

# Globalization: an overview

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## *Objectives*

- Due to global interdependence, very few enterprises operate exclusively within their national boundaries. Whether through off-shoring, strategic partnerships, direct equity participation, hiring of staff, or the spread of ideas, **all companies** are in a sense **global**.
- This lecture will serve as an **overview** on **globalization**, the current **international business environment**, **international business and trade theory**, and **international business operations**.

## *Key Text Readings*

- Krugman PR, Obstfeld M, Melitz M (2017). *International Economics: Theory and Policy* (11<sup>th</sup> Edition). Boston: Pearson.
- Elms DK, Low P (eds.) (2013). *Global Value Chains in a Changing World*. Geneva: World Trade Organization.
- Hallward-Driemeier M. (2009). Who survives? The impact of corruption, competition and property rights across firms. Policy Research Working Paper n° 5084. Washington, D.C.: World Bank.
- Peng M, Wang D, Jiang YJ (2008). An institution-based view of international business strategy: a focus on emerging economies. *Journal of International Business Studies* 39(5): 920-926.

## *Key Text Readings*

- Stiglitz JE (2002). *Globalization and its Discontents*. New York and London: W.W. Norton.
- UNCTAD (2013). *World Investment Report 2013: Global Value Chains: Investment and Trade for Development*. New York: United Nations Conference on Trade and Development.
- UNIDO (2016). *Industrial Development Report 2016*. Vienna: United Nations Industrial Development Organization.
- World Bank (2017). *Doing Business 2017: Equal Opportunity for All* (14<sup>th</sup> Edition). Washington, D.C.: World Bank.

# The complexities of globalization

## *What is Globalization?*

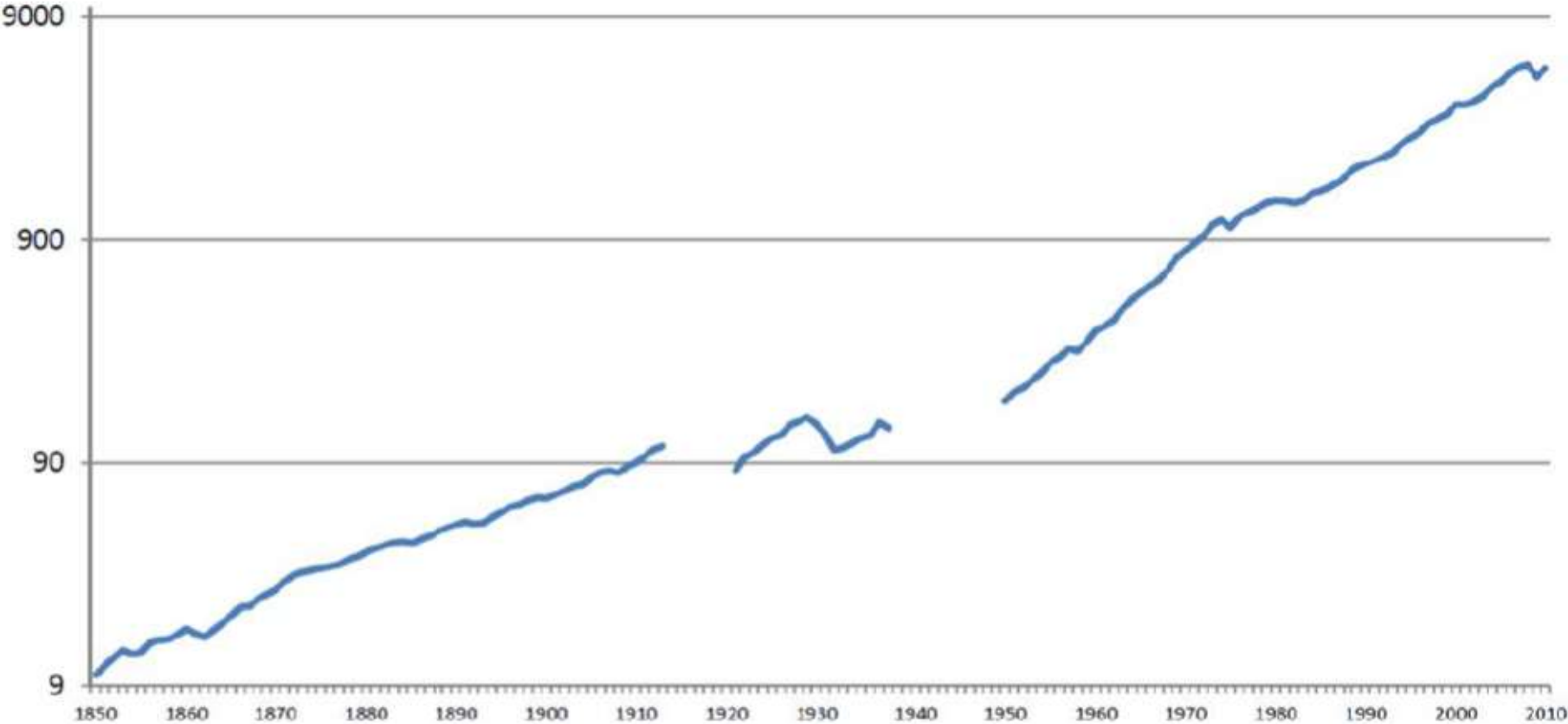
1. Increase in international transactions in markets for goods, services, and factors
2. Growth and expanded scope of international institutions and organizations
  - Multinational Corporations
  - International Institutions: UN, World Bank, IMF, WTO

[Deardorff and Stern, 2002]

## *How Can Globalization Be Measured?*

1. **Trade flows:** exports and imports of goods
2. **Trade in services:** transportation, healthcare, telecommunications, business services (consulting, IT, back-office, call center) ...
3. **Foreign asset ownership**
4. **Immigration**
5. **Price convergence:** Possibility of trade (even if it does not occur)  
may have important effects

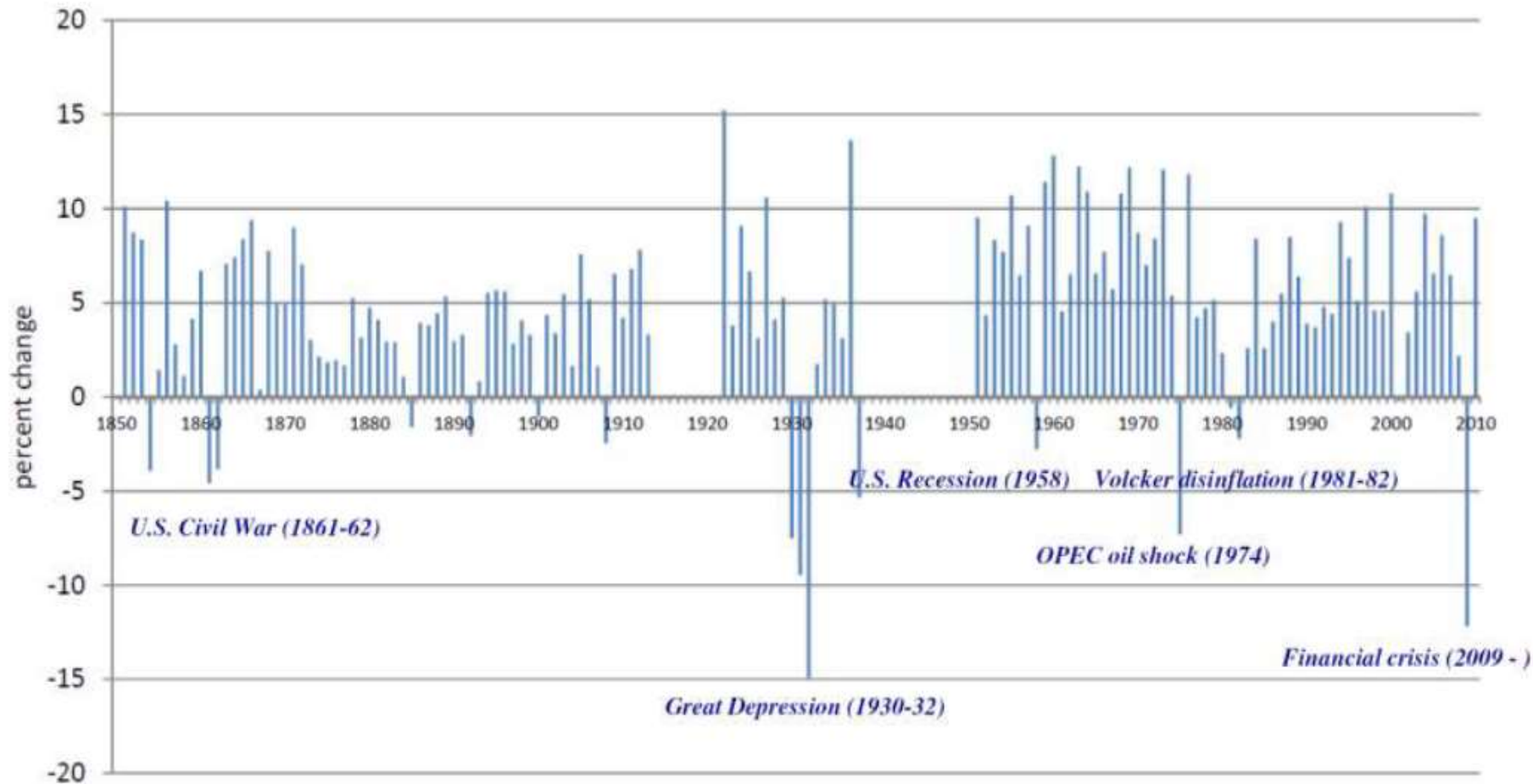
# Measure 1: The volume of World trade, 1850 – 2010 (in log scale)



Source: Irwin and O'Rourke (2011)



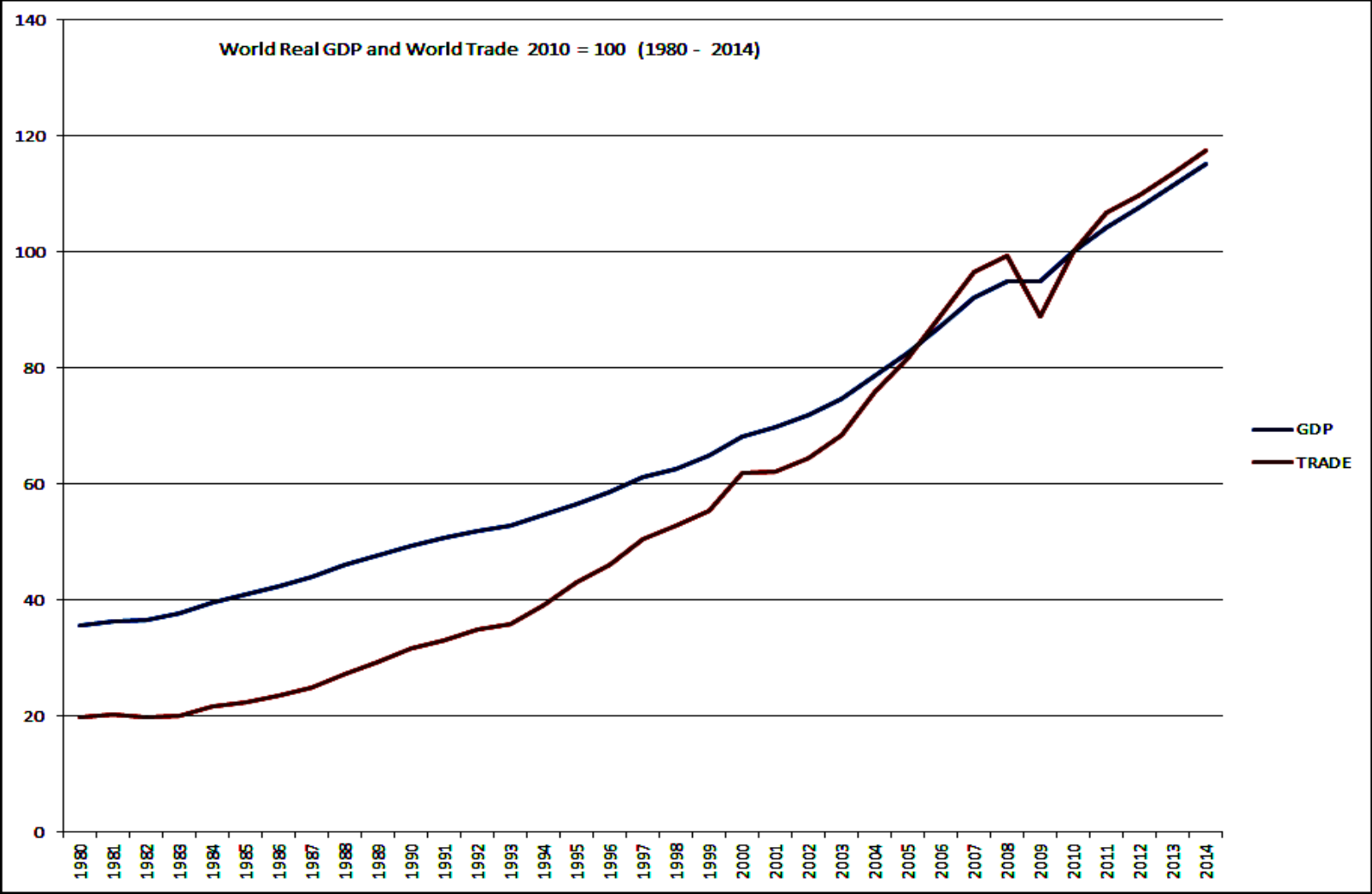
## Percentage Change in World Trade Volume, 1850-2010



*Note:* The declines in 1892, 1908, 1930-32, and 2009 were associated with financial or banking crises on a global scale

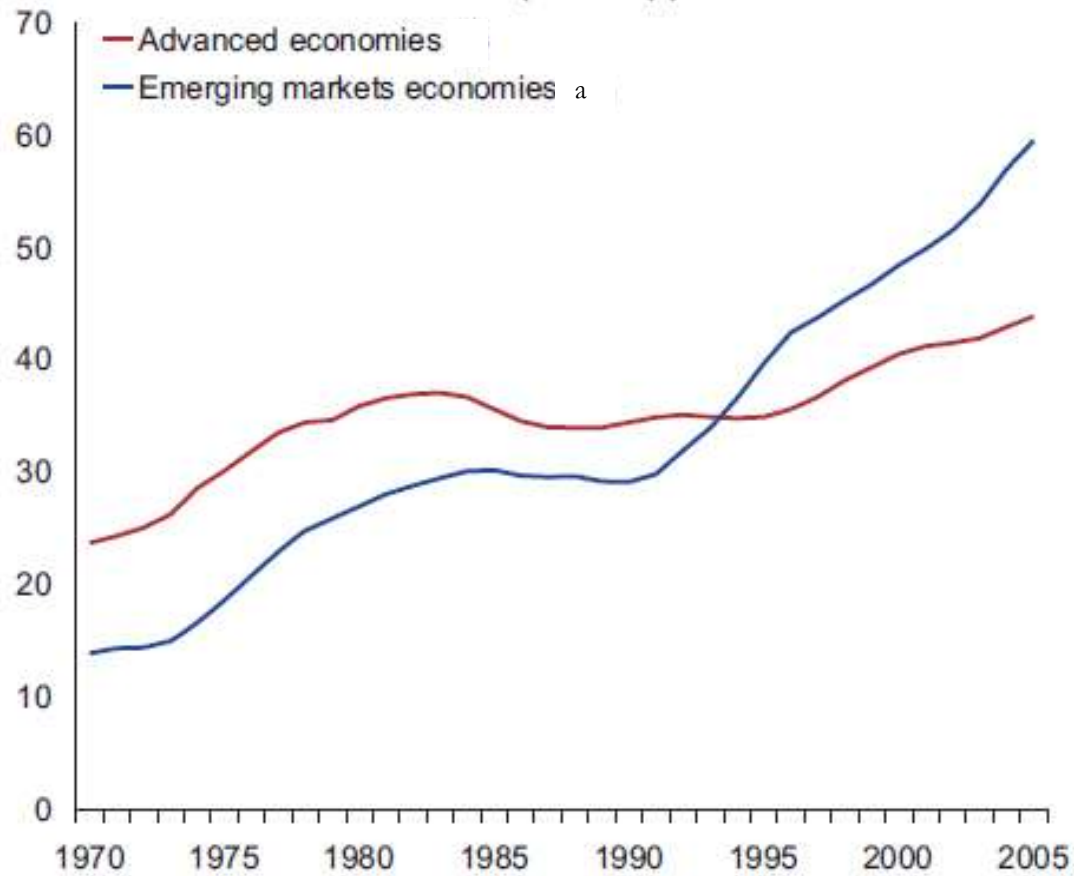
*Source:* Irwin and O'Rourke (2011)

# Trade grew about twice as rapidly as GDP



# Trade openness

(sum of exports and imports in percent of GDP; five-year moving average)

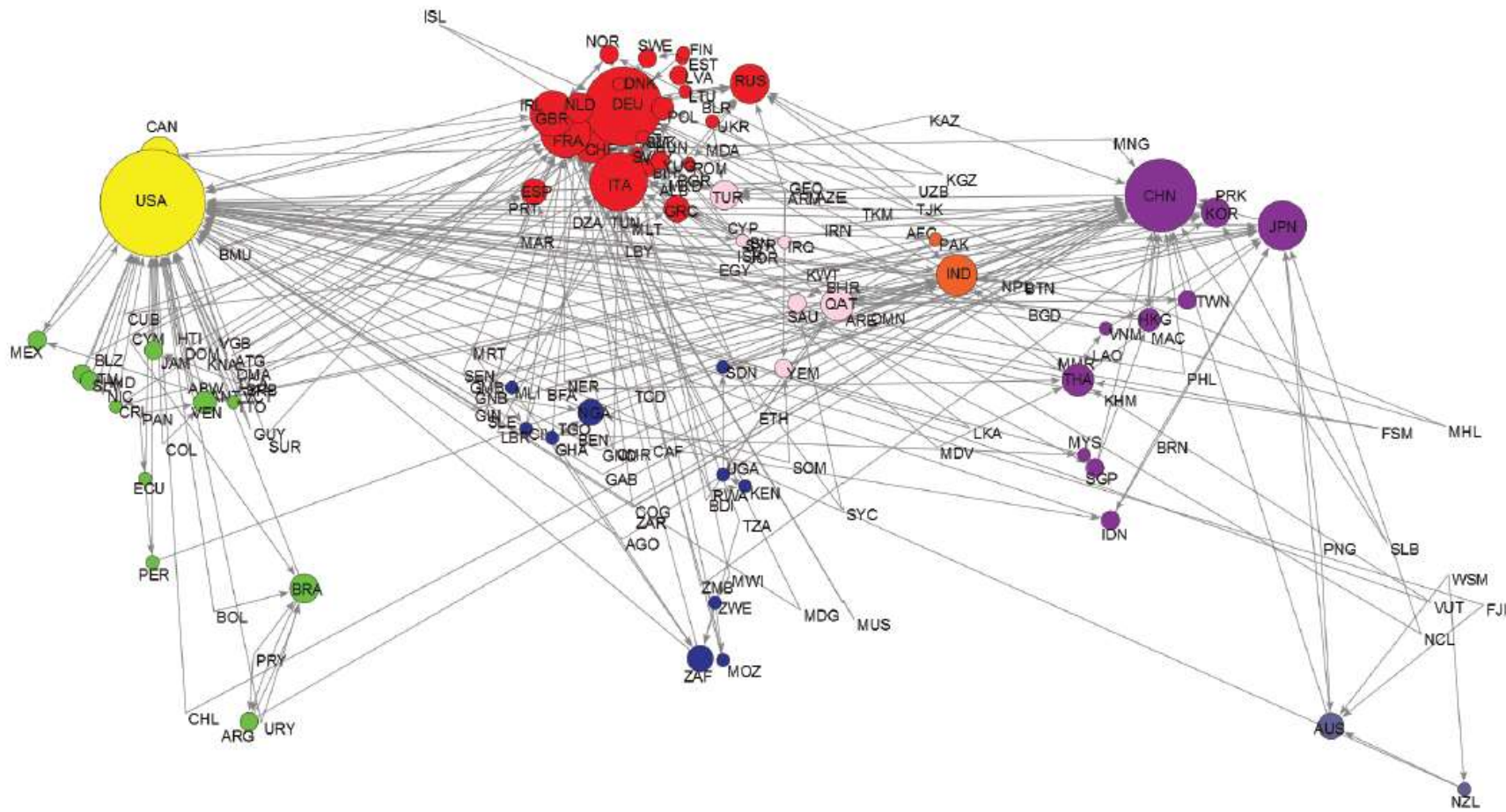


The acceleration in globalisation reflects the growing openness of developing and emerging market economies – in many cases in the wake of political and economic reforms – with special emphasis on large economies such as China and India and countries of Central and Eastern Europe.

<sup>a</sup> Argentina, Brazil, Chile, China, Colombia, Czech Republic, Dominican Republic, Ecuador, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, and Venezuela

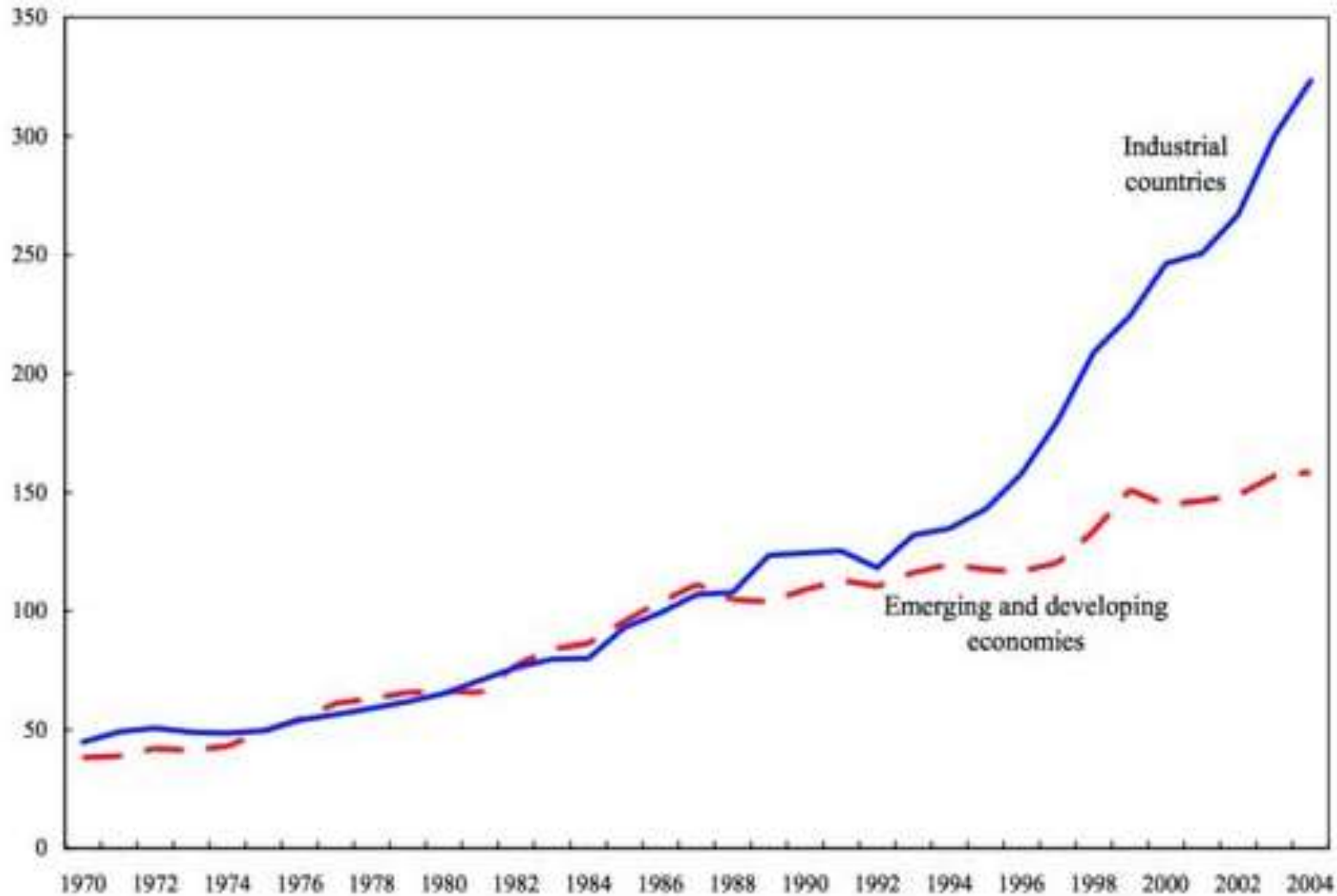
*Source:* IMF World Economic Outlook (April 2006)

# Map of world trade in goods as a geographical network (two major export partners, 2007)



Source: De Benedictis *et al.* 2014

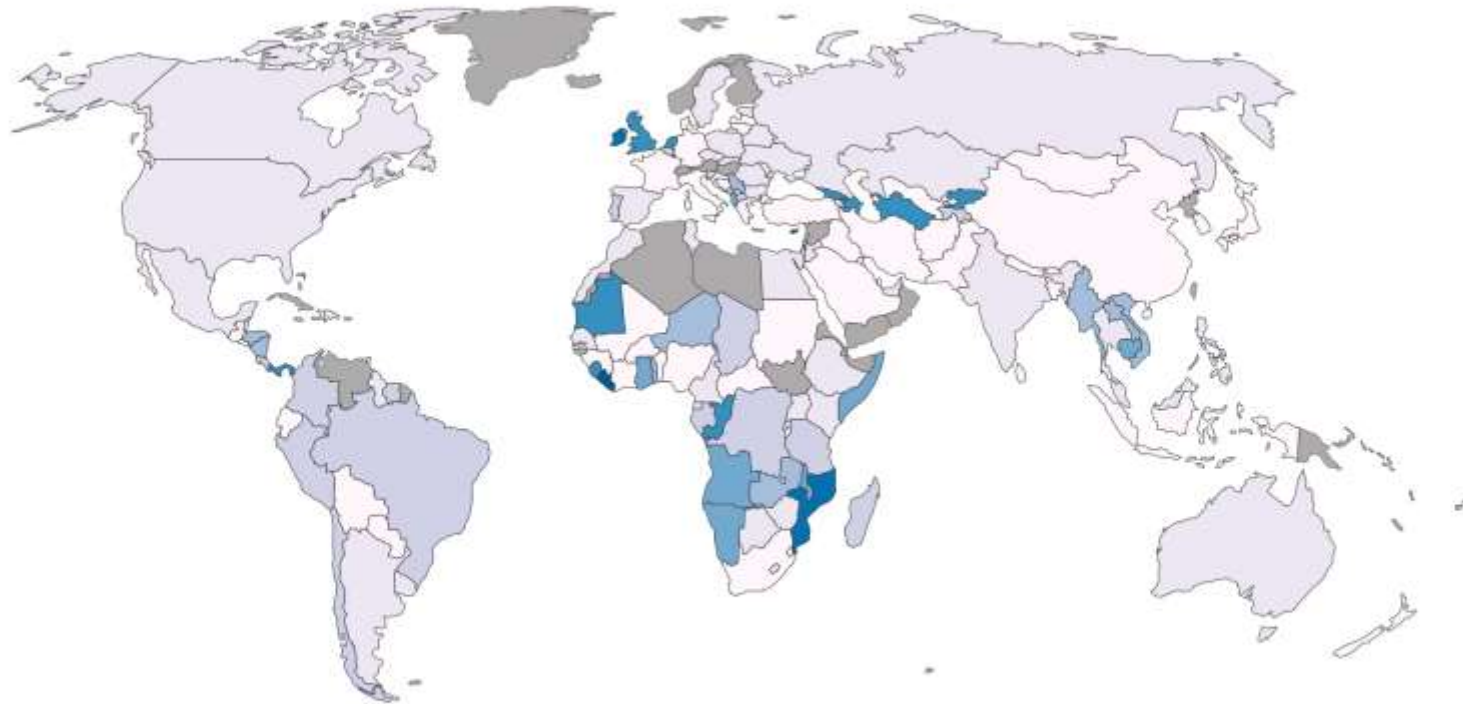
## Measure 3: World Assets and Liabilities, 1970 – 2004 (ratio of sum of foreign assets and liabilities to GDP)



Source: International Monetary Fund

# Foreign direct investment – Net inflows as share of GDP, 2016

FDI net inflows of investment to acquire a lasting management interest (10% or more of voting stock). Sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments.

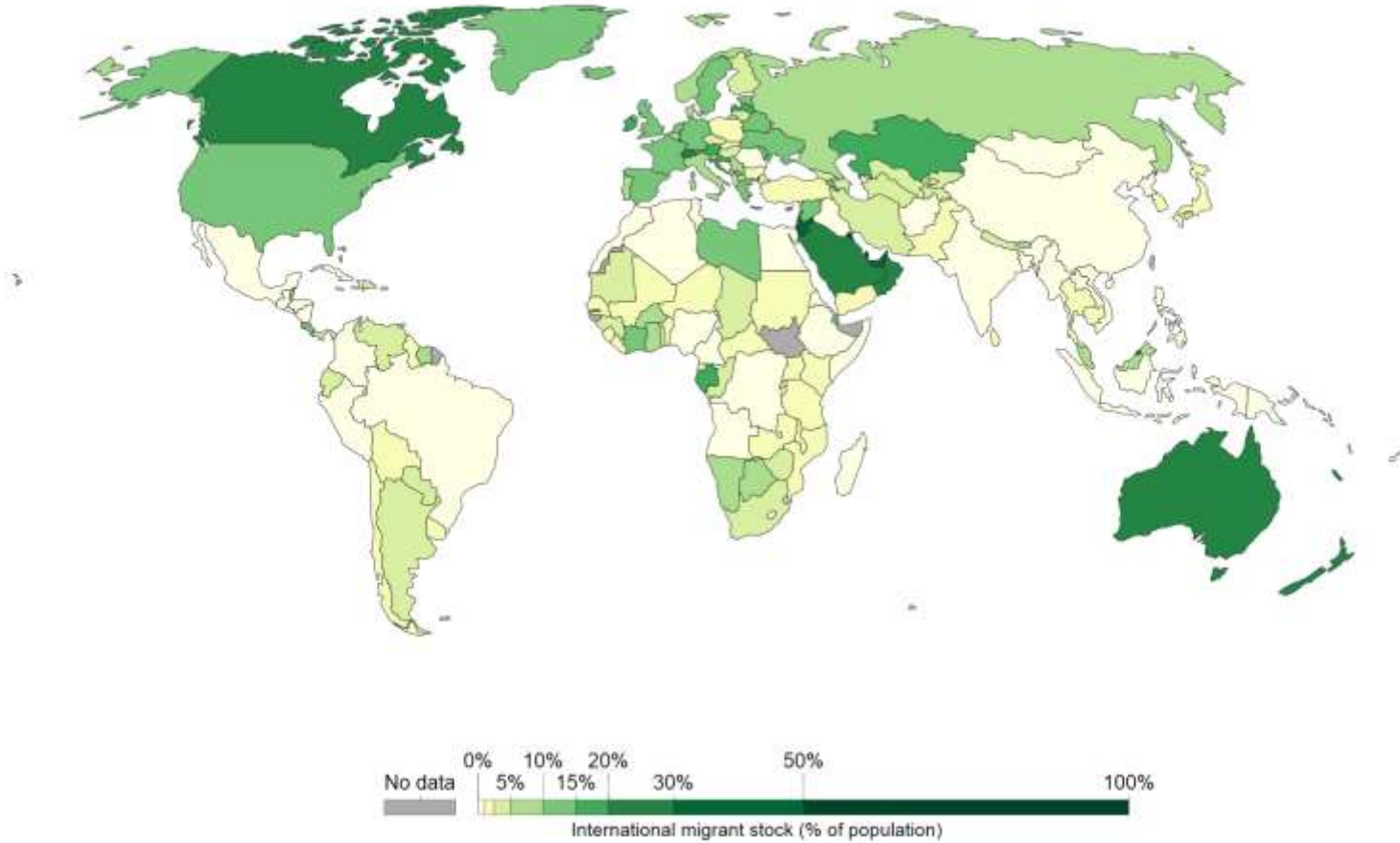


Source: World Bank – WDI: Foreign direct investment, net inflows (% of GDP)

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# Measure 4: Immigration

Share of a country's population that is not born within the country, 2010  
International migrant stock (% of population)

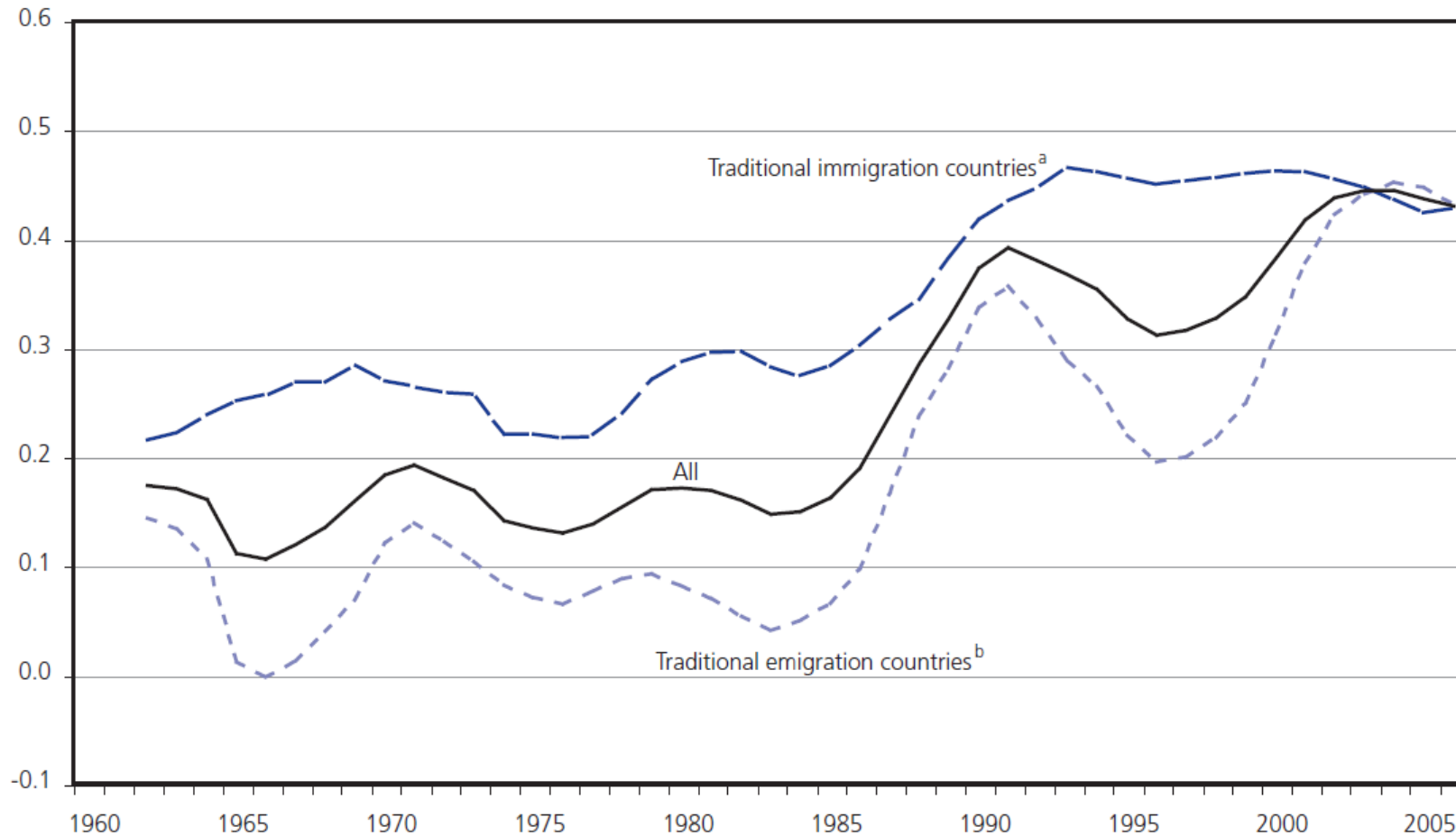


Source: World Bank – World Development Indicators (International migrant stock (share of population))

OurWorldInData.org/migration/ • CC BY-SA

# Net immigration into developed countries, 1960-2006

(five-year moving averages, net immigration as percent of population)



<sup>a</sup> Traditional immigration countries comprise Australia, Canada, New Zealand and United States.

<sup>b</sup> Traditional emigration countries are composed of 18 western European countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and United Kingdom.

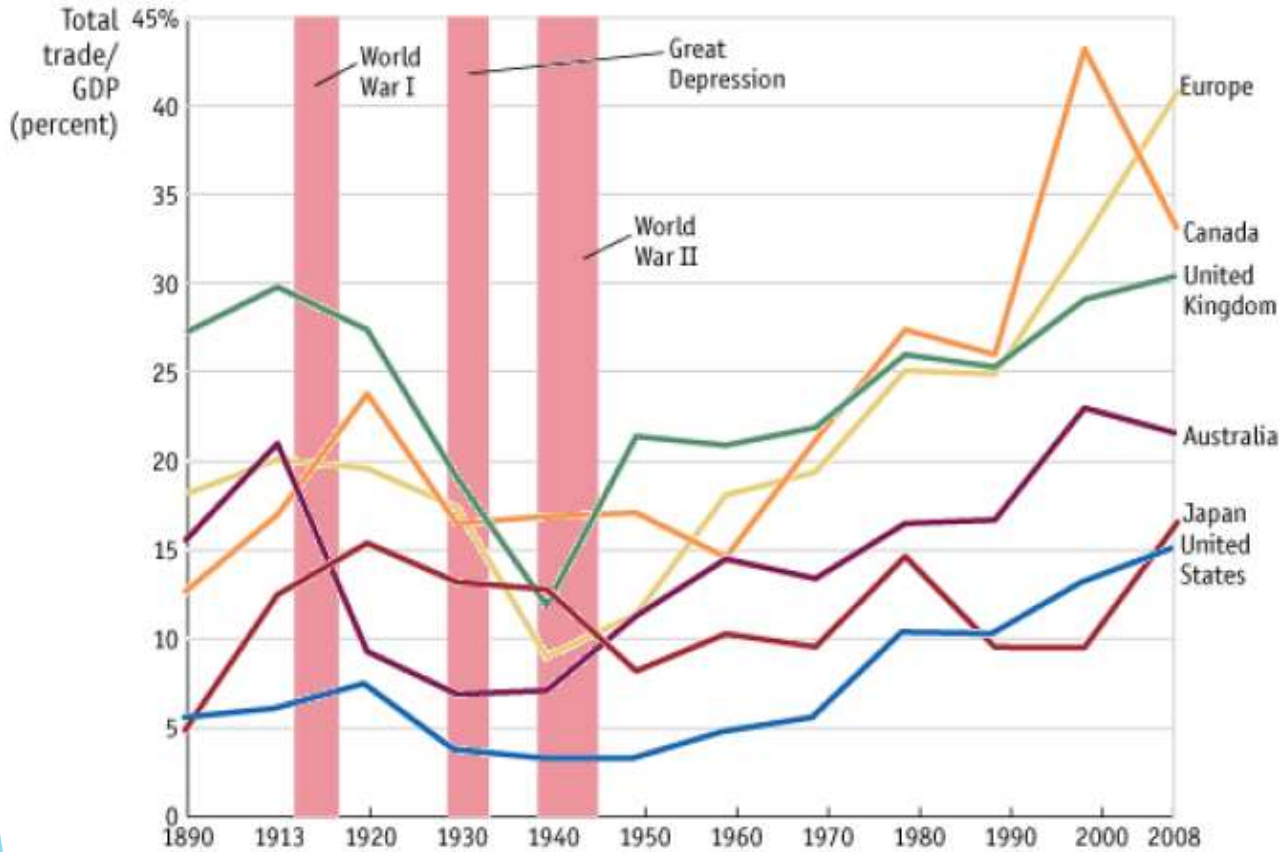
Source: OECD, Labour Force Statistics.



## Measure 5: Price convergence

- Fall in transportation costs in 19<sup>th</sup> century led to much greater price convergence than has been observed at any time since WW2
  - Example: Grain prices between Chicago and Liverpool
    - 60% difference in 1870 dropped to 15% in 1912
- Similarly, there was substantially more real wage convergence in the 19<sup>th</sup> century than since WW2

# Globalization waves in the 19<sup>th</sup> and 20<sup>th</sup> century



There was a **considerable increase in the ratio of trade to GDP between 1890 and 1913**. This trend was ended by World War I and the Great Depression. Most of the industrial countries shown did not reach the level of trade prevailing in 1913 until the 1970s.

## *“First Golden Age” of Trade*

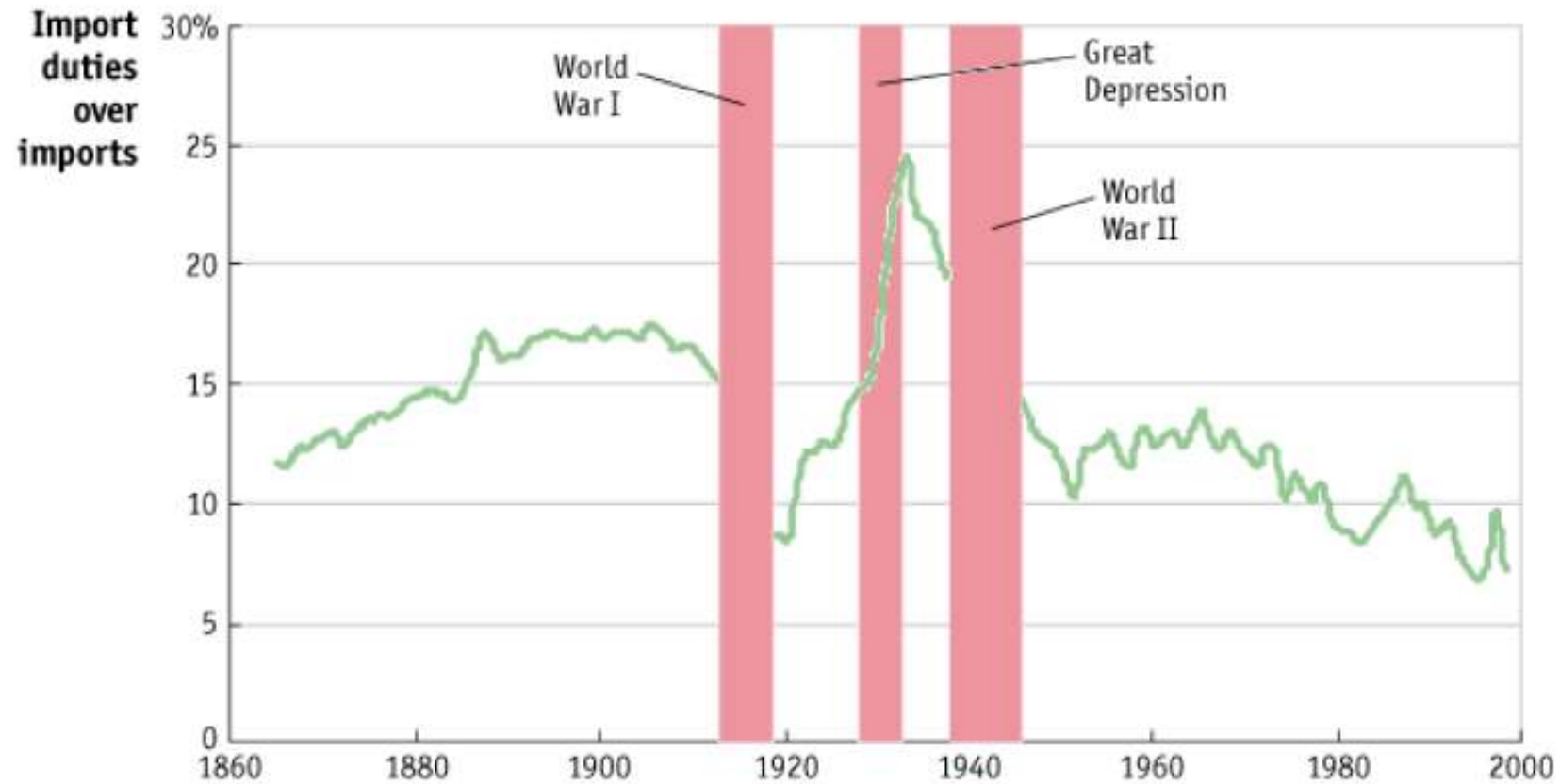
- The period from 1890 until World War I (1914 - 1918) is sometimes referred to as a “**golden age**” of international trade.
- Those years saw **dramatic improvements in transportation**, such as the steamship and the railroad, that allowed for a great increase in the amount of international trade.

## *Interwar Period*

- Signed into law in June 1930, the Smoot-Hawley Tariff Act raised tariffs to as high as 60% on many categories of imports.
- These tariffs were applied by the United States to protect farmers and other industries, but they back fired by causing other countries to retaliate.
- Canada retaliated by applying high tariffs of its own against the United States; France used import quotas to restrict imports from the United States.

# Average Worldwide Tariffs, 1860 – 2000

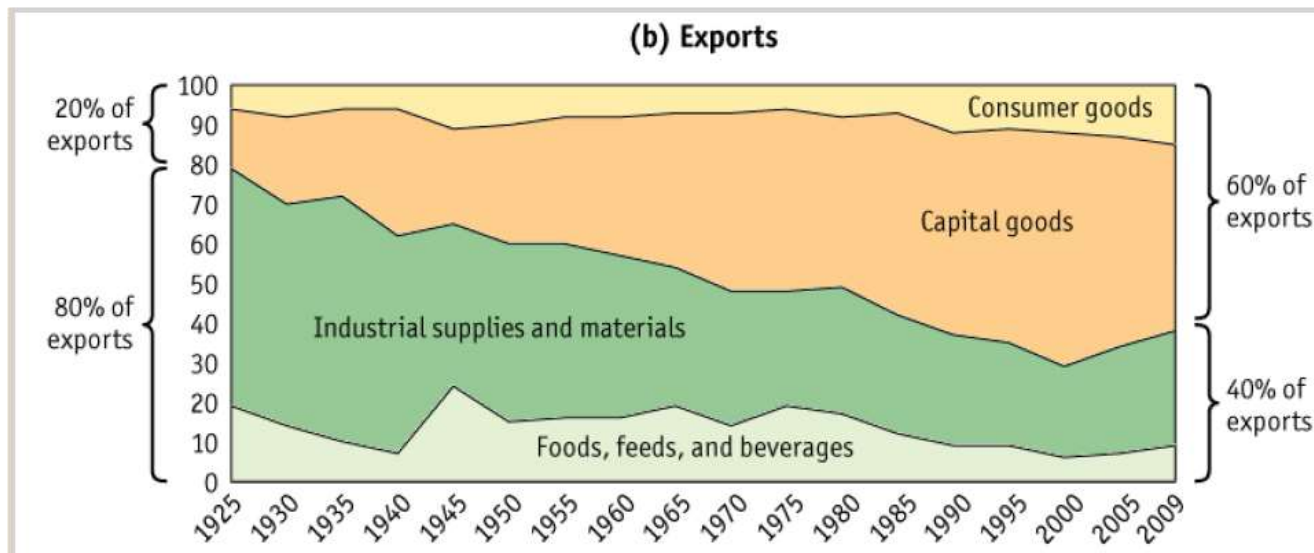
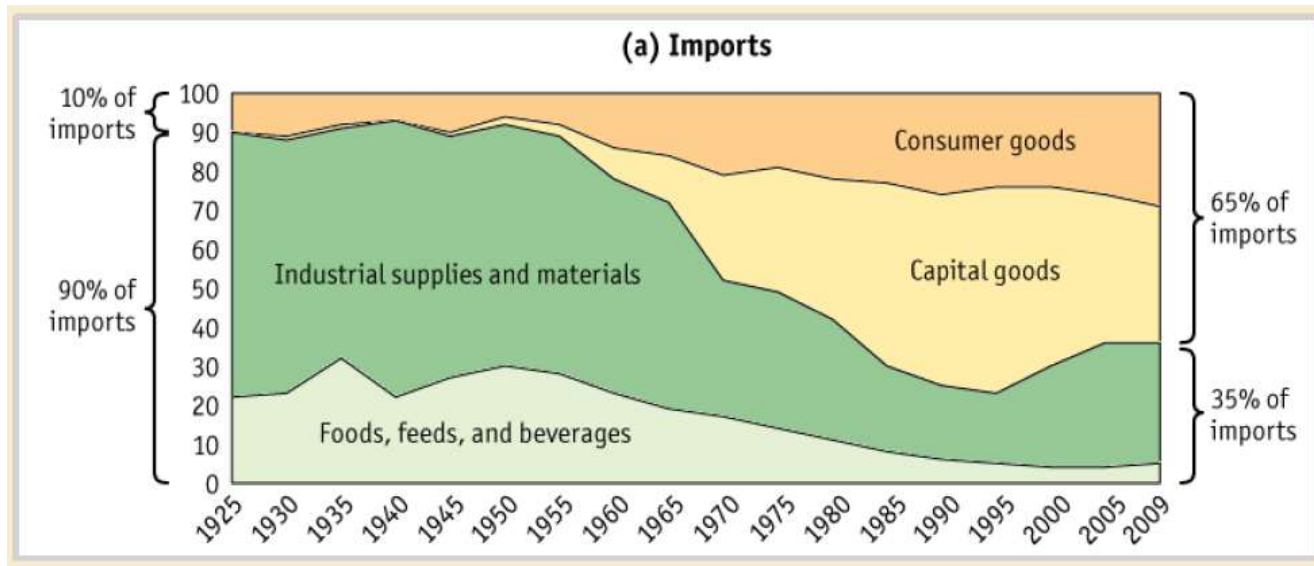
(world average tariff for 35 countries from 1860 to 2000)



## *“Second Golden Age” of Trade*

- In addition to the end of World War II and tariff reductions under the General Agreement on Tariffs and Trade, improved transportation costs contributed to the growth in trade.
- The shipping container, invented in 1956, allowed goods to be moved by ship, rail, and truck more cheaply than before.
- World trade grew steadily after 1950 in dollar terms and as a ratio to GDP. For this reason, the period after 1950 is called the “**second golden age**” of trade and globalization.

# Is Trade Today Different from the Past?



The type of goods imported and exported by the United States has **changed drastically** over the past 84 years.

## *Cause of Globalization*

1. Information and communication technology (ICT) revolution
2. Deepening of trade liberalization and continuing transportation cost reduction
3. Political developments expanding the reach of globalization



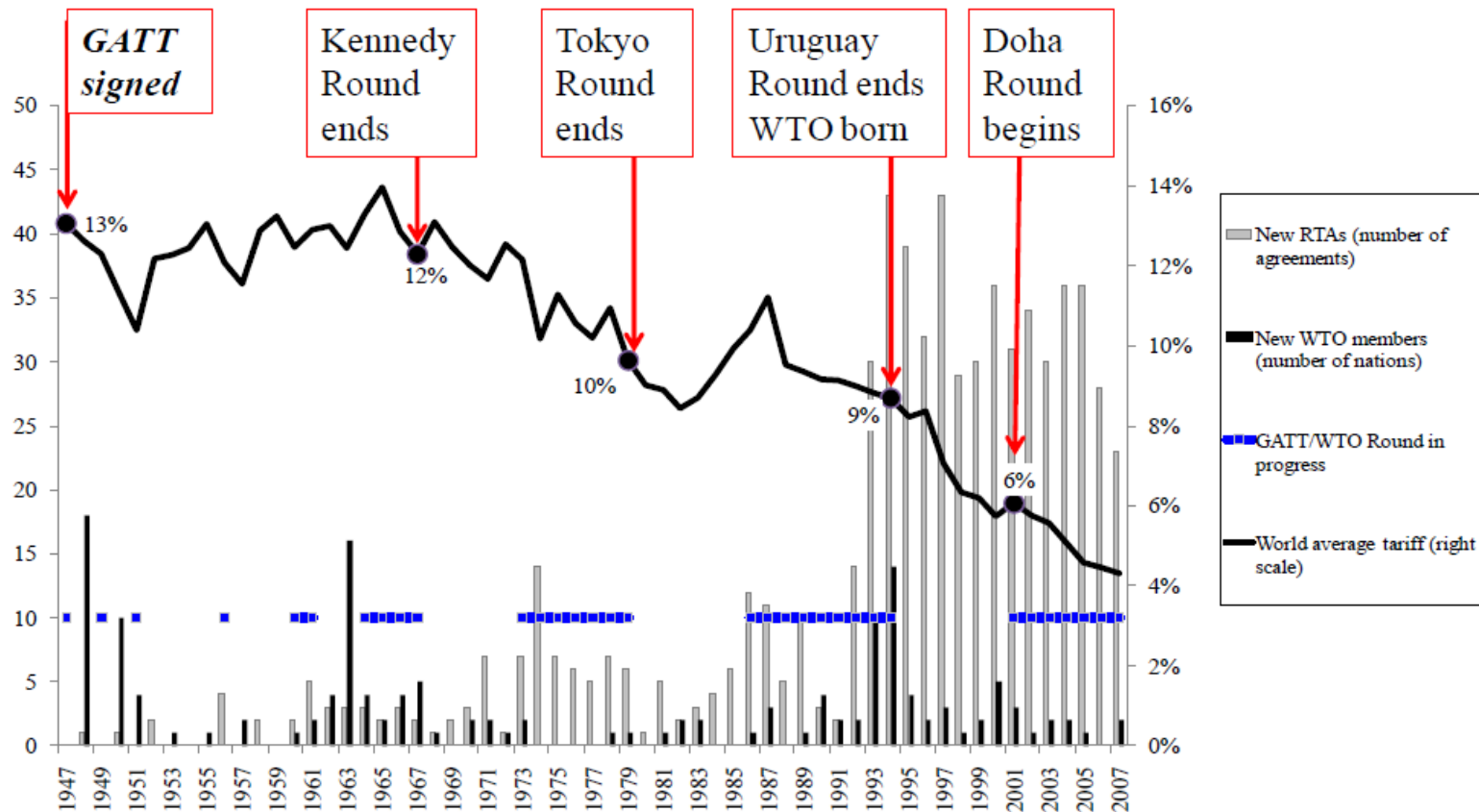
## *Cause of Globalization*

1. Information and communication technology (ICT) revolution
  - Processing power and memory capacity of computers
  - Cost of transmitting information over an optical network

## Cause of Globalization

### 2. Deepening trade liberalization and falling transportation costs

- EU, NAFTA, Mercosur, ASEAN FTA, China's WTO accession, etc.



## *Cause of Globalization*

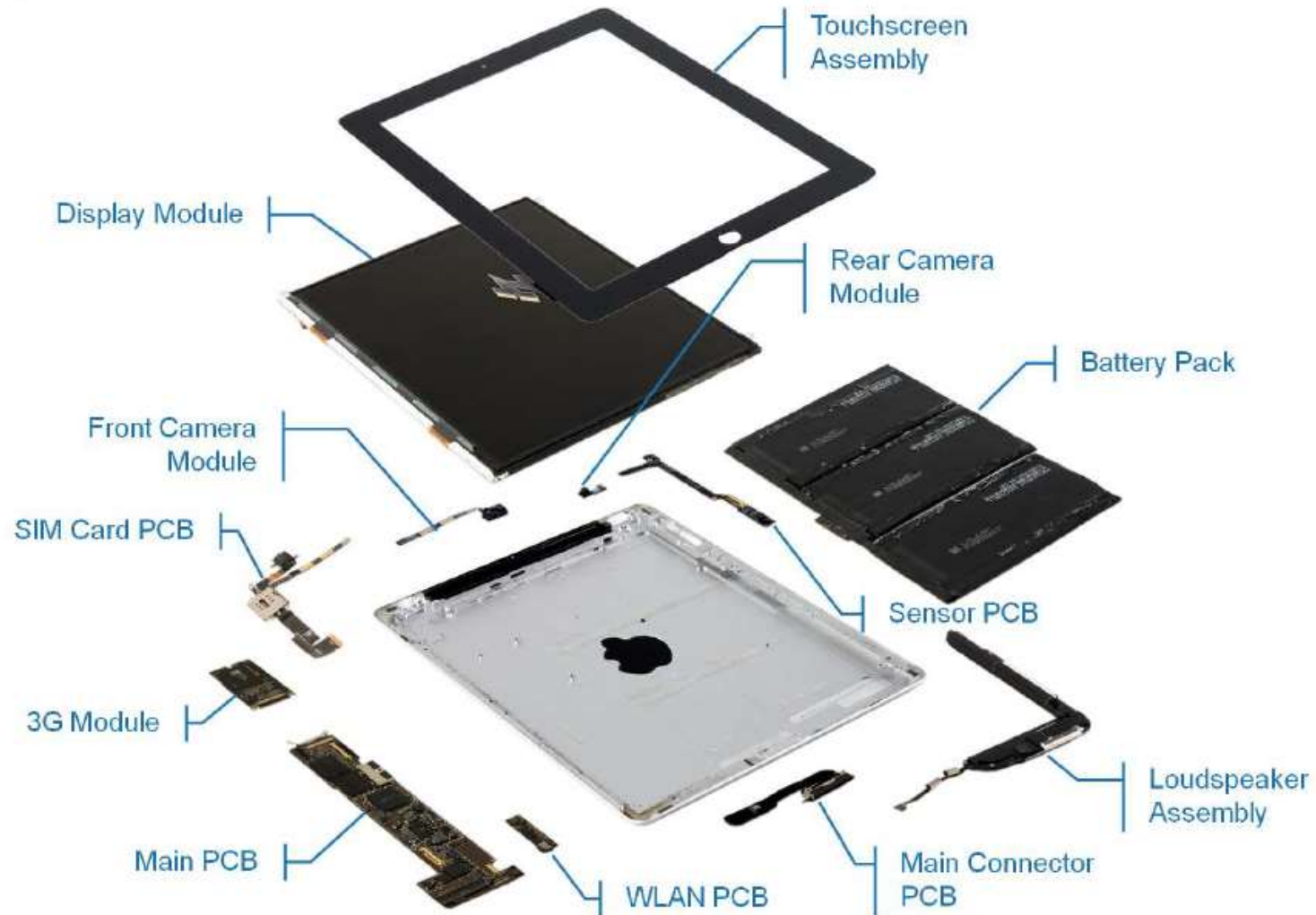
3. Political developments expanding the reach of globalization
  - Fall of communism, worldwide ideological shift to the right in large parts of the globe

*An implication: Rise of Global Value Chains*

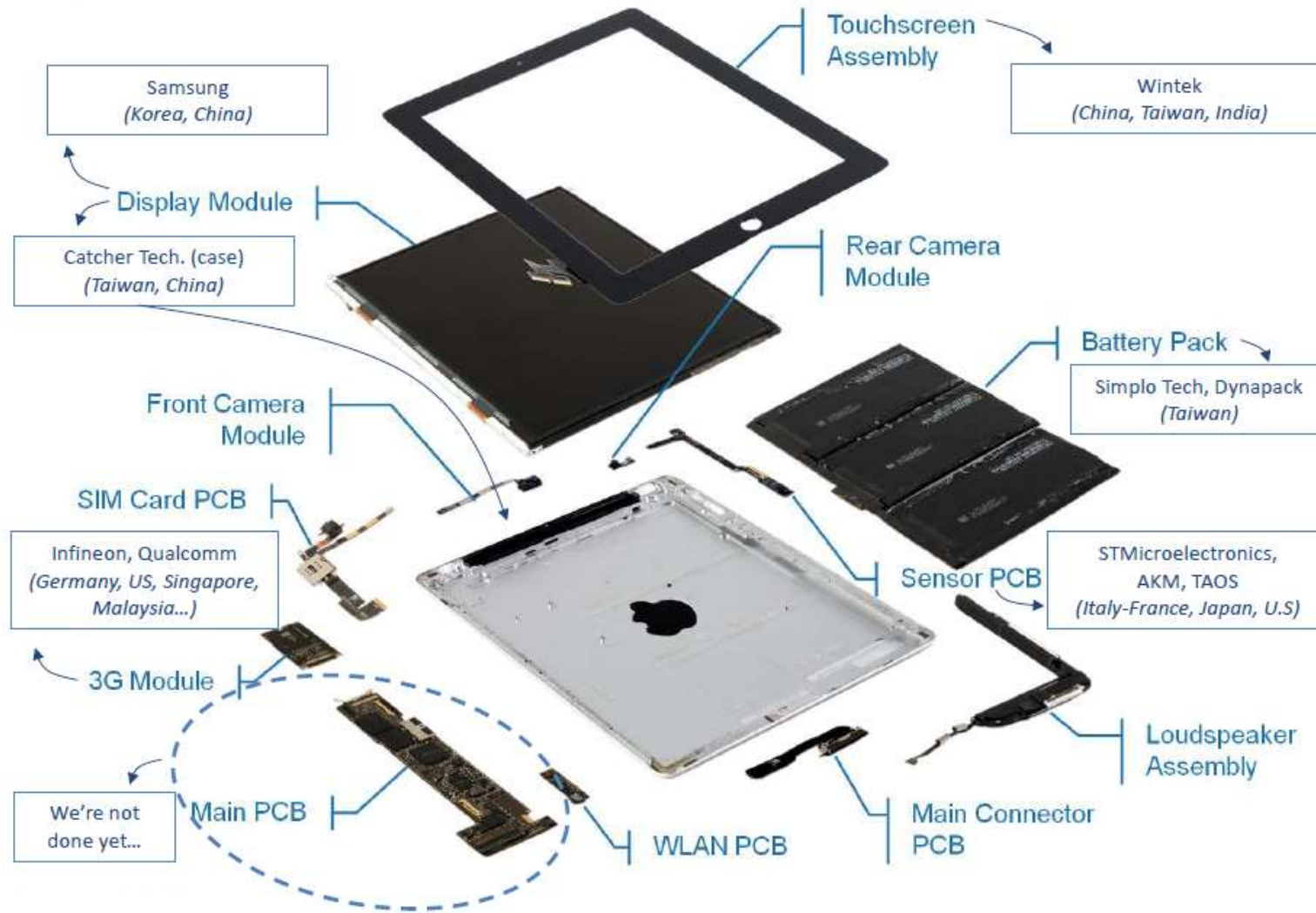


Designed by Apple in California, Assembled in China

*An implication: Rise of Global Value Chains*



# *An implication: Rise of Global Value Chains*



# *An implication: Rise of Global Value Chains (it's not just North-South fragmentation)*

## Fragmentation of production: the example of the Boeing 787 Dreamliner



## *The Pros and Cons of Free Capital Flows*

- capital moves from low to high return countries, enhancing growth
- open capital accounts enable diversification and consumption smoothing
- global financial markets impose financial and macro discipline
- capital moves in reverse direction, and growth effects are indiscernible
- volatility in EMs have increased, and financial crises are frequent
- global financial markets weaken budget constraints by increasing elasticity of fund supply



## *The Pros and Cons of Free Capital Flows*

- “The general lesson from these historical episodes is that **liberalized financial systems weaken financing constraints**, thereby providing more room for the build-up of **financial imbalances**” (Bordo and James 2015)

## *The Argument for Financial Openness*

- Stanley Fischer in 1997:
  - “What I would like to do is to persuade those of you who remain skeptical about capital account liberalization of [these] things:
    - that the benefits of liberalizing the capital account outweigh the potential costs;
    - that countries need to prepare well for capital account liberalization: economic policies and institutions, particularly the financial system, need to be adapted to operate in a world of liberalized capital markets ...”

## *The Argument for Financial Openness*

- Benefiting from financial globalization requires a host of complementary reforms in institutions, regulation, and macroeconomic management
- So the case for financial openness, packaged with these other reforms, remains strong ...

## *Two questions*

1. How do you know that you have all the complementary reforms in place, and what do you do if you do not?
  - second-best mindset may be more appropriate and practical
2. Is the saving-constrained model, under which capital inflows are the most beneficial, the right model?
  - an investment (demand)-constrained model may be more relevant

## *1. First-best vs. second-best frames*

- “The world is second-best, at best”

-- Avinash Dixit

## *The list of prerequisites*

- Property rights, contract enforcement, low corruption, transparency and quality of financial information, corporate governance, monetary, fiscal, and debt stability/sustainability, market-determined exchange rate, financial regulation and prudential supervision, ...
- The illogic of presuming first-world institutions as prerequisite to reforms that are supposed to enable convergence

## *The list of prerequisites*

- Lesson of the financial crisis of 2008-2009: **free finance a problem even for advanced countries with “sophisticated” regulatory systems**
- Plus, what about the imperfections in international financial markets?

## *2. Saving vs. investment constrained economies*

- Economies sharply differ in their response to capital flows
  - depending on whether growth is constrained by low private expected returns or high cost of investible
    - resources investment- vs saving-constrained economies



# **International trade system and foreign direct investment**

## *Where Do Gains From Trade Come From?*

- International trade **almost always** represent a **mutually beneficial transaction between buyer and seller**
  - So buyers (consumers who buy imports) and sellers (firms that export) find this trade beneficial
  - Of course, other sellers (domestic firms that make similar goods) would be better off without that competition
    - ... and workers employed by those domestic firms may be better off without that international trade
    - ... although they would still be worse off as consumers

## *Some Reasons To Be Concerned About Trade*

- In some circumstances, one might care about what goes on in the *black box*:
  - Differences in non-economic labor market conditions
  - Rights to organize
  - Working conditions
  - Child labor

## *Some Reasons To Be Concerned About Trade*

- Infant industries
- Foreign monopolies
- Externalities
  - e.g. effects on the environment
- Public goods
  - ‘Cultural’ goods
- None of these nullify the gains from trade, but imply that governments may be able to improve aggregate welfare by imposing some restrictions on trade

## *Trade models*

- According to international trade theory, countries engage in trade for two reasons:
  1. to take advantage of their differences
  2. to benefit from economies of scale in production and product differentiation

## *Trade models*

- In the first type of models, trade arises because countries can benefit from their differences by specializing in the production of goods that they are relatively efficient at producing, that is, in which they have a **comparative advantage**.
- The **Ricardian model** emphasizes **technological (productivity) differences** as the source of comparative advantage; the **Heckscher-Ohlin-Samuelson model** focuses on **differences in factor endowments**.
- The resulting trade is of the **inter-industry** kind.

## *Trade models*

- Ricardo's model

Formally, assuming that production requires only labour in fixed amounts per unit of output (let  $a_{GC}$  be the amount of labour needed to produce one unit of good G in country C), then country A has a comparative advantage in producing good 1 if it can produce it with less labour relative to good 2, compared to country B.

$$\text{That is, } \frac{a_{1A}}{a_{1B}} < \frac{a_{2A}}{a_{2B}}$$

Comparative advantage involves a double comparison, across both goods and countries. Hence, it is impossible by definition for a country to have a comparative disadvantage in every good.

## *Trade models*

- The Heckscher-Ohlin theorem states that each country will specialize in and export the **good whose production is relatively intensive in the factor in which the country is relatively more abundant.**
- The Stolper-Samuelson theorem shows who wins and who loses when a country opens up to trade. It states that when **the relative price of a good falls, the real return to the factor used intensively in its production will fall.**



## *Trade models*

- In the second type of models, a combination of **scale economies** and **consumer preferences for variety** leads each country to specialize in the production of only some varieties.
- The new trade models introduced scale economies, product differentiation and utility functions including preference for variety and replaced the assumption of perfect competition on product markets with the one of **monopolistic competition**.

## *Trade models*

- The resulting trade is **intra-industry**, that is, it consists of two-way trade in similar products or varieties (countries' exports and imports are in the same industry).

## *Trade models*

- The “**new new**” **trade theory** incorporate **firm-level heterogeneity** (Bernard, Eaton, Jensen and Kortum (2003) and Melitz (2003)).
- These models have identified an additional source of welfare gain from trade: the opening up of the country to international trade produces **an aggregated productivity gain**, driven by **reallocations of market share and resources towards the more productive firms in each industry.**

## *Multinational Firms and FDI: Definitions*

- Multinational firm  $\equiv$  Firm that operates plants in multiple countries
- In U.S. statistics, a U.S. company is considered multinational if it holds 10% or more of the stock of a foreign company
- Investment made in the Foreign country is referred to as Foreign Direct Investment (FDI)
- Company making the investment abroad is called a parent
- Company receiving the investment is called an affiliate

## *How Important are Multinational Firms in Practice?*

- Multinational firms account for 25% of World GDP in 2011
- Multinational firms account for 1/3 of international trade in 2011  
(from 2000 to 2011, around 50% of total U.S. imports were intrafirm)
- The 700 largest multinational firms account for roughly 50% of world R&D spending and close to 70% of world business R&D spending

## *What Determines the Organization of Multinationals?*

- To understand the organization of multinationals, we need to explain:
  1. **Location:** Why is a good produced in two countries rather than in one country and then exported to the second country?
  2. **Internalization:** Why is production in different locations done by one firm rather than by separate firms?

## *The Location Decision*

1. **Horizontal FDI:** When exporting is costly, replication of the production process in a foreign market may be profit-maximizing
2. **Vertical FDI:** Multinationals may also arise when, in the presence of factor price differences across countries, a producer “breaks up” the vertical chain of production and produces some components/inputs in different countries

## *Horizontal FDI*

- Consider the situation of a firm that is trying to decide how to best service a foreign market
- There are two possible options:
  1. **Export:** Increase production from the currently existing plant and export this additional amount
  2. **Horizontal FDI:** set up an affiliate and produce in the foreign market



## *Horizontal FDI*

- What is the basic trade-off?

Compared to exports, horizontal FDI saves on (variable) transport costs, but leads to extra fixed costs associated with new plant

- Horizontal FDI will tend to dominate exporting in industries in which:
  1. Transport costs are high
  2. Plant-level fixed costs are low
  3. Market size is large

## *Vertical FDI*

- Consider the situation of a firm that is trying to decide how to produce a final good at minimum average cost
- The production process entails two tasks: (i) a skill-intensive task (R&D) and (ii) an unskill-intensive task (assembly)
- There are two possible options:
  1. **Domestic production:** Perform both tasks at Home
  2. **Vertical FDI:** Perform one of the two tasks abroad

## *Vertical FDI*

- What is the basic trade-off?

Compared to domestic production, vertical FDI allows to take advantage of factor price differences across countries, but it involves transport and communication costs

- Vertical FDI will tend to:
  1. Decrease in transport and communication costs
  2. Increase in relative factor endowment differences across countries (which generate factor price differences)
  3. Increase in relative factor intensity differences across tasks

## *Internalization*

- In developing their global sourcing strategies, firms not only decide where to locate different stages of the value chain, but also the extent of control over them
- Why will fragmentation occur within or outside the multinational's boundary?
  1. **Technology transfer:** transfer of knowledge or technology may be easier within a single organization than through a market transaction (e.g., licensing)
    - Patent or property rights may be weak or non-existent
    - Knowledge may not be easily packaged and sold

## *Internalization*

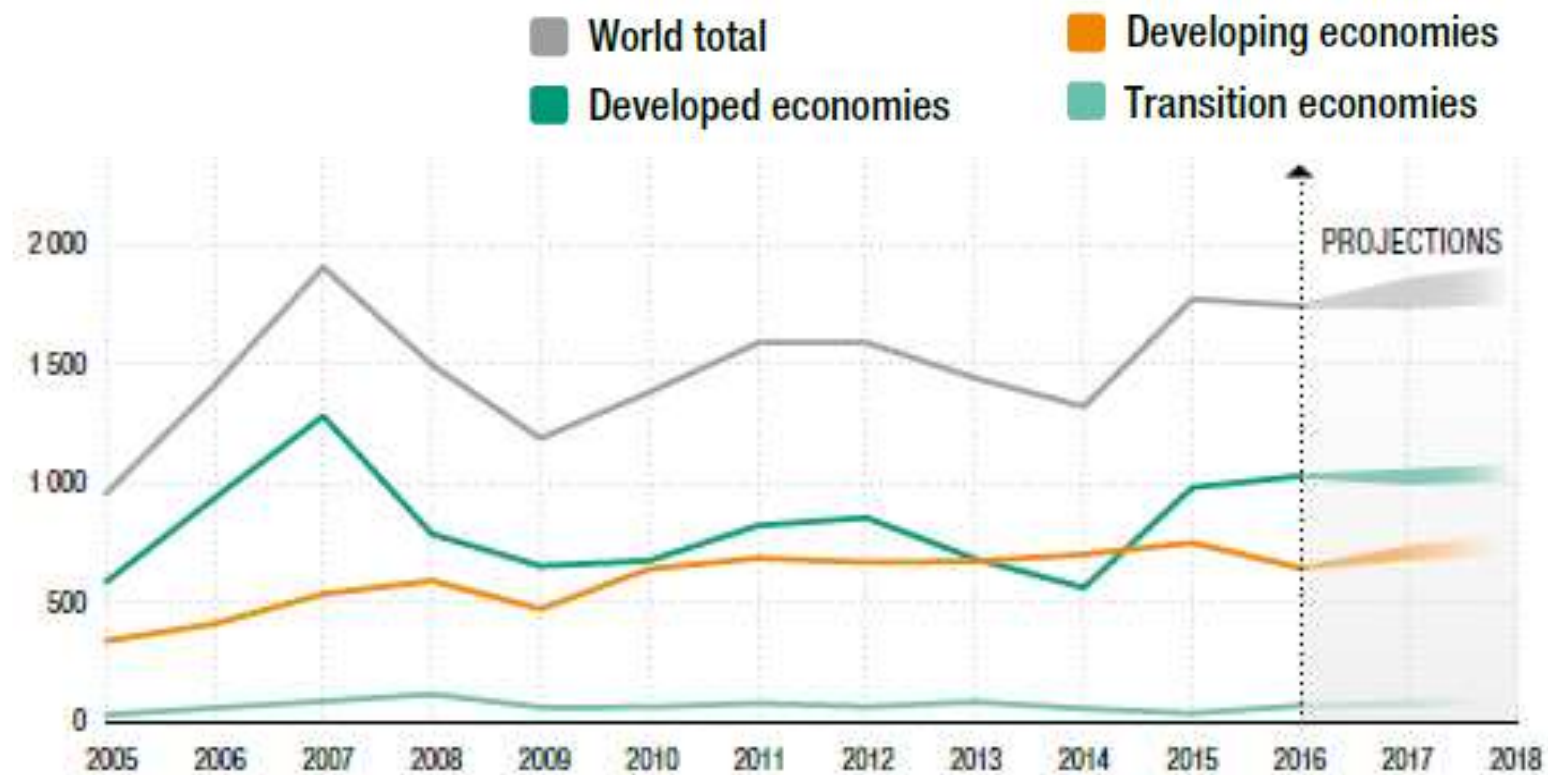
### 2. **Vertical integration:** consolidation of different stages of production process

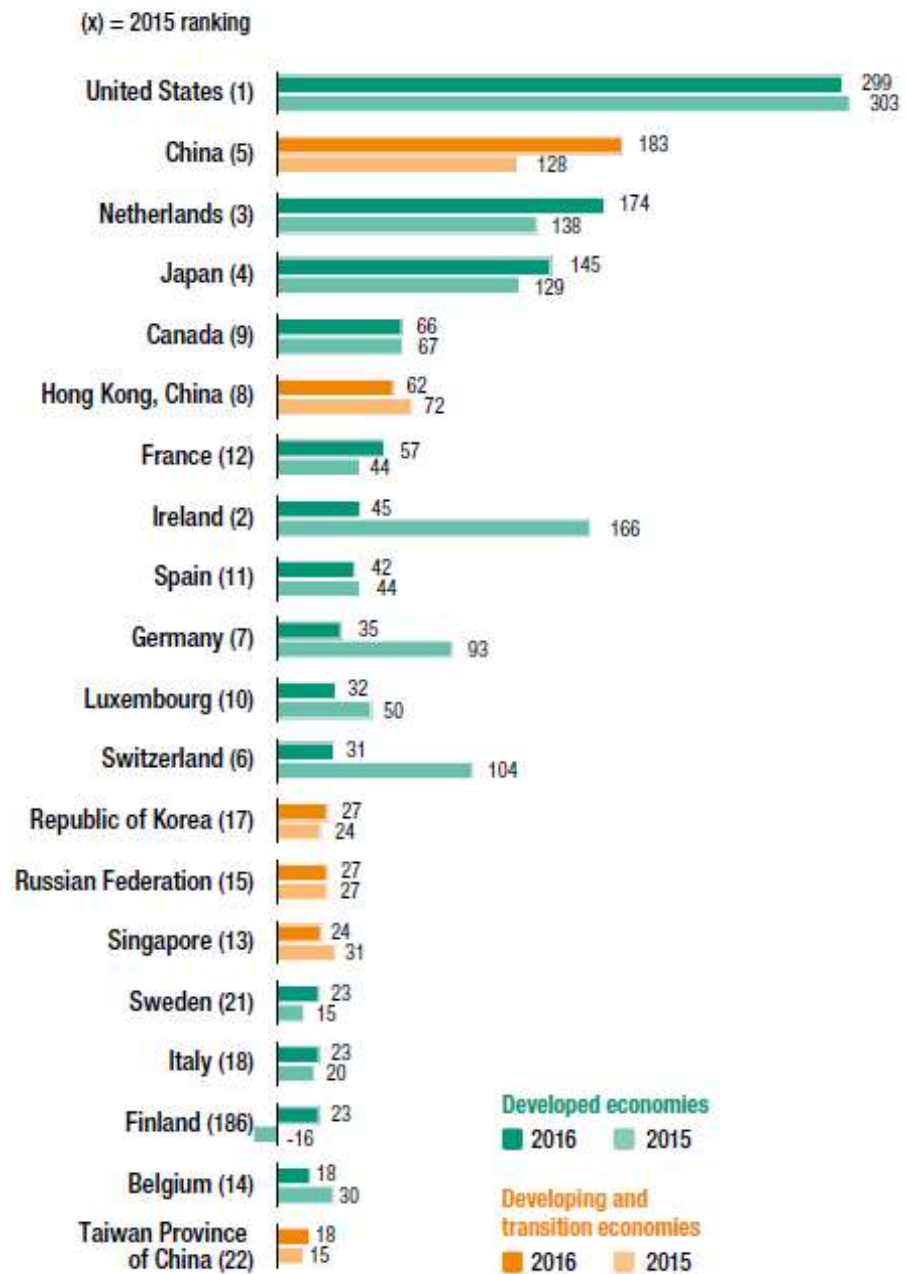
- Intrafirm purchases may avoid or attenuate contractual difficulties
- Integration may affect the relative bargaining power of producers and suppliers in a profit-enhancing way

# The Rise of Multinationals from the Emerging Markets

The background of the slide features abstract, overlapping geometric shapes in various shades of blue, ranging from light sky blue to deep navy blue. These shapes are primarily located on the right side of the slide, creating a modern, dynamic feel.

# FDI inflows, global and by group of economies, 2005–2016, and projections, 2017–2018 (Billions of dollars and per cent)





## FDI outflows, top 20 home economies, 2015 and 2016 (Billions of dollars and per cent)

Source: [www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)



## *OFDI from Emerging and Developing Economies: Causes*

- Progressive liberalization of developing country economies
- Increase in bilateral investment agreement
- Consistent surpluses in balances of payment
- High competition at home because of rising FDI

## *Theoretical Background*

- The literature on the international activities of firms is based mainly on observation of MNEs from the so-called triad (i.e., US, EU, and Japan)
- The most influential approach to studying the international activities of MNEs is represented by the **eclectic paradigm**, originally proposed by John Dunning (1981).
  - Ownership-Location-Internalization (OLI) framework

## *Theoretical Background*

- The OLI framework includes no specific provision explaining the pattern of internationalization of developing country MNEs
- Main criticisms:
  - 1. Firms from developing countries might not possess the same competitive advantages as firms from developed countries**

## *Theoretical Background*

2. **The OLI framework is a (comparative) static model**, that takes into account only the existing advantages prior to the FDI decision, but does not explain the **opportunities for the development and evolution of firm capabilities over time** based on accumulated experience in the international market.

## *Theoretical Background*

- Based on these criticisms, Mathews (2002) proposed an ad-hoc theoretical framework referred to as the “**Dragon Multinationals**”
- **Linkage-Leverage-Learning (LLL) framework**
  - *Linkages*, such as joint ventures, strategic alliances and other forms of collaboration in global value chains with foreign companies (the incumbents) represent a fast and efficient way to access the resources that emerging MNEs lack.

## *Theoretical Background*

- Once linked, ‘latecomer’ firms use their global connections to *leverage* their resources and particularly their cost advantages, and to *learn* about new sources of competitive advantage and how to operate internationally.

## *Theoretical Background*

- Dunning and Lundan (2008) recognize the **importance of institutions** as an essential component in the internationalization process of firms
- According to the literature on latecomer firms, the role of **home country institutions** and particularly government is **key to shaping the process of internationalization** of domestic firms and especially in the case of Asian firms

## *Theoretical Background*

- Cuervo-Cazurra and Genc (2008) stress that developing country MNEs enjoy greater **competitive advantage** compared to MNEs from developed countries, in the more **difficult institutional environments**, such as characterize the group of the least developed countries
- Developing country MNEs possess the **technological capabilities** useful for operating in a developing country context (Kumar, 2008)



## *Internationalization as a Strategy for Technological Catch-up*

- A group of “global first-mover” developing country MNEs, operating mainly in the high-technology industries, has been able to jump some technological stages and grow fast by adopting a strategy of **greenfield investment in emerging countries**, and **M&As in developed countries**
- Strategic acquisitions provide a faster alternative to building technological capabilities in house and allows access to more advanced resources through direct transfer of knowledge

*Thank you for your attention!*

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