

## Case A.5

# Global Economics

### Economic problems on a grand scale

‘Globalisation’ has become a fashionable term in recent years. But what does it mean in the context of economics? It refers to the integration and interdependence of the world economy. This interdependence has increased dramatically in the past 40 years and has had a profound effect on national economies and the ability – or inability – of their governments to tackle economic problems.

Globalisation has a number of dimensions:

- Global transport and communications have improved, especially with growth in air transport and the information technology revolution. Between 1930 and 2016, the average cost of a three-minute telephone call from London to New York fell from nearly \$250 to around \$0.10. This has been accompanied by a new technologies, such as Skype and FaceTime, which have effectively reduced the financial cost of global communication to zero.
- International trade and movements of finance have increased, as government restrictions on imports and on the flow of money and capital abroad have diminished (or in many cases have been abolished). Between 1970 and 2016, well over 100 countries eliminated foreign exchange controls. These countries are now free to exchange their currency into others when they wish to buy imports.
- Giant ‘multinational’ companies, such as Ford, Sony, GlaxoSmithKline, Nestlé and McDonald’s, have expanded their operations to more and more countries. In 2015, the stock of global foreign capital invested in industries in other countries was valued at over \$25 trillion (\$25,000,000 million). It grew at a staggering average of 11 per cent a year between 1990 and 2015.
- Consumer tastes for a whole range of products from trainers, hamburgers, soft drinks and computer games to spectator sports and television soaps have become more similar.

Just as we can look at macroeconomic and microeconomic issues for a particular economy, so too we can look at these issues in the context of the global economy.

#### **Global macroeconomics**

What causes the global economy to grow? Why does this growth tend to fluctuate? Why was it that most countries experienced rapid economic growth in the late 1980s, often with accelerating inflation, and yet a recession in the early 1990s and late 2000s? Clearly there are international forces at work here.

The point is that countries are *interdependent*, especially those countries within a particular region, such as the European Union, North America or East Asia. Thus when Thailand and Indonesia experienced a financial and banking crisis in 1997 and a resulting recession, the effects spread rapidly around the region. By early 1998, Japan, South Korea and other East Asian economies were also experiencing a large economic downturn. But then the effects spread beyond the region. By mid-1998, the Russian economy was in virtual ‘free-fall’ as international investors pulled out, and by the autumn countries in Latin America had

come under attack. Leaders of the seven most powerful industrial nations (the G7 – the USA, Japan, Germany, France, Italy, the UK and Canada) were anxiously seeking policies to deal with a possible *global* recession as the ‘Asian contagion’ spread.

An even greater global interdependence was demonstrated during the ‘credit crunch’ and subsequent recession of 2007–9. Banks around the world had granted too many risky loans. These loans had been bundled up into complex financial securities and sold on to other financial institutions worldwide. A major example of risky loans were so-called ‘sub-prime mortgages’ in the USA and other countries. These were mortgages granted to householders who had little chance of paying if house prices were to fall. When house prices did start to fall and many people defaulted on their mortgage payments, this put banks in serious difficulties: not just those granting the mortgages, but anyone holding securities which included this sub-prime debt.

This led to a collapse of confidence in banking and many banks around the world had to be bailed out by governments. This in turn led to a severe reduction in bank lending (the ‘credit crunch’), a consequent reduction in spending by both consumers and firms, and a worldwide recession. In other words, with the globalisation of world finance, a financial problem that began in the USA and a few other countries, rapidly became a global problem.

Another example occurred in the mid-2010s as world growth was held back by slowing growth in China, the world’s second largest economy after the USA. China is a major purchaser of imports of raw materials and, in recent years, of manufactured products. Slower growth in China was a major contributing factor in falling commodity prices, which, in turn, had ramifications around the world. Commodity exporters suffered a fall in exports earnings, which curtailed their growth, while lower commodity prices did at least help to increase real incomes of commodity importing countries. But the net effect of slowing growth in China was slowing export growth for the rest of the world and a growing worry about the fragility of the global economy.

If solutions to global problems are to be found, then do they require global action? Will the uncoordinated actions of individual governments be sufficient? In 2010, it became clear that several European countries had persistently overspent during the period leading up to the ‘credit crunch’ and had subsequently failed to address this. Portugal, Italy, Ireland, Greece and Spain were amongst those deemed to be highly vulnerable to bank and government financial meltdown. In previous decades this might have been a matter of moderate concern to other European countries. However, the existence of the single currency, precipitated what became known as the ‘Euro crisis’. Collective action was required, with a bailout scheme put in place to ensure that the system did not collapse. But, as we shall see in Chapter 14, the terms of bailouts for countries such as Greece, were very harsh and led to extreme hardship.

These are issues we shall address in Part D of the *Essentials of Economics* (7<sup>th</sup> edition).

### ***Global microeconomics***

Just as we can study the *what*, *how* and *for whom* questions within a country, so we can study them within the global economy. How will output (*what*), techniques (*how*) and incomes (*for whom*) differ between countries? Why will a poor African country produce a large proportion of primary products (food and raw materials) using relatively labour-intensive techniques, whereas countries in western Europe produce a large proportion of manufactured products and services, using technology that is often sophisticated and highly automated? And why does the degree of inequality within countries differ from one country to another? Why, for example, did the poorest 20 per cent of the population receive over 9 per cent of national

income in both Norway and Finland in the mid-2010s, but only 3.3 per cent in Brazil and 2.5 per cent in South Africa?

Then there is the question of distribution *between* countries. According to IMF data, in the richest five countries of the world, the average person's income in 2014 could buy the equivalent of just over \$71 300 worth of goods and services. In the poorest five countries, it could buy only \$670 worth. This concentration of buying power in the rich countries then affects what goods the world produces. Clearly, world production will be geared towards satisfying consumer demands in the rich countries.

Can international policies, such as policies to reduce barriers to international trade, lead to greater equality in income distribution? How important are multinational organisations, such as manufacturing companies and banks, in determining the pattern of output? Just how much are a country's microeconomic decisions determined by its citizens? These too are big issues and we will be examining them at various points throughout the book.

***Question***

What dangers do you see from increasing globalisation in the world economy?