OCR A Level Economics Course Companion

Year 2 Macro Topics

The Global Context

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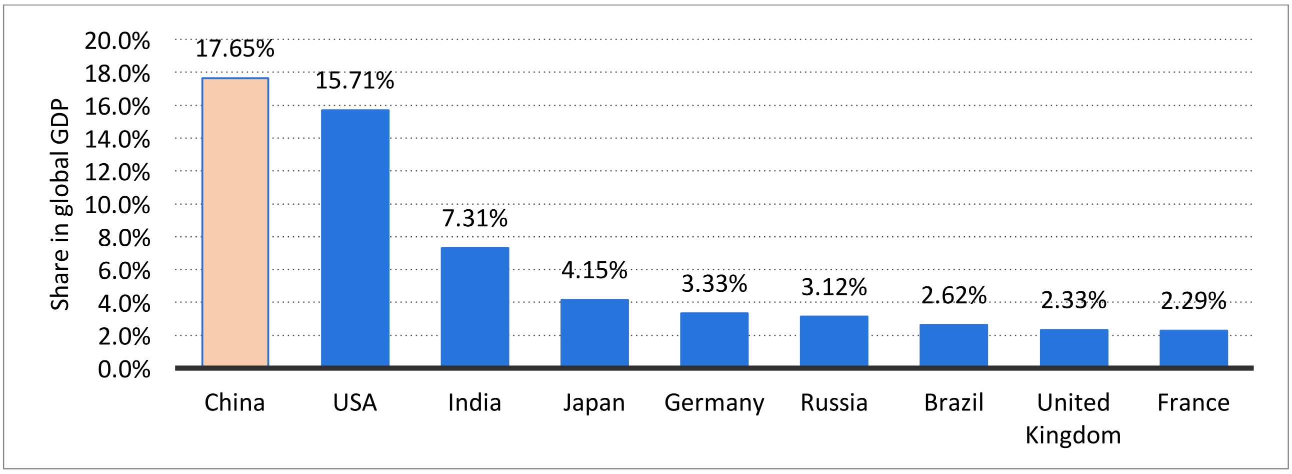
Globalisation

What is globalisation?
Globalisation is a dynamic process in which national economies have become increasingly integrated and inter-dependent. The OECD defines globalization as
"The geographic dispersion of industrial and service activities, for example research and development, sourcing of inputs, production and distribution, and the cross-border networking of companies, for example through joint ventures and the sharing of assets."

Percentage share of the main industrialized and emerging countries in global GDP (adjusted for purchasing power) in 2016, Source: IMF World Outlook



Characteristics of Globalisation


Trade to GDP ratios are increasing for most countries


Expansion of Financial Capital Flows between countries

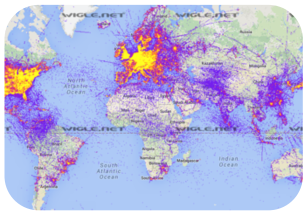
Foreign Direct Investment and Cross Border M&A

Rising number of global brands – including from emerging countries


Deeper specialization of labour – components come from many nations


Global supply chains & new trade and investment routes e.g. South-South trade


Increasing levels of international labour migration and migration within countries


Increasing connectivity of people and businesses through mobile and Wi-Fi networks

Key Causes of Globalisation

1. **Containerization** – the costs of ocean shipping have come down, due to containerization, bulk shipping, and other production efficiencies
2. **Technological change** – reducing the cost of transmitting and communicating information – sometimes known as "the death of distance" – a key factor behind trade in knowledge products using web technology
3. **Economies of scale:** Many economists believe that there has been an increase in the minimum efficient scale (MES) associated with some industries
4. **Differences in tax systems:** Many countries have adjusted their tax systems to attract foreign direct investment (FDI)
5. **Less protectionism** – in many countries, borders have opened and average import tariff levels have fallen – that said in the last few years there has been a rise in non-tariff barriers such as import quotas, product regulations and currency manipulation

Impact of Globalisation – Key Gains

Some of the key gains from globalisation are as follows:

1. It encourages producers and consumers to reap the benefits from deeper division of labour and economies of scale
2. Competitive markets reduce the scale of monopoly profits and incentivize businesses to seek cost-reducing innovations
3. Enhanced growth has led to higher per capita incomes – and helped many of poorest countries to achieve higher growth and reduce extreme poverty to below 10% of the world's population (measured using an extreme poverty line of $1.90 per day PPP)
4. Advantages from the freer movement of labour between countries
5. Dynamic efficiency gains flowing from the sharing/diffusion of new ideas/skills/technologies across national borders
6. Opening up of capital markets increases the opportunities for developing countries to borrow money to help overcome the limits of a domestic savings gap
7. Increased awareness among people around the world of the substantial challenges from climate change and wealth/income inequality
8. Competitive pressures of globalisation may prompt improved governance and better labour protection through improved business standards

Main Disadvantages / Costs from Globalisation

1. **Rising Inequality / Relative Poverty** - leading to political and social tensions and instability as a backlash.
2. **Threats to the Global Commons** e.g. threats of irreversible damage to ecosystems, land degradation, deforestation, loss of bio-diversity and the fears of permanent shortages of clean water
3. **Macroeconomic Fragility** – in an inter-connected world economy, external shocks in region can rapidly spread to other centres – this can lead to highly volatile capital movements and swings in trade flows
4. **Trade Imbalances:** Increasing trade imbalances lead to protectionist tensions and a move towards managed exchange rates
5. Higher **Structural Unemployment** especially in countries where manufacturing production has shifted to lower cost centres, many previously well-paid white-collar jobs in advanced economies have been lost over the last two decades
6. **Dominant Global Brands** – businesses with dominant brands, economies of scale and superior technologies may squeeze out local producers who have less market power

7. **Poor behaviour of some global multinationals** – exploitative conditions for low wage workers, tax avoidance, and failures to address environmental issues. Tax avoidance and tax inversion have become dominant issues.

Professor Diane Coyle on the Impact of Globalisation
“Globalisation, far from making the world flat, has thrown into sharper relief economic inequalities. It has made the geography of economic activity more rather than less salient.”

“The distributional consequences of globalisation, driven by the new technologies and manifested in flows of goods and services, capital and people, have long been foreseen. Unfortunately, it has taken a generation for any policy response to get under way.”

Professor Diane Coyle (July 2016)

Professor Dani Rodrik on the Impact of Globalisation
“Openness to the world economy can be the source of many economic benefits…. But these are only potential benefits, to be realized in full only when the complementary policies and institutions are in place domestically".

“These involve both social policies (especially education) and policies to assist firms that are being left behind in the increasingly competitive world.”

Professor Dani Rodrik

Globalisation and External Economic Shocks

Most countries are vulnerable to international and or regional external shocks that can affect both the demand and the supply-side of their economies. Some of these are summarized in the following graphic.

Global Financial Crisis (GFC)

Euro Zone Economic Crisis

Volatile World Commodity Prices

China Slowdown

International & Regional Trade & Investment Deals

Currency volatility and policy changes e.g. devaluation

Extreme weather events

Geo-political uncertainty & terrorism

Top Ten Global Economic Risks 2016 (Source: EIU)

1. China experiences a hard landing
2. Russia's interventions in Ukraine and Syria precede a new "cold war"
3. Currency volatility culminates in emerging markets corporate debt crisis
4. "Grexit" is followed by a euro zone break-up
5. Beset by external and internal pressures, the EU begins to fracture

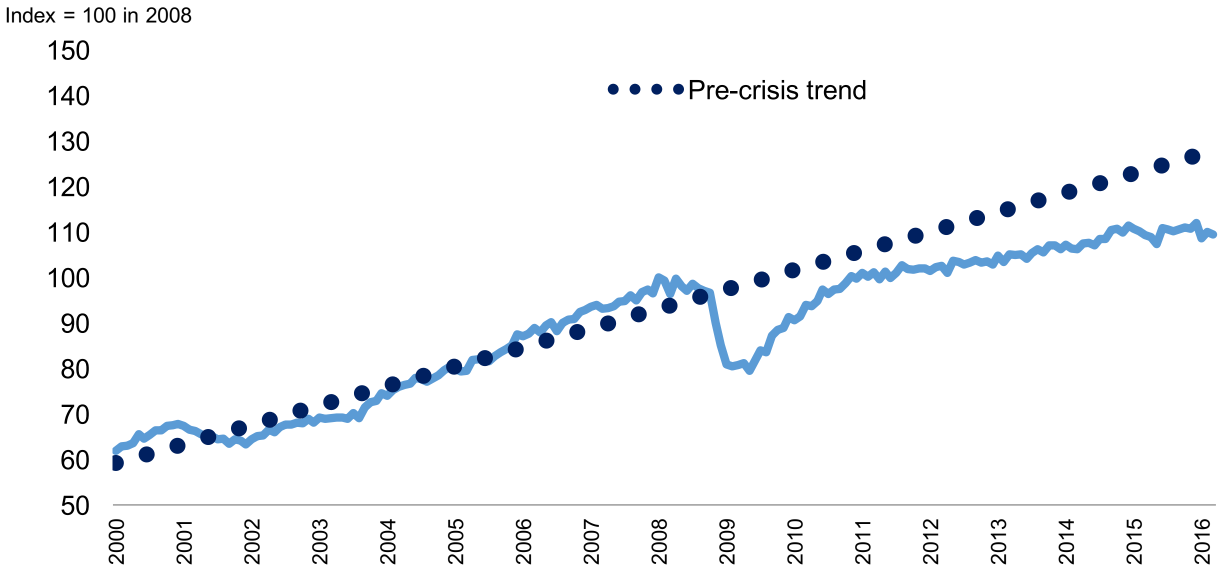
6. The rising threat of jihadi terrorism destabilizes the global economy
7. Donald Trump wins the U.S. presidential election (Nov 2016)
8. The UK votes to leave the EU
9. Chinese expansionism prompts a clash of arms in the South China Sea
10. A collapse in investment in the oil sector prompts a future oil price shock

De-globalisation: Slowdown in growth of global trade

Globalisation is not inevitable – indeed since the Great Recession of 2008-09 there has been a significantly slower growth of world trade. It is now well below the pre-crisis trend.

Why is World Trade Growing Slowly at the Moment?

1. Weak economic growth in many of the world's richest countries – indeed some economists believe that Western nations are suffering from secular stagnation
2. Slowing pace of trade liberalization. The big gains to trade from cutting import tariffs may have already happened.
3. Non-tariff barriers (NTBs)) have grown and regional trade blocs such as ASEAN have become more common in place of a new global trade agreement which remains a long way from being achieved
4. Rising prosperity itself. As people become richer they spend a higher proportion of their income on services, such as education, leisure and health – global trade in services is actually lower as a share of GDP than manufactured products
5. Technological change – e.g. 3D printers are being used to manufacture a set of orders e.g. for aircraft equipment or artificial joints used in medicine – they no longer have to be shipped around the world



Impact of multinationals (MNCs)

What is a Multinational Company (MNC)?

- A multinational company (MNC) is a business that has operations in more than one country. Note that a business does not become an MNC simply because it sells its goods and services overseas. The key to being an MNC is that the business has business operations in two or more countries.
- Around 1,300 companies control 80 per cent of global operating revenues, with 40 per cent of this controlled by only 147 organisations

Key Reasons for the Rapid Growth of MNCs

- Global brands seeking to drive revenue and profit growth in emerging economies (in particularly seeking rising demand from increasingly affluent consumers)
- The search for economies of scale, to reduce unit costs by concentrating production in a few key international locations
- The need to supplement relatively weak demand in existing, developed economies
- The need to operate in many countries to avoid protectionism such as import quotas
- Increased takeover activity that has built businesses with international operations

Potential Benefits of MNCs to the Countries in Which They Operate

1. MNCs provide significant employment and training to the labour force in the host country helping to raise employment and productivity
2. Transfer of skills and expertise, helping to develop the quality of the host labour force
3. MNCs add to the host country GDP through their spending, for example with local suppliers and through capital investment – there might be large multiplier effects
4. Competition from MNCs acts as an incentive to domestic firms in the host country to improve their competitiveness, perhaps by raising quality and/or efficiency
5. MNCs extend consumer and business choice in the host country
6. Profitable MNCs are a source of significant tax revenues for the host economy (for example on profits earned as well as payroll and sales-related taxes)

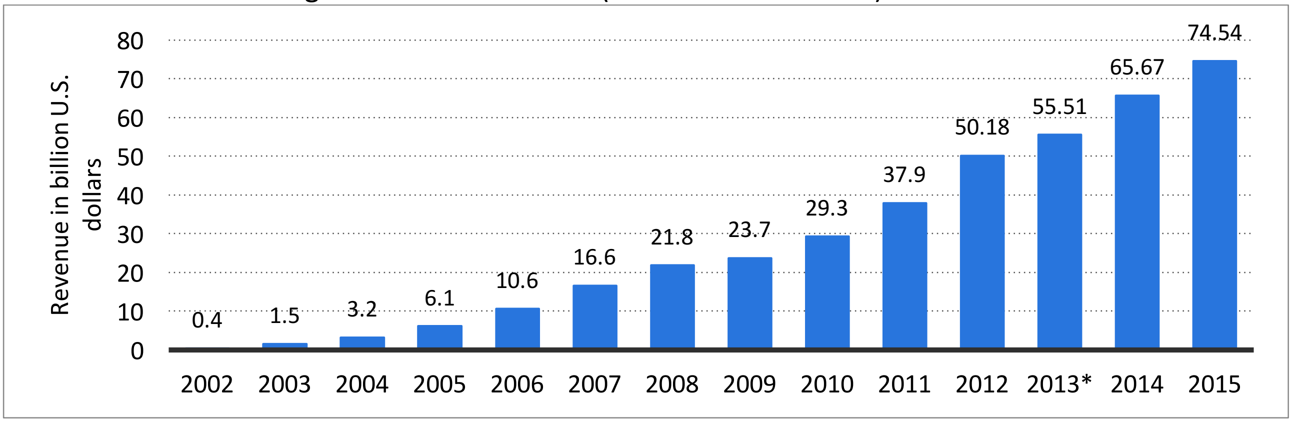
Potential Drawbacks of MNC Activity in The Countries in Which They Operate

1. Domestic businesses may not be able to compete with MNCs and some will fail – for example, Uber is one of the fastest-growing MNCs and has faced significant resistance from national markets it has entered
2. MNCs may not feel that they need to meet the host country expectations for acting ethically and/or in a socially-responsible way
3. MNCs may be accused of imposing their culture on the host country, perhaps at the expense of the richness of local culture.
4. Profits earned by MNCs may be remitted back to the MNC's base country rather than reinvested in the host economy.
5. Some MNCs are accused of exploitation of working conditions in developing economies in search of low production costs - The complexity of international supply chains makes it hard for MNCs to control & monitor all aspects of their production
6. MNCs may make use of transfer pricing and other tax avoidance measures to significant reduce the profits on which they pay tax to the government in the host country – high profile cases have included Amazon, Facebook, Google & Starbucks

Brands that have been caught out using child labour or sweatshops

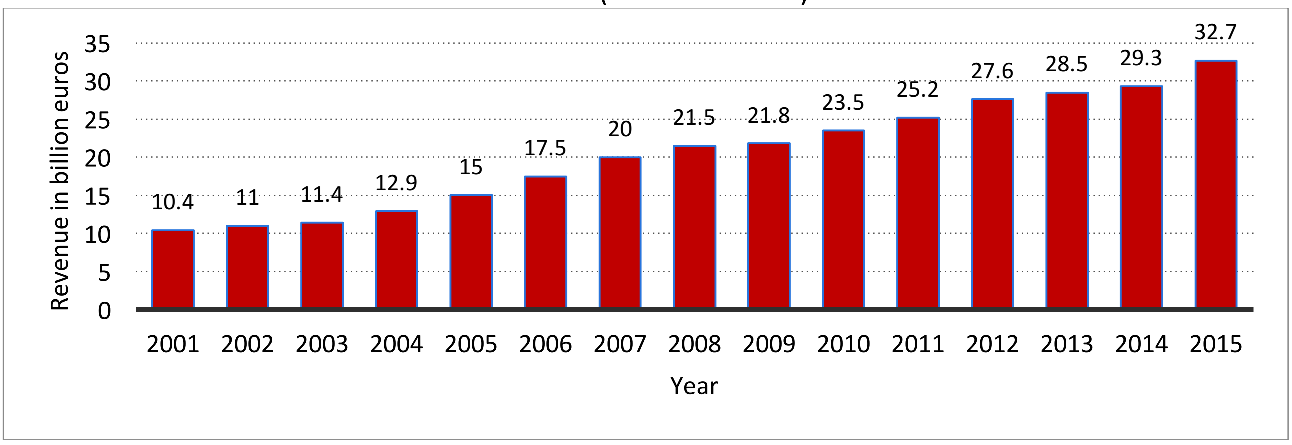
Example: Global Growth of Google as an MNC

Annual revenue of Google from 2002 to 2015 (in billion U.S. dollars)

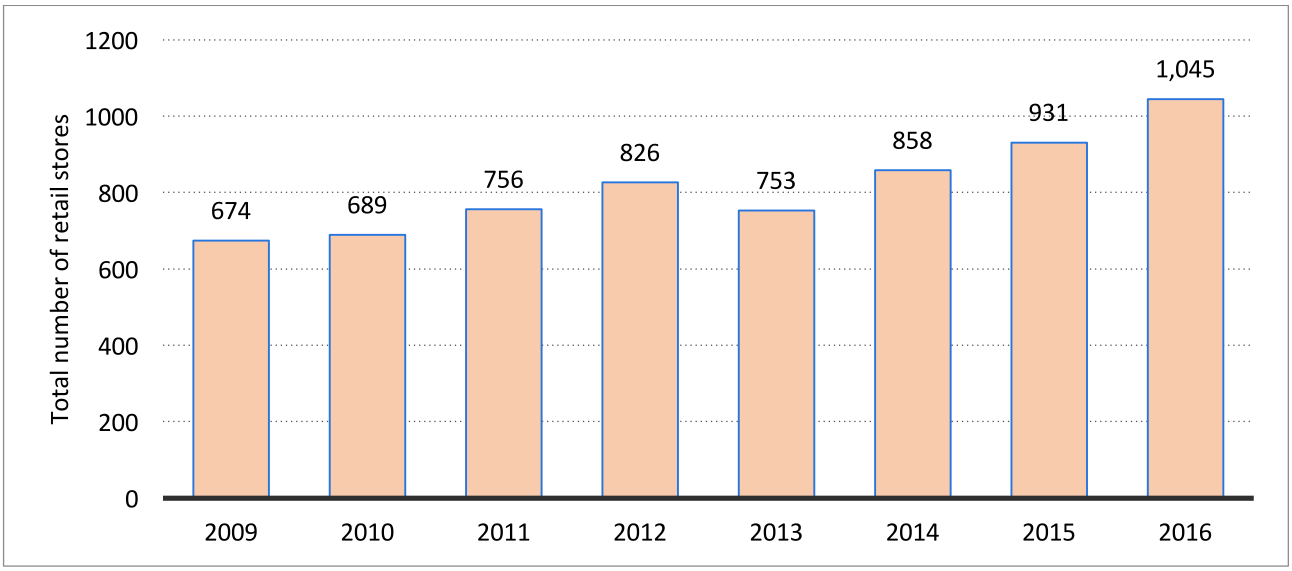


Example: Global Revenues for IKEA

IKEA's revenue worldwide from 2001 to 2015 (in billion euros)



Total number of Nike retail stores worldwide from 2009 to 2016



Controlling Global Companies (Transnationals)

Corporate tax competition
Increasingly there are trans-national companies (TNCs) operating globally whilst tax policy is mostly a matter of national governments. Foreign direct investment has grown rapidly - well ahead of the expansion of world GDP. Global companies have become much more important in the last decades but corporate income tax rates (paid on profits) has actually declined as many countries reduce their tax rates in bids to remain competitive. This is sometimes called a "race to the bottom."

Supporters of lower business taxes often justify their policies using the idea of the **Laffer Curve**. Critics of the drop in corporate tax rates believe that tax revenues from multinationals become eroded and leaves national governments with less income to spend on essential public and merit goods. Multinational businesses have - by and large - become more profitable, and perhaps they should be making a bigger contribution to national tax receipts? Corporate tax is a substitute for personal taxation. If we don't collect taxes from businesses, household taxes would have to be higher and/or government spending lower.

Tax avoidance (profit shifting)
- Tax avoidance is known as profit shifting and can happen through over-reporting of costs and under-reporting of a global corporation's production and revenues.
- There is a big current debate about tax avoidance by multinational companies. Numerous newspaper headlines have highlighted allegations of tax avoidance by multinationals such as Apple, Amazon, Starbucks, IKEA and Fiat among others.
- The EU is proposing legislation that will force companies to disclose their earnings and improve the transparency of their business models.
- Google CEO Eric Schmidt was quoted as saying that tax avoidance is a natural feature of capitalism.

The (estimated) scale of tax avoidance
- In October 2015 – War on Want published a report on tax avoidance from transnational companies operating in Zambia. According to the report, Zambia is losing $3 billion a year from corporate tax dodging. The sum is equivalent to nearly twice Zambia's spending on health and education.
- Oxfam estimate the annual revenue loss for developing countries from tax avoidance at around $50 billion. Remember however that a lot of tax avoidance is done by individuals operating in the shadow economy.
- The EU estimates that corporate tax avoidance costs member states €50m-€70bn a year in lost taxes

Tax Evasion
Tax evasion is illegal whereas tax avoidance happens when individuals and businesses find tax loopholes that reduce the amount of tax they pay. According to the Financial Times in 2013 "Much of the developing world is struggling to tax globally mobile profits and capital. African countries are hemorrhaging tens of billions of dollars in potential revenues each year."

Transfer pricing
- Transfer pricing is the price at which divisions of a company transact with each other.

- For example, a multinational mining company operating in Zambia or the Central African Republic might invoice their parent company for the costs of consultancy / engineering services or for loans.
- This reduces their profits and thus lowers their liability to pay corporation tax

Key economic effects of corporate tax avoidance:

1. Distortion of market competition between multinationals and domestic firms
2. Squeezing of tax revenues can lead to higher fiscal deficits and fewer resources for public and merit goods
3. Huge expenses given over to tax planning by businesses 9and wealthy individuals) is a waste of scarce resources

Limits to government ability to control global companies

Some of the world's biggest economies are corporations!

1. Capital is increasingly footloose meaning that foreign direct investment (FDI) can flow to many different countries depending on factors such as unit labour costs, ease of doing business, capital controls and government regulations on labour markets and the environment
2. Many countries require inflows of external finance to help sustain growth and development, the power relationship works in favour of multi-national businesses
3. Many of the world's biggest corporations have significant monopsony (buying) power in different countries – for example the buying power of the global coffee, copper and rubber processing businesses when they purchase from local growers and miners.
4. National governments may be limited by the international agreements they have signed for example full-membership of the World Trade Organisation which might control freedom to set import quotas and tariffs. Indeed, transnational corporations have used their money, size and power to influence international negotiations including trade deals
5. Corporations often have huge lobbying budgets which might be used to lobby against new legislation that affects their most profitable industries – consider for example the lobbying influence of tobacco and drinks businesses worldwide. Big businesses might also lobby for example against immigration reforms that could affect their ability to hire the best people from different countries.

Increasingly, opposition to the worst excesses of corporate power comes from well-organised pressure groups and consumer organisations many of whom make effective use of social media to highlight their concerns and seek redress.

In the summer of 2016, the European Commission (which is a supra-national body with responsibility for all EU member nations) announced it was requesting Apple to pay back $13bn linked to its Irish tax scheme. Apple has faced criticism for paying a 2 per cent corporate tax rate in Ireland, far lower than the headline 12.5 per cent rate. (The rate in the UK is 19%).

The Australian government is introducing a "Google Tax" to reduce the scale of (legal) tax avoidance by foreign multinationals.

International Trade

What is international trade?

- International trade is the exchange of products (goods and services)
- Trade doesn't take place between countries, it takes place between the economic agents of that country, such as businesses or state governments or even consumers
- When the conditions are right, external trade brings benefits to all countries involved and it can also be a powerful driver for sustained GDP growth and rising average living standards / improved economic welfare

What is Free Trade?

This is international trade free from artificial barriers such as import tariffs, quotas and other trade barriers. Trade reflects the impact of **specialisation** and **exchange**

- **Specialization:** specialisation of scarce resources
- **Exchange:** based on comparative advantage in supplying different goods and services

David Ricardo in the 19th century proposed a theory of comparative advantage as a key economic argument for international trade.

What are the main gains from Free Trade?

One way of expressing the gains from trade in goods and services is to distinguish between:

- **Static gains** (i.e. improvements in allocative and productive efficiency in markets)
- **Dynamic gains** (i.e. the gains in welfare from improved product quality, increased choice and faster and more innovative behaviour).

Gains:

- Trade makes countries better off by allowing them to specialise according to their comparative advantage, providing access to new and cheaper imported goods, and increasing competition between producers
- Dynamic gains from trade make a domestic economy more productive. Examples of potential gains from trade liberalization that fall into this category are:
- Diffusion of knowledge and technology across borders
- Economies of scale in the long run (i.e. increasing returns to scale)
- Increased competition and innovation within markets
- A within-country selection of more productive firms challenging for market share
- Access to cheaper and more productive inputs into a country's supply-chain
- Less rent-seeking behaviour by monopoly businesses and reduced incentives for corruption which then aids long-term development

Summary of the key gains from trade


Export revenues and jobs help to reduce the scale of extreme poverty


Increased market contestability reduces prices for consumers


Better access to new technologies lifts productivity

Inflows of knowledge across borders raises human capital

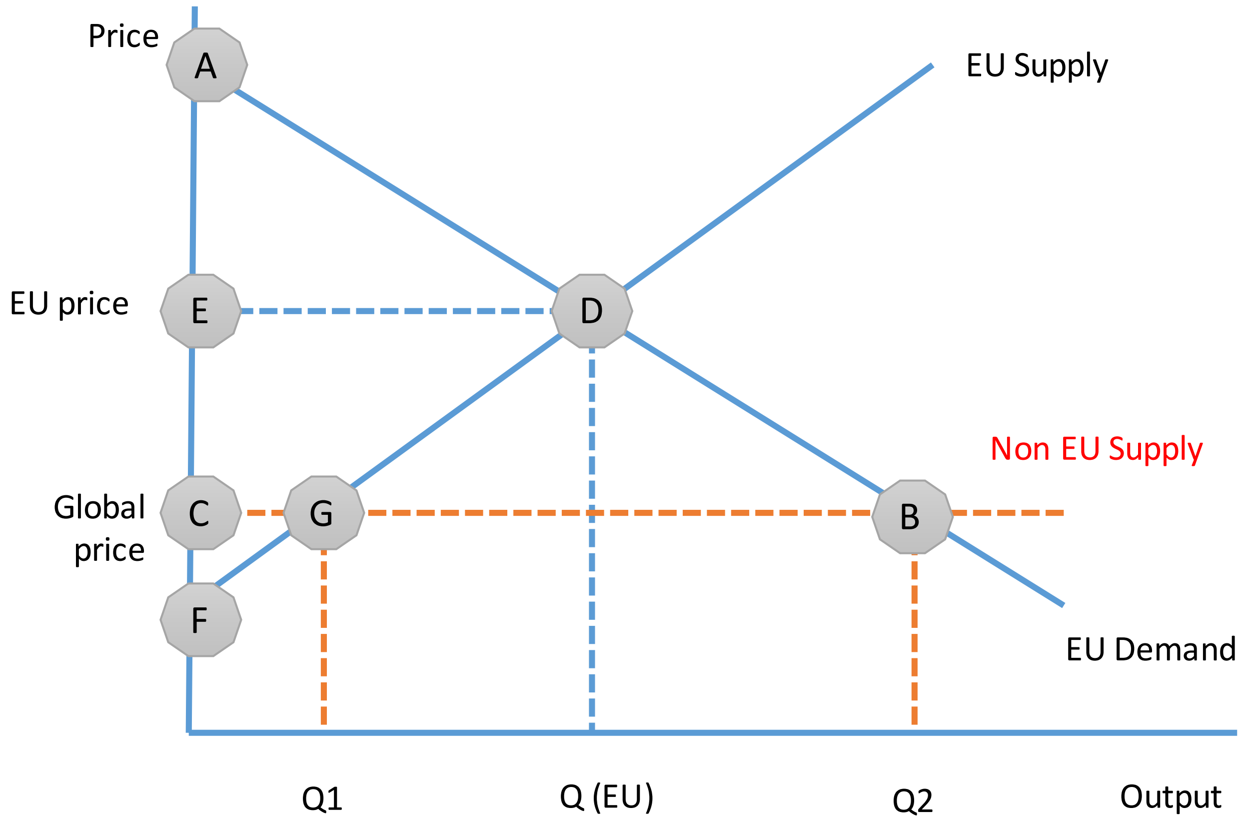

Exploiting economies of scale – causing lower unit costs and prices


Better use of scarce resources from trade in sustainable technologies

Supply and Demand Analysis to Illustrate some of the Gains from Free Trade

In the analysis diagram we look at the European market for coal.

- The EU price is the price if the only coal available is coal supplied from EU coal producers
- We assume non-EU countries can export coal into the EU at a lower world price. This causes demand to expand and EU domestic supply to contract
- Consumer surplus before trade = area AED
- Consumer surplus after trade = area ACB
- Therefore, there is a net gain in consumer welfare
- Producer surplus before trade = area EFD
- Producer surplus after trade = area CFG
- Therefore, there is a net loss of producer surplus



Absolute and Comparative Advantage

- **Absolute advantage:**
    - This occurs when a county can produce a product using fewer resources than another nation
    - If a country using the same factors of production can produce more a product, then it has an absolute advantage
- **Comparative advantage:**
    - Focuses on when a country has lower relative opportunity cost when it decides to specialise in a particular product
    - Opportunity cost is the sacrifice of alternative products made when you specialise in another good or service

Absolute Advantage – An Example

Output with both workers having 10 hours of time available		
	Bricks Laid	Cakes Baked
Hilary	80	20
Donald	40	50
Total	120	70

In this example, assuming both people have the same factor resource (time) available:

- Hilary can lay more bricks than Donald (8- to 40)
- Donald can bake more cakes than Hilary (50 to 20)
- Hilary has the absolute advantage in brick-laying
- Donald has the absolute advantage in baking cakes
- If they both both specialise fully then total output can increase

