

# Macroeconomic and distributional effects of globalisation

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## Abstract

This note aims to shed light on the possible consequences of globalisation for the global economy. It assesses the effects of international financial and trade integration, migration and remittances on economic growth, as well as those of protectionist trade policies, with special attention to the implications for emerging market economies (EMEs). The channels through which globalisation influences inflation are also discussed. For EMEs, we ask whether remittances are a source of stability or instability. The links between globalisation and inequality are also discussed. Finally, the links between globalisation and external stability are considered.

Keywords: globalisation, economic growth, inflation, international trade and financial integration, remittances, stability.

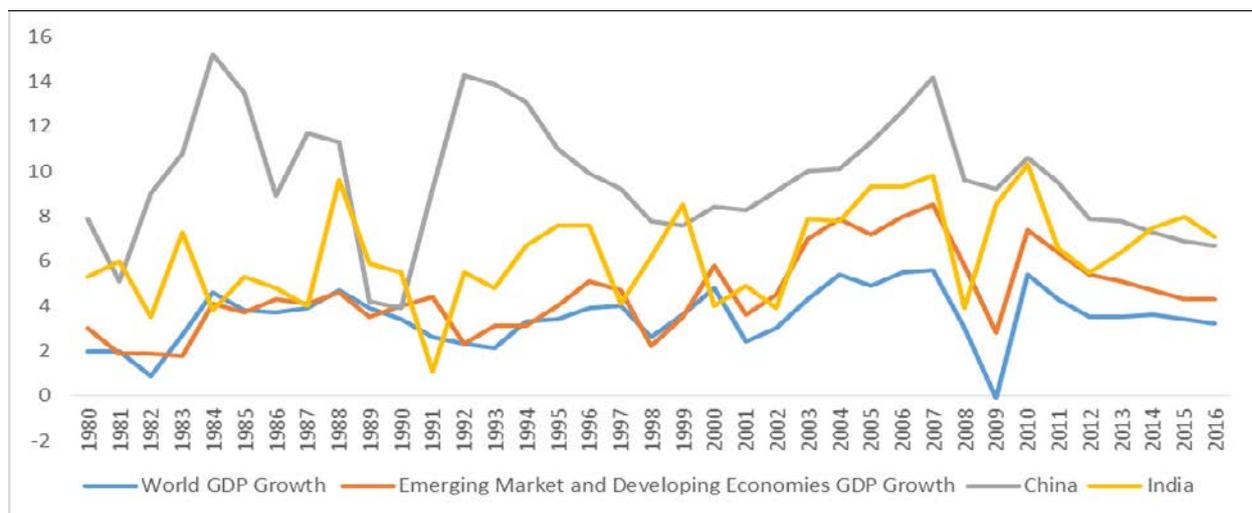
JEL classification: B17, F22, F24, F60, F62, F68.

## 1. The impact of trade integration, migration and remittances on economic growth

For emerging market economies (EMEs), integration with the global economy has a powerful effect on economic growth and productivity. Over the preceding two decades, EMEs have benefited from trade integration via multiple trade and regional integration agreements.<sup>1</sup> This in turn reflects the essential role of trade as an engine of economic growth for EMEs and has resulted in growth rates above the world average. Indeed, some EMEs such as China and India, have outpaced the overall growth rate of all EMEs combined, as shown in Graph 1, due to their economic integration with the rest of the world. In addition, the World Trade Organization's statistics reveal that the share of trade as a percentage of GDP over the 2014–16 period for some EMEs such as China, India and Mexico averaged 20.0%, 22.4%, and 31.2% respectively. Moreover, remittances have become an important source of growth for EMEs, although remittance inflows as a percentage of GDP tend to differ widely. According to World Bank statistics, the average remittance received as a percentage of GDP in Bangladesh, China, India and Mexico was roughly 7.6%, 0.3%, 3.2%, and 2.3%, respectively, during the 2014–16 period.

Economic growth rate (%)

Graph 1



With this background in mind, it is important to understand how trade integration and remittances influence economic growth and productivity in EMEs. The influx of remittances accelerates their pace of economic growth and productivity. In general, remittance inflows into EMEs affect economic growth via two channels. First, workers' remittances can be used for consumption in the receiving economies, which in turn enhances domestic sources of economic growth. Alternatively, remittance inflows can stimulate economic growth through productive investments, if workers

<sup>1</sup> For instance, China has trade agreements with various blocs and countries such as ASEAN (the Association of Southeast Asian Nations), Australia, Chile, Costa Rica, Georgia, New Zealand, Pakistan, Peru, Singapore, Korea, and Switzerland. Likewise, India maintains trade agreements with ASEAN, the European Union, Sri Lanka, Singapore, and Thailand.

use their savings to invest in new business, real estate or other assets. Such investments are likely, given that these workers have more information about their home country's market perspectives than do foreigners. The evidence shows the important role of remittance inflows in promoting economic growth in Brazil, Russia, China and South Africa, among other EMEs.

International trade has a no less essential role in promoting economic growth, as evidenced by the economic literature. Hence, over the last 20 years, EMEs such as China, India, Indonesia, Mexico, the Philippines and Turkey have focused on trade integration via trade agreements to lower trade barriers and reap the benefits of trade for economic growth. Trade integration tends to be accompanied by trade liberalisation policies (ie cuts in tariffs, quotas and restrictions on capital flows). In other words, trade liberalisation opens up countries' access to a wide range of goods and services, knowledge and technology. It also helps to attract private and foreign capital, generating more employment opportunities and reducing price distortion. Furthermore, trade promotes the development of activities with a comparative advantage and increases foreign earnings. Together, these factors play key roles in boosting economic growth in EMEs. For instance, Chinese industries with comparative advantages have attained a high level of specialisation, leading to a higher rate of employment as well as massive inflows of hard currency. In sum, China's integration with the world economy has enabled the country to sustain and even boost its economic growth. There is abundant evidence that countries which are active in international trade are more productive than countries that focus only on their domestic markets.

## 2. Economic response to protectionist trade policies

Some parts of the world are instituting anti-trade integration policies as well as new barriers to trade. This wave of rising populism and trade protectionism may slow global growth as well as accelerate inflation in countries that are subject to new trade barriers, depending on their economic structure. With regard to EMEs, the possible consequences of trade protectionism might be severe. To start with, restrictions on trade will affect the competitiveness of EMEs in international markets and hinder their export-led growth models.

In general, any spread of trade protectionism will undoubtedly have negative effects on the exports of EMEs. Likewise, it is essential to note that most foreign direct investment flows into EMEs come from multinational corporations in advanced economies. Protectionist policies might induce these corporations to scale down their operations in EMEs and take their investments back to their home countries, responding to incentives for investors to repatriate their funds.

In sum, it can be inferred that trade protectionism would have an adverse impact on exports and investment in EMEs. In addition, protectionist measures could push import prices up and impede global trade, thereby lifting inflation rates worldwide, especially in economies confronted by higher trade barriers.

### 3. The role of trade and financial integration on business cycles synchronisation

The literature on business cycles stresses the roles of both international trade and financial integration in synchronising business cycles. The convergence of the growth rates of any two countries (or regions) over time evidences business cycle synchronisation.

Numerous factors, including trade integration, similarity of economic structures, and similarity of monetary and fiscal policies, determine the level of business cycle synchronisation. In particular, it seems that trade integration may lead to a rising level of business cycle correlation when the demand channel becomes the dominating factor in a country's or region's business cycle. In contrast, an acceleration in trade integration between countries or regions may result in either an increase or a decrease in the level of business cycle correlation; this will occur when the factors linked to specific industry become the principal ones influencing business cycle fluctuations.

The role of trade integration in determining the degree of business cycle synchronisation appears to vary among countries. For instance, Frankel and Rose (1998) document that intensive international trade is associated with business cycle synchronisation in OECD countries over the period 1959–93. Likewise, Inklaar et al (2008) re-examine the link between international trade intensity and business cycle correlation for OECD countries during 1970–2003 and find similar evidence to that of Frankel and Rose (1998), albeit with a lower impact than that suggested by the earlier paper. Further empirical evidence confirming the important role of trade integration on business cycle synchronisation has been found in other regions such as Latin America and the advanced economies (Caporale and Girardi (2016), the European Union (Rana et al (2012), and East Asia (Moneta and Ruffer (2009)). In this light, it can be inferred that countries with a higher degree of trade integration tend to have a higher level of business cycle synchronisation.

Financial integration is another significant factor for business cycle synchronisation. However, the literature is equivocal in assessing the impact of financial integration on business cycles. For instance, Imbs (2004) analyses the effects of key elements that might impact the degree of financial integration on the business cycle for 24 countries over 1980–99. He finds that countries with higher degree of financial integration lean towards having more synchronised business cycles. Additional evidence by Kose et al (2003) is supportive of the notion that greater financial integration results in more business cycle synchronisation in a group of industrial and developing countries. Kim and Kim (2013), who focused on the role of capital flows in capturing the correlation of business cycles in 12 East Asian countries over the period 1980–2006, provide further evidence. In particular, they suggest that cycle synchronisation in these countries is associated with capital market liberalisation. But other studies show that financial integration does not necessarily imply the correlation of business cycles. Kalemli-Ozcan et al (2003), for example, show that business cycles tend to be less synchronised for economies with greater financial integration. They argue that countries with a greater degree of financial integration appear to have more specialised industries; thus, the degree of business cycle synchronisation is low. The most recent research by Caporale and Girardi (2016) concludes that, unlike trade integration, capital flows have a limited role in explaining the high correlation of business cycles between Latin America and the economies of

China, Europe, Japan and the United States. In sum, it can be concluded that the role of financial integration in explaining the correlation of business cycles depends on various elements such as the modelling approach, data span, countries, the economic structures of these countries, and the degree of trade and financial integration.

#### 4. Remittances as source of stability or instability

Remittance inflows have become a predominant source of external finance in developing countries, surpassing the flow of foreign direct investment. It is thus important to assess whether remittances are a source of economic stability or instability. Undoubtedly, an inflow of remittances has significant impact on receiving EMEs since it represents a share of their GDPs that may range from 5 to 40%, according to Machasio (2016). Remittances help to smooth consumption, increase investment, alleviate poverty and promote financial development. The notion that they may therefore play a powerful role in stabilising the economy is supported by studies from Chami et al (2009) on 70 economies, Frankel (2011) on 64 economies, Cato (2012) on the Mexican economy, and Machasio (2016) on 81 developing economies.

Finally, it is important to note the consequences of remittance outflows on the source economies, since this may have a negative impact. Edrees (2016), for instance, indicates that remittance outflows from selected GCC countries, including Saudi Arabia, contribute to impeding economic growth in these countries.

#### 5. Globalisation and the sectoral composition of the economy

Globalisation has changed the sectoral composition of the economy, due to some countries switching from heavy manufacturing to service industries, while other economies have maintained diversified sectors. Dauth and Suedekum (2014), for instance, assess how globalisation has affected Germany's industrial structure during 1978–2008. Their analysis reveals a decline in manufacturing as opposed to an acceleration of modern services. Likewise, Russu (2015) documents that, due to the Great Financial Crisis (GFC), the EU's industrial sectors became more diversified rather than specialised during the 2000s. It is also crucial to note that changes of sectoral composition are associated with economic integration, notably trade. In other words, trade theories agree that trade liberalisation leads to a higher degree of specialisation, leading economies to benefit from their comparative advantages. Empirical evidence also agrees with theory on the essential role of trade integration in accelerating specialisation. For instance, Amiti (1999) analyses the data for 27 industries for selected European countries and shows that specialisation increased significantly only in six, whereas it fell in three countries between 1968 and 1990. However, with a special focus on the period between 1980 and 1990, the author finds that all 10 countries studied experienced a significant increase in specialisation. Further empirical evidence based on production data indicates the increase of specialisation in European industries during the 1980s and 1990s (eg Aiginger et al (1999)). Imbs and Wacziarg (2003), on the other hand, argue that the specialisation patterns

depend on the level of development of the economy. In particular, their empirical findings suggest that less developed countries usually tend to diversify their industries to mitigate the risks of sector-specific shocks, while specialisation occurs more often in advanced economies. Finally, how far manufacturing sectors can substitute imports may vary from one country to another depending on their economic structures and the degree of economic integration. For economies with more specialised industries, substituting imports would not be applicable; however, economies with diversified industries may be able to substitute imports.

## 6. Globalisation and inequality

It is evident that globalisation reflected by trade and financial integration boosts economic growth. However, as this economic growth is not distributed evenly, globalisation might also be expected to create income inequality. Technological advances tend to have the same effect, with a notable impact on unskilled labour. The Gini index, a measure of income inequality, reveals the variation of income inequality among EMEs, as shown in Table 1.

Brazil	Chile	China	Colombia	India	Indonesia	Mexico
49.7	50.5	46.5	53.5	35.2	36.8	48.2
Morocco	Pakistan	Peru	Philippines	Russia	Saudi Arabia	Turkey
40.9	30.7	45.3	44.4	41.2	45.9	40.2

Source: The World Factbook.

The empirical evidence is ambiguous about the impact of globalisation on income inequality. For instance, Acosta and Gasparini (2007) argue that the rise of income inequality in Argentina is due to skill-biased technological change, whereas trade integration has a lower contribution to reducing income inequality, as suggested by Galiani and Sanguinetti (2003). Nevertheless, Ferreira et al (2007) find that further trade openness has curbed income inequality in Brazil. Even though the empirical studies are still struggling to determine the winners and losers from globalisation, it can be inferred that nations with similar economic structures, especially with higher education levels, would benefit the most from further trade and financial integration. Likewise, it is anticipated that industries with intensive capital and technology should benefit more than would labour-intensive industries.

## 7. Globalisation and inflation dynamics

Global inflationary cycles appear to correspond to an intensification of globalisation, which tends to propagate common shocks via commodities, financial and trade channels. Since the early 2000s, global inflation increased from 4.7% in 2000 to 6.3% in 2008; however, this rate fell to 2.7% in 2009 due to the GFC and subsequent recession. It was not until 2011, when global inflation peaked at 5.0%, that it started

declining at a gradual pace, reaching 2.8% in 2016.<sup>2</sup> Similar inflationary cycles appear in both advanced economies and EMEs during these periods.

Policy debates and empirical studies suggest that trade integration is the basic channel for the potential effects of globalisation on inflation dynamics. Trade integration, especially when accompanied by policy incentives, plays an essential role in bolstering competition, with both direct and indirect effects on inflation. The direct effect is to contain costs, by curbing workers' compensation and reducing real import prices. The indirect effects work through generating more pressure for innovation, leading to higher productivity. In turn, increased productivity is associated with lower production costs. Price increases might be moderated if the profit margins charged by firms were reduced.

## 8. Globalisation and external stability

Over the past decade, the high external imbalances of major economies such as those of the euro area, India, Japan, the United Kingdom and the United States have become a source of concern for both economists and policymakers. Some analysts argue that these imbalances should be brought down to sustainable levels via large exchange rate adjustments, notably against the US dollar, with potentially disruptive effects on global economic activity and financial markets. Other analysts, however, argue that these imbalances might be resolved via further economic and financial integration.

The increasing global dimension of economic and financial transactions points to changes in the environment of external imbalances and their adjustment mechanism. In other words, the existence of greater external imbalances may be related to the increased linkages between financial markets across borders; it is also important to bear in mind that the acceleration in trade integration, accompanied with greater competition across the globe, will play an equally vital role in the adjustment process for global imbalances. The possible challenge for economies with large external imbalances is that they could be more exposed to financial markets shocks or to shifts in investor expectations.

<sup>2</sup> Inflation rates are from the IMF's *World Economic Outlook* database, October 2017.

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