

Policy Challenges of Globalisation: A Selected Overview

Nigel Pain

OECD

Presented at a Conference on 'The Euro and the Dollar in a Globalised Economy', Washington University, St. Louis, May 2006.

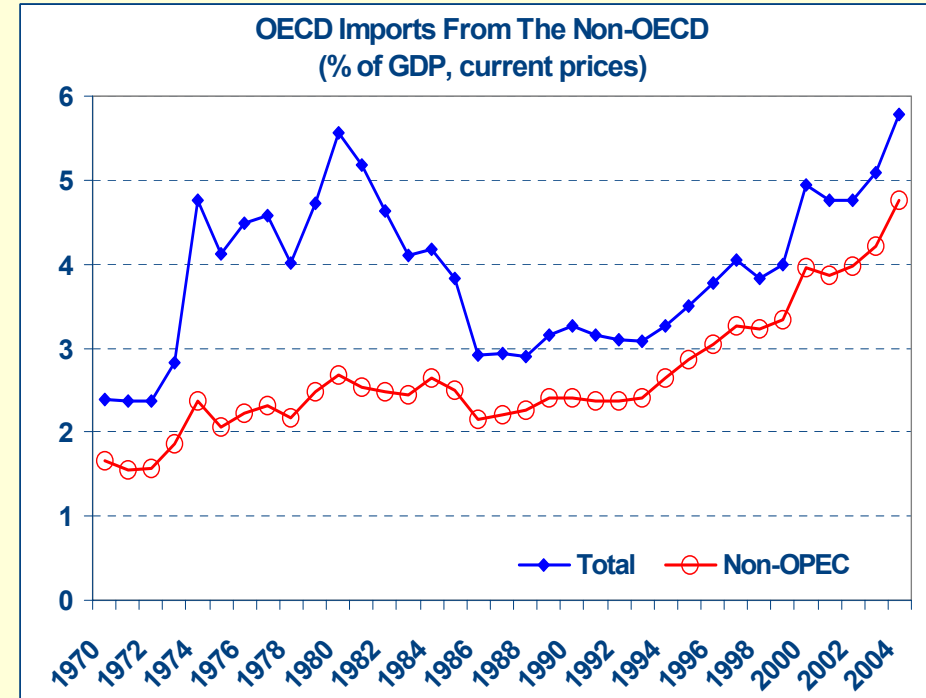
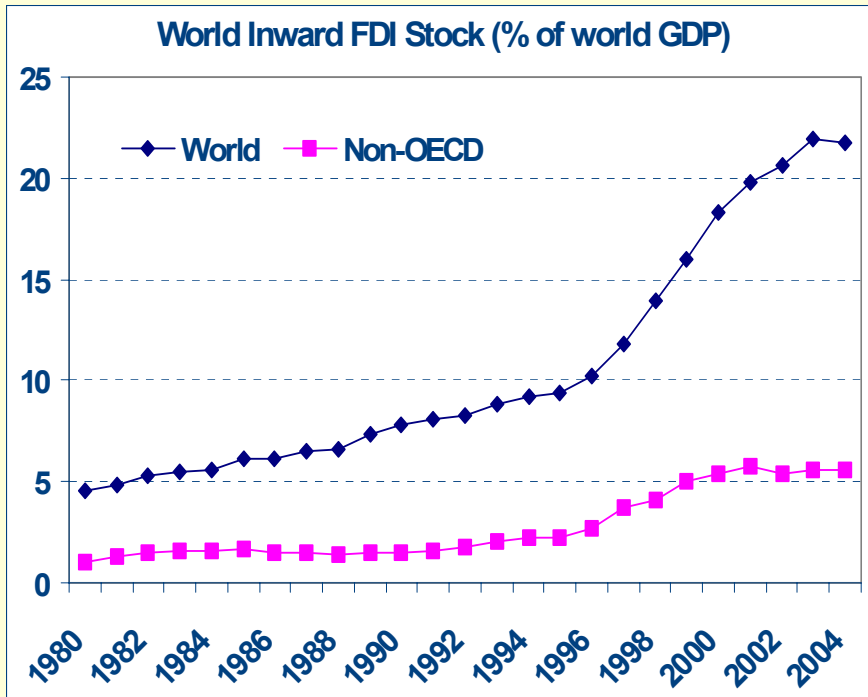
OECD Globalisation and Structural Adjustment Project 2005-07

- This has three main components:
 - The macroeconomic effects of globalisation
 - The development and effects of the outsourcing of business services
 - The sectoral impact of trade on labour markets
- The project examines the policy challenges from:
 - The spread of global trade & production networks and IT-enabled global sourcing.
 - The impact of non-OECD economies on commodity markets and competition pressures in the OECD.
 - The enhanced role of non-OECD economies in international financial markets.

OECD Globalisation and Structural Adjustment Project 2005-07

- The general focus for the macroeconomic part is the risks and challenges to OECD economies from changes in trade, production and financial markets
- The macroeconomic work considers 3 main issues:
 - The globalisation of production & labour markets
 - The impact of globalisation on inflation
 - The impact of globalisation on the speed & extent to which economic ‘shocks’ move across national borders (using macroeconomic model simulations)
- It will assess the structural & macro policies that best deal with the challenges of globalisation.

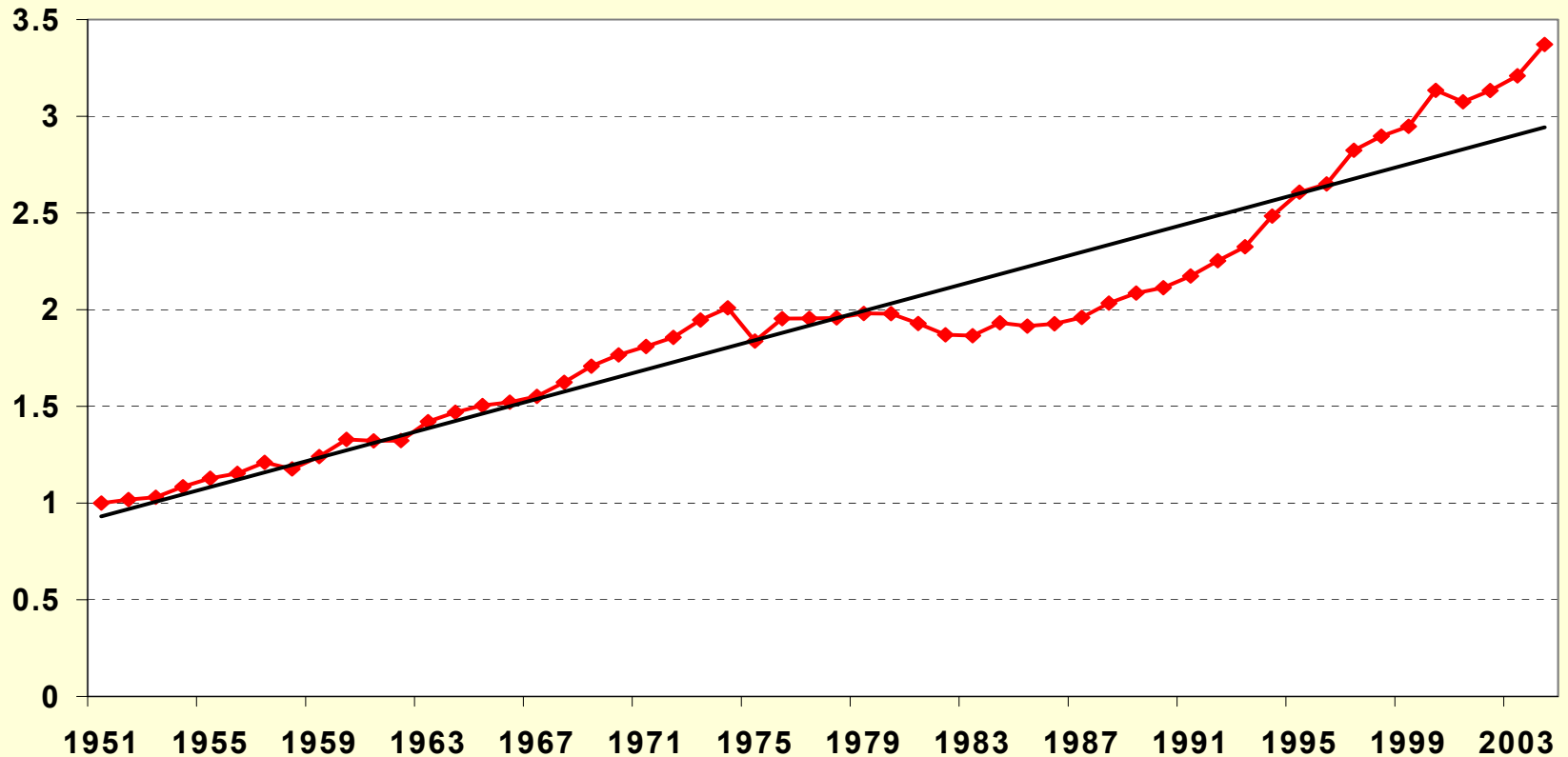
The Spread of Global Trade & Production Linkages



- Global FDI and OECD imports from the non-OECD have both accelerated markedly since the mid-1990s
- FDI has risen most rapidly in the OECD economies, but the non-OECD share has more than doubled

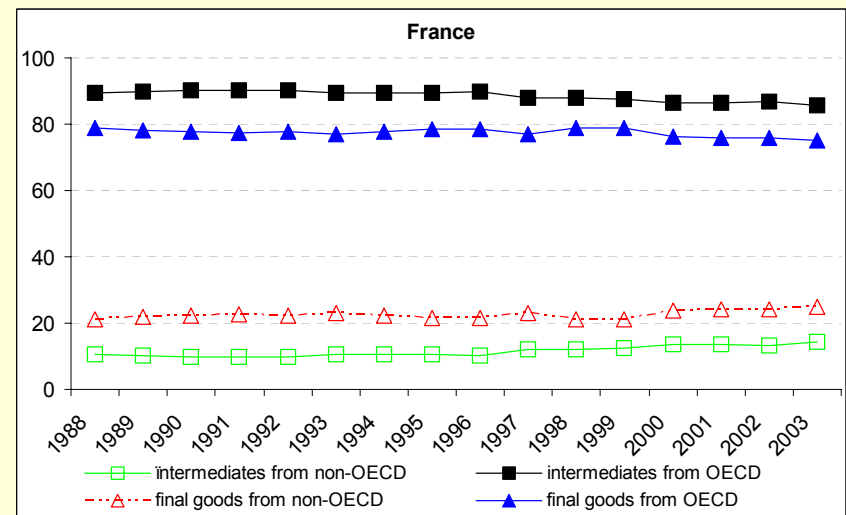
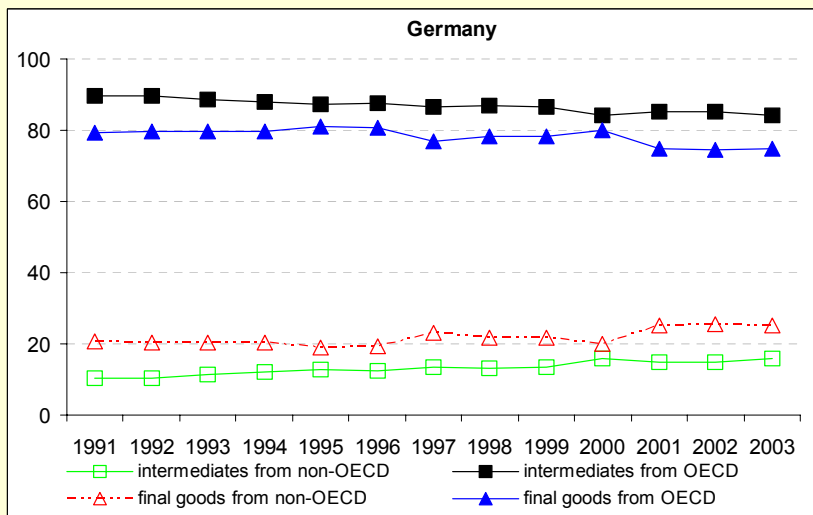
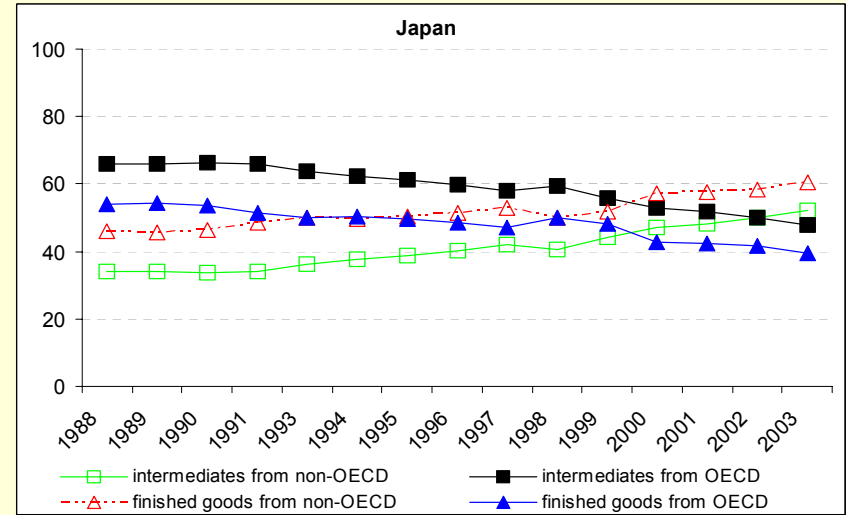
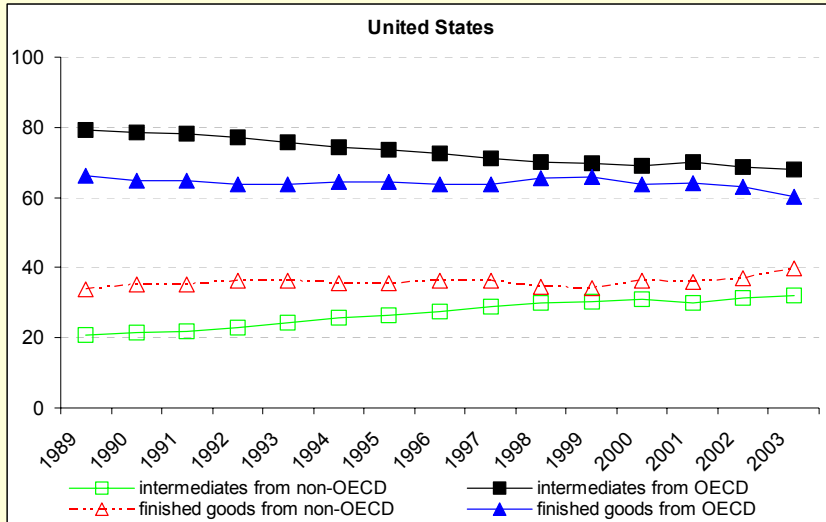
Trade volumes have risen consistently relative to global GDP since 1950

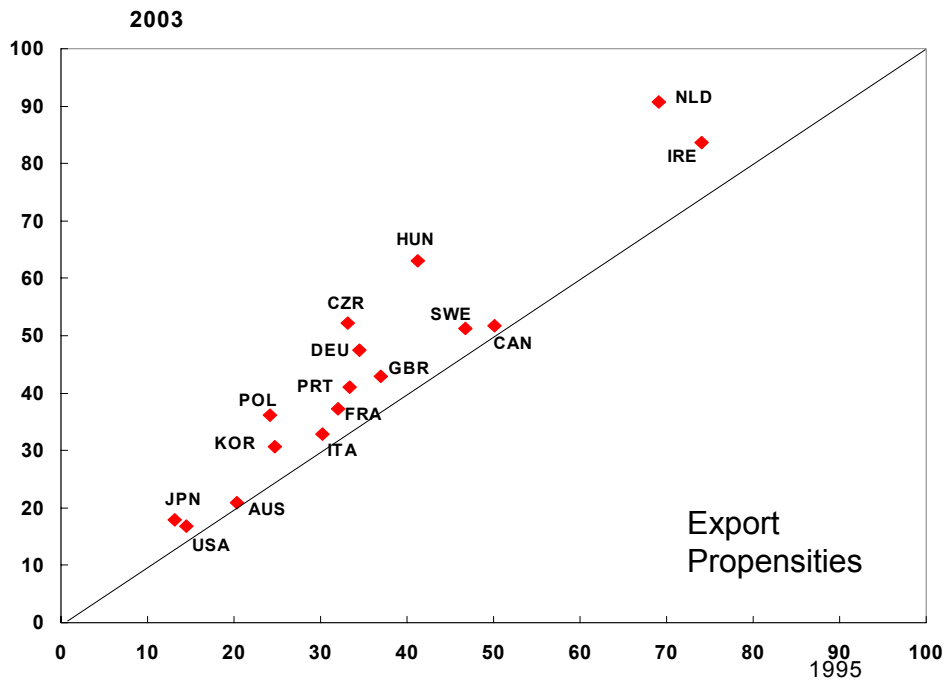
Global Merchandise Trade-GDP ratio (1951=1)



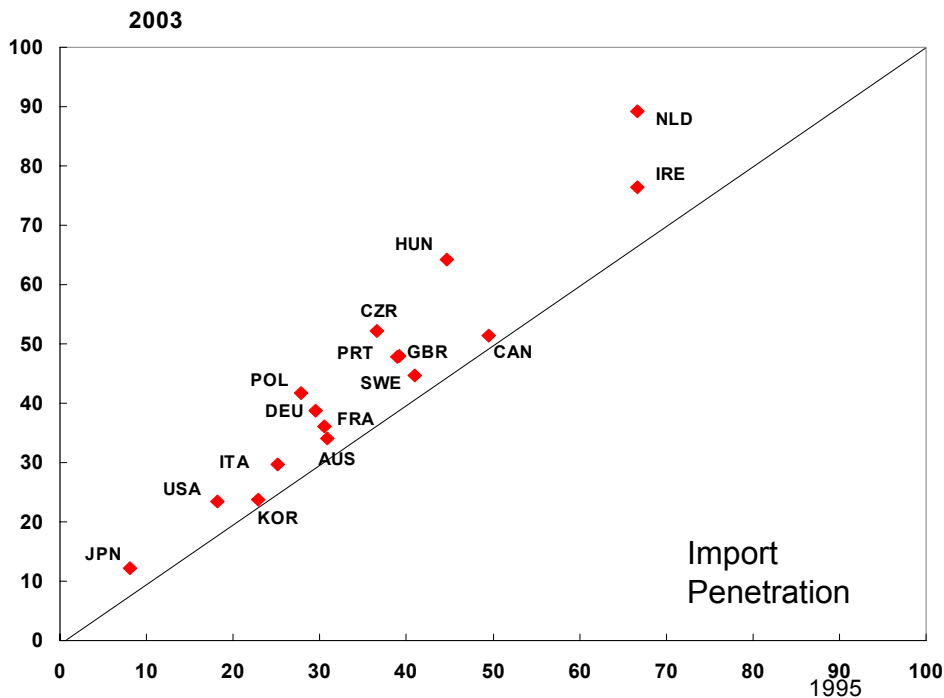
- The acceleration has again been especially marked over the past decade:
 - rising intra-industry trade and import content of exports

Differences across countries in their share of imports from non-OECD economies - both for finished goods and for intermediates. But offset by different trade-GDP ratios.



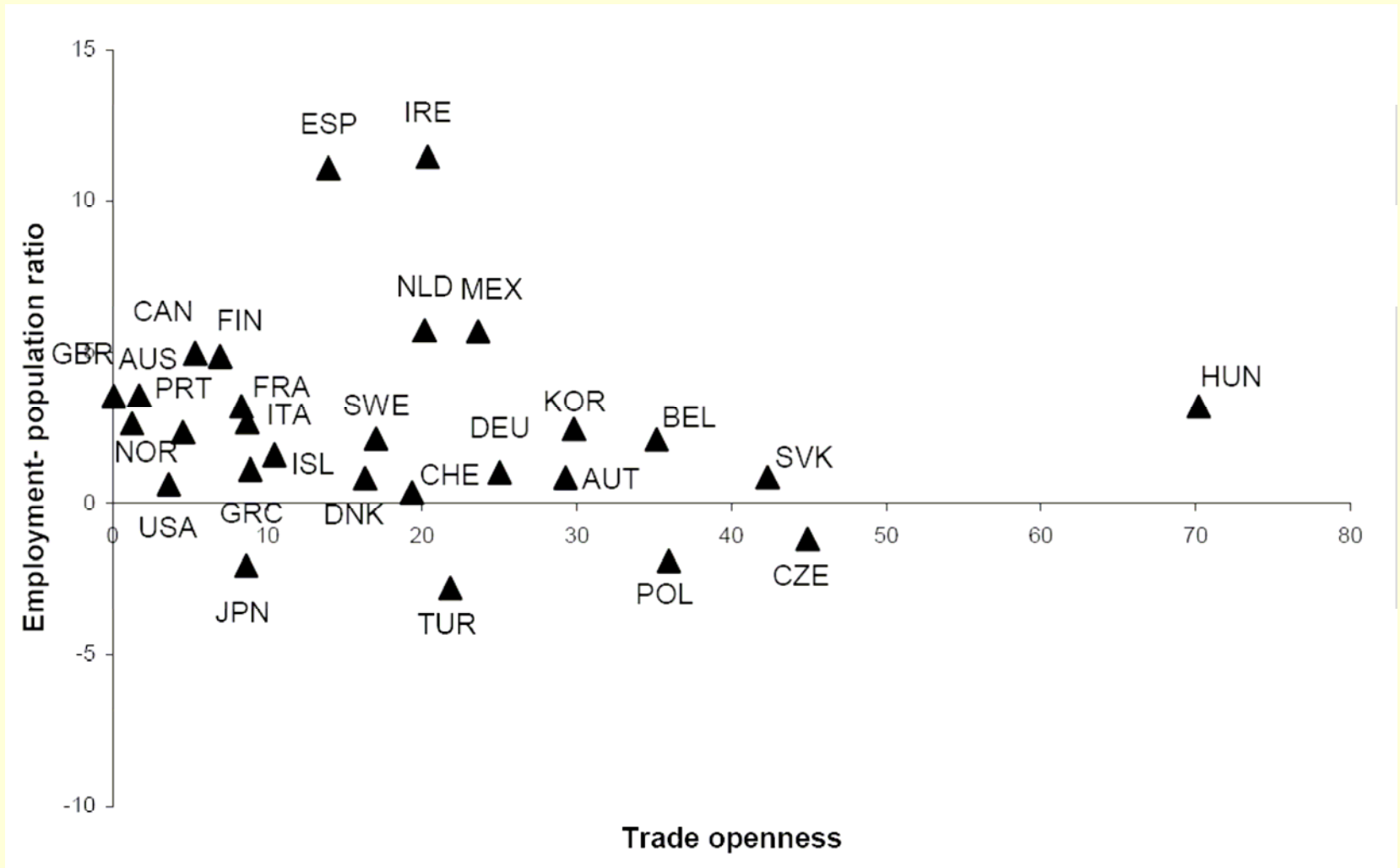


- The Figures show export propensities & import penetration in OECD manufacturing sectors over 1995-2003.



- In all countries firms have become more exposed to international competition
- Smaller countries more exposed than larger ones

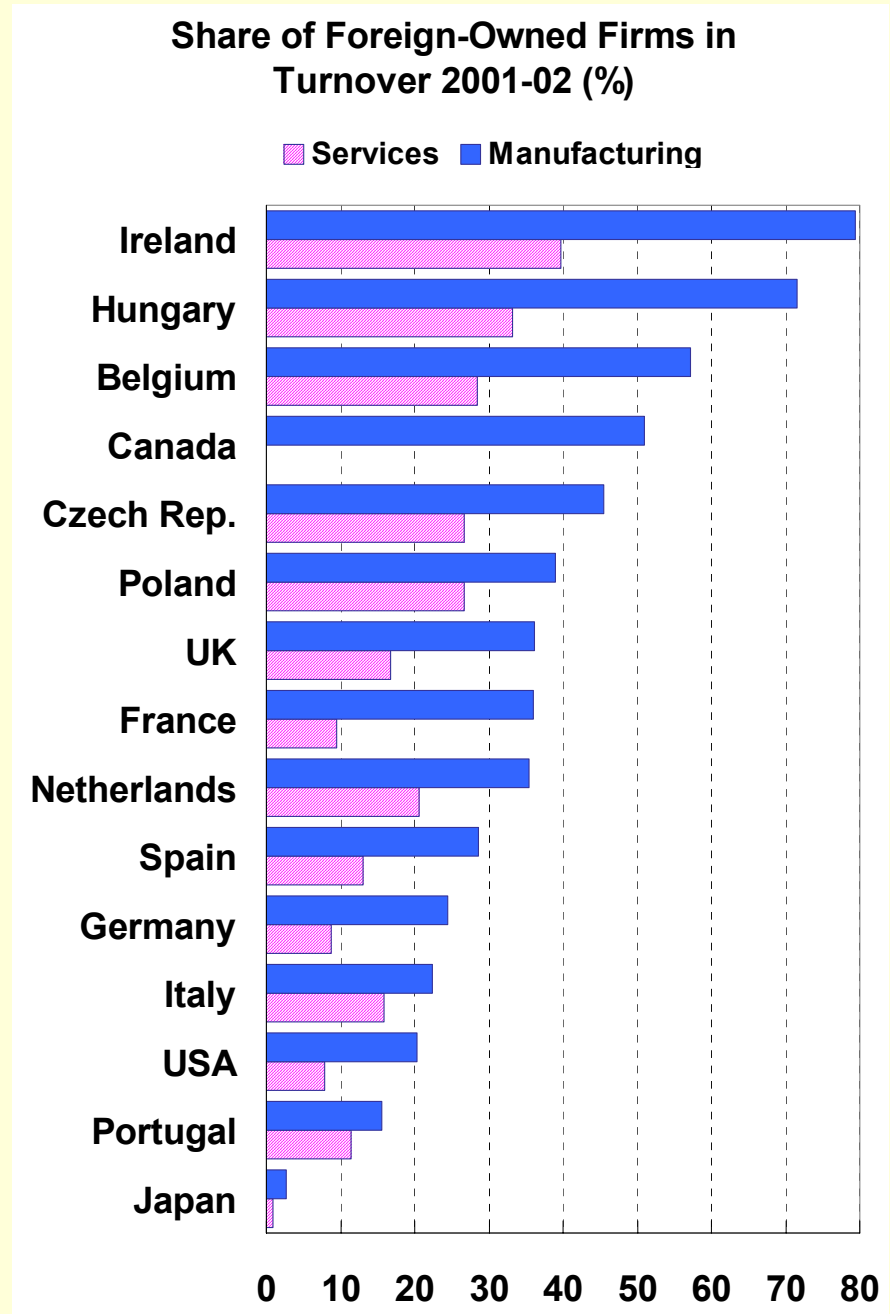
Little evidence of a strong correlation between changes in employment rates and openness to trade in OECD members (1994-2004; %pt changes)



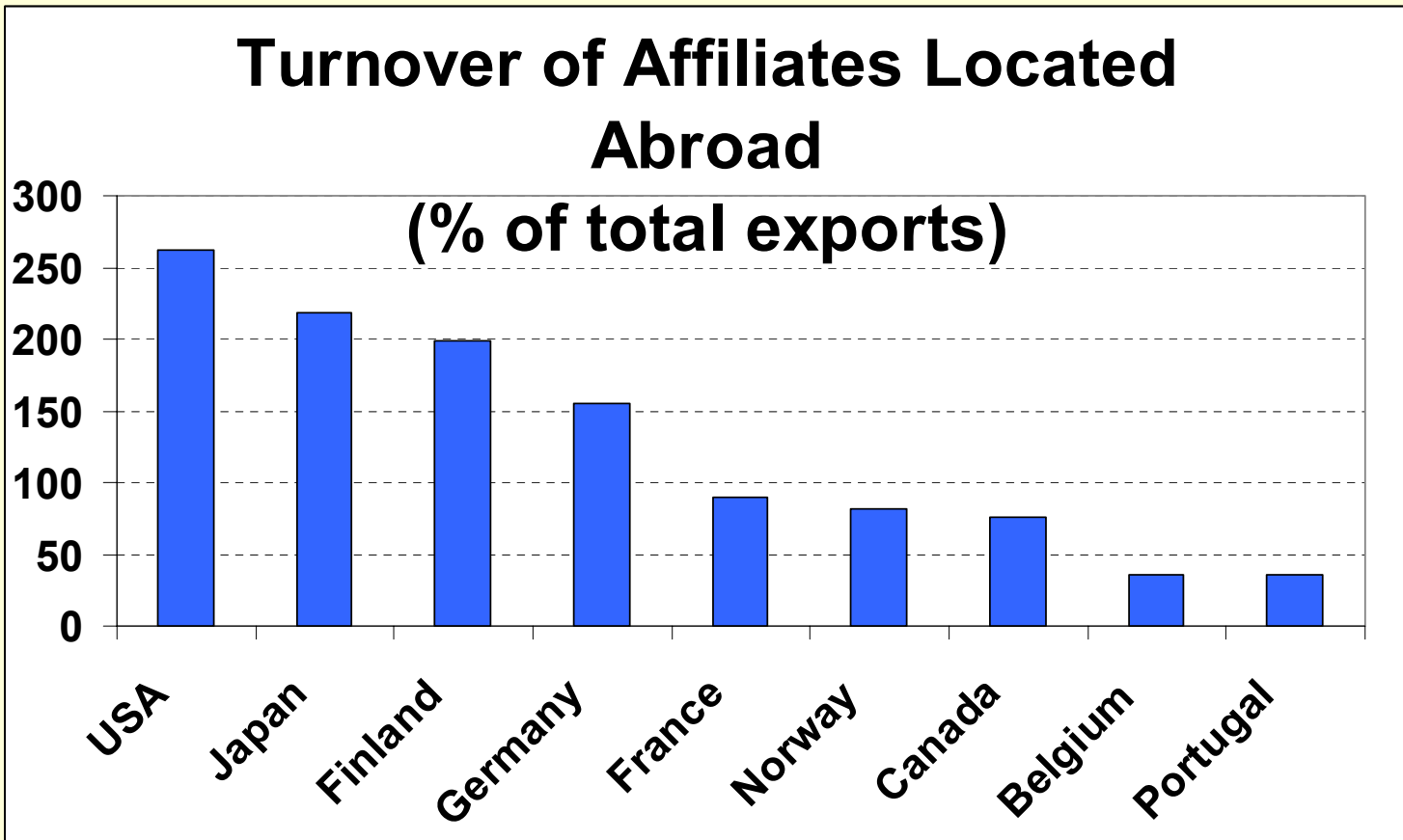
Foreign Direct Investment has increased exposure to cross-border developments:

- A significant proportion of domestic economic activity is now accounted for by foreign-owned firms
- Especially in the manufacturing sector

Source: OECD Economic Globalisation Indicators



Sales by foreign affiliates are also now an important means of serving global markets



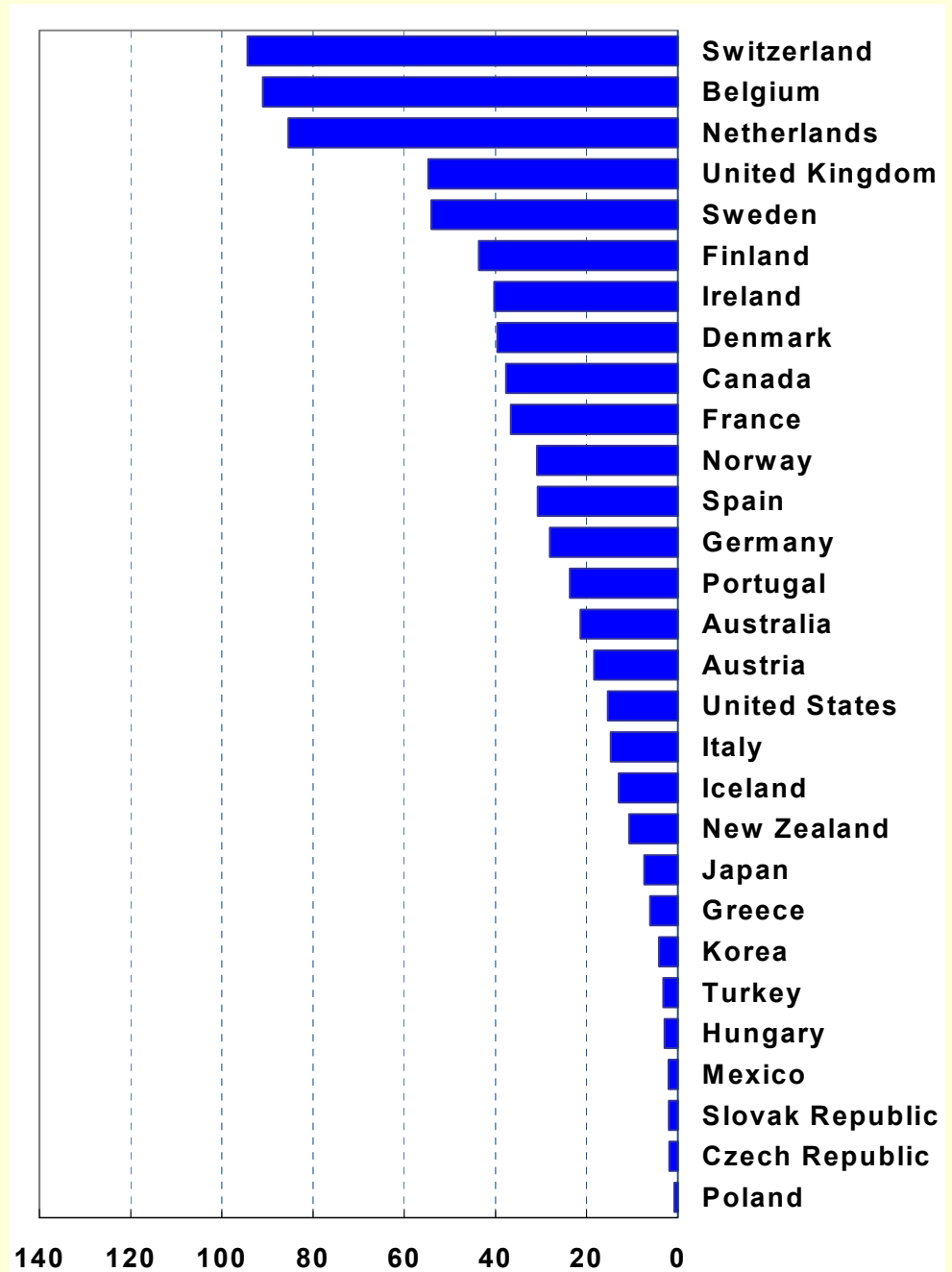
- Data shown for 2001-02 .

Source: OECD Economic Globalisation Indicators

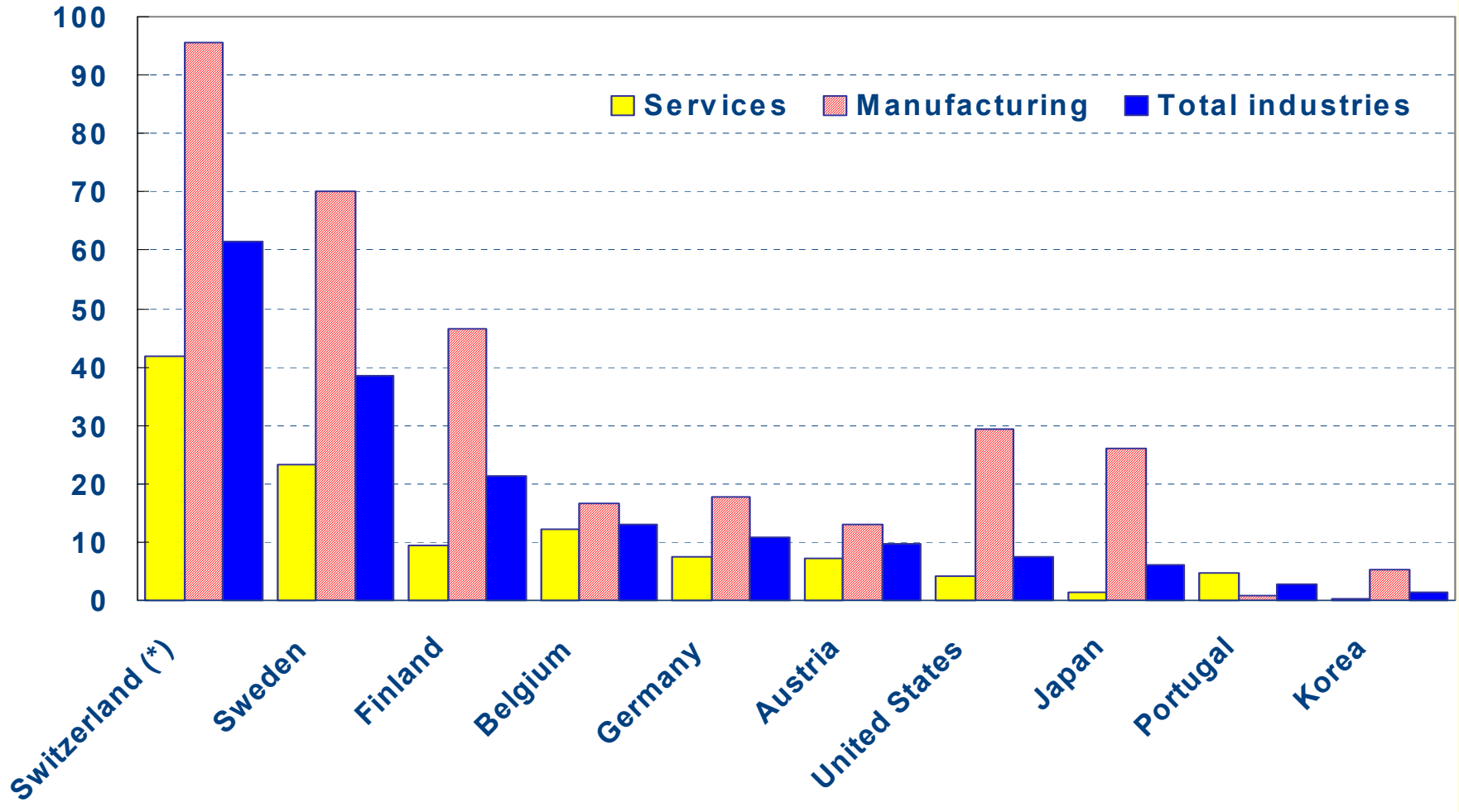
Outward FDI Stocks of OECD Countries, 2002 (% of GDP)

Outward FDI stocks of OECD economies

- Large relative to domestic output in smaller open economies with high labour costs, especially in Europe
- Amongst the G7 the UK has the highest outward stock (as a % of GDP)
- CHE, BEL & NLD may partly reflect special circumstances (taxes and company headquarters)
- Only FIN and KOR have over 50% of the stock in manufacturing sector

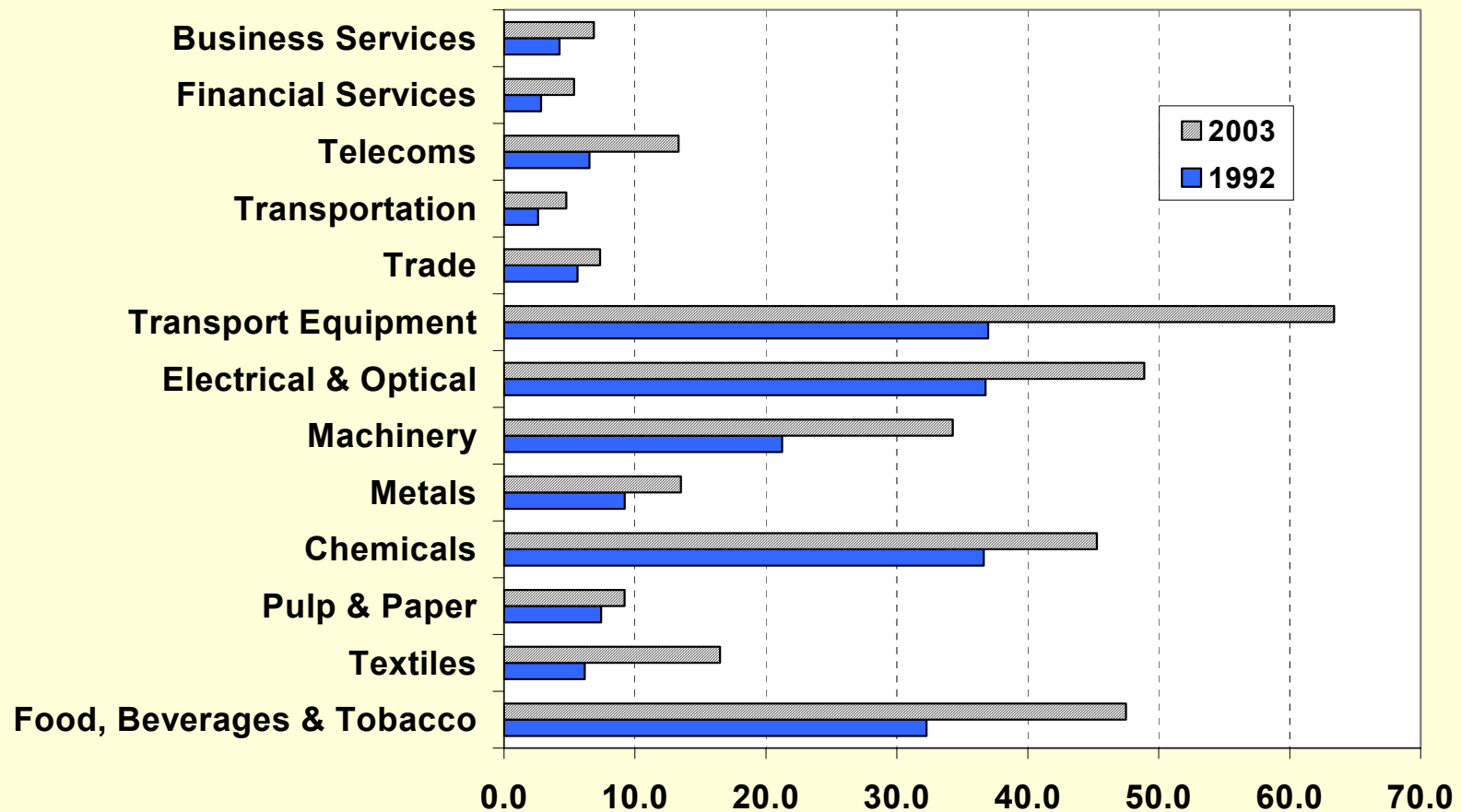


Employment in Outward Foreign Affiliates 2002
(% of total domestic employment)



- Employment in foreign manufacturing affiliates is larger relative to domestic employment than employment in services affiliates.
- Data for some countries may be distorted by ‘headquarter’ effects.

Ratio of U.S. Foreign Affiliate Employment to Employment in the U.S. (%)



- U.S. foreign affiliate employment risen relative to domestic employment between 1992-2003 in all sectors, although large differences across sectors in ratio foreign/home EMP
- A similar pattern is found for Japan and Germany.

Overview of economic issues

- The growth of trade and production networks should have welfare benefits & raise productivity levels and per capita incomes:
 - Greater specialisation in parts of value chain
 - Better access to foreign knowledge
 - Potential terms of trade gains for the OECD
 - Stronger export market growth (non-OECD)
- But gains may not be evenly distributed
- One key concern is labour market impact of greater international sourcing of intermediate goods and services
 - Facilitated by trade + production relocation

Existing Literature on Labour Markets

- Impact of outward investment & imports on home country labour markets is small
 - prices adjust to return employment to sustainable rates.
- Impact varies by occupational/skill groups.
Contributes to rising skilled labour premium.
- A few studies suggest that the bargaining power of employees has been reduced.
- Intra-MNE substitution of employment is more likely to occur with affiliates in developed countries rather than in emerging markets.
- Within emerging markets, substitution is more likely with affiliates in Asia and Eastern Europe.

Some Economic Implications

- Foreign affiliates give parent companies extra flexibility – production can sometimes be moved between different locations as factor prices change.
- Substitution of employment between home and host locations is more likely for cost-saving investments and the larger the host relative to the home country.
- Possible implications are that:
 - Outward investment makes domestic labour demand more sensitive to wages in the home country
[substitution]
 - Outward investment affects the speed of adjustment of employment when desired labour demand changes

OECD estimates suggest [1]:

- The effects of outward investment differ significantly across industries and countries.
 - so it is difficult to draw strong conclusions
- There are significant differences in the effects found for the G3 economies at the sectoral level:
 - a 1% rise in foreign affiliate employment is associated with a rise of 0.1-0.2% in domestic employment in the United States after two years (1993-2003) *[controlling for output & wages]*
 - a 1% rise in foreign affiliate employment is associated with a fall of 0.02% in domestic employment in Japan after two years (1998-2003)
 - no significant effect found in Germany (1994-2001)
- Differences may reflect maturity of investments and different motivations for investment.

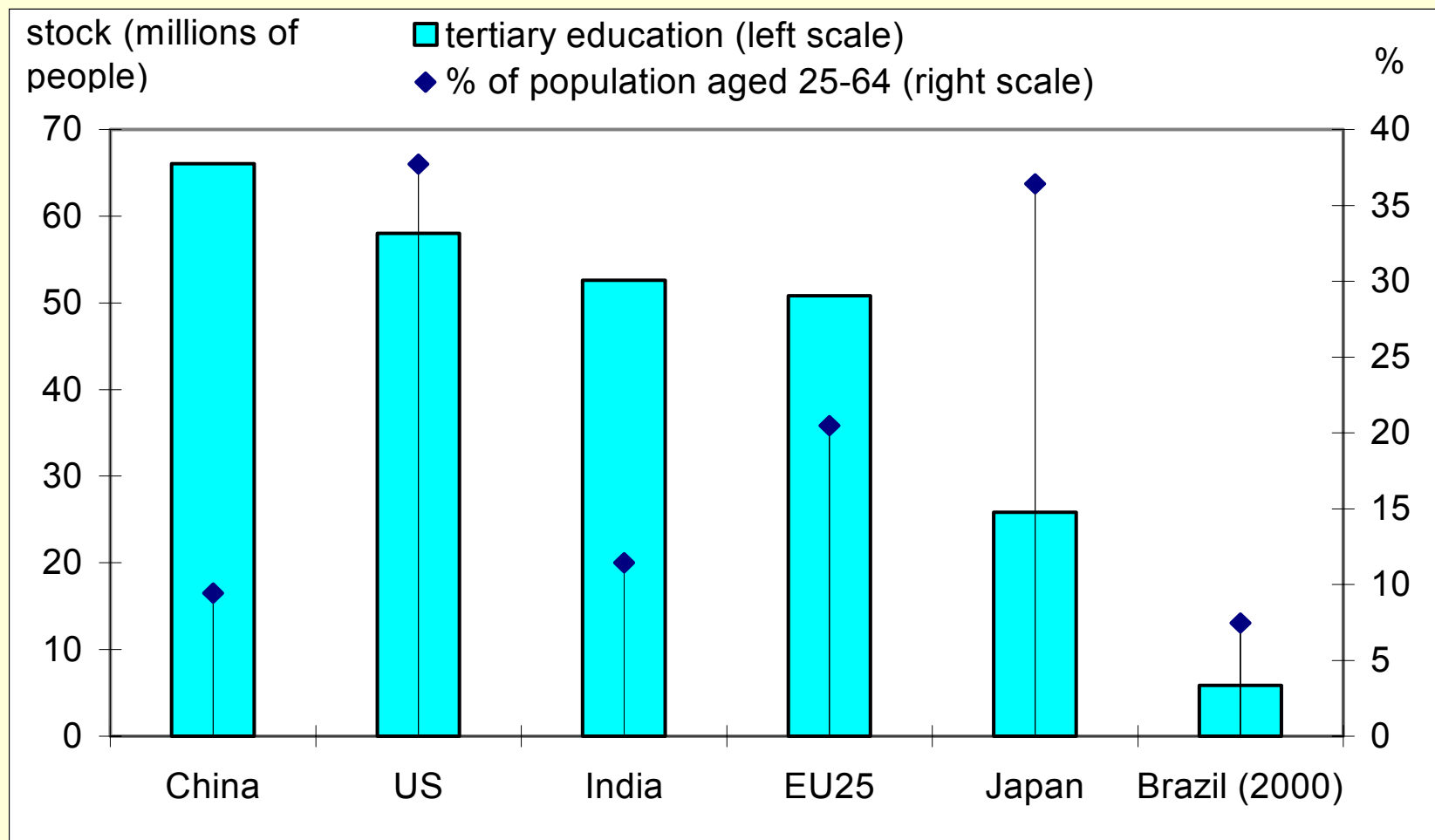
And [2] that:

- There are significant differences in the effects found across industries.
 - Domestic and foreign employment are partially substitutable in manufacturing, but possible complements in services.
- For a group of 4 manufacturing industries with strong commercial links with the non-OECD a higher level of outward FDI:
 - reduces domestic employment for a given level of production.
 - raises the speed at which employment adjusts
 - raises the long-run sensitivity of domestic employment to changes in domestic wages. [*Elasticity* ↑ from 0.8% to 1.0%]

Ongoing labour market challenges

- There are reasons to believe that the labour market challenges will increase:
 - Vertical multinationals & production fragmentation become more likely as trade and communication costs fall and as location becomes possible in countries with different factor endowments.
 - China & India have significant reserves of underemployed labour.
 - OECD estimates suggest that up to 20% of occupations in the major economies are potentially offshorable (high ICT content).
- Rising numbers of displaced workers from trade and production relocation

- High-skill workers in the OECD may also be exposed to competition. There are more university educated people in China than in the US or the EU



Source: Schaaper (2005)

Adjustment Challenges

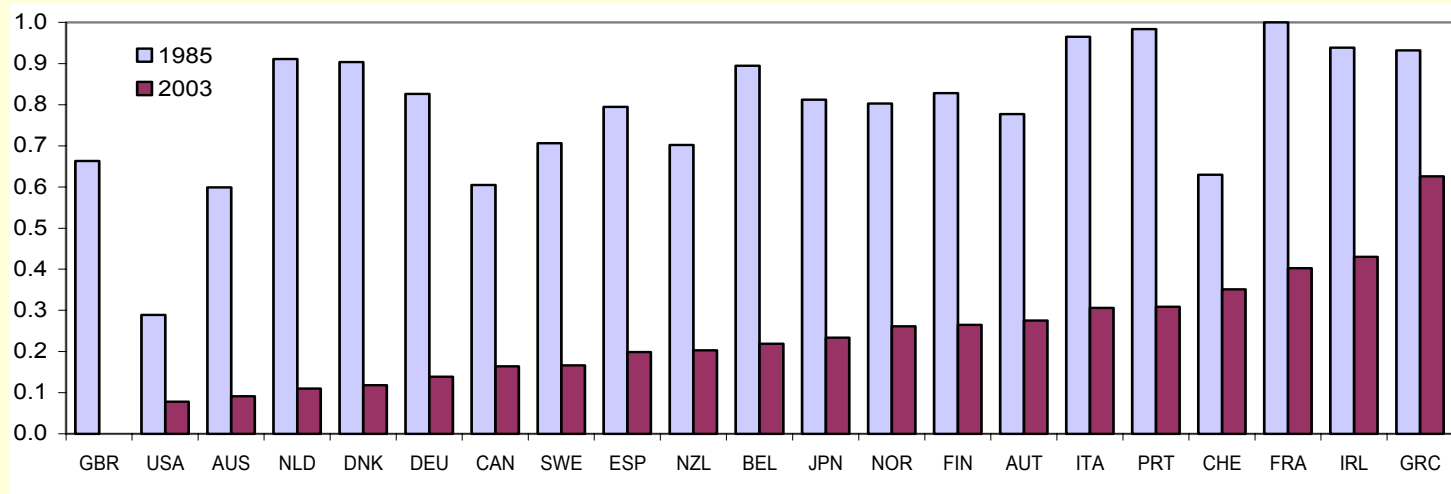
- How quickly will economies adjust?
- Structural reforms needed to facilitate the movement of labour and capital across sectors & enable the gains from globalisation to be realised.
 - Product market regulations lowered to allow free entry and exit and enhance competition
 - Enhancing the adaptive capacity of labour markets:
 - Upgrading work force skills (lifelong-learning)
 - Enhance job creation (and effectiveness of job search)
 - Income assistance for displaced workers
 - Promotion of labour mobility
 - Policies to facilitate the creation and diffusion of innovations and new forms of economic activity.

Structural Reform Challenges

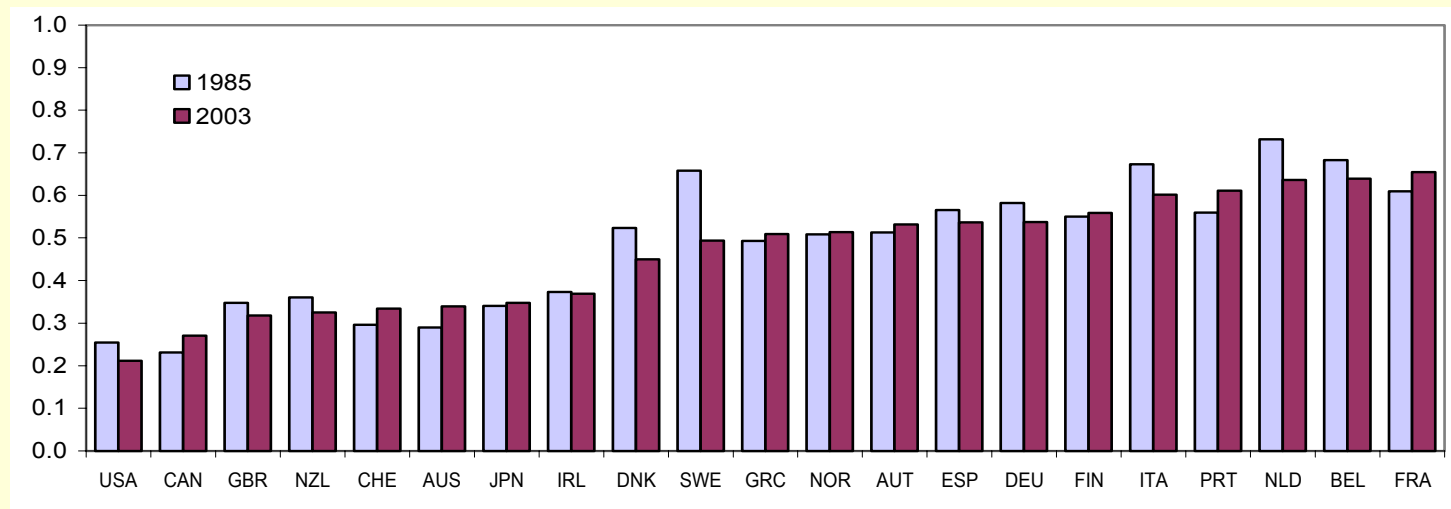
- The feasibility of reforms is conditioned by the macroeconomic situation:
 - Macro policies designed to keep output near potential may facilitate reforms by minimising costs to the potential near-term 'losers'.
- The sequencing of reforms can also matter:
 - Financial and product market reforms should eventually prove growth-enhancing.
 - This facilitates labour market reforms.
- New policies to assist those displaced by reforms:
 - e.g. more active assistance for job-seekers.
- A different policy mix may be needed for displaced workers in services (more skilled)

Reforms have progressed more in product markets than labour markets (OECD composite indicators).

Product market regulation

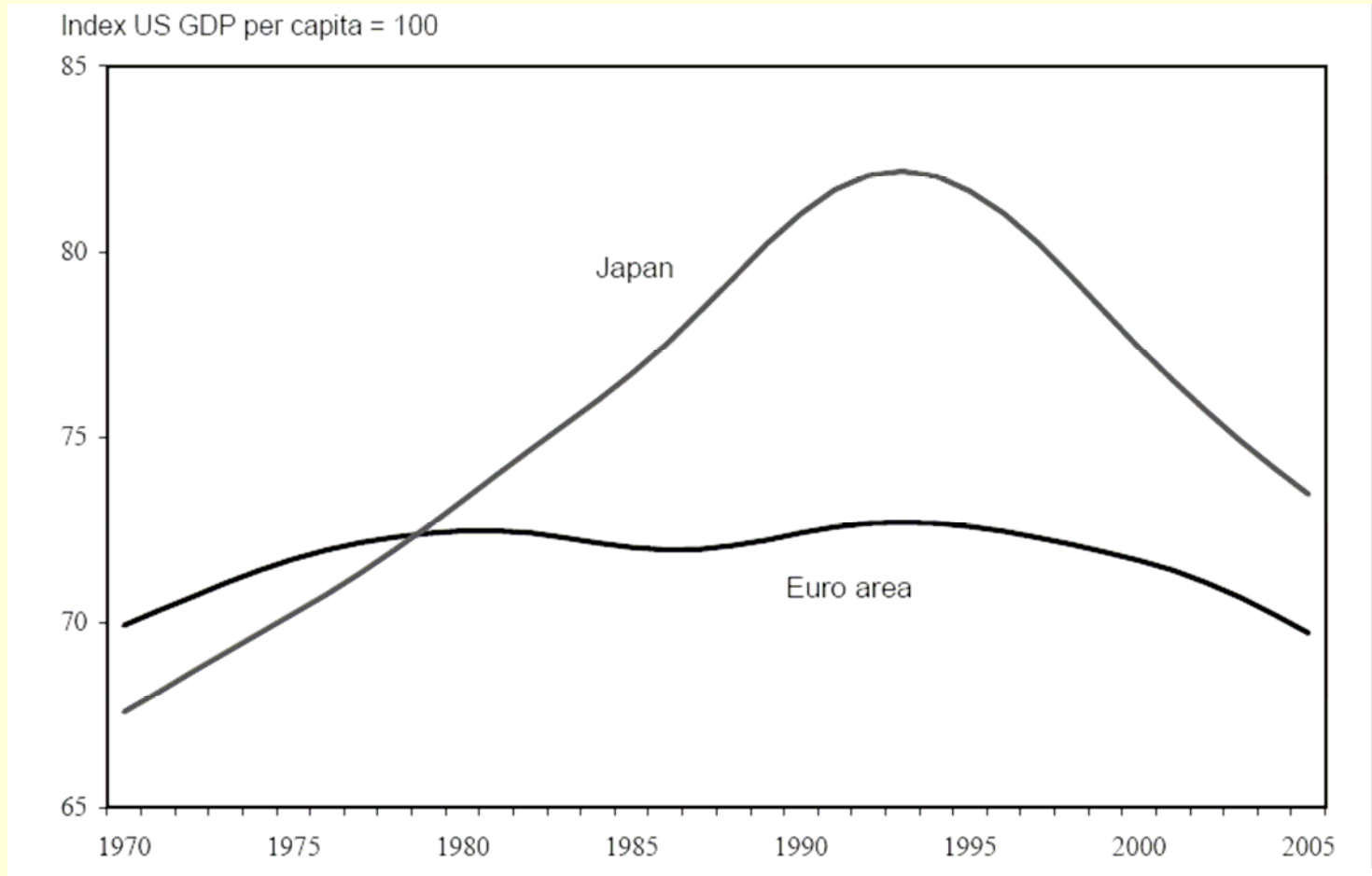


Labour market regulation



Synthetic indicators of regulation, normalised to range from 0 to 1, where 1 indicates the highest degree of regulation. For the construction of the indicators, see ECO/CPE/WP1(2006)7.

GDP per capita has begun to diverge in the OECD:



- The euro zone would benefit from a single services market and more flexible labour market institutions.
- Japan needs reforms to ease the burden of ageing.

Globalisation and Inflation

- The effects of non-OECD countries on prices and inflation in the OECD is another important aspect of globalisation.
- This ongoing work has four main elements:
 - The ex-ante impact of trade with low cost producers on the consumer price level
 - The evolution of exchange rate pass-through into import prices
 - The impact of growth in emerging markets on commodity prices (more commodity intensive)
 - The impact of foreign competition & relocation on domestic price-cost mark-ups and cost inflation
 - Is inflation affected by domestic or global output gaps?

Globalisation & Inflation (evidence so far)

- OECD estimates suggest that:
 - Trade with China has led to an *ex-ante* fall of 0.1%pts per year in US CP inflation over 1996-2005.
 - and a reduction of 0.3%pts per year in CP inflation in the euro zone since 2000.
 - reflects rising import penetration and goods inflation differentials (assuming constant importers mark-ups).
 - But, Chinese demand accounted for over 25% of the cumulated growth in global oil demand 1999-2005.
 - Exchange rate pass-through into import prices has fallen due to declines in commodity share of imports.
 - Domestic inflation has become increasingly sensitive to global (or regional) output gaps.

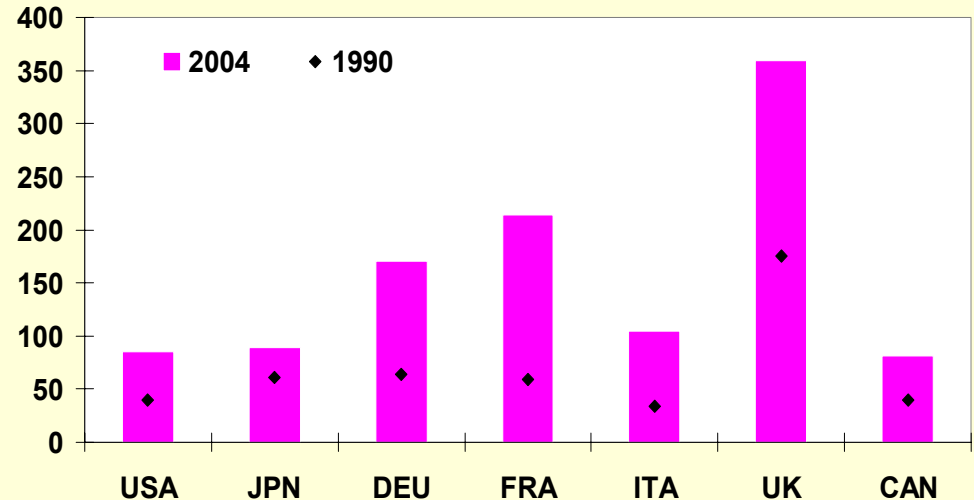
Some Monetary Policy Challenges

- Ultimately the effect of such changes on inflation should be offset by monetary policy
- But policymakers face the challenges of judging:
 - the extent of structural change
 - the persistence of structural change
 - whether changes are to the price level or to inflation
- The effects of globalisation should be viewed as a whole – falling goods prices (core inflation) offset by rising commodity prices (non-core inflation).
- Relative price shifts may have implications for meeting 2 year ahead inflation targets.

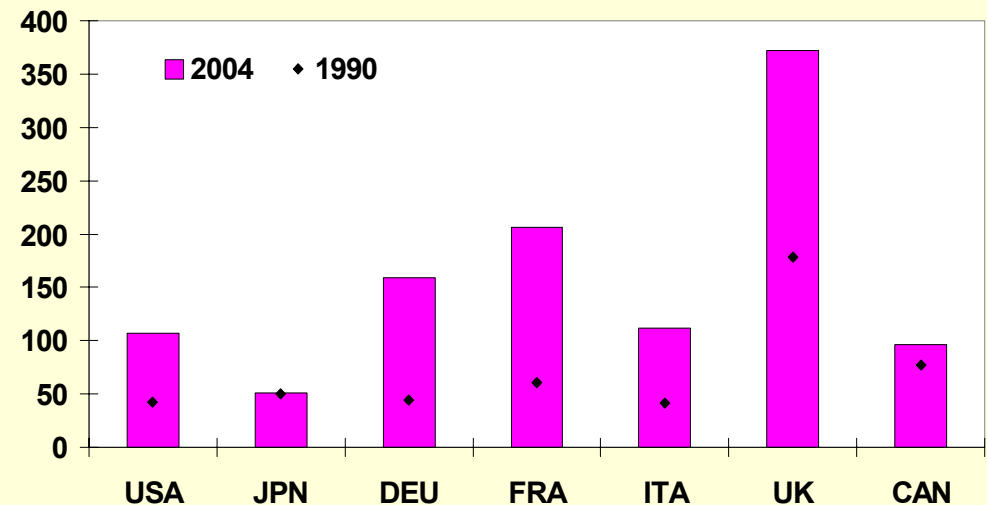
Financial Globalisation

- Cross-border financial diversification of assets & liabilities has risen sharply over past two decades
- Valuation effects (from asset prices) have become increasingly important for private sector net wealth and incomes.
- Poses new policy challenges

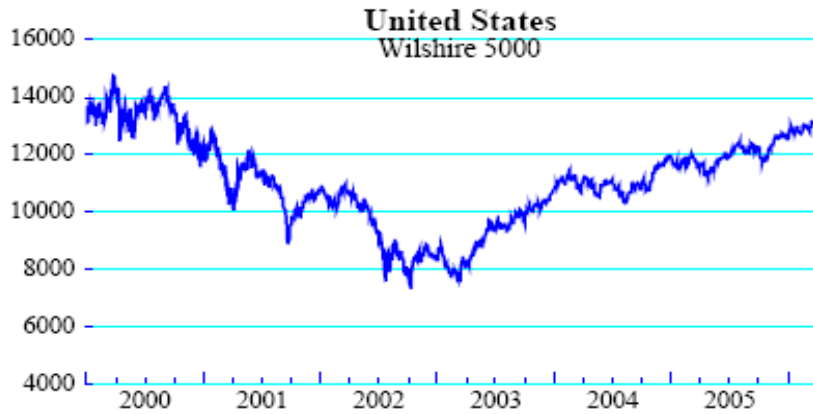
G7 International Financial Assets (% of GDP)



G7 International Financial Liabilities (% of GDP)



Financial Integration



- International asset markets have become increasingly integrated, although national factors still matter.
- Financial market linkages can accentuate cyclical fluctuations

Financial Globalisation: Summary

- Increased financial globalisation should help to ensure that financial capital is invested where the returns are highest.
 - reduces capital shortages in emerging economies, but can raise exposure to financial market volatility
- Portfolio diversification has widened, reducing the impact of country-specific shocks on total returns
- But potential exposure to global ‘shocks’ has risen:
 - For 10 BIS-reporting countries, foreign exposure of banks now equivalent to >50% of total assets on balance sheets
 - Derivatives important as well as cross-border lending
- Contagion risk gives new challenges to regulators.

Globalisation Statistics

- A common element in many of these issues is the need for better measurement
- Some important aspects of globalisation are especially difficult to measure:
 - The activities of foreign multinationals
 - Developments in services – prices, offshoring
 - Movements and exposure of cross-border financial assets/liabilities
 - Potential productive capacity in the non-OECD economies
- Better measurement would help identify the full policy challenges of globalisation.

Concluding Comments

- Globalisation is beginning to have clearly identifiable effects on OECD economies.
- Labour, product & capital markets are becoming increasingly linked across national borders.
- The benefits of globalisation likely to be maximised by a stable macroeconomic environment and further structural reforms.
- Policymakers also need to allow for the increased potential for the relocation of economic activities.
- Important potential role for global macroeconomic models to study the challenges of globalisation under different policy settings.