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How Globalization Works: Seventeen Theses on Its Impact on Trade, FDI, Income and Welfare

1 Definition and Dimensions

We tentatively define globalization as the extension of the horizon of action. Economic strategies, but also social relations, knowledge, and culture cease to be limited by national borders; they become international and finally global.

Within the economic realm, globalization implies a larger horizon for trade, production and sourcing as well as for physical and financial investment. The origin of goods consumed widens, also for intangible activities and services, specifically information, technology, organization, culture and finally for the socio-economic model. The choice of the location for living and working – a topic covered by the term "mobility" within an integration area and by the term "migration" outside – is especially important.

In comparison to the related concept of integration, globalization by definition refers to regions which are very different from each other, not only because they are far apart, but because they have different cultures, economic systems, and income levels.

If we want to discuss the impact of globalization on incomes and wealth, it is important to distinguish between impacts for all countries, the world (W), and then separately for the poorer countries (P), and for the developed countries (R). In the literature, these regions are often called developed versus developing countries, or North versus South.

While globalization has been an important topic for a long time, there are several new aspects, as stressed in Pichelmann and Vengelers (2005):

- the weak economy in the EU versus the buoyant growth of the world economy[1]
- the emergence of *new players*, with especially large labor forces and relatively high technical capacities
- information and communications technologies, which allow knowledge to be codified, boosting the tradability of goods and services and causing vertical fragmentation; there is a specialization according to *Ricardo for segments of the production cycle* instead of for complete goods
- the extension of the division of labor to **services** – considered nontradable until recently; this includes audiovisual, cultural, business and training services; services are easier to relocate, since they require fewer resources, less space and less equipment
- greater migration and labor mobility
- the imposition of changes on farmers, workers and firms by the *Doha round and WTO*

[1] *In the five years from 2002 to 2007, the world economy will have expanded by 25% (including the predicted value for 2007), while European growth will only have amounted to 10%.*

2 The Advantages of Globalization

Economic theory tells us that globalization – in parallel to all forms of integration and openness – will increase incomes in both (P) and (R) regions and a forteriori also in the world (W). The driving forces are the following: (i) an increasing variety of products, inputs, sources, (ii) the diffusion of technologies and best practice, (iii) the convergence of per capita incomes, and (iv) risk diversification (inputs, outputs, and assets). Furthermore, welfare increases more than

GDP or incomes, due to cheaper inputs, increasing variety and choices.

3 The Disadvantages of Globalization: A Symmetric Case

It makes sense to analyze first the case of countries which are more similar, or where the trade effect is rather balanced. Even in the balanced case there are winners and losers in R and in P. In the rich countries, the high-skilled groups win, while the low-qualified tend to lose; in the poor regions the opposite happens. This is due to fact that the original scarcity of low-skilled labor is reduced, since labor-intensive goods will be imported in R.

Second, the speed of change and its implied short-run burden increases in all countries. Disequilibria may result in the short run (unemployment rises in sector A, labor is not transferred into sector B), and unemployment may become persistent under specific circumstances (rigidities).

Theory states that the losers can be compensated, since *gains are larger than losses* ("net welfare increases"). Usually, however, compensation does not take place.

4 Disadvantages of Globalization: Asymmetric Cases

Most critiques of globalization start from the assumption that some countries reap the advantages of globalization while others suffer. Interestingly, people in the rich countries often claim that R are the losers, while the arguments for unbalanced globalization tend to hint at necessary conditions for poorer countries to make globalization beneficial for P.

"Unfair" *advantages of R* might be the following:

- asymmetric trade and investment, giving firms in R a first-mover advantage
- multinational firms usually have their headquarters in R, and the economic and political interests of location of headquarters shapes the outcome
- firms with headquarters in R extract rents in P and transfer profits to R, giving rise to arguments about expropriation and unfair prices
- the poor countries specialize in low value added goods, with a low income elasticity (development trap)
- social dumping (child labor etc.) and environmental degradation occur in P

Unfair *advantages of P or nonacceptable pressure on labor in R* might be come from

- dumping, undervaluation of currency
- "unfair, prolonged, policy-dependent" wage advantages
- possible subsidization of labor-intense sectors in R (export promotion)
- wage pressure on R (the "are-wages-set-in-Beijing debate")

Therefore, interestingly often both R and P believe that they are the losers of globalization, even if both are probably in the long run net winners. The reason for this is that the negative consequences of globalization tend to be visible and concentrated, while the benefits are dispersed and the origin of the advantages is not attributed to globalization, but to innovation, management and prudence.

5 The Empirical Evidence 1: Cross-Country Income Differences

It is not easy to summarize the huge literature on equality and inequality of nations and persons in a few sentences. My reading, however, is that the inequality of per capita incomes across countries is decreasing. This process is slow and nonlinear, but significant. There is one important exception: Africa is falling back instead of catching up.

Second, profits rise relative to the wage bill. The reason for this is that capital is more mobile and more powerful. It has a large and increasing bargaining power. Globalization increases the options, and capital can use it for threats (to relocate firms), which governments want to preempt; they want to lure firms by low taxes and subsidies.

Third, the volatility of the development might increase, as the experience of financial crises in Asia, Mexico, Argentina and Turkey demonstrates.

6 The Empirical Evidence 2: Intracountry Income Differences

Inequality within countries is increasing. This holds for *P*, for rural incomes versus cities. This development might not follow from globalization alone; it is aggravated natural disasters or civil wars and stems from the lack of education and bad domestic policies. The burden of change imposed asymmetrically on regions and persons, however, adds to existing inequalities and might further destabilize regions.

The rising inequality holds for poor countries, it might even be seen as typical or indispensable in takeoff periods (unequal development hypothesis). However, it also held for most R in the 1990s. As to the causes in rich countries, rising inequality may come from globalization (production and exports of labor-intensive and low-skill goods is lost in R) or from technology change. This is an intensive and controversial debate in economics.

The trend toward rising inequality seems to have leveled off in late 1990s or since, and may have been reversed in some countries lately.

7 The Empirical Evidence 3: Openness and Growth

More open countries tend to grow faster. This is specifically the case for GDP. The results for per capita income might be less, if high growth attracts migration. There is, however, also the opposite claim that net immigration and abundant labor stimulate growth (more GDP, less GDP per capita).

8 Globalization Impact: Empirical Results for the EU

In summarizing the impact of globalization on Europe, we follow Pichelmann and Veugelers (2005).

The EU has by and large defended its world market share (in contrast to its share in world GDP). EU-trade is balanced, leaning to the positive specifically for the EU-15. The EU generates a trade surplus of 1% of GDP in business services (where outsourcing is suspected).

There is no significant outflow of investment into low wage countries. Employment is increasing somewhat, with losses occurring in manufacturing. Inward FDI in EU is increasing slightly in the EU-15 and more in the EU-10.

Unemployment of low-skilled labor is high but decreasing. Net immigration is increasing and is now higher than in the U.S.A.; it is low-skill immigration.

The exports of the EU and those of China and India are complementary (Pichelmann and Veugelers, 2005). The trade deficit with Asia is fully compensated by a surplus with the U.S.A. and with the new Member States and the "new" neighbors.

Pichelmann and Veugelers (2005) present a very convincing statistical record of globalization for Europe: of the increase in European living standard over the past 50 years, 20% are due to integration in the world economy. This has to be compared with 10% due to integration within Europe. The remaining 70% stem from increased production (use of resources).

9 The Growth Evidence: 2002–2007 (Including Forecast)

The growth experience among regions has become surprisingly different over the past five years. We calculate figures for the five years from 2002 to 2007, including the current WIFO prediction for 2007:

– the world economy is growing by 4% per annum (cumulative over five years: 28%)
– Europe is growing by 2% per annum (cumulative: 8%)
– China is growing by 9% per annum (cumulative: 68%)
– the new Member States are growing by 4% per annum (cumulative: 27%)
– the U.S.A. is growing by 3% per annum (cumulative: 20%)

In the long run, the U.S. growth path imposes some risks on the world economy with its twin deficits, lack of internal savings and overvalued house prices, but strategies for a soft landing and international coordination are to be discussed elsewhere.

10 European Underperformance

European underperformance with respect to growth and employment generation is not related to globalization. It comes from internal reasons, like insufficient macromanagement, neglect of the Lisbon strategy and especially low investment in the future (research, education, lifelong learning, and modern technologies. Maybe we have to add insufficient flexibility (flexicurity), the lack of vision, trust, strategy, consensus. A tentative – albeit not sufficient – proof for this is the lack of a current account deficit of the EU.

11 Net Benefits for Europe from Growth in China, India Prevail

Specifically the buoyant business climate stemming from increasing world trade is important for solving the European underemployment problem and for increasing flexibility. Labor market reforms work better in periods of rising demand, and fiscal debts can be reduced without crisis if export demand rises. Finally, investment in the future can be financed if profits rise.

12 Globalization Worldwide versus Globalization in a Wider Europe (Global versus Neighborhood)

For Europe in general and for Austria specifically, "neighborhood globalization" may be as important as rising trade with Asia. For Austria, trade with Eastern Europe amounts to 12% of GDP (exports plus imports) as compared to 6% for trade with Asia and 3.5% for trade with the U.S.A.

Integration in a wider Europe is a sort of globalization, since it is the integration of very different per capita incomes. However, it happens within a very small geographical sphere. Austria is located at a welfare ridge: wages 500 km east of Austria amount to 25% of Austrian wages; at a distance of 1,000 km, they are 10%. The forecast of the wiiw for a "wider Europe" defined as the EU-25 plus Southeastern Europe, Ukraine and Turkey, shows just how dynamic the "neighborhood" is: the GDP of this area is predicted to increase as fast as that of the U.S.A.

13 Integration and Globalization Experience for Austria

Austria has experienced a dramatic experience of openness: *Trade openness* increased from 50% to 75% in ten years (1995–2005, goods, exports plus imports) after stagnating for 15 years. Three forces were involved in the acceleration: member-

ship in the EU, the opening of Eastern and Southeastern Europe, and the shifting role for Austria at the center of a dynamic region.

Austria has clear net benefits from its new openness: The trade balance deficit leveled off, starting from a deficit larger than 5, % of GDP. *Direct investment* flows in percent of GDP rose from 1.6% in 1992 to 6% in 2005, and here again, the past deficit eroded: outward stock equals now inward stock. Third, the high-tech deficit is leveling off; export unit values now equal those of imports.

The labor-intensive industries are the losers. Unemployment has increased, and differences in unemployment between unskilled and skilled workers are growing. All this follows the predicted short-run impact of globalization if macroeconomic policy and investment in the future are not very active in a specific period (1995–2005, see thesis 15).

14 Double Strategy: Wider and Nearer Globalization for Austria

The trade balance of Austria with eastern countries is highly positive: The export share to the east rose from 2.5% in 1992 to 6.7% in 2005; imports rose from 1.9% to 5.8% in the same period. The trade balance with Asia is negative: The export share increased from 1.6% in 1992 to 2.5% in 2005; imports increased from 2.8% to 3.8% in the same period. Austria switched into a net export position with the U.S.A., with export shares increasing from 0.6% in 1992 to 2.5% in 2005; imports only expanded from 1.1% to 1.3%. Austria's deficit with the EU-15 shrank from 4% to 2%.

The overall conclusion is that the rising deficit with Asia is more than compensated by the surplus with Eastern Europe plus exports to the U.S.A., which is partly feasible only due to vertical division of labor with the east.

The balance of outward versus inward direct investment has also leveled today. Half of the outward flows go to Eastern Europe (narrowly defined). The deficits with the EU-15 are fully compensated by net investments; direct investment with the U.S.A. and Asia are negligible.

15 Consequences for Economic Policy

Some strands of economic policies are becoming less effective. This hold for trade barriers and investment incentives, specifically those *discriminating between domestic and foreign* investment, the use of exchange rates to stimulate the economy or to correct imbalances.

On the other hand, competition for direct investment is increasing and now relies less on direct subsidies and more on offering physical infrastructure or even more intangible infrastructure (legal system, education, innovations system).

Tax competition increases (specifically business taxes, manager tax load).

We should furthermore not forget that demand and growth policy (macroeconomic policy and growth-enhancing strategies) are needed if wages increase less than productivity and if domestic profits are used for foreign investment. Competition policy has to be enforced vigorously to reap benefits from the lower prices of imported goods.

If business taxes are reduced and income taxes in the highest segment are not to increase, the tax load on consumption, energy, wealth and interests have to increase, and/or government expenditures have to be curtailed.

16 Proactive Policies Can Increase Positive Net Benefits

Benefits can be increased and disadvantages can and should be limited by prudent proactive policy. Many international organizations and economists forget this in their recommendations. I would label the recommendation to liberalize, deregulate and globalize the economy, and then wait for the positive results in investment, innovation and employment generation to come up the "Paris Consensus." The problem of this consensus is that the recommended strategies – while hopefully positive in the long run – have a restrictive impact on demand and employment in the first stage ("pains precede gains"). If macromanagement does not cope with these problems, cumulative downward forces may prevent the positive results of higher productivity and a better division of labor.

Managing globalization properly in developing countries includes policies to

- reduce poverty, foster education, fight against corruption
- encourage endogenous forces
- limit volatility
- introduce minimum social and environmental standards

Managing globalization properly in developed countries (R) implies

- upgrading the skills of unskilled labor
- distributing the burden of change fairly
- managing change in a forward-looking manner
- stimulating growth by increasing R&D, education and lifelong learning

17 Summary

1. Globalization is not a panacea, it is a *necessary but not sufficient condition* for growth and welfare improvement.
2. Net gains *also need political and macroeconomic stability*, i.e. a high investment-to-GDP ratio, a reliable legal system, investment in human capital, physical infrastructure in P, investment in R&D, education and lifelong learning in R.
3. Globalization *increases the importance* of economic policy. These policies are different from the past: proactive policies, the enforcement of positive externalities, retraining, competition policy. Subsidies are less important; strategies preventing structural change become very costly under globalization.
4. Globalization *increases the speed of change; this is a burden*. However, globalization also increases choices and welfare.
5. The possibility that for some *R losses dominate* gains is *unlikely but possible*. However, *pains can precede gains*, and the *political weight of losers* can be greater than that of the winners.
6. The possibility that for some *P the losses are higher* than the gains is *not unlikely*, but could be prevented by domestic policies and international organizations.
7. *Properly managed globalization* is a *win-win situation*. Preventing globalization is *impossible* and would create a *lose-lose situation*. Globalization *increases the scope* (and changes the instruments) of economic policy. *Laissez-faire globalization* and following the Paris

Consensus result in *political risks, backlashes and conflicts*.

8. *Multinational organizations* should *not only press* for liberalization, privatization and deregulation, but also *for proactive education policies, regional policies* and macro-management.
9. For *Austria "neighborhood" globalization* is at least as important as world-wide globalization, though differences across sectors exist, and relations with and policy attention to the *fast-growing Asian countries* are important, too.

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