GLOBALISATION AND ALL THAT

ABHIJIT BANERJEE

THEMES TO BE DISCUSSED

- Assessing the debate around globalisation pertaining to

1. Analysing factor price convergence hypothesis (Samuelson-Stopler theory) - empirical experience of countries during pre-WW I phase and post WW II phase
2. Assessing Distributional consequences of trade
3. What is missing in the trade theory?
4. What policy measures can be taken to ensure losers can be reduced/compensated?

The ones in red are imp.

DEBATE ON GLOBALISATION

- Traditional theory - trade based on comparative advantage -> gains to winners> income losses to the losers of trade -> mutually beneficial (Ricardo)
- This is incomplete - does not talk about the distributional consequences of trade - i.e., who are the losers - poor population? *
- Thus, trade theory that incorporates distributional consequences from intl trade is imp - "high trade theory"

*If poor are worst hit through opening up of trade, would they be satisfied by merely knowing if someone in the economy is winning big time!Also, if the poor gets poorer and rich gets richer, inequality increases. Thus, loses to poor should have more weight while taking decisions about opening up intl trade and considering its distributional consequences.

SAMUELSON-STOPLER THEOREM

- States that - if a labor-abundant country trades with a land-abundant country then labourers in the first country benefit (as their wages rise) while labor in the second country worse-off. Also, land-owners in the second country benefit from rising land prices.

  Factor-Price convergence

- We know that Labor-abundant ctry specialises in L-intensive goods. What is expected from distribution of gains point of view?

A. such countries are generally poor. Trade -> rise in wages -> Y of poor increases.

B. Y of Land owners in such a country would decrease with factor price convergence -> Inequality decreases.

Thus, we look at consequences of trade from the perspective f factor price convergence, inequality and who are the ultimate losers.

EMPIRICAL EVIDENCE (1870-1913- PRE WW I)

Comparing *L-abundant + land-scarce* Western and Central Europe with *Land-abundant + Labor-scarce* New world (US,Australia, Canada) with regard to trade in grains (land-intensive crop)

A. Prices of grain - Gap between first world and new world decreased *-as predicted by traditional theory

B. Theory predicts that land prices must rise in Land-abundant (new world) but not in Europe. Evidence shows - land prices increased significantly in US and others but also increased in European countries like Spain, Germany etc. (!)

C. Similarly, wages in Europe must theoretically rise faster than in US - but evidence shows that the wage-growth for UK etc was same as that in US and in fact, lower than Canada (!)

* Prices of foodgrains decreased in first world and increased in the Land-abundant countries.

EMPIRICAL EVIDENCE (1870-1913- PRE WW I)

- If we look at relative factor prices (Wage/land prices) -> does seem to support the hypothesis.*
    - Wage/land prices ratio increased for West and Central Europe while it declined for the New world.
- Equality increased with trade in Uk as well as US.

*The previous empirical result may be justified if we consider that there are a whole list of other factors that may cause wages and prices to increase simultaneously besides cost adv. - K accumulation + Technology. Thus, we also need to the consider <u>“Relative Factor prices”</u> and not just absolute factor prices

POST WW II*

- Asian Tigers - specialised in export of L-intensive goods and evidence showed that low-skilled workers did well after trade liberalisation

- Latin America (Case of Mexico)

With liberalisation - coverage of import quote and average tariffs were reduced. Consequently, blue-collar workers lost 15% of wages while white-collar gained in same proportion -> inequality increased.

- China - Post liberalisation, income share of poorest quintile decreased while that of the top quintile increased (1980-98)

- India, inequality in urban areas exploded (1991-2000)

*This was a period of decolonisation, emergence of trade barriers (since 1950s) and emergence of institutions like GATT, IMF and world bank. We focus on what happened in countries that liberalised (like the Asian tigers - Korea, Singapore, Taiwan; Latin American - Mexico , Argentina ; India & China. The experience of Asian tigers and Latin American countries was very different.

TRADE LIBERALISATION AND INEQUALITY POST WWII

To get a better idea of impact of trade liberalisation, researchers compared the situation in countries that opened up with ones that did not.

- It was shown that opening up trade either increases inequality or has no effect at all.
- For bottom 40% (poor), incomes grow slowly relative to rich as well as in absolute terms for economies that did open up.

But correlation does not imply causation. Thus, some researchers argue that it was not trade per se that led to increasing inequality -> case of Mexico examined (Feenstra and Hanson 1997)

CASE OF MEXICO EXAMINED

ANALYSING FACTORS OTHER THAN TRADE

1. Liberalisation -> Inc in foreign investment & setting up of US factories -> DD for skilled workers increased (Feenstra and Hanson 1997). Banerjee argued that

A. Evidence showed that skilled worker did gain where foreign Investment was high and half of wage difference can be explain this way - but 50% is still left

B. Why did firms not shift to use of low-skilled labour - which is where Mexico's cost advantage lay? No labor reallocation- Puzzle

2. Latin American countries were importing L-intensive goods despite the fact that 90% of its trade is with L-scarce countries* - Puzzle

*Because liberalisation occurred in the form of reducing tariffs and import quotas -> before liberalisation DD for imports should have been quite high.

Conclusion

Trade theory would predict that post liberalisation, labor allocation would change (even if foreign investment is coming in - did not happen) and that a L-intensive country should import Land intensive goods (which also did not happen in the Latin America.

WHAT EXPLAINS THE PUZZLE?

REPUTATION AS THE MISSING FACTOR

- Reputation - catchall variable that includes expectation of quality from a brand name+ trust regarding quality and service between two parties that have been engaged in business activity for long*
- Consumers pay higher for a brand name because they are assured of quality. Similarly, retailers would be willing to pay more to trusted suppliers for quality.
- Price is not as important as it used to be for sale/purchase of goods - quality has become quite imp.

WHEN REPUTATION IS INCLUDED ?

- Its like a Fixed Cost (independent of how much you can sell) - like amazon.com
- When firms shift production to a Third World country, they are reluctant to change production processes to take cost advantage fearing it may alter quality. Thus, they demand same kind of labor that is used at home (skilled)
- Firms capitalise on brand names by providing services. These services employ large number of white collar workers relative to blue-collar
- There exists inertia in choice of who to buy from - Thus, if a country has been importing a L-intensive good from L-scarce country - they may continue to do so even if trade opens.*
- In long run, trade may be according to natural advantages but reputation (trusting a new supplier) takes a long time to build -> Multinational firms may continue to buy from old ones.

* they may be buying from L-scarce country in the first place because they would expect quality to be better for goods imported from a developed country like US or UK

WHAT CAN BE DONE TO BUILD REPUTATION?

- More effective court systems - to build trust with Multinationals.
- Public scoring system for buyers and sellers where buyers report experience with specific seller - like on amazon.com
- Creating a business friendly environment for MNCs so that they can trust domestic capitalists
- Improving K markets - firms doing well and quickly scale their operations provided they are not constrained by the capital market

HOW CAN LOSES THROUGH GLOBALISATION BE MINIMISED

1. Globalisation with Min. Acceptable Guaranteed living fr all

- In form of Right to education and health through specific policies aimed at children

- Compensate the small firms that may lose from trade liberalisation

2. Countries must share the benefits and *especially costs of trade* fairly. Particularly, with issue of brain drain.

- A developing country loses a valuable resource (say, doctors shift to US) which benefits the rich country (say US). Consequently, US must compensate India for this. For eg: a system of quotas for immigration to rich countries for everyone (and not just doctors - high skilled) in poor countries

There are gains to be had from globalisation, thus, we have to globalise while looking at who the losers are and compensating them (particularly the poor who may be adversely hit. Consequently, it is essential to globalise while providing an acceptable guaranteed minimum living for all.