic growth. This economic growth would have generated jobs.

Dumping: When foreign firms sell their goods to other countries at a price below its cost of production, which is usually surplus stock. Foreign firms can then establish a market share in the country whilst local firms can be forced out of the market.

Methods Of Protection

Tariffs: Taxes placed on goods produced in other nations. They act by artificially raising the selling price of imported goods through increased production costs. They raise revenue for the government, and allow infant industries to become more efficient by increasing their market share at the expense of foreign producers.

Subsidies: Cash payments made by the government to domestic producers. It allows them to decrease their production costs, thereby reducing the final cost of the good and more favourable competition with foreign producers.

Subsidies shift the supply curve down, and to the right = falling prices, greater quantity of production, increased demand.

Quotas: A limit on the quantity of a good that can be imported into a country over a given period of time. The imposition of quotas decreases the supply and thus increases the price of imports. Once all imported goods are sold consumers are forced to purchase the domestically produced good.

Local Content Rules: Laws that specify certain percentages of a good has to contain domestically produced components.

Export incentives: Grants, loans and specific incentives such as tax concessions and technical advice offered for domestic producers encouraging them to become more export orientated and competitive.

Effects Of Protectionist Policies

Misallocation of resources: All forms of protection involve a transfer of resources from efficient industries to inefficient ones. Industries that are efficient and competitive are disadvantaged by the government to assist inefficient ones. Due to this inefficiency, returns to all factors of production will be lower if they were allocated to efficient industries. A misallocation of resources means that scarce resources are wasted and hence total output in the economy is less than what it could be (economy producing inside the production possibility frontier) resulting in lower economic growth. This then leads to lower standards of living as there is lower income (Y=C+I+G+(X-M) and since inefficient industries are shielded, goods and services will reduce the utility value of consumer income.

Redistribution of income: Protection increases the profitability of inefficient industries. It enables them to offer higher incomes, and attract scarce resources from other industries. The higher prices paid by consumers as a result of protection mean a redistribution of income away from consumers and towards producers in protected industries. i.e If imported goods prices are $7, due to tariffs, domestic producers will raise prices to $6.50.

More foreign investment: If tariff barriers are high, foreign companies will be encouraged to set up a subsidiary (A company controlled by a holding company) in a domestic economy, thereby avoiding tariffs whilst being protected by them too.

Contemporary Trading Blocs And Agreements

Two major types of trade agreements

1. **Preferential Free Trade Agreements (Regional or Bilateral)**

- **Bilateral** trade agreements are arrangements between two countries where one country exports a given quantity of goods to the other country in exchange for an agreed quantity of imports. Trade diversion.

2. **Multilateral** (Open to all regions) trade agreement are open to all regions and non-exclusive where commodities are arranged between members. They lead to trade creation.
3. A **Trading Bloc** is when a group of countries establish a free trade zone between them whilst maintaining protection levels with the rest of the global economy. Trade diversion.

The European Union (EU) Trading bloc

- The European Community (Those in the Union) abolished tariff between members and erected a common tariff called the common external tariff (CET) against non-member countries.
- The creation of a single European market has led to the free movement of people, goods, services and capital between member countries
- Adoption of a singular currency (EURO) has reduced transaction costs between members. Monetary union: one currency.
- When one economy falls, there are spill over effects.

The North American Free Trade Agreement (NAFTA) Trading bloc

- Created to improve USA's competitiveness with the EU and Japan and to facilitate free trade through the elimination of tariffs and other trade barriers.
- Allowed the USA and Canada to exploit low production costs in Mexico in order to improve international competitiveness.
- Mexico also benefited as there was greater access for its exports to the large and high income US and Canadian markets.

International Organisations Affecting Trade

The Organisation For Economic Co-Operation and Development (OECD)

To carry out research on a wide range of economic policy issues and to coordinate economic cooperation among member nations which are developed democratic countries. Research is made to achieve the highest sustainable economic growth and employment and a rising standard of living in member countries whilst maintaining fiscal stability, and thus contribute to the development of the world economy.

World Trade Organisation (WTO) :

- Role is to implement and advance global trade agreements and to resolve trade disputes between economies as a forum. The WTO has the power to enforce trade agreements.
- Effective for resolving small country disputes such as forcing Australia to abandon its ban on Canadian Atlantic Salmon.
- Doha round of trade liberation talks in 2001 has advanced global trade:
  1. Broad agreement was reached on giving the 50 least developed members of the WTO tariff and quota free access to developed markets for 97% of all goods.
  2. World Bank projected that the increase in global trade due to the Doha Round would increase economic activity by $520 billion by 2015 and lift over 140 million people out of poverty in the developing world.

International Monetary Fund (IMF) maintains international financial stability, by assisting nations in dealing with exchange rate problems caused by speculator activity.

Governments might run out of foreign reserves (Foreign currency) to continue trade normally. No foreign reserves would mean that trade would collapse, leading to sharp rises in unemployment as importing firms collapse due to lack of products for sale. Other producers may face problems of no raw materials and capital goods for production. The IMF's purpose is to provide emergency access to funds, however this assistance is only provided to economies that agree to change their economic policies in accordance of the IMF.

World Bank

Provides assistance to developing countries for economic development in order to raise living standards in the form of:

1. Reconstruction assistance for countries experiencing natural disasters
2. Aid to countries experiencing post conflict rehabilitation
3. Lending funds for infrastructure projects in the poorest developing countries.

G8 and G20

The G8 consists of the 7 largest economies plus the EU and is an unofficial forum that aims to coordinate global macroeconomic policy because its members contribute 60% to GWP and 14% to the world population. Agenda includes general political and economic issues such as climate change, and poverty.

The G20 consists of the 19 largest economies plus the EU which contributes 80% towards GWP and two thirds of the world's population. The shift in importance from G8 to G20 reflects the shift in global economic powers as emerging economies such as China and India grow larger. After the GFC, the G20 emerged as the leading council of nations responsible for the management of the global economy.

Impact Of Globalisation On The Standard Of Living In The Global Economy

Income And Quality Of Life Indicators

The two main ways to measure **standard of living** is through quantitative and qualitative indicators. Quantitative indicators such as GNI refer to income whilst qualitative refer to creating statistics such as average life span, education, access to clean water, infant mortality rates like the HDI.

Income Indicators

The **GNI (Gross National Income)** is the total income earned by domestically owned factors of production over a period of time.

The GNI can be distorted by exchange rates, but can be adjusted for **purchasing power parity** measurements where the utility value of an individual's income is standardised by measuring the price of a basket of common goods. The PPP theory states that exchange rates should adjust to equalize the prices of identical goods and services in different economies.

Human development index: A measurement from 0 to 1, where 1 means high living standards whereas 0 is poor. Takes into account:

- Life expectancy at birth: Indicates health standards
- Level of education: Adult literacy rate, indicates capability of workforce
- GDP per Capita: Used to determine the accessibility people have to G/S

Distribution of income and Wealth

Poverty levels have fallen from 42% to what is projected to be 15% in 2015 due to globalisation. However this is due to the trickle-down effect, and the benefits of globalisation are not shared evenly between advanced, emerging and developing economies.

According to the World Bank 75% of the world's population is in the bottom income quintile, whilst 1.7% are in the top.

The global distribution of wealth refers to a comparison of the ownership of total net asset values between countries. Wealth is more unevenly distributed in the global economy with North and America and Europe accounting for 64% of global wealth.

Contrasts in levels of development

Economic growth: Economic growth refers to a sustained increase in the production of goods and services over a period of time measured by percentage changes in real GDP. Economic growth leads to an outward shift in an economy's PPF (Production Possibility Frontier) and can come from two main sources:

- Capital widening: Employing more factors of productions.
- Capital deepening: Increased productivity of existing resources

Economic development: Economic development is a qualitative indicator of the standard of living in a nation through indicators of health, education, environmental quality and material living standards. It is normally accomplished by increasing economic growth.

Reasons for difference between nations

Development gap: The large contrast in the levels of economic development achieved by developed countries and less developed countries. Caused by:

- Low per capita incomes in developing economies reduce standards of living relative to the advanced economies though a reduction in the ability of a country's population to save and invest. Therefore LDC's experience difficulties in achieving high levels of productivity.

- Lack of infrastructure and capital formation retards economic growth and development by hindering the formation of markets and efficient allocation of resources which then leads to unemployment/underemployment.

- High population growth rates leads to high dependency ratios on governments and increases demand for education, health, housing and other services. If population growth outstrips economic growth in developing economies, there will be a fall in living standards and rise in poverty.

Developing economies, newly industrialized counties, transition economies, high income economies

Developing economies: such as Brazil, Indonesia and Nigeria seek to achieve economic growth through a system of markets which often lack allocative efficiency. These economies have low levels of GDP, high unemployment and are agriculture based.

Emerging economies: Such as India and China have high levels of GDP and high levels of unemployment. Their economies are market based, but governments have intervened with these markets to encourage the development of manufacturing based export industries, often financed by FDI in the form of TNC's.

Advanced economies: These economies have sustainable levels of GDP, low unemployment and are services based. The government's role is confined to the provision of welfare, public goods, economic and social infrastructure and the conduct of economic policy. The price mechanism is the main instrument of allocation and distribution of factor incomes.

Impact of Globalisation

International convergence: Economies are becoming more integrated within the global economy, that is, they start moving in sync with one another and may face spill over effects.

The International Business Cycle

The closer linkages between economies hold benefits and risks.

- Increased specialization due to increased convergence
- Flow on effect of high world economic growth will be greater
- Greater mobility of labour, technology, trade, finance and investment

Implications for government economic policies

The emergence of globalization has meant that nations have to maximise the benefits of globalization: Reducing trade barriers, run fiscal surpluses or balance to ensure confidence of foreign investors

Environmental stability

Environmental problems have worsened as global economic activity increases and a rising population puts pressure on natural resources – the **malthusian theory.** Two decades of growth in the global economy has led to greater greenhouse emissions. By 2040, average global temperatures are expected to rise by 2 degrees. The World Bank predicts this will erode decades worth of development and make their goal of eliminating poverty by 2030 impossible. The temperature is forecasted to have detrimental effects upon developing economies which are agrarian, with 40% of land currently used in Africa for growing maize rendered barren due to extreme drought and heat.

General

World Bank reports China's GDP reached $7295 billion USD making it the second largest economy in the world. Despite dampened growth due to the Eurozone crisis, the OECD forecasts that China's economy will become the largest economy in 2017.

(2005) Managed Exchange Rate – Pegged against US dollar

OECD estimates Yuan is undervalued by 48%

IMF: Before exchange rate, exports contributed to 10% of GDP (1978) VS After: 39.7% of GDP (2012) worth 180.2 billion USD in June 2012.

Trading economics: GNI per capita (PPP) in 2012 3.6 times greater versus past decade leading to rises in HDI.

HDI levels 0.404 in 1980 – 0.667 in 2011. Average annual HDI growth at 1.73% in this period **(China Daily report).**

SMH: 500 million people lifted out of absolute poverty in the last decade, average life expectancy risen from 36 years in 1960 to 75 years in 2012.

The Guardian: GINI coefficient rising from 0.425 in 2005 to 0.438 in 2010. Wealth disparity: 93% in urban regions vs 7% in rural regions. Incomes earned in urban regions average 4X greater than rural. → Consequence of SEZs policy which bought inequality between agrarian rural provinces and manufacturing based urban regions.

Eurozone debt crisis

EU demands 1/5 of China's exports. China's Yuan appreciated 23% against Euro = contraction in demand 50%

FDI flows from EU to China fell by 27.9% in first four months of 2012 vs same period 2011. 2000 HK factories expected to close down due to lower volume of exports.

Annual GDP growth rates dampened by 2.5% from 9.6% in 2011 to 7.4% in 2012.

Environment – Fiscal policy, 12th Five Stage Plan (shows priority of economic development over growth)

Reuters reports that Chinese industry has used 4 to 10 times more water per unit of GDP than similar economies and with 90% of China's groundwater polluted in 2012 more than 400 Chinese cities faced water scarcity.

Chinese bureau of statistics: 1/3 of China's population do not have access to clean drinking water and health issues as a result of pollution due to eco growth is expected to cost China 10% of its GDP.

Banking Regulatory Commission: China's fiscal policy will invest 450 billion USD into environmental protection, another 450 billion USD into renewable energy and 600 billion USD into smart grids. Aimed to reduce energy consumption by 20% per unit of GDP

CONC

China has been reducing its dependence on external demand as trade surplus has fallen from 8% in 2007 to 2% in 2011 of its GDP. It seeks through structural change to abandon an economic model which has an over reliance on debt-financed construction and exports and embrace one driven by domestic consumption. Trends of the industry sector suggest it has been contracting, from a contribution of 72.8% of China's GDP in 2005 to 30.5% in 2011 according to the World Bank. This contrasts to the services sector's contribution has risen from

39% of GDP in 2010 to currently 45% according to Reuters. Additionally, in the first quarter of 2012 domestic consumption took over as the main driver of growth, contributing to 3 / 4 of GDP growth. Reuter's Chinese Tea Leaf Index which measures internal demand reports that retail cells have risen by 12.7% in the 2012-13 financial year.