The global economy

Read pages 133–139 of the textbook.

The global economy consists of all the countries in the world that produce goods and services, therefore contributing to world Gross Domestic Profit (GDP). The global economy comprises many countries at different stages of development including:

- developed or advanced industrialised economies such as Australia, USA, the United Kingdom, Japan and Germany, which have high levels of development and a high standard of living
- newly industrialised economies such as South Korea, Singapore, Taiwan and Hong Kong that have made the transition from developing economies to industrialised economies
- developing economies such as China, India, Bangladesh, Papua New Guinea and Ethiopia with lower levels of development and standards of living compared to industrialised economies
- economies such as Russia, Poland, Hungary and the Czech Republic which are making the transition from planned to market economic systems.

The industrialised economies tend to dominate world output, trade and investment because of their advanced systems of markets and high levels of income which create a supply of goods and services for export and a demand for imports of goods and services from other countries. Developing economies have not been able to achieve high rates of economic growth and development. This has resulted in lower standards of living for their populations.

Shares of world GDP, exports and population by groups of countries

Classification	Number of countries	GDP share (%)	Export share (%)	Population share (%)
Advanced economies	29	55.5	74.6	15.4
Emerging and developing economies	146	44.5	25.4	84.6

Source of data: IMF World Economic Outlook, April 2004

Activity 1

Comment on the relative shares of output, exports and population of the advanced economies with the rest of the world, and suggest reasons for the differences.

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What is globalisation?

Globalisation refers to the increasing level of economic integration between countries. It involves the spread of economic activity across national borders, leading to the emergence of a single world market. Instead of countries being independent and closed to the outside world, nations are increasingly becoming part of one global economy. The growth in economic activity consists of:

- international trade
  A growing share of spending is devoted to imports from other countries, and a growing share of what is produced is sold as exports.
- foreign direct investment
  Firms in one country are increasingly making investments to establish business operations in other countries.
- capital market flows
  In many countries, savers are increasingly investing in foreign financial assets (such as shares or loans), while borrowers increasingly turn to foreign sources of funds.

While globalisation has been going on for over 200 years, the pace of economic integration has accelerated in recent years due to:

- the general movement away from government involvement in economies and towards capitalism and freer markets
- improvements in the speed and costs of transport and communications
- rapid developments in technology
- a more sophisticated world financial system
- the growth of multinational (or transnational) companies.

Globalisation has been the source of much debate in the past decade and has raised a number of issues. Critics have argued that globalisation has exploited people in developing countries, causing massive disruption to their lives with few benefits in return. Supporters point to the significant reductions in poverty achieved by countries which have embraced globalisation such as China and India. However, for many of the poorest economies, the problem is not that they are being impoverished by globalisation but that they are unable to participate in it. These countries need assistance in becoming integrated into the world economy. Even within advanced economies, there has been much debate about the level of involvement a country should have in the world economy. Some of these globalisation issues are discussed below.

Activity 2

1. What is meant by economic integration? How is it linked to globalisation?

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2. Distinguish between the three types of economic activity that are fuelling globalisation.

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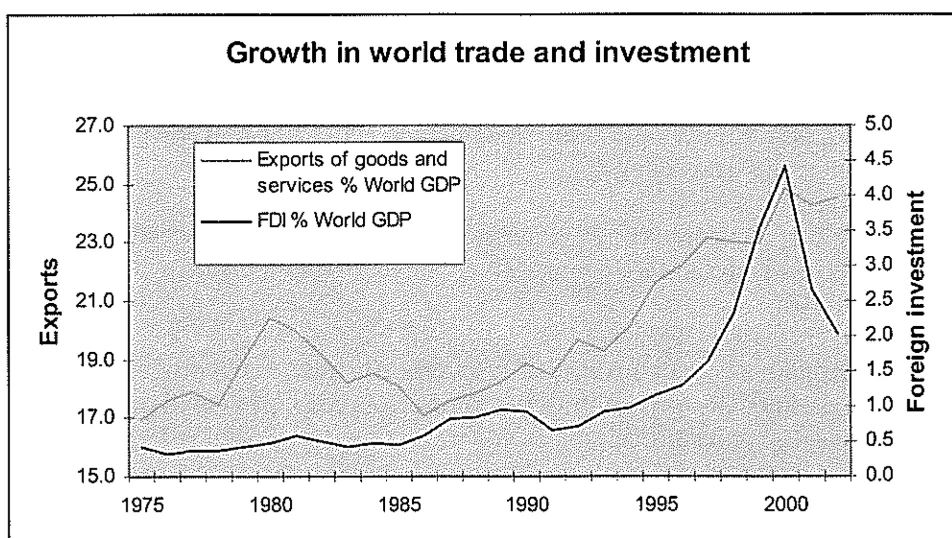
3. Examine the graph below.



Source of data: UNCTAD, 2004 and IMF, 2004

(a) What is the overall trend for trade and foreign investment (FDI) over the period shown?

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(b) Give a possible reason for the decline in foreign investment after 2000.

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Globalisation and trade

International trade refers to the exchange of goods and services between countries. Free international trade occurs when trade takes place without protective barriers such as tariffs (taxes on imports), quotas (limits on the quantities imported) and subsidies (payments to producers) which are designed to restrict trade.

Note: Protection is discussed in detail later.

Why countries trade – the principle of comparative advantage

The main reason for international trade is the principle of comparative advantage, which says that countries should specialise their production in those areas where they are most efficient. This means that they can produce those goods at a **lower opportunity cost** compared to other countries.

This happens because the distribution of resources amongst countries is uneven and the efficient production of goods and services requires different combinations of resources and technologies. Countries can specialise their production in those areas where their resources are most suited and then trade to get other goods and services. As a result, overall production is higher and a country's residents enjoy a higher standard of living. For example, Australia has vast amounts of iron ore resources and is able to produce iron ore more cheaply than other countries. If Korea is able to produce cars more efficiently than Australia then logically the two countries should specialise and then trade as both countries would benefit.

An example of comparative advantage

Note: The comparative advantage model will not be tested with numbers for exam purposes. An example is provided here to better illustrate the principle of comparative advantage.

The principle of comparative advantage is that countries should specialise in producing those goods at which they are comparatively more efficient: that is, where there is a lower opportunity cost.

Assume that with a certain quantity of resources Australia could produce 200 units of computers or 400 units of rice. With the same resources Japan could produce 500 units of computers or 100 units of rice.

	Computers	Rice
Australia	200	400
Japan	500	100

Japan can produce more computers and Australia more rice. However, the opportunity costs of producing each good need to be calculated to determine whether each country has a comparative advantage in production.

- The opportunity cost of producing each computer in Australia is 400/200 = 2 units of rice.
- The opportunity cost of producing each computer in Japan is 100/500 = 0.2 units of rice.
- The opportunity cost of producing one unit of rice in Australia is 200/400 = 0.5 unit of computers.
- The opportunity cost of producing one unit of rice in Japan is 500/100 = 5 units of computers.

By comparing opportunity costs we can see that Japan is comparatively more efficient in producing computers as it costs only 0.2 units of rice compared to 2 units of rice in Australia. On the other hand, Australia is comparatively more efficient in producing rice as it only costs 0.5 units of computers compared to Japan's 5 units of computers.

- Australia has a comparative advantage in rice production.
- Japan has a comparative advantage in computer production.

By specialising in producing those goods in which they have a comparative advantage, total output can be increased as shown below:

Situation 1

Assume each country does not specialise but devotes 50 resources to both computer and rice production:

	Computers	Rice	Total units
Australia	200 × 50 = 10 000	400 × 50 = 20 000	30 000
Japan	500 × 50 = 25 000	100 × 50 = 5 000	30 000
Total	35 000	25 000	60 000

Situation 2

Assume each country specialises according to comparative advantage:

	Computers	Rice	Total
Australia		400 × 100 = 40 000	40 000
Japan	500 × 100 = 50 000		50 000
Total	50 000	40 000	90 000

Total production overall has increased. Computer output has increased by 15 000 units and rice output has increased by 15 000 units. The two countries can then trade computers for rice to get the output they want, as shown below:

Situation 3

Assume 15 000 computers are traded for 10 000 rice:

	Computers	Rice	Total
Australia	15 000	30 000	45 000
Japan	35 000	10 000	45 000
Total	50 000	40 000	90 000

Both countries have more of both products available to consume.

Activity 3

1 (a) Explain the principle of comparative advantage.

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(b) Why do countries have a comparative advantage in producing some goods compared to other countries?

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2. The table below shows the production possibilities for cars and butter for two countries:

	Cars	Butter
Country A	500	500
Country B	200	400

(a) Calculate the opportunity costs of producing 1 unit of cars and 1 unit of butter for each country and complete the table below:

	Cost of 1 unit of cars	Cost of 1 unit of butter
Country A		
Country B		

(b) Which goods should each country specialise in and why?

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Arguments for involvement in free trade

- Trade allows countries to specialise their production, leading to economies of scale which result in lower unit costs of production and greater output and employment. By having access to overseas markets, local firms are able to manufacture on a large scale. Mass-produced goods generally cost less to produce compared to manufacturing on a smaller scale. The car industry in Australia is an example.
- Specialisation and trade allows for an increase in the quality and quantity of goods and services as well as greater variety for consumers who may experience a rise in living standards.
- Workers in export industries tend to be better paid and have more secure jobs.
- Resources are allocated more efficiently, allowing firms to be more productive.
- Trade increases the competition for local firms, leading to lower consumer prices and higher real incomes. Competition also forces local businesses to adopt world best practices. The Australian car industry again provides an example.
- Increased competition also provides incentives for firms to use the latest technology and innovations in production.
- Lower costs for producers using imported components may lead to reduced inflation in Australia.

Benefits of international trade to Australia

- 1 in 5 jobs in Australia relies on exports, 1 in 4 jobs in regional Australia.
- Approximately 1.7 million jobs are directly or indirectly connected to the production of exports.
- Gains from more open trade have increased annual family income by $1000 on average each year since 1986.
- Trade accounts for almost 25% of Australia's total income.
- Exporting companies pay an additional $17 400 in higher wages on average.
- Exporting companies generate jobs, income and infrastructure throughout Australia.
- Trade widens Australia's markets and makes our income more diverse, reducing our vulnerability to global economic downturns.

Source of data: Department of Foreign Affairs and Trade, 2004

Arguments against involvement in free trade

Free international trade can have a number of disadvantages for individuals and economies:

- New firms may find it difficult to become established as they face high establishment costs and take time to develop a market and achieve economies of scale. Competition from cheap imports may force these new industries out of business before they can become established. This is sometimes known as the infant industry argument.
- In free trade the most efficient and competitive producers attract resources away from less efficient and competitive industries. This may cause structural unemployment and possibly the loss of key industries to some regions. An example is the textile, clothing and footwear (TCF) industry in Australia.

- Free trade may lead to negative externalities if a lack of government intervention means that firms do not have to pay for the consequences of their production such as pollution or environmental degradation.
- Countries that specialise according to comparative advantage may not diversify their production and may become dependent on a narrow economic base for production and exports. For example, countries that specialise in agricultural products may not have a high level of industrialisation, which means they are dependent on imports for manufactured goods.
- Countries that pursue free trade may experience an ongoing current account deficit if they are unable to finance import spending with export income. This may occur because the country lacks import competing industries or export income is variable or insufficient, particularly for agricultural products.
- Trade unions and human rights groups are concerned about exploitation of some people such as employees who face reduced working conditions when production is moved to countries with less protection for workers.

Activity 4

1. Summarise the arguments for and against free trade in the table below.

Arguments in favour of free trade	Arguments against free trade

2. Discuss which of these arguments you consider to be the most important. Do you think Australia should be involved in international trade or should we protect local industries?

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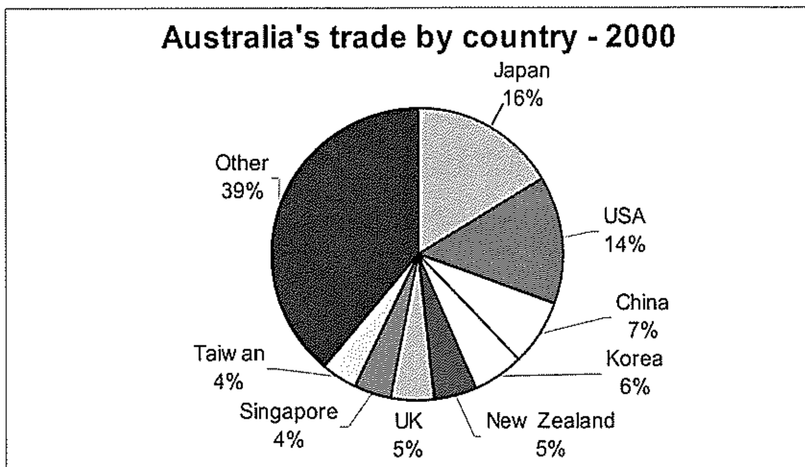

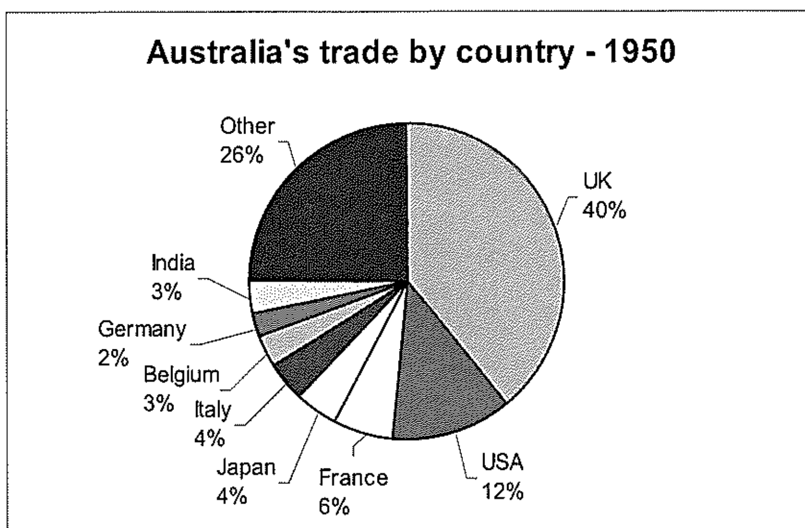

Source of data: Austrade: Merchandise Exports and Imports. One Hundred Years of Trade

(a) Compare the direction of Australia's trade in 1950 with that of 2000.

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(b) Give reasons for the changes noted.

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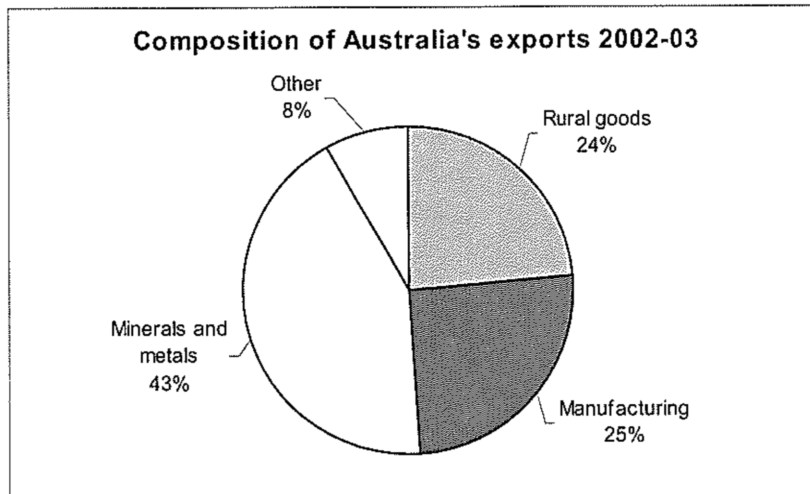
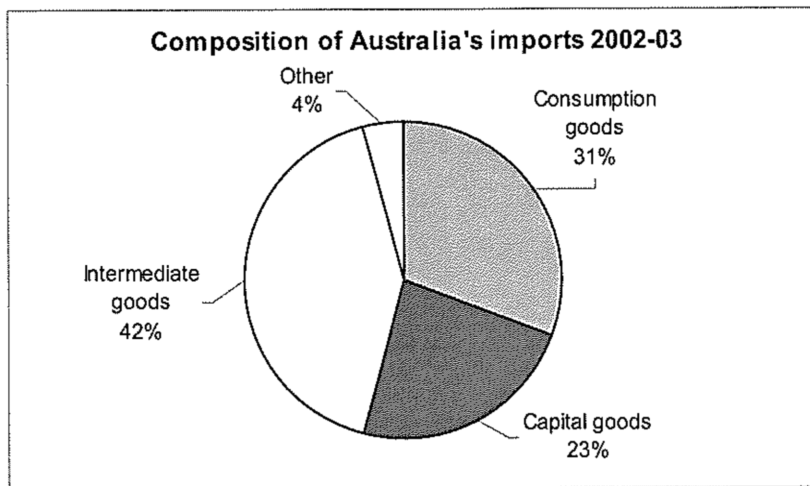
4. Comment on the composition of Australia's imports and exports.



Source of data: Australian Economic Indicators, February 2004



Source of data: Australian Economic Indicators, February 2004

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Activity 5: Review questions

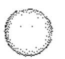
1. Globalisation:
   - J. means that high income economies account for a majority of world trade
   - K. means there is more economic competition due to there being less multinational companies
   - L. has only occurred in the last decade as trade barriers are reduced and technology improves
   - M. refers to the increasing integration of the world's economies.

2. The principle of comparative advantage is based on:
   - J. economies of scale
   - K. opportunity cost
   - L. absolute advantage
   - M. terms of trade.

3. A country that has a comparative advantage in the production of a good can produce that good:
   - J. using more resources than another country
   - K. using less resources than another country
   - L. more efficiently compared to another country
   - M. at a higher opportunity cost than another country.

4. A major advantage of free trade is:
   - J. new industries are more likely to become established
   - K. increased rates of economic growth and higher living standards
   - L. the government receives more tax revenue from tariffs
   - M. countries are more likely to diversify their production.

5. A potential problem of free trade is:
   - J. an increase in negative externalities from production
   - K. higher prices for consumers
   - L. an increase in efficiency of resource usage
   - M. economies of scale received by exporting businesses.



Protection

Read pages 139–150 of the textbook.

Despite the advantages of free trade, most governments impose some restraints on trade using protective measures. Protection is any action taken by governments to give domestic industries an artificial advantage over international competition.

Types of protection

The major forms of protection include:

- **Tariffs**

  Tariffs are taxes on imports. They make imported goods more expensive, so locally made goods are more easily able to compete. Tariffs have been the main method used to protect Australian industry, although the government now has a plan to reduce tariffs.

- **Quotas**

  Quotas are restrictions on the quantity of goods that can be imported. This gives locally made goods a bigger share of the market. Quotas are no longer used in Australia.

- **Embargos**

  An embargo is a total prohibition on the importation or exportation of a good. Generally, Australia uses embargoes to protect consumers (for example, there are embargoes on illegal drugs and firearms) or the environment (for example, there is an embargo on the export of native fauna). An embargo does give locally made goods the entire domestic market.

- **Subsidies**

  Subsidies are payments made to local producers to reduce their costs or increase their incomes. A subsidy allows local producers to sell their product at a lower price than they otherwise could, allowing them to compete with imports. Subsidies are being phased out.

- **Tariff quotas**

  This means a certain amount (or quota) of goods is allowed into the country at the normal tariff rate. Imports in excess of the quota are charged a higher tariff. All tariff quotas have been abolished.

- **Local content rules**

  Imported goods must have a specified quantity of locally made components. For example, imported cars may have to use Australian made engines.

Reasons for protection

There are a number of arguments put forward to justify protection. Most of them are difficult to sustain in an economic sense. The main arguments for protection (which are also the arguments against free trade) are as follows:

Infant industry argument

An infant industry is one in the initial stages of development. The argument is that these industries should be protected from cheaper imports while they are becoming established so that they can develop into internationally competitive industries. When this occurs the protection is removed.

What difficulties might the government be faced with in protecting infant industries?

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Protection of employment argument

This argument has especially been used in times of recession, as a way of reducing unemployment. The argument is that protection from overseas competition means that there will be more production and employment in local industries. Consumers have to pay higher prices, but this is preferable to rising unemployment.

Protection would increase production and employment in the protected industry, but what would be the effect on production and employment in other local industries?

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Balance of payments argument

Protection is sometimes justified as being necessary to reduce import spending and so reduce a current account deficit. However, diverting spending to local production from imports will encourage an inefficient use of resources and make exports less competitive.

What is the likely effect on the current account deficit if our trading partners retaliate with their own tariffs?

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Prevention of dumping

Dumping occurs when goods are exported at unrealistically low prices. This usually happens when there is an oversupply of a good and a country is willing to sell it at a low price, even below cost, rather than letting it go to waste. Protecting local industry from dumping is valid if local industry would be seriously damaged and the low prices were temporary with no long-term benefits. An example is the importation of Brazilian orange concentrate.

Keeping money in the coutry argument

This is a patriotic argument urging consumers to put their money into their own country, for example as seen in Buy Australian campaigns. However, the country is unlikely to benefit. Directing spending away from imports to local output tends to encourage inefficient local producers. Consumers will pay higher prices and all industries will face higher costs. In addition, buying imports gives foreign countries the ability to buy from us the goods we are best suited to produce, while we buy goods that can be made more efficiently by others.

Self-sufficiency argument

A country may protect important industries such as food and energy in order to be self-sufficient. This is an argument that may be justified in terms of national defence, if a country is prepared to accept lower total production overall. Also, a country may not want to be wholly dependent on a few export industries in case of sudden changes in price or demand. For example, agricultural exporters' incomes are vulnerable to drought or falling world prices. In this case a country may protect local industries to ensure a more diverse economy.

Activity 1

1. What is protection?

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2. Why do governments protect domestic industries from import competition?

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3. Distinguish between tariff and non-tariff barriers to free trade.

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4. Which arguments in favour of protection are economically justifiable?

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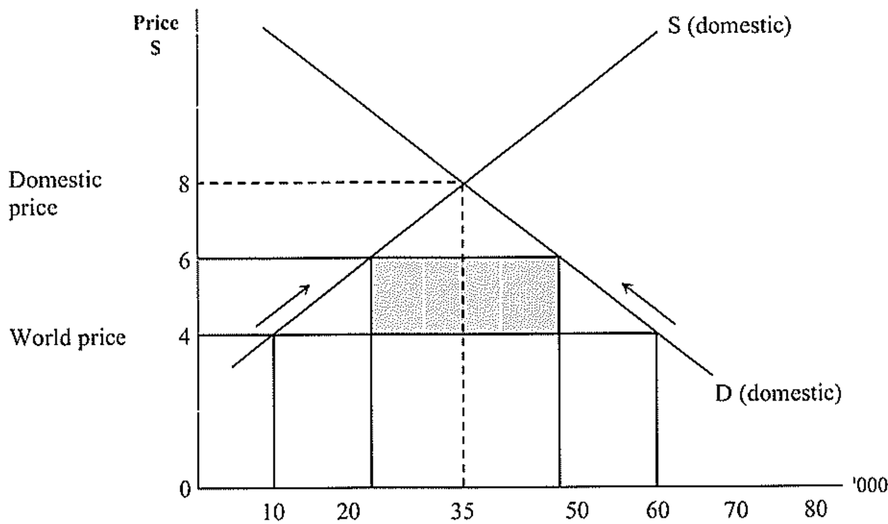
Effects of protection

Tariffs

Tariffs are taxes on imports that can be passed on, at least in part, to consumers as higher prices. The higher price makes the imported good less attractive to consumers compared with locally produced goods. Local producers can raise their prices and compete with imports to maintain a higher market share. Tariffs raise revenue for the government and cause resources to be reallocated away from efficient, competitive industries to inefficient, uncompetitive industries.

The effects of a tariff can be demonstrated on a demand-supply diagram as shown below:



The domestic demand and supply curves intersect to give an equilibrium price of $8 per unit and quantity 35 000. The world price is $4 per unit. At the world price of $4, domestic firms are only willing to supply 10 000 but consumers demand 60 000. The shortage of 50 000 is made up by imports.

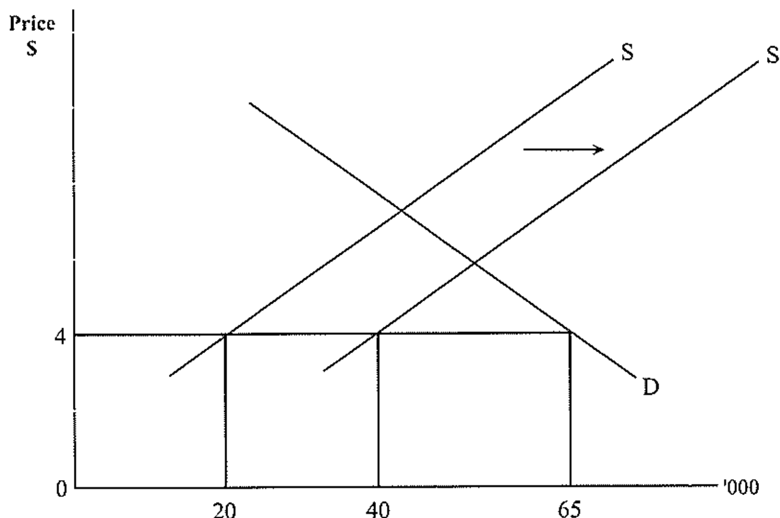
If the government imposes a tariff of $2 per unit, the new price becomes $6 per unit. At this price the amount supplied by domestic producers increases to 22 000. The quantity demanded will decrease from 60 000 to 48 000, so imports decrease to 30 000. The government receives taxation revenue equal to $2 × 30 000 = $60 000 as shown by the shaded rectangle.

Summarise the effects of a tariff below:

Price of good	
Quantity bought by consumers	
Quantity imported	
Quantity supplied by local producers	
Government tax revenue	
Redistribution of income	

Subsidies

Subsidies are payments to local producers to encourage supply in the face of import competition. Subsidies have the effect of reducing production costs in an industry. This means the supply curve will shift to the right as shown below:



The world price is $4 per unit. At this price, domestic producers are only willing to supply 20 000 but consumers demand 65 000. Imports are therefore 45 000. If the government pays domestic producers a subsidy, the supply curve shifts to S_1. Domestic producers are then willing to supply 40 000 and imports decrease to 25 000. Summarise the effects of a subsidy below:

Price of good	
Quantity bought by consumers	
Quantity imported	
Quantity supplied by local producers	

Subsidies are preferable to tariffs because they are paid from taxation, are more likely to be subject to review, and lead to lower prices. However, resources are reallocated away from taxpayers to a small sector of the economy. Also, all taxpayers contribute to subsidies, even if they do not use the imported good. Finally, subsidies increase government spending and may lead to higher taxes or lower spending in other areas.

Activity 2

1. Compare the effects of a tariff with those of a subsidy.

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2. What are the advantages and disadvantages of subsidies?

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Effects of protection

- Local industries gain as resources are able to raise prices, increase output and increase market share.
- Resource efficiency is affected as resources are reallocated away from efficient, competitive industries and into inefficient, uncompetitive industries.
- Employment and production grow in inefficient industries that usually supply only the domestic market and do not export to the world.
- Inflation may result, especially if tariffs are used, and flow on to domestic prices as local producers face higher costs from more expensive imports. Efficient industries may be less internationally competitive as a result.
- Consumers will suffer a fall in real incomes (that is, the total amount their incomes can buy) as they pay higher prices.
- Economic growth is less than its potential because resources are not being used efficiently in protected industries.
- Export earnings may be less than possible due to the lack of competitiveness of exporting firms and the tendency for protected industries not to export.
- Protected industries tend to use outdated work and management practices and suffer from low levels of productivity as they are not exposed to competition.

Protection overseas has had a significant impact on Australian industry. Agricultural subsidies used in Europe and by the USA in particular have affected Australia's farm exports. As an efficient wheat producer, Australia does not rely on wheat subsidies to be internationally competitive, unlike farmers in the USA and Europe. However, subsidies have reduced the world market price and restricted access to overseas markets for Australian farmers. As a result, Australian farmers have suffered lower export incomes.

Activity 3

1. Summarise the advantages and disadvantages of protection on the Australian economy in the table below.

Advantages	Disadvantages

2. Discuss whether you agree with industry protection or not.

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3. Read the article below and answer the questions that follow:

TCF industry continues to unravel

Clothing manufacturer Fletcher Jones yesterday announced the closure of its factories in South Australia and Victoria. The company is the latest example of decline in textile manufacturing. At its peak in the 1970s, the company employed about 1800 workers. Yesterday's closure leaves about 70 employees in Mt Gambier out of work. A spokesman for the company said they had found it too difficult to compete with cheap overseas imports.

A Textile, Clothing and Footwear Union official said that the Federal Government's commitment to lower tariffs had driven many companies to import stock from overseas and downsize local manufacturing or close altogether. He claimed that about a third of all retrenched textile, clothing and footwear workers never worked again, and another third had to settle for lower paid jobs.

(a) What problems associated with removing protection are illustrated in this article?

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(b) What would be the effect on regional economies such as Mt Gambier?

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(c) What would be the government's reasons for reducing tariff protection?

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Car industry wins reprieve

The government has announced an extension of the timetable for tariff cuts and a package worth $4 billion for Australia's car manufacturing industry. The plan is to keep the industry competitive until 2015 by keeping tariffs of 10% on foreign cars until 2010. Tariffs will then fall to 5% from 2010.

The Prime Minister said the plan, and the extra funding, would keep the country's automotive workers' jobs secure. He claimed the package did not conflict with the government's push for free trade as 5% tariffs were better than industry protection in other countries.

(d) What reason was given for further protection of the car manufacturing industry?

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(e) Why do you think a similar plan was not used for the textile, clothing and footwear industry?

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Activity 4: Review questions

1. Which of the following is an economic argument used to justify protection?
   - J. to maintain employment in protected industries
   - K. resources will be allocated more efficiently
   - L. consumers will have a greater variety of choice
   - M. total production will increase.

2. Which of the following methods of protection result in lower prices for consumers?
   - J. tariff
   - K. subsidy
   - L. quota
   - M. embargo.

3. Which of the following is the most likely consequence of a reduction in tariff levels?
   - J. higher prices
   - K. lower level of imports
   - L. more efficient allocation of resources
   - M. lower levels of structural unemployment.

4. One reason why governments might prefer tariffs rather than subsidies as a method of protection is:
   J. the price of imported goods will be lower
   K. unemployment will be higher
   L. the government will be better off financially
   M. inflation will be lower.

5. A reduction in tariff levels is likely to lead to:
   J. higher levels of employment and increased exports in the short term
   K. lower tax revenue to the government and higher prices
   L. lower prices and more efficient allocation of resources
   M. a lower current account deficit and improved standard of living.

6. Write an essay plan for the following question:
   (a) Evaluate the arguments used to justify the protection of local industry.
   (b) Discuss the potential gains from an increase in free trade.

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International trade agreements

Read pages 176–178 of the textbook.

Globalisation has increased the amount of international trade between countries around the world. The greater integration of most countries into the global economy has led to agreements being developed that aim to liberalise international trade by removing or reducing the barriers to free trade. There are two main types of trade agreement:

- Multilateral trade agreements. These involve a number of countries, for example agreements in the World Trade Organisation (WTO).
- Bilateral trade agreements. These are agreements between two countries only.

Groups of trading nations that form regional trading arrangements are sometimes known as trading blocs. There are three major trading blocs that dominate world trade. They are:

- The European Union (EU). In 2004 the EU consisted of 25 member countries, including the major economies of the UK, Germany and France. As well as free trade most countries share a common currency (the euro).
- The North American Free Trade Agreement (NAFTA) between the US, Canada and Mexico.
- The Association of South East Asian Nations (ASEAN), which formed a free trade area in 2003 for 10 countries in the South East Asian region. ASEAN is an important regional trade grouping for Australia as it is a major export market and source of imports. Australia's application to join was rejected in 2000. However, in 2004, ASEAN agreed to talks to consider an ASEAN/Australia/New Zealand free trade area.

Trade agreements involving Australia

World Trade Organisation (WTO)

The WTO is the only global organisation dealing with the rules of trade between countries. The WTO has nearly 150 members, accounting for over 97% of world trade. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible by reducing barriers to free trade. WTO agreements are negotiated by member countries. Australia, as a comparatively small economy, relies on WTO rules to achieve market access and better trading conditions for our exporters.

The WTO provides a forum for multilateral trade negotiations between member countries through rounds of talks. These negotiations are quite complex and can take several years. The Doha round of talks looking at agriculture and services started in 2001 and had a deadline to be completed by 1 January 2005.

The WTO also provides a dispute settlement system, where member countries can settle disputes either through negotiation or by a WTO ruling. For example, Australia used this system in 2001 to get the US to remove its tariff quotas on imported lamb, which had cost Australian exporters about $30m.

Asia Pacific Economic Cooperation (APEC)

APEC is a multilateral regional trade forum (rather than a trading bloc) which aims to promote freer trade among member countries. It was formed in 1989 and has 21 members, including the US, Japan, Russia, Canada, China and Australia. This group constitutes almost 40% of the world's population and accounts for around 50% of world GDP and 60% of world trade. This group also buys around 75% of Australia's exports.

APEC promotes trade and investment liberalisation in the region and supports multilateral trade negotiations in the WTO. Member countries meet annually to develop strategies for promoting growth and economic development in the Asia-Pacific region. Governments, business and industry also cooperate to reduce the barriers to trade and investment. In 1994, the group signed an agreement to remove trade barriers between member countries by 2020. Developed countries like Australia agreed to achieve free trade by 2010, while developing countries were given another ten years.

Bilateral trade agreements

Australia is a participant in a number of bilateral free trade agreements with other countries including:

- Australia New Zealand Closer Economic Relations Trade Agreement (also known as ANZCERTA or the CER agreement) which aims to eliminate trade barriers and encourage trade between the two nations.
- Singapore-Australia Free Trade Agreement (SAFTA) which eliminates tariffs and guarantees market access in certain areas.
- Thailand-Australia Free Trade Agreement (TAFTA) which removes Thailand's tariffs and quotas on Australian imports.
- United States-Australia Free Trade Agreement which provides for the removal of most tariffs on non-agricultural exports from Australia and improved access for Australian agriculture.

Australia is also working on trade negotiations with other countries including China, Japan, Egypt and Korea as well as the ASEAN group.

Activity 1

1. Distinguish between multilateral and bilateral trade agreements.

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2. Why are multilateral trade agreements considered to be more preferable than bilateral trade agreements?

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3. Investigate the outcome of the WTO Doha round of WTO trade talks.

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The effects of trade agreements on the Australian economy

Australia's participation in trade agreements is consistent with the benefits and costs of promoting free trade and the impact of reducing protection. While the main gains from trade liberalisation are likely to result from multilateral agreements, the negotiations and the implementation of them tend to be slow. For this reason Australia is also pursuing trade opportunities through regional groupings or bilateral trade agreements. While many people see advantages in these agreements, others argue there are disadvantages. These arguments are presented below.

Arguments in favour of trade agreements (benefits of trade agreements to the economy)

- **Increased market access for Australian exports**
  Australia has a relatively small market. Trade agreements provide access to overseas markets for Australian producers and increases our exports. For example, total trade in goods between Australia and New Zealand has increased by over 500% since the CER was signed in 1983. Higher export earnings contribute to higher levels of growth, production, income and employment. For example, the trade agreement with the US was estimated to increase Australia's GDP by $6bn after a decade and deliver an extra 30 000 jobs.
- **Stability and confidence in the business sector**
  Local firms are assured of cheaper access to essential imports used in production. Exporters gain access to overseas markets allowing them to expand production and develop economies of scale. Domestic companies are exposed to the latest technology and management practices, so investment is therefore encouraged.
- **Increased level of competition**
  Freer trade increases competition in both domestic and overseas markets, resulting in a greater variety of goods and services becoming available at lower prices. Standards of living should improve as a result. Increased competition also encourages domestic producers to allocate resources more efficiently and adopt world's best standards of practice.
- **National security**
  Trade agreements strengthen national security because countries which have trade links are more likely to support each other in times of external threat.

Arguments against trade agreements (costs of trade agreements to the economy)

- **Effects on import-replacement industries**
  Industries that compete with imports which have high levels of protection reduced or removed may not be able to compete. Firms in these industries may close or face high adjustment costs to survive.
- **Structural unemployment**
  Jobs may be lost in some sectors that are unable to compete due to lower protection levels. The structural unemployment that may result may mean that financial assistance is required from the government.

- **Trade diversion rather than trade creation**
  The benefits of free trade only occur if trade agreements create new trade rather than just diverting trade away from more efficient producers. Trade diversion occurs when member countries are not the most efficient producers of a good. The trade agreement may mean that a country is locked into buying from a less efficient producer rather than trading with a more efficient country which is outside the agreement.
- **Increased complexity in international trade**
  A large number of bilateral trade agreements increase the complexity of international trade and can increase transaction costs for business as they comply with different rules.

Note: The greatest benefits of free trade come from multilateral trade liberalisation. However, bilateral trade agreements are easier to negotiate and deliver gains more quickly, so countries are more likely to participate in them. As a result, resources may be diverted away from multilateral negotiations and the greater benefits are lost or delayed.

Activity 2

1. Summarise the effects of international trade agreements on the Australian economy in the table below:

Advantages	Disadvantages

2. Discuss which of these arguments are the most important and whether you think Australia should be involved in trade agreements.

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Multinational corporations and foreign investment

Globalisation includes not just an increase in international trade but also in foreign investment as many governments reduce barriers to entry into their capital markets. Foreign investment involves the residents of one country owning assets in another country. There are two types:

- Direct investment occurs when a business is established, taken over or expanded overseas. It is generally long term in nature.
- Portfolio investment involves the purchase of shares or bonds to make a profit. It is generally short term in nature and volatile. As financial markets become more open to the world economy, capital flows have increased as savers in one country invest in foreign financial assets such as shares or loans.

A major reason for the increase in foreign direct investment has come from the growth in multinational (or transnational) corporations. A multinational corporation is a company with operations located in more than one country. An example is General Electric which is a diversified technology, media and financial services company. It operates in more than 100 countries and employs more than 300 000 people worldwide. Another example is BHP Billiton, an Australian resources company with 35 000 employees working in more than 100 operations in approximately 20 countries.

Over the past decade, firms based in one country have increasingly made investments to establish and run business operations in other countries. The increasing level of financial openness in many countries saw foreign investment rise from $US324 billion in 1995 to about $US1.5 trillion in 2000. There are estimated to be about 65 000 multinational companies worldwide employing over 50 million people. Many of the largest multinational companies have sales greater than the value of many countries' GDP as shown in the table below:

Country or corporation	GDP or Total revenues ($USbn, 2002)
United States	10 383
Japan	3 993
United Kingdom	1 566
China	1 266
Australia	409
Wal-Mart Stores	218
Norway	190
ExxonMobil	188
General Motors	177
BP	174
Indonesia	173
Ford Motor	162
DaimlerChrysler	137
Royal Dutch Shell	135
Greece	133
Thailand	127
General Electric	127
Ireland	124
South Africa	104
Philippines	78
New Zealand	59

Source of data: UNDP Human Development Statistics, Forbes Magazine Global 500

Effects of multinational companies and foreign investment

Advantages

Multinational companies and foreign investment, particularly direct investment, have provided a number of advantages for the recipient country:

- Foreign investment inflows can raise domestic investment, allowing that country to develop resources and industries that otherwise might remain undeveloped. This is an especially important source of finance for poor countries.
- Foreign investment allows the recipient country to increase its productive capacity without using savings. Again, this is important for poor countries who may have a low level of savings anyway.
- Foreign investment provides employment opportunities and training for local workers. Multinational companies also tend to pay higher wages than local businesses.
- Foreign investment can also result in the transfer of technology. This is particularly important for poor countries that are unable to develop new technology themselves.

Disadvantages

Multinational companies and foreign investment, especially portfolio investment, have a number of disadvantages as well:

- When foreigners invest they gain control over that country's resources. They may make decisions that are not necessarily in the best interests of the recipient country. For example, if a multinational company decides to close down a company in another country, there will be unemployed workers in that country.
- Profits and dividends paid to the foreign investor may cause a deficit on the current account of the recipient country.
- Many countries compete to attract foreign investment using financial incentives, particularly as multinational companies can play off one country against another to gain extra concessions. However, these incentives may reduce the benefits from foreign investment, for example tax concessions, resulting in lost taxation revenue for the government. Also, there is some concern that as countries compete for investment they may lower their standards in relation to the environment or worker conditions. This so-called 'race to the bottom' may lead to exploitation of workers and the environment, causing pollution and the depletion of non-renewable resources.
- Multinational companies have been blamed for taking advantage of the lack of regulation in some developing countries. This has led to the location of polluting industries in poor countries, the depletion of natural resources and the production of harmful chemicals.
- Multinationals have also been criticised for exploiting workers in countries that do not give workers the right to organise unions to represent them or which allow child labour. As a result wages and working conditions are poor.
- Increased capital mobility has sometimes resulted in excessive inflows or outflows of finance for a country, particularly for portfolio investment. This can have a significant impact on exchange rates and financial systems. An example was the Asian financial crisis of 1997, when Western investors lost confidence in Asia and pulled money out, triggering the collapse of the currencies of Thailand, Indonesia and Korea. Each economy applied for emergency financial assistance from the International Monetary Fund (IMF) as a result.

Activity 3

1. (a) Distinguish between direct and portfolio investment.

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(b) Why is portfolio investment more likely to be short term and volatile?

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2. (a) Explain what is meant by a multinational company, giving some examples.

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(b) Give some reasons for the large increase in the number of multinational companies in recent years.

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3. Summarise the advantages and disadvantages of foreign investment in the table below:

Advantages	Disadvantages

International organisations affecting trade and investment

World Bank

The World Bank is not a 'bank' in the common sense. It is one of the United Nations' specialised agencies, and is made up of 184 member countries. These countries are jointly responsible for how the institution is financed and how its money is spent. The World Bank is one of the world's largest sources of funding and knowledge for developing countries. Its aim is to help developing countries reduce poverty, increase economic growth and improve their quality of life. The Bank works with over 100 countries in a variety of different areas. They support projects that allow developing countries to:

- invest in health and education
- fight corruption
- increase agricultural production
- construct roads and ports
- protect the environment.

In 2002, the Bank approved $19.5bn in loans and grants for 229 projects. Middle income economies receive loans at a low rate of interest and with long repayment periods. Poorer countries may receive grants or loans at no interest rate. Loans are negotiated with the Bank and must have specific development goals, such as poverty reduction.

An example of a World Bank project was the $50m loan given to the Chinese government in 1992 to help control the spread of tuberculosis disease (TB). The money was used to buy low cost, high quality drugs, train staff and diagnose and treat TB patients. By 2000 the program had diagnosed and cured nearly 1.2m infectious TB patients.

More information about the World Bank and its activities can be found at its web site at www.worldbank.org

International Monetary Fund (IMF)

The International Monetary Fund is another specialised agency of the United Nations. It was established in 1945 to help promote the health of the world economy. It has a membership of 184 countries. The IMF is responsible for ensuring the stability of the international monetary and financial system – the system of international payments and exchange rates among national currencies that enables trade to take place between countries. The Fund seeks to:

- promote economic stability and prevent crises
- help resolve crises when they do occur
- promote growth and alleviate poverty.

In the event that member countries do experience difficulties financing their balance of payments, the IMF is also a fund that can be used to help in recovery. Financial assistance is available to give member countries the time they need to correct balance of payments problems. A policy program supported by IMF financing is designed by the national authorities in close cooperation with the IMF, and continued financial support is conditional on effective implementation of this program.

A recent example of IMF assistance was in 1997 when a rescue package of $US60bn was made available to Indonesia after their currency collapsed. The money was given in return for the implementation of a number of economic reforms by the Indonesian government.

More information about the IMF can be found at its web site at www.imf.org

Note: Both the IMF and the World Bank have been criticised by developing countries for the conditions they have imposed on assistance given. They argue that these conditions mean a loss of control by the developing countries over economic policy or how funds are spent. Since the IMF and the World Bank usually require developing countries to implement structural changes in their economies to receive assistance, and both are controlled by developed countries, many developing countries have interpreted their policies as undermining their national sovereignty.

Another criticism of both the IMF and World Bank is that they are not doing enough to alleviate poverty, and may in fact be contributing to it by giving poor countries loans which they are unable to repay. Many poor countries face massive debts that prevent or restrict their ability to develop. In some cases they have had to reduce spending on things like health, education and development to concentrate on debt repayment. Critics have argued that poor countries should have their debts to international banks excused. In response, the World Bank and the IMF are collaborating on a scheme to reduce the excessive debt burdens faced by many poor countries.

Organisation for Economic Cooperation and Development (OECD)

The OECD has 30 member countries, including all 23 industrialised economies (which includes Australia). Its main aim is to promote high levels of sustainable economic growth and rising living standards in member countries as well as contributing to world economic development. It supports the multilateral trading system of the WTO and promotes freer trade.

More information about the OECD, as well as economic statistics and information can be found on their web site at www.oecd.org

Activity 4:

1. (a) Outline the roles of the World Bank and the IMF.

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(b) Why have both organisations been criticised by developing countries?

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Activity 5: Review questions

1. The World Trade Organisation trade agreements are an example of a:
   J. regional trade agreement
   K. bilateral trade agreement
   L. free trade agreement
   M. multilateral trade agreement.

2. One of the criticisms about trade agreements is that they:
   J. may threaten national security
   K. decrease the level of competition faced by manufacturers
   L. restrict access to overseas markets for Australian producers
   M. are likely to increase the level of unemployment in some areas.

3. Direct foreign investment:
   J. tends to be short term and volatile
   K. has increased significantly in recent years largely due to the growth in multinational corporations
   L. is likely to decrease the standard of living in developing countries
   M. only occurs in developed countries.

4. A possible problem with foreign investment is that:
   J. some countries may be destabilised by large changes in flows of capital
   K. the country receiving the capital will have to run down its savings
   L. job opportunities for local workers may be lost
   M. the receiving country may be unable to increase its productive capacity.

5. The World Bank and IMF have been criticised because:
   J. they won't assist countries experiencing balance of payments problems
   K. the majority of their assistance is directed towards developed nations
   L. they impose conditions when they provide assistance to developing countries
   M. of the costs of becoming a member.