STRUCTURAL CHANGE IN GLOBAL, NATIONAL AND REGIONAL ECONOMIES

A Lecture Programme delivered at the Technical University of Košice

Andrew Harrison
Formerly of Teesside University, United Kingdom

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Andrew Harrison's Brief Biography

Andrew Harrison was a Principal Lecturer and Subject Group Leader in Economics at Teesside University until August 2010 and has been a visiting lecturer at the Technical University of Košice since April 1993. He has also been a visiting lecturer in Germany, Ukraine and Singapore. Since leaving the full-time staff of Teesside University, he has continued to work as an occasional lecturer and as an external examiner at two other UK universities. He holds qualifications from London, Salford and Leeds Universities and Trinity College of Music, London. In April 2008, he was awarded the degree of Doctor Honoris Causa by the Technical University of Košice. He is married to Heather and has two grown-up children, David and Rachel. In his spare time he is a keen amateur pianist and organist.

Brief Course Description

We live in a world of continual political and economic change. Of course, change is not a new phenomenon but the pace of change seems to be accelerating. In this short lecture programme, we explore some of the major historical and current trends in the development of the global economy and also the way in which these changes affect the status and structure of national and regional economies. The lecture programme will focus especially on changes in the relative importance of countries and their industrial sectors, making use of ideas and concepts from the economics of globalization, development economics, regional economics, industrial economics, historical macroeconomic analysis and related fields. This type of analysis helps to shed light on the nature of change in the global economy and the implications for individual countries.

Preparation for the Examination

There will be a written examination based on this lecture programme. It will last **ONE HOUR** only and the examination will include four questions based on the following four topics:

1. The changing future balance of world political and economic power.

2. The structure of the global economy.

3. The structure of national economies.

4. The structure of the regional economy in Slovakia.

You will be required to answer **TWO** questions only. Further information will be given during the lecture programme.

LECTURE PROGRAMME

1. Globalization and the Changing World Order

Globalization is connecting the world's economies, but countries do not of course play an equal role in this process. Throughout much of the period since 1945, international business activity has been dominated by the Triad: North America, Western Europe, and Japan. The relative importance of these economies has changed over time, but even today the Triad account for just over half of world merchandise exports, almost two thirds of world exports of commercial services, and just over 80 percent of world FDI outflows. The dominant position of the Triad in world economic activity is gradually declining, but it would be premature to suggest that these countries are no longer important. What is clear, however, is that countries like China and India are becoming gradually more important in the world economy. In 2001, Goldman Sachs coined the term 'BRIC' to describe the world's four largest emerging economies, Brazil, Russia, India, and China. These economies have all been growing rapidly and, in a subsequent paper, Goldman Sachs estimated that by 2039 the BRIC economies may have overtaken the G6 (France, Germany, Italy, Japan, UK, and USA) and that by 2050 they were likely to be the world's largest group of economies by a considerable margin.

Of course, these projections depend on the BRICs' ability to sustain something like their recent economic growth performance for the next thirty or forty years, but even if the projections are optimistic, there is likely to be change in the balance of economic power during the first half of the twenty-first century. Arguably, China is already beginning to assume a more prominent role, having become the world's second largest economy and largest exporter of merchandise goods, and having survived the 2008-9 world recession in a stronger economic and financial position than any of the Triad countries. Other countries beyond the BRICs could also be considered to be potential economic leaders of the future. Goldman Sachs have proposed a further list of eleven large emerging economies with growth potential, described as the Next Eleven (N-11) – Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, Philippines, Turkey, South, and Vietnam – though apart from South Korea and Mexico , these countries are generally less developed. The term 'EAGLEs' has also been suggested to describe the 'emerging and growth-leading economies' of the next few years (including Brazil, China, Egypt, India, Indonesia, South Korea, Mexico, Russia, Taiwan, and Turkey), though recent developments in Egypt following the Arab uprising in early 2011 and slow recovery from the world recession may necessitate a re-evaluation of this view. It should also be recognized that most of these economies, including the BRICs, although large, will have considerably lower GDP per capita than the Triad even in 2050.

The world political order has been somewhat different. The post-war settlement left the world divided between the North Atlantic Treaty Alliance (NATO), led by the United States, and the Warsaw Pact countries, led by the USSR. This bi-polar world order continued until the collapse of the Soviet Union in 1991. Since then, the United States has been dominant politically and militarily. For the United States, political power has been reinforced by economic power, but this was not the case with the Soviet Union, whose economic power was largely confined to the group of countries in its own sphere of influence, mainly in Central and Eastern Europe. Since 1991, not only has the United States confirmed its political and economic position, but some of the countries formerly under Soviet influence have joined NATO and the European Union. Whilst NATO's role is now less clear than it was during the cold war, the EU has become a powerful economic force alongside the United States. This is not, however, true to the same extent in the political sphere, except perhaps in relation to their influence over trade policy at the WTO.

How long the US unipolar world order will continue is uncertain. It is clear that China is now becoming a significant economic power and, despite its current reluctance to play a global role comparable to that of the United States, it is likely that Chinese political influence will gradually increase over the coming years. The extent to which China will be joined by the other BRIC countries or other emerging economies to create a multi-polar world order is less clear. What is clearer, however, is that the world political and economic order is likely to change significantly during the next few decades. This has potentially huge implications for international economic activity, the policies of the major international institutions, and the relative importance of different regions of the world. This emerging scenario is illustrated below.

Figure 1: The Changing World Order: An Emerging Scenario

Key Dates	**Global Governance: Key International Institutions**	**Political Power: Key Countries and Groupings**	**Economic Power: Key Countries and Groupings**
1945 End of World War II	United Nations, IMF, World Bank G7 (1975/76)	Bipolar world: USA (Nato), USSR (Warsaw Pact)	Triad: N. America, W. Europe, Japan
1991 End of the 'Cold War'	United Nations, IMF, World Bank, WTO (1995) G7/G8 (1997) G20 (1999)	Unipolar world: USA	USA, EU, Japan
2012 Slow recovery from world recession	United Nations, IMF, World Bank, G20 G7/G8?	USA (end of unipolar world?) Growing influence of China (and BRIC?)	USA, China, EU, Japan?
2050 A new order?	New institutional arrangements?	Multipular world? USA, China, India, Russia, Brazil, Others ?	China/BRIC, USA, EU, Japan (?), Others?

2. The International Political Context

Post-World War II international relations were dominated by the 'cold war' between the world's two superpowers, the United States and the USSR. This east-west political divide led to a build up of military power and periodic tensions between the two sides. It also created two separate economic spheres, one where the United States traded mainly with its partners in Western Europe and Japan (sometimes known as the 'Triad'), the other where the USSR and its satellite states traded in the CMEA area that was largely cut off from the rest of the world. Most of the world's economic activity was dominated by the Triad, while the economies of the Soviet bloc gradually fell behind. Even in 2008 the Triad accounted for a significant share of world and foreign direct investment.

However, a number of other events have had a major impact on the international business environment since the 1980s. The collapse of communism in the Soviet bloc, at the end of 1989 in much of Eastern Europe and in 1991 in the USSR, brought about the end of the cold war. These events were accompanied by a wave of optimism as old enmities were forgotten and the 'iron curtain' between east and west was torn down. On 9th November 1989 the fall of the Berlin Wall, which had divided East and West Berlin since 1961, came to symbolise the reuniting of Eastern and Western Europe. The end of almost seventy-five years of

communism in the USSR, or over forty years in most of Eastern Europe, would have been unimaginable only a few years earlier.

The period of optimism that followed the end of the cold war brought democracy to much of the former Soviet bloc, enthusiastically in western Europe's closest neighbours such as Poland or the former Czechoslovakia, more reluctantly in many of the former Soviet republics like Belarus or Kazakhstan. The 1990s also witnessed a transition from state planned economies to market economies in this region. Most of the Central European states, as we now call them, and the three Baltic republics that were formerly part of the USSR have made relatively good progress and joined the EU in 2004. Most of the other former Soviet republics have made more faltering progress, though after a difficult initial transition in the 1990s the Russian economy grew much faster during the 2000s.

Even before the collapse of Soviet communism, China had already embarked on its policy of economic reform in 1978 after Deng Xiaoping came to power. China's 'economic revolution' has been more gradual than Central and Eastern Europe's, but its impact on international business has been more significant. Both these developments have led to the opening up of important regions of the world that had been largely closed to international business during most of the post-World War II years. The opening up of Central and Eastern Europe also brought political fragmentation and the creation of new states such as Slovakia and Slovenia. The new political map of the world is also changing the patterns of international business activity.

Along with these events, several East and Southeast Asian developing countries (formerly known as the 'tiger economies') have been expanding rapidly since the 1980s and 1990s, or earlier in the case of South Korea. In Vietnam's case, a communist country has achieved rapid economic growth by following China's example in introducing gradual market reforms. Economic development in Latin America has been more fitful, though Mexico and Brazil have been attracting large amounts of foreign investment since the 1990s, along with Argentina until its financial crisis came to a head in December 2001. On the other hand, the world's least developed countries, many of them in Africa, have been lagging behind. These countries are not excluded from international business but they have been unable to enjoy many of the benefits in terms of their economic development.

The emerging economies of Central and Eastern Europe, Asia and Latin America, together with the renewed vitality of the US economy in the 1990s, all contributed to a massive growth in international trade and investment and an acceleration of the forces of globalization up to the year 2000. Optimism rarely lasts indefinitely, however. Even before globalization had apparently reached its peak, the chorus of 'anti-globalization' protestors was becoming more audible. Protest groups, from anti-capitalists to environmentalists and campaigners against Third World poverty, were berating multinational companies and rich nations for the perceived inequalities and injustices of the world trading system. This pessimism was soon accompanied by a slowdown in world economic growth and the collapse of 'new economy' share prices and businesses at the end of 2000 and beginning of 2001. World trade fell briefly in 2001 then quickly recovered. Foreign direct investment took longer to recover after falling in 2001-03 but gradually began to grow as investor confidence returned in 2004.

Pessimism took hold in earnest after the terrorist attacks of '9/11' (September 11th 2001). Despite the relative resilience of the world economy, 9/11 signified a growing divide between the Islamic and western worlds. Although most Muslims condemn the atrocities of 9/11, there has been increasing awareness of a rift between western and Muslim perceptions of the world. There was a measure of tolerance for the US-led retaliatory invasion of Afghanistan in October 2001, but Muslims were almost universally opposed to the invasion of Iraq in March 2003. The tensions that underlie these differences are deep-rooted, especially

Muslim perceptions of the west's role in the failure to find a solution to the Palestinian question in the Middle East. The events that began with 9/11 have brought these tensions to the surface.

The period since the end of the cold war has given rise to two main alternative interpretations of world events: Francis Fukuyama's view of the 'end of history' and Samuel Huntington's 'clash of civilizations'. Fukuyama argues that democratic capitalism has triumphed and that successful states will gradually adopt this system, while Huntington is more sanguine about the difficulties that will accompany the resurgence of diverse civilizations. International business flourished under post-cold war optimism in the 1990s and has remained remarkably resilient during the tense years that followed 2001. Most of the indicators of international business activity have been healthy. National governments and international institutions have also been more supportive towards international business in recent years, though the regulatory environment has become more complicated. International relations are rarely straightforward, but the years since the end of the cold war have added new dimensions to our study of the international business environment.

Practical Insight 1: The end of the 'Iron Curtain'

November 1989 was a key moment in twentieth century history. After the devastation of two world wars in the first half of the century and the cold war for much of the second half, the opening up of Eastern Europe and thawing of relations between east and west was remarkable by any standards. The speed with which borders were opened, governments fell, and democratic change was introduced could hardly have been imagined even a few months earlier. This was not, of course, the only geopolitical change that was occurring during this period as China and other regions were also opening up, but the end of communism in Eastern Europe was more dramatic and almost immediately heralded a new era in international relations. Since 1989, Russia and the other transition economies have had mixed fortunes politically and economically, as might be expected when undertaking such a major transition. They have also formed new political alliances with organizations such as the EU, NATO, or the Commonwealth of Independent States (CIS).

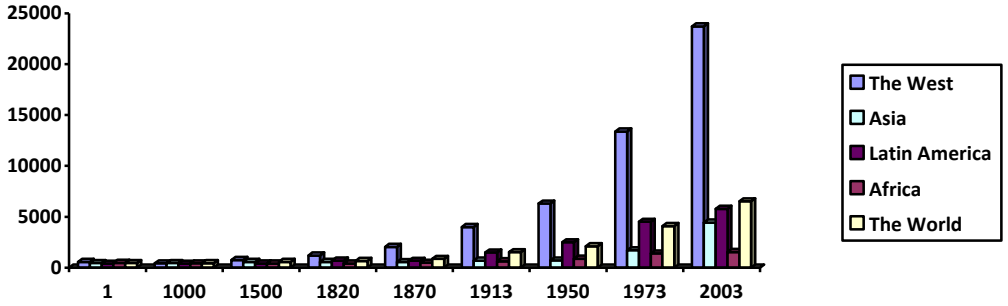
Question: What are the main implications of the end of communism in Eastern Europe for the international business environment?

3. A Historical Perspective on Economic Development

Economic development is closely related to the development of technology and the improvements in productivity that often accompany technological development. Technological developments have occurred throughout history. Even in prehistoric times primitive tools made out of stone, wood, and other natural materials represented the technology of a particular period. However, in modern times, the most productive period of technological development dates from the late eighteenth century to the present time. This period has been the most productive, not so much because of the number of inventions (which has been significant), but more especially because of the impact of technological developments on productivity, GDP, and GDP per capita. The early part of this period, from the late eighteenth to the mid-nineteenth century is often described as the 'Industrial Revolution', which began in Britain, then spread to other parts of Europe and North America. The most significant aspect of this period, and indeed the period that followed the Industrial Revolution, is that technological and organizational change led to sustained economic growth and continual improvements in the standard of living in the countries concerned.

For centuries technological innovation had led to temporary or minor improvements in living standards, but these benefits had generally been cancelled out by conflict or population increases, leaving the majority of people little better off. This is starkly illustrated in Figure 2, which is based on Angus Maddison's estimates of GDP per capita from the year 1-2003AD. According to Maddison, world GDP per capita was only about half as much again in 1820 as it had been in the year 1 AD; this represents remarkably little economic progress during most of the first two Millennia AD. The rate of increase was marginally higher in the West (mainly Europe and North America), but Africa was slightly poorer in 1820 than it had been eighteen hundred years previously. By 2003, however, GDP per capita was almost twenty times higher in the West, the cradle of the industrial revolution, than it had been in 1820. Latin America and Asia lagged behind, though their GDP per capita had grown significantly by the end of the twentieth century. African GDP per capita was about three and half times higher in 2003 than it had been in 1820, though some individual African countries experienced little, if any, improvement over this period. These statistics illustrate the dramatic change that occurred after the onset of the industrial revolution, particularly in the West, and also the way in which some parts of the world have been left behind.

Figure 2: GDP per capita, Major Regions and the World, 1-2003AD



Source: Maddison, A. (2007), Contours of the World Economy, 1-2030AD, Oxford University Press, Table 2.1, p. 70. The vertical scale represents 'International Dollars' valued at 1990 prices.

4. Nature and Patterns of International Business Activity

4.1 The Location of Business Activity

For much of the latter half of the twentieth century international business activity was predominantly based in the Triad countries of North America, Western Europe and Japan. At the beginning of the twenty-first century this is still broadly true, though the Triad are now being joined by some of the other East Asian countries, notably China and South Korea, and gradually by India and the larger Latin American countries, especially Brazil and Mexico. Most of these countries are developing countries, as can be seen by their GDP per capita in Table 1, but their economies are large.

Using the purchasing power parity method of measuring GDP, China, India, Brazil and Russia were among the ten largest economies in the world in 2008 (see table 5.1). However, it would be wrong to suggest that they have almost caught up with the world's leading economies as their economic wealth is consumed by large populations, leaving them well behind in terms of their standard of living. Nevertheless, as locations of economic activity, these countries are becoming increasingly significant. Given their generally faster rates of economic growth, they are also gradually converging with the richer economies. This

is especially true in the case of China and, to a lesser extent India. Brazil has a large economy but has been growing more slowly and Russia has been recovering its position after a period of economic decline during most of the 1990s.

Until recently, much of the world's international business activity was located in North America, Western Europe and Japan. These countries are still the richest nations but their dominance is gradually being challenged by the emerging economies of Asia and Latin America (see Practical Insight 2).

Table 1: The world's leading economies, 2011

Rank	Country	GDP ppp basis ($ billion)	GDP current prices ($ billion)	GDP per capita ppp basis ($)	Annual Average GDP Growth Rates (%) 2000-8	2008-11
1	United States	15094	15094	48387	2.3	0.4
2	China	11300	7298	8382	10.4	9.6
3	India	4458	1676	3694	7.0	8.1
4	Japan	4440	5869	34740	1.2	-0.6
5	Germany	3099	3577	37897	1.6	0.5
6	Russia	2383	1850	16736	7.0	0.3
7	Brazil	2294	2493	11769	3.7	3.3
8	United Kingdom	2261	2418	36090	2.6	-0.5
9	France	2218	2776	35156	1.8	0.2
10	Italy	1847	2199	30464	1.3	-0.6

Source: IMF World Economic Outlook Database, April 2012

Practical Insight 2: The G20 London Summit

In April 2009, leaders of nineteen of the world's most important economies, together with representatives of the European Union, met in London to agree a coordinated response to the 2008-9 financial crisis and world recession. The communiqué issued at the end of the summit indicated an agreed commitment to restore confidence in the financial system and the world economy, promote trade and invest, and avoid protectionism, as well as to work towards an 'inclusive, green, and sustainable recovery'. The summit was remarkable in that there was apparently a willingness to take shared responsibility for the problems facing the world economy and, beyond that, to adopt a broadly liberal economic consensus while taking account of environmental and other concerns. It also represented an important landmark in that the common sense of purpose was shared by developed and developing countries alike and countries like China and Brazil shared a platform with the United States.

Question: Does such a gathering suggest that the locus of international economic power is gradually shifting towards countries like China and Brazil?

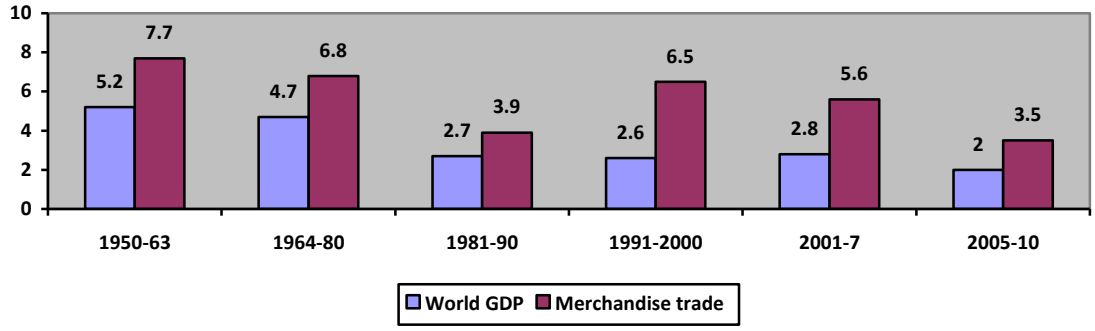
4.2 International Trade

For many centuries international trade has been the mainstay of cross-border business activity. In terms of the value of world exports and imports this is still true today, though international trade's share of international business activity has declined as foreign direct investment and other international market entry strategies have become more popular. Despite this, there has been a persistent increase in the proportion of world output traded internationally since the 1950s (see figure 3). Between 1950 and 1990 the rate of increase in

trade was on average half as much again as the rate of increase in world GDP. In the 1990s the increase in trade was about two and half times the increase in output, from 2001-07 it was twice as much, despite the world slowdown in 2001, and from 2005-10 merchandise exports exceeded world GDP by 75 per cent.

The increase in trade during the post-war years may be attributable to a period of relative peace and stability among the major trading nations, to a general reduction in trade barriers (encouraged by GATT and the World Trade Organization), and to the exchange rate stability and trade financing facilities of the IMF, among other factors. However, there was a marked increase in the proportion of goods traded after 1990. This corresponds with the opening up of China and Central and Eastern Europe, as well as the rapid development of information and communication technology which has largely eliminated distance as a barrier to international business. Indeed, it was about this time that the term 'globalization' started to come into widespread use.

Figure 3: World Production and Merchandise Exports, 1950-2010
(Average Annual Change in Volume, %)



Source: WTO International Trade Statistics 2008, table A1, p. 174 and WTO International Trade Statistics 2011, table I.1, p. 19

Table 2: World Merchandise Exports by Region and Selected Economy, 1948-2010

	1948	1953	1963	1973	1983	1993	2003	2010
	Exports ($ billion)							
World	59	84	157	579	1838	3675	7377	14851
	Share of World Exports (%)							
N. America	28.1	24.8	19.9	17.3	16.8	18.0	15.8	13.2
United States	21.7	18.8	14.9	12.3	11.2	12.6	9.8	8.6
S. & C. America	11.3	9.7	6.4	4.3	4.4	3.0	3.0	3.9
Brazil	2.0	1.8	0.9	1.1	1.2	1.0	1.0	1.4
Europe	35.1	39.4	47.8	50.9	43.5	45.4	45.9	37.9
Germany[a]	1.4	5.3	9.3	11.7	9.2	10.3	10.2	8.5
CIS	-	-	-	-	-	1.5	2.6	4.0
Africa	7.3	6.5	5.7	4.8	4.5	2.5	2.4	3.4
Middle East	2.0	2.7	3.2	4.1	6.8	3.5	4.1	6.0
Asia	14.0	13.4	12.5	14.9	19.1	26.1	26.2	31.6
China	0.9	1.2	1.3	1.0	1.2	2.5	5.9	10.6
Japan	0.4	1.5	3.5	6.4	8.0	9.9	6.4	5.2
India	2.2	1.3	1.0	0.5	0.5	0.6	0.8	1.5

a. Federal Republic of Germany from 1948-83
Source: WTO International Trade Statistics 2011, table 1.6, p. 22

The relative importance of international trade to different countries and regions can be seen in Table 2, as well as the massive increase in the value of world exports since World War II. Although US exports have been increasing, its share of world exports has declined as Europe's and especially Asia's shares have increased. In Europe's case the growth reflects its post-war recovery and the success of the European Union in generating intra-EU trade. In Asia's case, the growth is a reflection of the rapid development of China and the South-East Asian tiger economies. It is also worth noting that international trade is still dominated by the North America and Europe, including some of the smaller European countries, though China and South Korea have risen up the rankings in the recent years (see table 3).

Table 3: Leading Exporters and Importers in World Merchandise Trade, 2010

Rank	Exporters	Value ($ bn)	Share (%)	Rank	Importers	Value ($ bn)	Share (%)
1	China	1578	10.4	1	United States	1969	12.8
2	United States	1278	8.4	2	China	1395	9.1
3	Germany	1269	8.3	3	Germany	1067	6.9
4	Japan	770	5.1	4	Japan	695	4.5
5	Netherlands	573	3.8	5	France	606	3.9
6	France	521	3.4	6	United Kingdom	560	3.6
7	Korea, Rep. of	466	3.1	7	Netherlands	517	3.4
8	Italy	448	2.9	8	Italy	484	3.1
9	Belgium	412	2.7	9	Hong Kong, China[a]	442	2.9
10	United Kingdom	406	2.7	10	Korea, Rep. of	425	2.8
	Extra-EU (27)	1788	15.1		Extra-EU (27)	1991	16.5

a. including imports for re-export
Source: WTO International Trade Statistics 2011, tables 1.8 and 1.9, pp. 24-5

Table 4: Leading Exporters and Importers in Commercial Services, 2010

Rank	Exporters	Value ($ bn)	Share (%)	Rank	Importers	Value ($ bn)	Share (%)
1	United States	518	14.0	1	United States	358	10.2
2	Germany	232	6.3	2	Germany	260	7.4
3	United Kingdom	227	6.1	3	China	192	5.5
4	China	170	4.6	4	United Kingdom	161	4.6
5	France	143	3.9	5	Japan	156	4.4
6	Japan	139	3.8	6	France	129	3.7
7	India	123	3.3	7	India	116	3.3
8	Spain	123	3.3	8	Ireland	108	3.1
9	Netherlands	113	3.1	9	Italy	108	3.1
10	Singapore	112	3.0	10	Netherlands	106	3.0
	Extra-EU (27)	685	24.4		Extra-EU (27)	590	21.9

Source: WTO International Trade Statistics 2011, tables 1.10 and 1.11, pp. 26-7

Broadly the same picture applies to trade in commercial services, though the ranking of countries is slightly different and the Triad have a larger share of world trade (see table 4). It is interesting to note that India and Spain appear among the top ten exporters of commercial services and India and Ireland appear among the top ten importers. India's recent

development has been predominantly in the service sector, especially in IT services, Spain is a major player in tourism and financial services, and Ireland has attracted inward investment in financial and telecommunication services. It is perhaps surprising that international trade is still predominantly in merchandise goods rather than commercial services (see table 5), despite the developed countries' increasing reliance on services in their domestic economies. This is likely to change gradually in the next few years, though for the time being manufacturing and other merchandise trade remain an important component of most countries' balance of payments. The changing patterns of international trade are considered further in Practical Insight 3.

Table 5: World Exports of Merchandise Trade and Commercial Services, 2010

	Value ($ billion)	Share (%)
Merchandise trade	15237	80.5
Commercial services	3695	19.5

Source: WTO International Trade Statistics 2011, tables 1.8 and 1.10, pp. 24 and 26

Practical Insight 3: Changing Patterns of Trade

Despite the fact that multinational companies are increasingly using alternative modes of entry when venturing abroad, both the volume and value of international trade have grown significantly since the late 1940s. Trade has also been important for the world's rapidly growing economies in various parts of the world, from Ireland to Vietnam, and remains important for Germany and other leading economies.

Questions:

1. Why do you think international trade has generally increased at a faster rate than world output throughout the post-war period (figure 3)?
2. How would you explain the changes in Europe's share of world exports between 1948 and 2007 (table 2)?
3. China has been rapidly climbing up the table of the world's leading exporters and importers of merchandise trade in recent years. What other countries would you expect to be following on behind (table 3)? Try checking the latest edition of the WTO International Trade Statistics to verify your answer.
4. Why do you think the United States now has a larger share of exports of commercial services than of merchandise trade (tables 3 and 4)?
5. Why do you think the value of world merchandise trade still far outweighs trade in commercial services, despite services representing a larger share of the economies of most of the major trading nations (table 5)?

4.3 Foreign Direct Investment

Foreign direct investment (FDI) is by no means a new international business activity, but it has become much more prominent in recent years. This has been especially true since 1990. As table 6 illustrates, the cumulative world stock of FDI increased dramatically from 1990-2011. Whilst the rate of growth of international trade also accelerated during the 1990s, the growth of FDI might be described as an 'explosion'. The world economic slowdown in 2001 led to a significant decline in FDI flows from 2001-03, but a steep recovery had occurred by 2007. The slowdown affected FDI more than trade, probably because decisions to invest abroad have longer term implications and are influenced by investor confidence which was badly damaged after the events of 9/11. This effect has been mirrored to some extent during

the 2008-9 world recession and its aftermath. However, the decline in FDI was more marked in the developed countries than in the developing countries, where it recovered more quickly.

Multinational companies have been locating their activities abroad at an unprecedented rate in recent years. FDI involves the establishment or acquisition of production or other facilities in a foreign country over which the investing firm has some degree of control. It may involve a greenfield investment, a take-over, or partial equity ownership in a joint-venture. 'Control' is what distinguishes direct investment from portfolio investment, though control is sometimes defined as an equity stake as low as 10 per cent. For a variety of reasons multinational companies have been wanting greater control over their foreign operations rather than simply exporting at a distance. At first sight, this seems surprising at a time when technology is reducing the impact of distance. However, it makes more sense when we consider the increasing importance attached to knowledge of local markets and culture and the global aspirations of many companies.

Table 6: World FDI Stock, 1990-2011
($ billions)

	FDI Inward Stock			FDI Outward Stock		
	1990	**2000**	**2011**	**1990**	**2000**	**2011**
World	2081	7450	20438	2093	7953	21168
Developed economies	1564	5654	13056	1947	7074	17056
European Union	762	2324	8081	886	3751	10444
France	98	391	964	112	926	1373
Germany	111	272	714[a]	152	542	1442[a]
United Kingdom	204	439	1199	229	898	1731
Japan	10	50	226	201	278	963
United States	540	2783	3509	732	2694	4500
Developing economies	517	1735	6625	146	857	3705
Asia	343	1072	3991	68	607	2573
China[b]	21[a]	193[a]	712[a]	4[a]	28[a]	366[a]
India	2	16	202	-	2	111
Latin America & Car.	111	507	2048	58	205	1006
Brazil	37	122	670	41[a]	52	203
Mexico	22	102	302	3	8	112
Africa	61	154	570	21	45	126
South Africa	9	43	130	15	32	72
CIS	-	54	672	-	20	397
Russia	-	32	457	-	20	362

a. Estimates
b. Excludes Hong Kong
Source: UNCTAD World Investment Report, 2012, Annex Table 1.2, pp. 173-6

It is clear from Table 6 that most FDI is undertaken by the developed countries (81 per cent of FDI outward stock up to 2011) and that most FDI goes into developed countries (64 per cent of FDI inward stock up to 2011). Among individual countries, the United States, United Kingdom, France, Germany, and Japan have been the leading outward investors, though Japanese investment fell well behind the others during 1990s and early 2000s. With the exception of Japan, they have also been the main recipients of inward investment, though

China, Brazil, and Mexico have been closing the gap. FDI flows are gradually being attracted to the emerging economies of Asia and Latin America, but the majority of FDI has flowed from one developed country to another. However, the figures for FDI stock mask a more significant shift in the annual flow of FDI into the developing countries which reached 45 per cent of total FDI inflows in 2011.

FDI is an indicator of the level of multinational production and service operations around the world. Until recently, these multinational operations were predominantly in the manufacturing sector, especially in the electronics, motor manufacturing, and oil industries. Companies like Shell, Toyota, and General Electric still rank among the world's largest multinational companies, but they are increasingly being joined by companies such as Wal-Mart Stores, ING, and E.ON in the retail, financial services, and energy sectors and by companies from the emerging economies such as China's Sinopec or Russia's Gazprom. Even more than international trade, FDI seems to symbolize the interconnectedness of the global economy and the important role played by multinational companies.

Despite its importance, the measurement of FDI is notoriously difficult. Whilst the overall scale of FDI is clearly evident, even the most authoritative figures may sometimes be misleading. FDI figures are taken from national balance of payments accounts and are converted into US dollars at the prevailing exchange rate. It involves the ownership of equity capital in a foreign operation, but it also includes the international transfer of funds within multinational companies as well as profit made and reinvested in foreign operations. The treatment of these components leads to a variety of interpretations of the scale of a particular firm or country's FDI. In addition, the 10 per cent minimum definition of control used in the World Investment Report is not applied uniformly by every country. The result is that the value of FDI flowing between two countries may be reported quite differently by each country involved. For example, FDI flows into China in 2002 were reported as $21.8 billion by the major investing countries but $31.0 billion by China itself. This problem also accounts for the discrepancies between inward and outward stocks in Table 6. Worldwide inward and outward investments should of course be equal as the same investment leaves one country and enters another, but this is rarely the case in the recorded statistics. Notwithstanding the measurement problems, however, there has clearly been a significant increase in the importance of FDI since 1990. Nowhere has this been more evident than in China (see Practical Insight 4).

Practical Insight 4: China's FDI

Table 6 clearly indicates the huge growth of inward FDI in China since 1990. Whilst outward FDI is still much lower, as in most of the developing countries, the rate of increase of China's outward FDI has been significant during this period. Much of the inward investment has been in manufacturing industries and some of China's indigenous companies have also grown rapidly in recent years. One of the main reasons for the growth in outward investment has been cross-border mergers and acquisitions, including Nanjing Automobile Group's acquisition of the UK's MG Rover from BMW and Lenovo's acquisition of IBM's personal computer division, both in 2005. However, the vast financial surpluses generated by China's rapid export growth have also facilitated large investments in the property market in other Asian countries, in natural resources and infrastructure projects throughout Africa, and increasingly in Latin America's natural resource industries.

Questions:
What are the implications of the increase in Chinese investment in Africa, Asia, and Latin America for China's role in the world economy?

5. A Country's International Competitiveness

5.1 The Importance of International Competitiveness

The concept of international competitiveness has been applied to firms, countries, regions, and even to cities or city regions in recent years. Fundamentally, international competitiveness is about the ability of a firm to compete in international markets. Why then should we apply the concept to a region or country? After all, firms compete in business, not regions or countries. Regions or countries may 'compete' with each other to attract inward investment, using promotional strategies or financial incentives, but whilst these activities may support regional development, competition to offer the biggest incentives may be counterproductive if it influences short-term decisions without offering long-term advantages to investors.

Countries may also consider an increasing share of world exports to be an indicator of success, but herein lies the problem with this use of the term 'competitiveness'. As Paul Krugman has forcefully pointed out, the idea of a country competing for export market share implies that its exports are to be encouraged at the expense of imports (i.e. another country's exports). This contradicts the lessons from international trade theory that all trade (both exports and imports) is generally beneficial for individual countries and the world as a whole. If national competitiveness is measured by export shares, therefore, the concept is potentially harmful if it leads to import protection as a means of restricting imports from 'competitor' countries'.

The concept of the international competitiveness of countries may be misleading in the context of international trade, but it has been increasingly applied to the quality of a country's business environment. In this context, it is about the ability of a country or region to provide an environment which enables firms to be internationally competitive – not only indigenous firms but also inward investors. Competition between countries to offer a high-quality environment for business seems entirely legitimate and healthy, and may even encourage countries with less attractive business environments to improve their performance. The concept of regional competitiveness has also attracted the attention of policy makers and development agencies, not only as a focus for improvements in the regional environment but also as a way of enhancing the reputation of a region (see Practical Insight 11.5).[28]

Practical Insight 5: Should Cities or Regions Compete?

It is common for cities and regions to offer financial incentives such as grants, tax concessions, or low-rent accommodation to incoming businesses. Whilst perhaps understandable as a way of attracting investment, income, and employment to the region, competition to be the cheapest location is in some ways a 'race to the bottom'. This is especially true if one considers that cities and regions are located in an increasingly open and integrated global environment. Most cities in the developed world have little hope of being the cheapest location for companies operating in global industries. What they can offer, however, is a high-quality urban environment. The 'race to the top' to provide the most attractive environment is also more likely to improve the general economic welfare of the local community and of the country as a whole, as well as to reduce the risks for incoming investors. This type of territorial competition requires public authorities, development agencies, and community organisations to work together with private businesses to create the infrastructure, facilities, and networks that are needed to establish high-quality tangible and intangible assets in a city or region.

Question: Given that industrial specialization often occurs at the local or regional level, is city or regional competitiveness more important than national competitiveness?

5.2 The International Competitiveness of Countries

- **The Economic Approach**

Comparisons of international competitiveness at the national level have often focused on quantifiable macroeconomic indicators. These relate most closely to the cost or price competitiveness of firms engaged in exporting or importing. One of the most important indicators at the national level is a country's exchange rate. An increase in the exchange rate between the euro and US dollar, for example, will make euro-area exports to the USA more expensive and euro-area imports from the USA cheaper. Given the volatility of freely floating exchange rates between the world's major currencies, export and import prices may vary considerably over relatively short periods of time. It is often thought that a depreciating exchange rate is helpful to an economy, as it makes the country's exports more price-competitive. However, this benefit may be short-term if there are underlying productivity, product quality, or inflation problems in the country concerned, none of which will be resolved by exchange rate depreciation.

Market exchange rates, which determine the rate at which one currency can be exchanged for another at a particular time, are sometimes described as *nominal or bilateral exchange rates*. The rate of exchange between the British pound and the euro is an example of a nominal exchange rate. Between January 2008 and January 2009 the rate fell from a monthly average of £1 = €1.34 to £1 = €1.09 (or from €1 = £0.75 to €1 = £0.92 if expressed in terms of the euro). The nominal exchange rate can be quite volatile from day to day or even during the course of a day if economic or political conditions are changing. Such changes have a major effect on the price of exports and the value of investments between countries. A high exchange rate in the home country makes exports less competitive but imports cheaper and it reduces the cost of investing abroad. A low exchange rate has the opposite effect and also brings imported inflation into the country. Nominal exchange rate movements therefore create a significant business risk, which is sometimes described as exchange exposure.

A broader view of how a country's exchange rate is changing with respect to its main trading partners can be obtained by using an *effective or trade-weighted exchange rate*; this rate is calculated using an index to compare one currency's value in relation to a 'basket' of other currencies, weighted by the volume of trade between the countries concerned, over a period of time. Relative inflation rates in exporting and importing countries also affect price competitiveness, so *real exchange rates* are sometimes used in place of nominal rates; the real exchange rate combines the nominal exchange rate with the relative inflation rate between two countries and is therefore a more useful measure of international competitiveness than the simple nominal rate. The real exchange rate between the British pound and the US dollar can be calculated as follows:

$$RER_{£} = (£ \text{ price of UK goods})/(\$ \text{ price of US goods}) \times (\$/£)$$

Thus, for example, if the UK inflation rate rises while the US inflation rate and the nominal exchange rate ($/£) remain unchanged, the pound's real exchange rate ($RER_{£}$) will rise and US citizens will pay more for UK goods. UK inflation will therefore have caused a loss of competitiveness for UK exporters. It is also possible to measure a country's international competitiveness in relation to a group of major trading partners rather than one country alone

using a *real effective exchange rate*, which combines the real exchange rate with the effective exchange rate.

The official rate of inflation, measuring changes in retail or consumer prices, is not the only factor affecting price competitiveness within a country. Sometimes, indices of producer prices (especially prices of manufactured goods) are used in preference to consumer prices as not all goods and services included in consumer price indices are exported. Export prices are also affected by costs of production. Cost competitiveness can be measured by comparing unit production costs in different countries. Unit production costs are the cost of labour, materials, energy, and other inputs per unit of output. They therefore take account of productivity (labour hours and other inputs per unit of output) as well as costs of production. Thus, for example, Germany, with its high labour costs, can to some extent mitigate its lack of cost competitiveness by having superior productivity.

- **Determinants of National Competitive Advantage (Porter's Diamond)**

The search for a wider range of competitiveness indicators owes much to the work of Michael Porter. Porter and his team carried out extensive research covering ten countries, identifying four main determinants of national competitive advantage. These determinants are sometimes illustrated diagrammatically as four points of a diamond and are commonly known as 'Porter's Diamond' (see Figure 4). Porter also recognizes the role of 'chance' and government policies, but he argues that governments should influence the main determinants rather than try to determine competitiveness directly. The four main determinants are as follows:

(a) Factor endowments – Porter distinguishes between 'basic factors', such as natural resources, climate, and the size of the labour force, and 'advanced factors', such as a high-quality infrastructure, advanced technology, and highly developed human capital; advanced factors were found to be particularly important for competitive advantage.

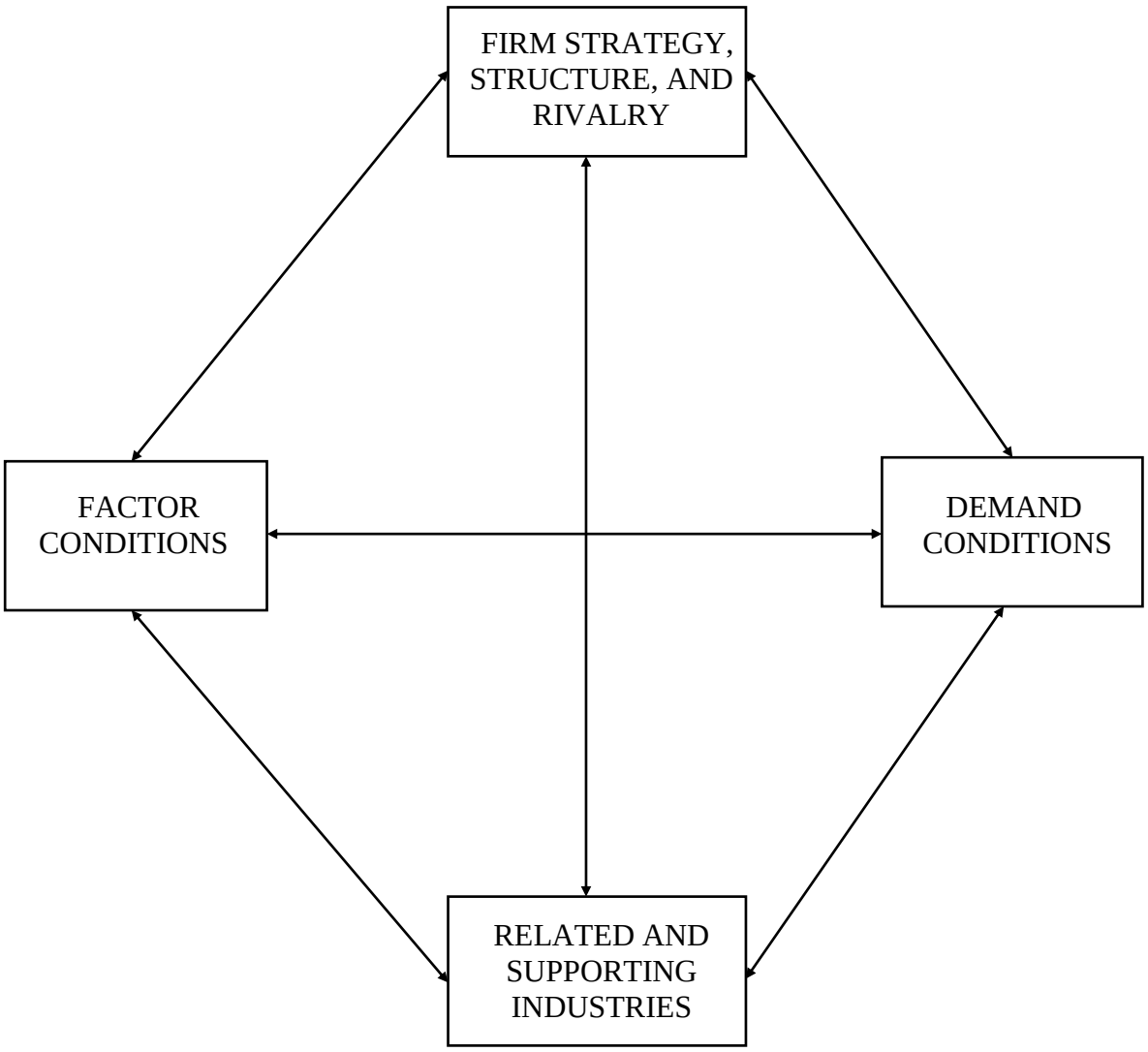
(b) Demand conditions – the quantity and quality of goods demanded by consumers and the expectations of consumers were found to be important in encouraging the development of innovative products and in creating growth in the home market which allowed firms to achieve economies of scale.

(c) Related and supporting industries – the close proximity of internationally competitive suppliers and firms producing complementary products or services in the home market was found to be important in establishing a strong basis for the competitiveness of firms.

(d) Firm strategy, structure, and rivalry – organizational and industrial structure, including intense rivalry between firms and the need for effective competitive strategies, were also found to be influential in promoting innovation and other competitive advantages.

Whilst Porter's diamond provides a basic framework for the analysis of national competitiveness, a number of more specific factors can be identified and Porter's work in this area is now being developed through the World Economic Forum.

Figure 4: The Determinants of National Advantage (Porter's Diamond)



Source: Porter, Michael E. (1990), The Competitive Advantage of Nations, The Free Press, a Division of Simon & Schuster, Inc.

- **International Competitiveness Rankings**

The growing interest in the international competitiveness of countries has led to a number of international initiatives aimed at analysing the differences between countries. These studies of international competitiveness now include both quantitative and qualitative factors, and attempt to provide a more encompassing view of the business environment, including the productivity and growth potential of an economy. The two most important organizations involved in this process are the International Institute of Management Development (known as IMD), which is an international business school based in Lausanne, and the World Economic Forum (WEF), an organization coordinating international gatherings of politicians, business leaders, and a wide range of professionals and community leaders, also based in Switzerland. IMD has been publishing its World Competitiveness Yearbook since 1989, but the most extensive analysis of international competitiveness can now be found in the WEF's annual Global Competitiveness Report. The Report includes the Global Competitiveness

Index, which in 2012-13 ranked 144 countries according to twelve competitiveness criteria (known as 'pillars'), organized under three general headings:

(a) Basic Requirements: institutions; infrastructure; macroeconomic stability; health and primary education

(b) Efficiency Enhancers: higher education and training; goods market efficiency; labour market efficiency; financial market sophistication; technological readiness; market size

(c) Innovation and Sophistication Factors: business sophistication; innovation

The above factors have been developed and refined in recent years. Some of them are measured using quantitative data, while the more qualitative indicators are derived from the WEF Executive Opinion Survey, which canvasses the opinions of over twelve thousand business executives around the world. The WEF has introduced a new Global Competitiveness Index, incorporating n a more rigorous conceptual framework. The new index has been developed by a team led by Michael Porter and it incorporates ideas from Porter's diamond at the microeconomic level, together with broader political, economic, social, and legal factors at the macroeconomic level. The underlying objective of the new Global Competitiveness Index is to identify the determinants of a country's productivity level in the belief that productivity is the main basis for sustainable economic growth and prosperity. Although this approach provides a broad view of the conditions under which businesses are likely to be successful, it is ultimately about national economic performance rather than simply the business environment. Perhaps inevitably, other factors could also be incorporated into indices of this type, especially bearing in mind the increasing emphasis now being placed on the role of social capital in national and regional economic development. Practical Insight 6 considers the concept of international competitiveness in relation to the Chinese economy.

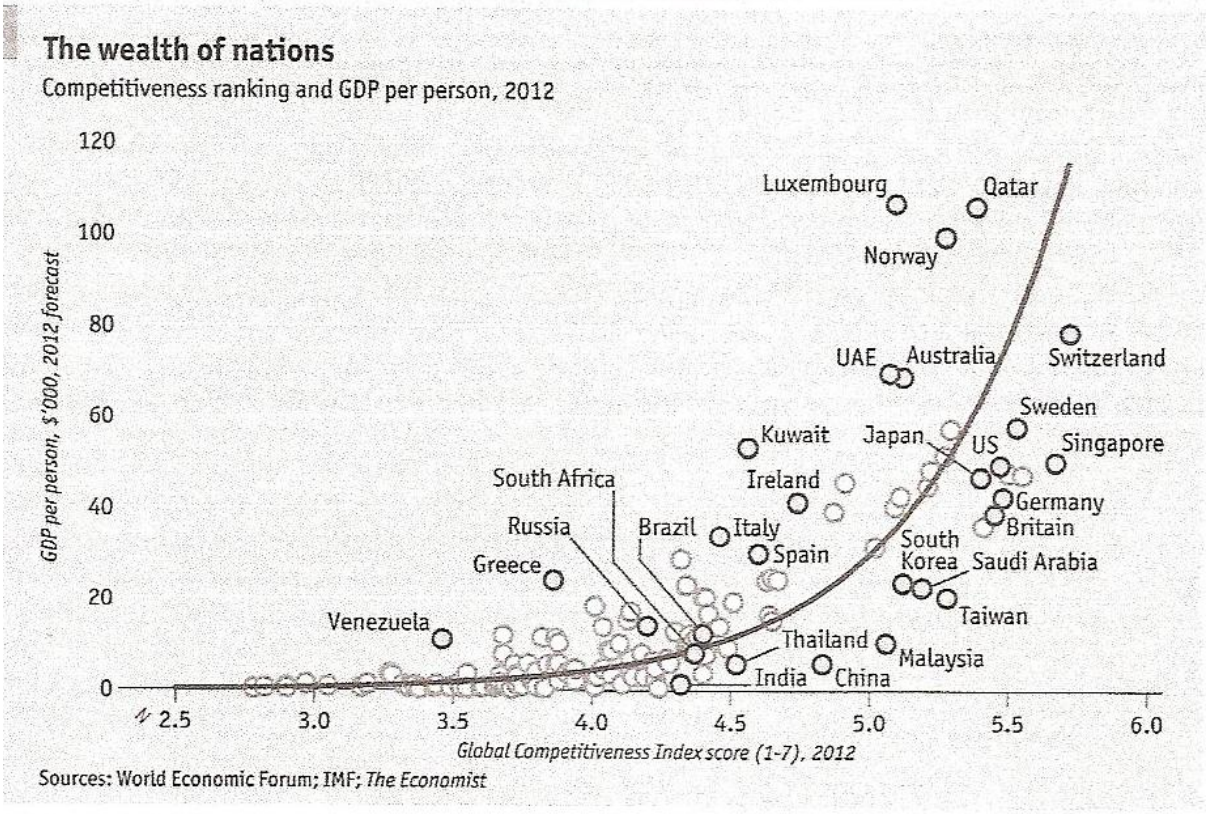
Practical Insight 6: China's International Competitiveness

In the 2012-13 World Economic Forum Global Competitiveness Index, China ranks 29th out of 144 countries. Whilst this position is above most of the world's developing countries, it may nevertheless seem surprising to a western manufacturer accustomed to being undercut by low-priced Chinese exports. Clearly, in terms of price competitiveness, Chinese goods are among the most competitive in the world. Foreign investors can also take advantage of China's low-cost business environment. However, as China's economic development progresses, the demand for resources will inevitably raise the costs of production and China's long-term international competitiveness will depend on the quality of its institutions, infrastructure, and other advanced factors rather than on low prices. China received its lowest competitiveness scores for factors such as technological readiness, financial market sophistication, and innovation, all advanced factors that will become more important as the country's economy develops.

Question: Do you think the WEF competitiveness rankings are less useful as a guide to the current business environment in a country than they are as an indicator of a country's future economic potential?

- **International Competitiveness and Economic Development**

Figure 5: Global Competitiveness and GDP Per Capita



Source: The Economist, 8th-14th September 2012, p. 58.

6. Scenario Planning

Scenario planning is a method increasingly being used to provide insights into a possible future course of events. It involves the development of plausible alternative scenarios, drawing on information, analysis, and understanding of a particular issue, which can be used as a basis for risk management strategies. Through the process of scenario planning, an organization is able to identify alternative ways of planning its operations in order to minimize the consequences of risk or even to influence the likelihood of a particular event occurring. Each alternative scenario is intended to envision a possible course of events and its consequences. This process makes use of warning signs, triggers, signposts and other indicators, but above all it requires insight and imagination. For this reason, it is often preferable to involve teams of people in developing scenarios in order to generate a wide range of ideas. The alternative scenarios represent a number of possible ways in which a particular issue may develop (see Practical Insight 7). Some scenarios may, of course, involve greater risks than others, but it is important for an organization to understand these risks and to put strategies in place to manage the risks effectively. It is also possible to include a few 'wild cards' when developing scenarios of the global environment: low-probability but high-impact events such as a terrorist attack or global epidemic that may disrupt the expected course of events.

Practical Insight 7: Developing Alternative Scenarios

Consider the following basic alternative geopolitical scenarios representing visions of the world in 2025. Try to flesh out what you consider to be the most likely scenario in more detail. You may use one the scenarios below or a different scenario of your own choice.

Scenario 1: The Bipolar World - a world dominated by the United States and China, two superpowers jostling for position in political, economic, and military affairs.
Scenario 2: The Multipolar World – a world dominated by powerful groups of countries in North America, Europe, and Asia, characterized by a changing balance of economic and political power.
Scenario 3: The Fragmented World - a world with no overall political leadership where there is little consensus on trade, environmental, or social issues.
Scenario 4: The Closed World – a world characterized by nationalism and security problems where countries develop a siege mentality and protect their economic and political borders.
Scenario 5: The Open World – a world characterized by free trade, increasing globalization, and open borders.

7. Globalization and the Changing Structure of the Global Economy

7.1 Globalization as a Process

Globalization describes a process, not a completed state. It implies that the world is 'globalizing', not necessarily that it is fully 'globalized', though descriptions such as the 'global village' suggest that, in some respects, the process has been completed.[4] So what does this process involve? It is probably more accurate to describe it as a set of interrelated processes rather than a single process. At its core, there is what the New York Times journalist and author, Thomas Friedman, calls a 'flattening' process.[5] According to Friedman, the world is being flattened in the sense that technology is creating a 'flat' or level playing field by allowing developing countries like China and India to become participants in international business on a par with the richer developed countries. This view implies that all countries could potentially participate in globalization, though in practice a number of obstacles may prevent this.

The idea that globalization involves the removal of barriers between countries is widely held. In a purely economic sense, a barrier-free world economy is effectively a world of free trade or laissez-faire as it was described in the nineteenth century. In this sense, the concept is not new, though the fact that free trade has gone further than before, both in volume terms and in its geographical spread, makes it different in degree at least. The idea of a borderless world can be extended to include the breaking down of political, social, and cultural borders, allowing the international movement of people, policies, ideas, customs, and beliefs and making nation states more interdependent in a political as well as an economic sense.

Globalization also seems to imply that the whole world is becoming involved in this process, for example that business activity is becoming 'global', with global resources being used by global companies that sell their products in global markets. This picture of globalization is of course exaggerated, as many companies and markets are not global, though resources seem to possess more of the characteristics of a global economy. This is especially true of capital, which flows apparently seamlessly from one country to another. Even bulk raw materials like coal or oil can easily be transported around the world at relatively low cost. People can also be transported quickly and easily and do so in large numbers for business and

pleasure, though international labour migration is proportionately less today than it was in the latter half of the nineteenth century when many Europeans were emigrating to the 'new world'.

Another aspect of globalization is the growth of supranational activities, especially through organizations such as the United Nations, International Monetary Fund (IMF), World Bank, and World Trade Organization (WTO). In this respect, globalization seems to be at least partially replacing 'territorialism' and the sovereignty of the nation state, with increasing political and social connections between states and their people.[6] Sometimes this argument is extended to suggest that nations have limited power in a globalizing world, particularly smaller states, and that multinational companies wield the real power. Comparisons between the worldwide turnover of some of the world's largest multinational companies and many countries' GDP seem to support this argument, but in the main the influence of companies is in a more limited sphere of activity than that of countries (commercial activities rather than defence, law and order, education, etc.).

Underlying many of these features of globalization is technological change. This is particularly true of information and communication technology. The widespread use of personal computers, the Windows operating system, and standard business software packages, coupled with the development of the internet and the worldwide web, has enabled businesses and individuals to communicate and share information across the world. It has increased the connections between different parts of the world, making the world appear smaller (reinforcing the concept of the global village). This characteristic of globalization has been described as the 'death of distance', implying that distance or spatial separation no longer has any significance when conducting business or personal affairs. Whilst this is largely true in relation to communication and information flows, it does not necessarily apply to all areas of business or personal activity. For example, where face-to-face contact is required, as in conventional retailing, or physical goods have to be transported, distance and location still matter. There may also be a number of other reasons why proximity to the customer is important, including the need for cultural awareness. Nevertheless, technology has allowed us to overcome many of the barriers that distance used to present (see Practical Insight 8).

Practical Insight 8: Technology and Remote Development

' . . . computers became cheaper and dispersed all over the world, and there was an explosion of software – e-mail, search engines like Google, and proprietary software that can chop up any piece of work and send one part to Boston, one part to Bangalore, and one part to Beijing, making it easy for anyone to do remote development.' Thomas Friedman's analysis of the global operations made possible by information and communication technology sees few limits to the way technology is connecting the world and flattening the barriers between rich and poor countries.

Question: Are there any limits to the remote development of business operations?

7.2 Global Governance and the Need for International Regulation

The immediate post-World War II years heralded a move towards multilateralism in world political and economic affairs. The League of Nations, an earlier attempt to establish a framework for multinational co-operation and security, had failed to prevent World War II, but renewed efforts were made after the devastation of two world wars in less than half a century. The United Nations (UN) was formed in 1945 and the International Monetary Fund (IMF) and International Bank for Reconstruction and Development (now part of the World

Bank Group) came into operation in 1946. Multilateral co-operation on trade began with the General Agreement on Tariffs and Trade (GATT), which came into effect in 1948, and a variety of other international organizations were set up during the early post-war years, most notably the Council of Europe in 1949 and the European Coal and Steel Community in 1951 (which led to the formation of the European Economic Community, now known as the EU, in 1957).

Multilateralism has become more established in recent years, reinforced by the belief that international problems require international rules enforced by international authorities. This system of global governance, as it is sometimes known, is not without its critics, both because of its inability to enforce compliance when individual countries flout its rules and because of the alleged unfairness of the rules themselves. This is a particular concern in the area of trade policy, which now comes under the remit of the World Trade Organization (WTO).

7.3 The Impact of Globalization

Globalization is moving the world's economies closer to being a single, interconnected global economy. Of course, in reality there are still numerous barriers between the world's economies, including a plethora of import and investment restrictions, market regulations, and many other discriminatory government policies as well as natural barriers imposed by history, culture, or geography. However, there is plenty of evidence of increased global economic activity, international competition, and interdependence between national economies. Some of the main economic effects of globalization on the business environment are as follows:

- The internationalization of markets, including the development of increasingly global products and the use of global marketing strategies.
- The internationalization of production**,** including global production strategies such as outsourcing and the offshoring of manufacturing and service operations.
- Rapid international communication, data transmission, and technology transfer.
- Increasing opportunities for economies of scope (adopting common production platforms to produce differentiated variants of standardized products).
- Changes in the relative importance of economies of scale at plant and organizational levels – shifting the focus away from conventional large-scale production towards scale economies in global sourcing, marketing, and strategic planning at the level of the organization as a whole.
- The changing structure of industry, as the relative share of manufacturing in national output and employment declines in developed 'industrialized' countries and increases in newly industrializing countries. 'De-industrialization' in developed countries generally gives way to an increase in service industries, though India is also developing a large service sector, especially in services linked to information technology (as discussed in the opening scenario to this chapter).
- Changes in the demand for labour. As the structure of industry changes, developed countries increase their demand for educated and skilled labour in high-tech and service industries but reduce their demand for low skilled labour, while traditional manufacturing jobs are created in developing countries.

These effects of globalization help to increase efficiency in the global allocation of resources, but bring a number of transitional problems and life-style changes in their wake. The ability of people, organizations, and economies to adapt is clearly crucial (see Practical Insight 9). In the next section we explore the economic principles underlying globalization.

Practical Insight 9: Changes in the Global Structure of Industry

The proportion of the working population employed in manufacturing and construction industry in the developed countries fell from an estimated 28.5 to 24.7 per cent between 1996 and 2006. In the developing countries the corresponding proportion increased from 18.5 to 20.5 per cent. These changes are part of a long-term trend, indicating both the higher level of historical industrialization in the developed countries and the recent global shift in manufacturing towards the developing countries. Of course, industrialized countries are now able to produce more goods with fewer workers because of technological progress, but a gradual change in the relative importance of manufacturing in different parts of the world is also under way. The loss of manufacturing jobs has caused considerable concern in some of the 'de-industrializing' countries and this issue became a hot topic among the candidates during the 2008 US presidential election campaign.

Question: Were some of the US presidential election candidates right to argue that the US government should do more to prevent the loss of manufacturing jobs?

7.4 The Economics of Globalization

There is no specific economic theory of globalization. However, there are various theories we can use to shed light on the processes involved. Conventional economic theory provides a useful starting point for our analysis. The conventional theory of market economics is derived from neoclassical microeconomics, that is, principles explaining the detailed working of markets that have been developed from the ideas of 'classical' economists like Adam Smith (1723-90) and Alfred Marshall (1842-1924). The basic idea is that markets allocate resources by equating supply with demand. If demand is high, producers will be attracted into a market by the prospect of profit. If demand is low, producers will leave the market and pursue opportunities for profit elsewhere. If the market is free from entry restrictions, competition between suppliers will normally be intense, which will drive down prices and production costs. In pure economic theory price plays an important role, acting as a signal to both consumers and producers, and market equilibrium is reached where demand and supply are equal at a particular price. As firms enter or leave the market they are allocating resources to the production of different goods and services. This process of resource allocation is known as the market mechanism.

We can now extend the concept of market equilibrium to an economy as a whole or indeed to the global economy. An economy is made up of many different markets, including markets for goods, services, labour, and capital. If all these markets are free from entry barriers, one of the characteristics of globalization, competition will drive prices and costs down and firms will move from one market to another in search of profit. When market equilibrium is reached in all markets throughout an economy, general equilibrium has been achieved. General equilibrium means that competition has promoted efficient resource allocation on a national or even global scale. Clearly, general equilibrium analysis relies on a number of restrictive assumptions. In the real world, competition is on product differentiation and quality of service, not just on price and costs, and not all markets are free from barriers and other restrictions. However, the outcomes of conventional microeconomic theory are not very far removed from some of the effects of globalization. Global competition does in fact force prices and costs down. This is why Marks and Spencer replaced some of its high-cost British suppliers with low-cost foreign suppliers when faced with falling profit, why Dyson

transferred its vacuum cleaner production to Malaysia, or why Norwich Union Direct transferred its call centre to India.

Price and cost pressures do indeed seem to be significant features of globalization, but they are not the only pressures. Competitive firms are continually innovating by developing new products, using new technology, and improving customer service. These are dynamic features of competition and globalization is above all a dynamic process. Its effects are changing constantly as the drivers pull in different directions and interact with each other. Dynamic theories of competition help to explain how this process works. Instead of seeing competition as a process leading to a state of market equilibrium, dynamic theories view competition as a process of continual turbulence and change. Entrepreneurs develop new products or differentiate their products from their competitors. Sometimes they succeed, sometimes they fail. Through experience they learn how to do things better as good decisions are more often rewarded than bad ones. Markets are imperfect but competition gradually makes them work better. The result is not a steady state of equilibrium, but a process of continual change. However, although this view of the competitive process is very different from the conventional view, the pressures on firms to be competitive are very much the same.

It is also important to note that globalization is not a zero-sum game. A zero-sum game is one where one player can only gain at another's expense as the size of the pay-off is fixed (i.e. zero growth). In the game of globalization the players are consumers, producers, workers, and governments. Let us consider the example of offshoring introduced in the opening scenario on India. Offshoring helps to reduce a firm's production costs to enable it to remain competitive. It results in a loss of jobs in the home country and the creation of jobs in the host country. But this is not simply one country's loss and another country's gain. Lower production costs mean that the firm can reduce its price. Consumers will therefore have to pay less for its products. This may increase the company's sales, but consumers will also have more disposable income to spend on a variety of other goods and services, which will create jobs in these other industries, some of them at home and some abroad. Of course, the workers who lost their jobs through offshoring may not be the ones who gain the new jobs. The jobs could be anywhere in the country. However, if an economy is functioning well, jobs are being lost and created continually, so the net effect may well be at least neutral for the home country and positive for the host country. This is an increasing sum game.

There are of course a number of problems with this scenario. For a variety of reasons displaced workers do not always find jobs quickly and their new jobs are not always as well paid as their old ones. This is a transitional problem of globalization and may become a longer term problem for the workers concerned and their families. There is also a fear that manufacturing, and increasingly, service jobs are disappearing from developed to developing countries. This is part of a process of changing industrial structure as countries like China and India develop the skills to perform these activities at lower cost. On the whole, however, the developed countries have been successful in adjusting to manufacturing and services that create higher added value. China is already finding that its labour costs are rising as the demand for labour increases (even with its huge population). Its future success will then depend on its ability to improve productivity and product quality, and other countries will take over as lower-cost producers. Again, it is a mistake to think of China's gain, as an exporter of cheap manufactured goods, as the old industrialized countries' loss. After all, China's cheap exports benefit Europe and North America's consumers, giving them surplus income to spend on other goods and services, thus increasing their standard of living. As China's income per capita rises, world demand will also increase and competition from Chinese goods will encourage other countries to improve the quality of their goods – as competition from Japanese cars and electronic goods did in the 1970s and 1980s. This is clearly not a zero-sum game.

Despite the economic benefits of globalization, industrialized and newly industrializing countries alike are wrestling with the problems of change. The developed countries have to come to terms with their changing industrial structure and labour markets, the developing countries with the problems of industrialization: poor factory working conditions, urban congestion, air and river pollution, and associated social problems. Basically, there are two options for the developed countries in response to globalization: either they attempt to slow down or prevent the impact of globalization using protective measures such as import controls, regulation, or financial subsidies, or they accept that globalization is inevitable and take measures to improve competitiveness by promoting education and training, research and development, productivity, and market reforms. For political and social reasons most governments use a combination of these approaches, though the logic of the economics of globalization clearly points in the latter direction. Practical Insight 10 considers how these issues are viewed by industrialists and consumers.

Practical Insight 10: Changing Views on Free Trade and Protection

During the 1970s and 1980s many North American and Western European industrialists argued for import protection when faced with intense Japanese competition, especially in the car and electronics industries. Governments were also persuaded by this argument and imposed quotas or voluntary export restraints (agreed rather than imposed quotas) on Japanese goods. By the 1990s many of these industrialists were arguing for free trade, often in the face of opposition from consumer organizations and trade unions.

Question: What do you think had changed?

7.5 Implications of Globalization at Local, National, and International Levels

Whilst the impact of globalization can be seen on an international scale, its effects permeate all levels of economic, political, and social activity. At a national level governments are faced with decisions such as whether to intervene to prevent industrial closure or whether to discourage foreign takeovers of their 'national champions'. Sub-national regions are also affected by global activity, sometimes more acutely that the country as a whole, and competition between regions to attract high-profile investors is often intense. In this and many other ways globalization is having a significant impact at all levels of economic activity and is therefore an important element of the business environment.

7.6 Implications for Industrial Structure at the National Level

- **Changing Industrial Structure**

One of the main characteristics of a country's national environment is its industrial structure. The pattern of industries in a country may change significantly even over relatively short periods of time. This can clearly be seen in the declining share of agriculture and other primary industries in countries like Ireland, Mexico, South Korea, and Turkey between 1970 and 2010 or 2011 (see Table 7). On the other hand, in France, Germany, Italy, Japan, the UK, and USA, there is a marked shift from manufacturing to services over the same period. Whilst Mexico, South Korea, and Turkey have become more industrialized as well as more service-oriented, Ireland was more industrialized in 1970 but has also changed its economic structure from agriculture to industry and then to services within a relatively short period of time. This reflects Ireland's rapid economic development during the 1990s.

Table 7: Main Industrial Sectors in Selected OECD Countries, 1970-2011 (% of Total Value Added)

	Primary		Secondary		Tertiary	
	1970[a]	2011	1970[a]	2011	1970[a]	2011
France	7.6	1.8	35.2	18.7	56.1	79.5
Germany	3.6	0.9	48.4	30.8	48.8	68.2
Ireland	17.4	1.7[b]	36.0	30.9[b]	47.9	67.4[b]
Italy	8.6	2.0	40.0	24.6	51.3	73.4
Japan	5.8	1.2[b]	43.7	27.5[b]	50.2	71.3[b]
Mexico	11.9	3.5[b]	25.8	34.3[b]	66.1	62.2[b]
South Korea	31.0	2.7	24.2	39.7	44.7	57.6
Turkey	37.9	9.2	23.1	27.7	38.5	63.2
United Kingdom	2.9	0.7	42.5	23.1	54.5	76.2
United States	3.4	1.2	33.9	20.0	62.3	78.8

Source: OECD Statistics

a. Even allowing for rounding errors, most of the percentage shares for 1970 do not quite add up to 100%. This reflects minor errors in the data. However, the main trends are clearly indicated.

b. 2010.

Underlying these changes in industrial structure there appears to be some kind of development process at work. One of the most influential explanations for this process since the 1960s has been Rostow's theory of the stages of economic growth. Rostow, an economic historian, suggested that countries progress through five stages of economic growth:

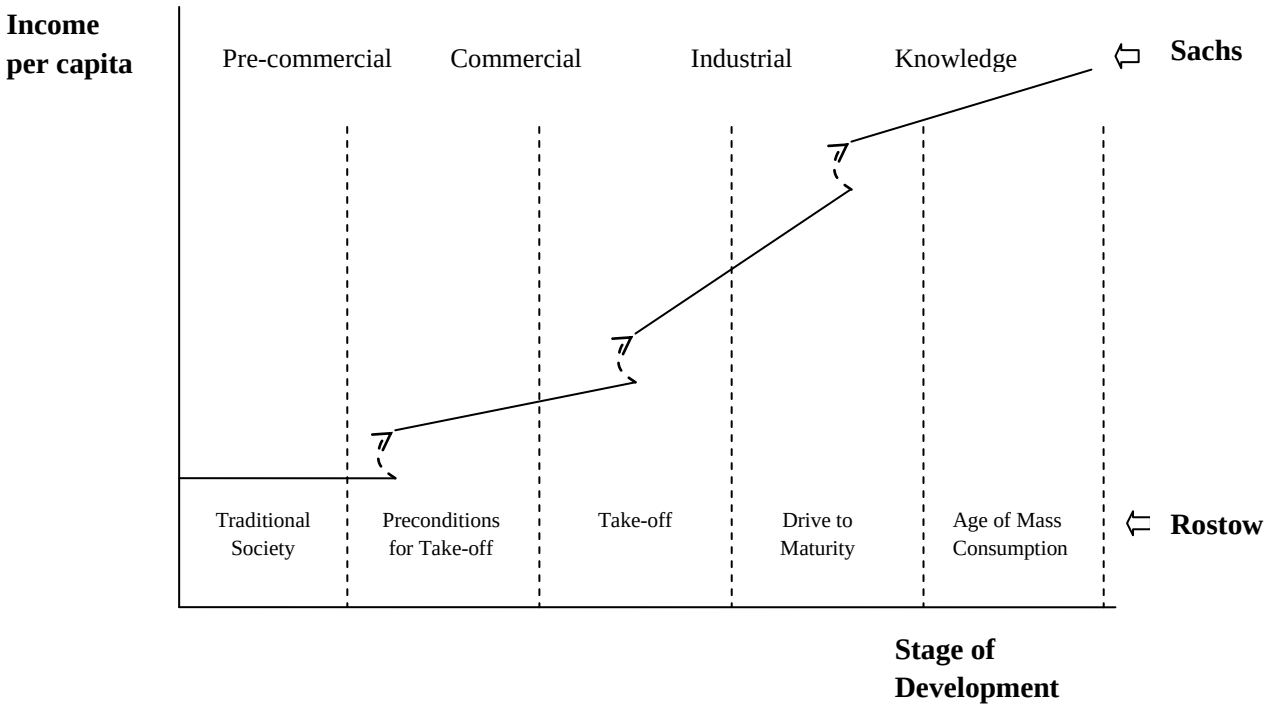
- the traditional society;
- the preconditions for take-off into self-sustaining growth;
- the take-off;
- the drive to maturity; and
- the age of high mass consumption.

However, with the exception of the role played by investment, the theory provides only a limited explanation of how a country can progress from one stage to the next.

Despite its limitations, Rostow's theory has intuitive appeal as a description of the stages of economic development experienced by the major developed countries. Although it is difficult to map a country's stage of development accurately to one of Rostow's five stages, in broad terms the UK went through its take-off or industrialization stage during the late eighteenth and nineteenth centuries. From the late nineteenth century and throughout much of the twentieth century the UK economy was using more advanced production methods and becoming more technologically developed (the drive to maturity). By the end of the twentieth century it had reached the age of mass consumption and services had taken over from manufacturing. The relative decline in manufacturing output and especially employment in the latter stages of this process are sometimes described as 'de-industrialization'. On the other hand, Germany's manufacturing and construction (secondary) sector was still relatively large in 1970, probably because post-war reconstruction had given its manufacturing industry a new lease of life. However, by 2007 the trend towards services (the tertiary sector) is clearly evident in both the UK and Germany.

An alternative explanation of the stages of economic development is offered by the US economist, Jeffrey Sachs. According to Sachs, there are four main stages of economic development: the pre-commercial, commercial, industrial, and knowledge stages. Although similar in conception to Rostow's theory, Sachs places more emphasis on the transformation process between each of the stages and on the role of knowledge rather than consumption at the final stage (see Figure 6). In pre-commercial societies there is a clear separation between the rural and urban economies and most of society is made up of isolated rural communities. In the commercial stage these economies become more integrated, allowing a basic division of labour and trade between the rural and urban sectors, though urban manufacturing is still relatively small-scale. Industrialization, involving mechanization, large-scale production, and international trade, occurs during the industrial stage. The final stage involves the transition to a knowledge-based economy characterized by technological innovation and rising productivity. Sachs considers many of the sub-Saharan African nations to be predominantly at the pre-commercial stage while China and India are somewhere between the industrial and knowledge stages, though he accepts that the stages may overlap and different regions within a country may be at different stages of economic development.

Figure 6: Stages of Economic Development



It is now widely recognized that the process of development within a country depends on a number of different factors (see Practical Insight 11). Some of these factors are economic; they include the level of technological development, the quality of human capital, the sophistication of financial institutions, the transport and communication infrastructure, and the intensity of competition. Political and legal factors are also important; the former include the efficiency of public administration and the appropriateness of government policies; the latter include the protection of property rights and the fairness and efficiency of the judicial system. Cultural and social factors are increasingly thought to influence the way an economy operates as they affect business practices, values and attitudes, the quality of education, and the health of a nation. Even geography may affect a country's national business environment, particularly where intense heat and drought, infertile conditions, or remote location make even basic economic activity difficult.

Practical Insight 11: Industrial Structure and the Stage of Economic Development

All the countries in Table 7 experienced a decline in the share of primary industries like agriculture and all of them apart from Mexico experienced an increase in the share of services in total value added between 1970 and 2010 or 2011. The developed countries also experienced a relative decline in manufacturing industry. The less developed countries, if we include South Korea which became a developed country during this period, saw an increase in the share of manufacturing. This suggests they have been at different stages of economic development, but also that the development process has been continuing in each case.

Question: What factors are likely to explain how a country's economy progresses from agriculture to manufacturing and from manufacturing to services over a period of time?

8. Regional Integration between Countries

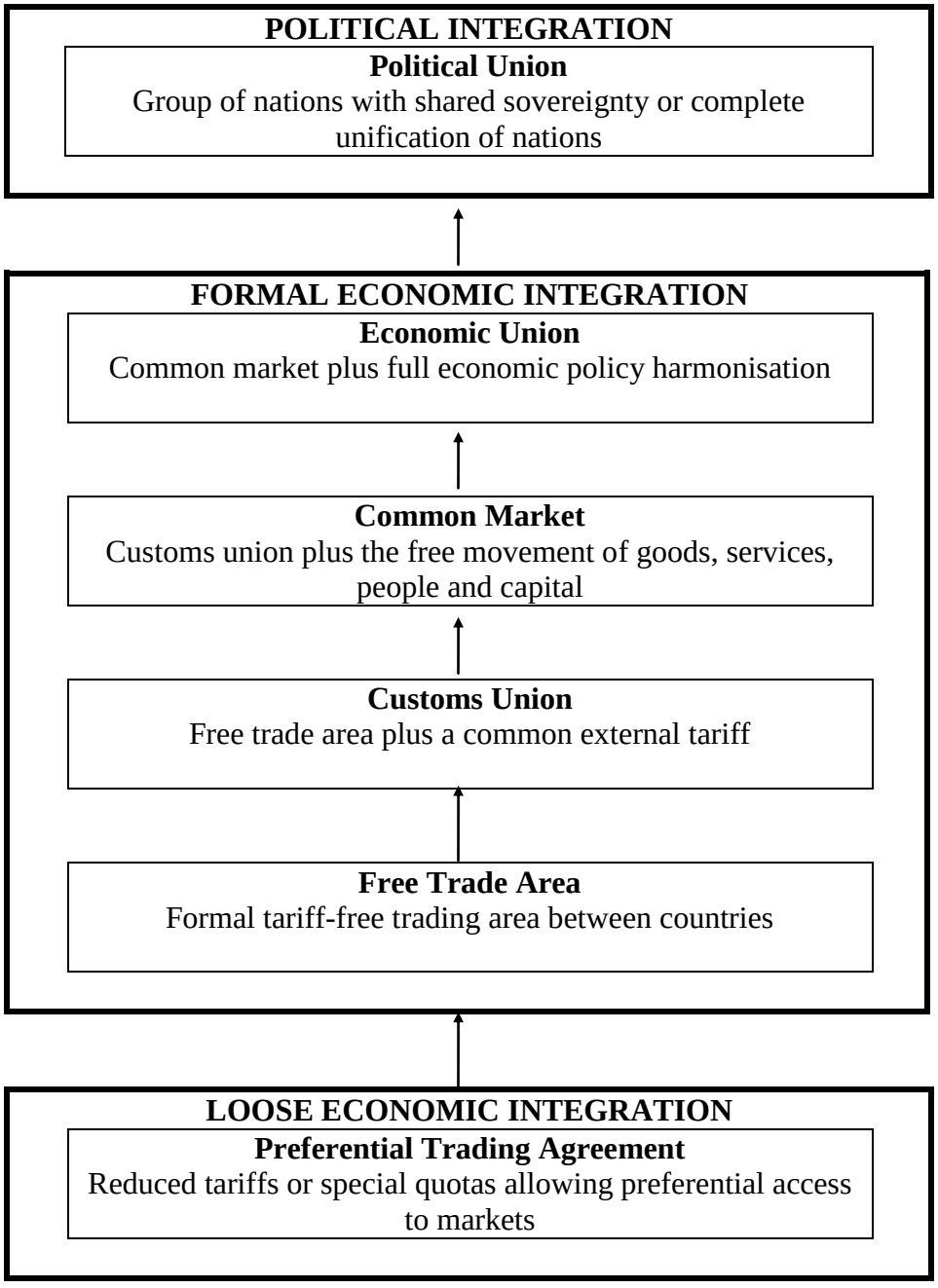
An important feature of the international business environment in recent years has been the development of regional economic groupings in many parts of the world. By far the most integrated grouping is the European Union, which has not only expanded to include twenty-seven countries, but has also developed an extensive range of policies and a high level of policy coordination. Other well-established regional groupings include the North American Free Trade Agreement (NAFTA), the Association of South East Asian Nations (ASEAN), and the Common Market of the South (Mercosur) in South America. A large number of other groupings also exist in most regions of the world.. Regional integration normally involves cooperation and trade within a group of neighbouring countries, but the type or level of integration varies considerably. The main levels of regional integration are now considered in turn (see also figure 7).

- Preferential trading agreement (PTA) – This is an agreement allowing preferential access for the exports of a particular country or group of countries. Typically, this type of agreement enables developing countries to sell their goods in the markets of developed countries. The most widely used form of PTA is the Generalized System of Preferences (GSP), which is a scheme operated under the auspices of the WTO by the EU, United States, and several other countries, granting reduced tariffs and other preferential arrangements to the products of a large number of developing countries. Other PTAs include the Cotonou agreement between the EU and the African, Caribbean, and Pacific (ACP) group, and the US African Growth and Opportunity Act (AGOA).

- Free trade area – This is the first level of more formal regional integration, involving a tariff-free area between a group of countries. Other barriers such as quotas are also likely to be eliminated. This type of integration forms the basis of NAFTA, ASEAN, and the recently formed Africa Free Trade Zone (AFTZ), for example – though free trade is a more distant prospect in the case of the AFTZ. The EU is also a free trade area, though it is much more than this. The most ambitious attempt to create a free trade area is being made by Asia Pacific Economic Cooperation (APEC), which is made up of a diverse group of countries around the Pacific rim, though progress to date has been limited. APEC is a loose grouping, including the United States, China, Russia, and a number of smaller countries,

which aims to achieve free trade by 2010 and 2020 for its developed and developing member countries respectively.

Figure 7: Levels of Integration Between Countries



Source: Harrison, A. (2010), Business Environment in a Global Context, Figure 5.2, p.127

- Customs union – The next level of integration combines a free trade area with a common external tariff. This means that the member countries forego the right to set their own national tariffs, but it avoids the problem of importers trying to find the lowest-tariff entry point into the trading area. Customs unions normally have arrangements to share the tariff revenues. This requires them to establish more formal institutional processes. Examples of

customs unions include the EU, Mercosur, and the Caribbean Community (Caricom), though in each case steps have been taken to progress to higher or deeper levels of integration.

- Common market – This was the term used by the European Economic Community (EEC) before it became known as the EU to describe its original economic aim and was widely used to describe the EEC as a whole in its early years. However, it is also the textbook name for the next level of integration. It incorporates a customs union as well as the free movement of goods, services, people, and capital (the *four freedoms*). It therefore goes beyond the removal of tariffs and quotas to tackle non-tariff barriers such as restrictions on the supply of services, the failure to recognize qualifications, or restrictions on foreign ownership. Mercosur, Caricom, and the African Union have all been attempting to create a common market, with varying degrees of success, but the most extensive common market has been achieved by the EU. The European single or internal market, as it is known, has created something approaching a common market, though complete free movement has proved difficult to achieve when there are significant economic and cultural differences between countries.

- Economic union – This is the most comprehensive level of economic integration between a group of independent nations. It involves a common market and the harmonization of economic policies. The EU is the closest example of an economic union, having a number of common policies, but it has only achieved a partial monetary union (a subset of economic union) and has not yet achieved tax harmonization, among other things. A higher degree of political integration is also required as a regional grouping progresses to the higher levels of economic integration.

- Political union – Complete political union would involve the unification of one or more formerly independent states, such as the unification of East and West Germany in October 1990. However, in the context of regional integration, it is more likely to involve close political coordination supported by a unified decision-making structure.

The primary purpose of regional integration is to achieve economic benefits. The potential benefits include a combination of static and dynamic effects. Static effects are those which create once-for-all benefits. Dynamic effects are those which create recurring benefits. Static effects of regional integration include the cost savings and other benefits that result from the removal of border controls, the simplification of trade documentation, and the adoption of harmonized standards, as well as the economies of scale and changing patterns of trade that arise in a large barrier-free market.

Changing trade patterns include *trade creation*, involving new trade previously prevented by trade barriers, and *trade diversion*, where trade is diverted from countries outside the trading area to countries inside. If the level of external trade barriers is no higher than it was for each individual country before integration occurred, the trade effects will generally be positive, allowing goods and services to be sourced from the most efficient producers. Dynamic effects include the way in which competitive pressures cause price reductions and stimulate efficiency, innovation, and overall economic growth in a large internal market. Efficiency applies not only to production methods, work practices, and competitive sourcing at the level of the firm, but also to the way in which industrial reorganization occurs through mergers, alliances, and other market entry strategies.

It should be noted, however, that these benefits are likely to be greater where there is a high level of integration, where the countries concerned have similar economic and political

structures, and where goods, capital, and labour markets operate flexibly enough to enable the necessary adjustment processes to work effectively. Some of the difficulties that can arise in regional groupings involving countries at different levels of economic development are illustrated in Practical Insight 12.

Practical Insight 12: A Trans-Pacific Free Trade Area

APEC Member Countries

Australia	Indonesia	Papua New Guinea	South Korea
Brunei	Japan	Peru	Taiwan
Canada	Malaysia	Philippines	Thailand
Chile	Mexico	Russia	United States
China	New Zealand	Singapore	Vietnam
Hong Kong			

Asia Pacific Economic Cooperation (APEC) is a loose grouping of Pacific-rim countries. Although not a formal regional economic grouping like the EU or NAFTA, it is nevertheless attempting to create free trade and investment by the years 2010 and 2020 for its developed and developing economy members respectively. However, this is no mean task given the diversity of its members' economies and political systems. A number of APEC countries have been trying to speed up the integration process and a Trans-Pacific Strategic Economic Partnership Agreement was signed by four APEC members, Brunei, Chile, New Zealand, and Singapore in 2005. By the end of 2008, Australia, Japan, Peru, Vietnam, and notably the United States had expressed an interest in joining this group to create a Trans-Pacific free trade area. These were followed by Malaysia in 2010 and Mexico and Canada in 2012. If successful, this free trade area will be unique in including developed and developing countries in Asia, Oceania, and both North and South America. There is clearly a desire for more open trade among APEC members, but the practical difficulties will be considerable. In particular, there has been criticism that some aspects of the draft agreement appear to strengthen the access of multinational companies at the expense of national authorities.

Questions: To what extent is a Trans-Pacific free trade area likely to bring mutual benefits for APEC member countries? Do you think trade agreements of this type are a useful stepping stone or a hindrance to global free trade?

9. Regional Integration within Countries

9.1 The Regional Location of Industry

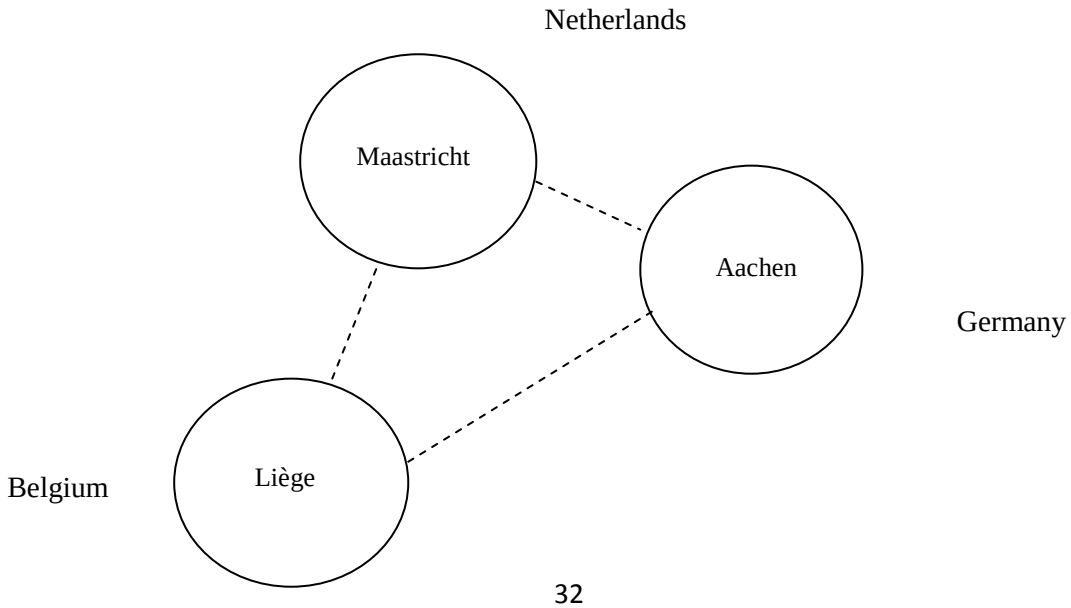
Regions within countries differ in a variety of ways. These differences may involve economic, political, legal, social and other factors. Economic differences include their unique industrial structures, labour market characteristics, local taxes, and industrial infrastructures, among other things. Political differences include their systems of provincial and municipal government. Individual regions may also have their own policies, laws, social structures, and cultural identities. Regions are often highly distinctive and their inhabitants fiercely loyal. The differences between regions have generally developed over a long period of time, though they may be affected by particular events such as the discovery of oil or the decline of an industry. A region with a particular concentration of industry may attract inward investment by firms in that industry and the arrival of these firms helps to reinforce or complement its regional specialization. In this way, a firm affects its regional environment, but that environment also has an impact on the market and supply conditions facing the firm.

9.2 Patterns of Regional Development

A simple view of regional development might consider two basic types of economic activity: rural agriculture and urban manufacturing. A basic distinction between rural and urban development is that the former makes extensive use of large areas of land whereas the latter makes intensive use of relatively small areas of land. Some regions are still predominantly agricultural, but the major influence on regional development during the nineteenth and twentieth centuries has been the growth of manufacturing and then service industries in the towns and cities. A common characteristic of urban development is the tendency for a central location to emerge, around which industrial activity and housing are located. An early attempt to explain this tendency is known as central place theory, published by a German geographer, Walter Christaller, in 1933. Central place theory argues that the development of a 'central place' is dependent on principles relating to the market area, transport routes, and administrative efficiency, and that a number of smaller towns will surround the main town along the main transport routes. Whilst this theory represents a rather static, conventional view of urban development, its broad predictions can often be observed in practice.

The issues raised by Christaller are clearly important ones. Industry and people need space but most people like to live within commuting distance of their place of work, so urban development is initially concentrated in a relatively small area. There also need to be linkages between different types of industrial and human activity, which helps to reinforce the concentration of activity around a central point or growth pole. This concentration or agglomeration of activity brings a number of benefits, sometimes referred to as economies of agglomeration or economies of spatial concentration, and these benefits attract other firms and people. Over time, the more successful urban developments expand and join up with smaller neighbouring developments and sometimes with neighbouring central points to form a larger conurbation. A number of studies have investigated the potential synergies that may arise between neighbouring growth poles, forming what are known as *polycentric regions* (see figure 8). Of course, urban development is not uniform and the pattern of development depends on factors such as the suitability of land for particular uses, the needs of particular industries, the demand for particular types of housing, the availability of transport, and people's willingness to commute, among other things.

Figure 8: The Maas-Rhine Triangle: A Cross-Border Polycentric Region



Many of these factors will also change over a period of time. Improvements in transport and rising incomes have allowed commuters to travel longer distances and buy more desirable housing away from the city centres. Inner city areas have also been abandoned by traditional industries, including many of the larger retailers that favour out-of-town developments. More recently, young professionals have been returning to the city centres where former docklands and industrial areas now offer exclusive modern housing. Regional development also reflects changing patterns of industry, and changing production systems and labour use. The central location of company headquarters and internationalization of company ownership have left some regions with 'branch-plant economies', without the security of the local industries they once enjoyed. Whatever the nature of change, regions are living organisms that develop and sometimes decline as the needs of people and industry change.

9.3 Economies of Spatial Concentration (Agglomeration Economies)

Concentrated pockets of economic activity in a particular location are common in many countries. Sometimes they are highly localized, sometimes spread over a larger area. This type of spatial concentration is now often described as a cluster, though it is by no means a new phenomenon. Many clusters occur naturally over a period of time, but some are created or encouraged by national or local government policy. Typically, clusters are made up of firms in a particular industry. Examples include high-tech clusters such as 'Silicon Valley' in California or Cyberjaya near Kuala Lumpur, the US movie capital, Hollywood, and 'Motorsport Valley in England's East Midlands, home of the British racing car industry. On a smaller scale, the term 'cluster' might be applied to a group of motor car showrooms or restaurants which have located close to each other.

Whilst one might expect location to become less important as transport and communication improve, it seems that new types of cluster are continually appearing. This has led theorists and researchers to search for new explanations. It has also led some to argue that clusters may actually be a significant driver behind economic development and regional development in particular. Two of the leading figures in this field are the US academics, Michael Porter and Paul Krugman.

Conventional explanations for the development of clusters have focused on three main areas:

- Knowledge spill-over effects, where firms learn from each other or from a neighbouring university (for example, Stanford University supports Silicon Valley).
- The advantages of 'thick' markets for specialized skills, enabling new businesses to take advantage of a large pool of skilled labour
- Backward and forward linkages, allowing businesses to find specialized supplies and a specialized market for their products.

These factors help to create a supportive environment so that, once established, clusters are more likely to persist. The larger the cluster, the larger will be the knowledge spill-over effects, the pool of skilled labour, the potential market, and the source of specialized supplies. Large clusters will also tend to attract more firms and support services and are more likely to reach a critical mass that will enable them to become self-sustaining.

It has long been recognized that clusters benefit from external economies of scale or increasing returns from their external environment; that is, regardless of the size of an individual firm, a group of neighbouring firms benefits from its combined scale in that it attracts specialized labour, support services, and a more extensive local infrastructure. The economist, Alfred Marshall, was aware of this towards the end of the nineteenth century.

However, more attention is now being focused on internal economies of scale or increasing returns to scale at the level of the firm, that is, the benefits derived from the increasing size of a firm. Not only does a small firm benefit from external economies of scale when operating in a cluster with many other firms, but this environment also enables the firm to become larger by taking advantage of the market the cluster provides. In addition, firms, universities, and other agencies which operate closely with each other within a cluster are likely to experience network effects, where all members of the network benefit from the innovation of an individual member, for example.

The dynamic process by which spatial concentration reinforces itself may be described as the 'snowball effect'. It is likely that some clusters tend to be more stable and self-reinforcing than others, indeed, that they gather momentum over a period of time. A cluster may be reinforced where labour and other factors of production are either fairly immobile or earn higher returns at a particular location. The key questions for researchers are; (a) what factors determine the stability or rate of growth of a cluster; and (b) is there any recognizable pattern to the way clusters develop? For example, do they tend to move towards equilibrium? In dynamic models there may be several possible equilibria or, in fact, the search for equilibrium may be illusive. There may also be several clusters in close proximity, for instance two or more neighbouring towns each with a large industrial or commercial centre. Sometimes neighbouring clusters may feed off each other, as in the case of London's banking and insurance sectors. Sometimes they may be in competition, for example two rival shopping centres. The dynamic process at work within clusters is not yet fully understood, nor is it certain that clusters necessarily bring benefits that cannot be achieved outside cluster developments. Practical Insight 13 considers the cluster around Cambridge University.

Practical Insight 13: Silicon Fen

The Cambridge Cluster, also known by its nickname Silicon Fen, is an example of a successful technology cluster located close to a leading university, similar to its more illustrious forerunner, Silicon Valley. Silicon Fen has helped to establish a large number of small businesses in fields such as computer software, electronics, and biotechnology. Only a few of these companies have achieved multinational status, but the strong pool of well qualified and flexible labour allows new companies to draw on a ready supply of workers with highly specialized skills. The cluster's critical mass therefore seems to come from its large number of specialized businesses and workers.

Question: What does this tell us about the relative importance of internal and external economies of scale in this particular cluster?

9.4 Causes and Consequences of Regional Disparities

Regional disparities exist in most, if not all, countries. They also persist over long periods of time. Considerable efforts by governments and regional authorities are often insufficient to create balanced regional development. In part, this may be because the effort is misplaced. Regional policy frequently tries to lure inward investors with the prospect of generous financial incentives without tackling the underlying reasons for a region's problems. It is also because some of the causes are intractable, perhaps because of a region's climate or remote location. However, there are also examples of regions, or depressed areas within regions, that have been regenerated and have taken on a new economic vitality. This is true of East London's docklands and similar inner city areas in Birmingham, Manchester, and Liverpool, for example. Table 8 illustrates two measures of regional disparity between UK regions.

These measures indicate significant differences between prosperous regions like London and the South East and lagging regions such as the North East and Wales.

Table 8: UK Regional Disparities

Region	Gross Disposable Household Income per Head, 2010 (Index, UK=100)	Gross Value Added per Hour Worked, 2010 (Index, UK=100)
London	128.8	133.3
South East	112.1	108.2
East of England	104.3	97.5
South West	99.6	92.0
Scotland	97.7	99.3
East Midlands	90.8	92.4
North West	90.2	87.7
West Midlands	89.3	86.0
Wales	87.7	83.9
Yorkshire & the Humber	86.5	88.5
Northern Ireland	86.3	81.0
North East	84.8	87.6
UK	100	100.0

Source: National Statistics website: www.statistics.gov.uk

It is also possible that regional disparities are not as great as official statistics suggest. Whilst unemployment statistics or measures of social deprivation may suggest clear underlying economic and social disadvantages, indicators such as gross value added or household income and expenditure may overestimate the differences between regions. This is primarily because price levels vary between regions. Gross value added measures the difference between final output and intermediate inputs, that is, the additional contribution to output made by a particular firm, industry, or region. Output is valued at the prices charged in a particular region. If these prices are lower in some regions than in others, any given volume of output will have a lower value in a low-price region than in a high-price region. The low-price region therefore appears to be less productive that it actually is. A similar problem arises where household expenditure representing the same 'basket' of goods and services is lower in a low-price region and higher in a high-price region. Household incomes are also typically lower in low-price regions but less income is needed to buy the same goods and services, so the difference in the cost of living between regions may also be smaller that it appears to be. This problem can be resolved by valuing output, income, and expenditure on a 'purchasing power parity' basis.

Purchasing power parity calculations are commonly used when comparing national income data but rarely used with regional data. Statisticians would have to compare the cost of a basket of goods and services in Region X with the cost of the same basket of goods and services in Region Y. So, for example, if the goods and services cost €100 in Region X (the low-cost region) and €120 in region Y (the high-cost region), we can calculate a purchasing power parity regional 'exchange rate' of $€_x1 = €_y1.20$. We can then convert $€_x$ into a common $€_y$ currency by multiplying the value of output, income and expenditure in Region X by a factor of 1.2, which will narrow the gap between the regions. These regional exchange rates are of course notional as regions do not normally have independent exchange rates. However, the important point is that differences in purchasing power between regions may account for part of the disparities between regions.

Gross value added per capita also depends on productivity. Productivity will inevitably vary with the balance of industries in different regions as it is sensitive to capital and labour intensiveness, levels of skill in the labour force, the use of technology, and other factors. Regions with low productivity will therefore have lower gross value added per capita than regions with high productivity. This does not mean that regional disparities caused by productivity differences are unimportant, simply that they may reflect structural differences between regions. Thus, for example, a predominantly rural region like Cornwall, with its small-scale agriculture, tourism, and other service operations, will almost inevitably have lower productivity and therefore lower gross value added per capita than regions with high-tech manufacturing or service industries. In fact, the gross value added per capita index number for Cornwall and the Isles of Scilly (a sub-region of the South West of England) for 2006 was only 63. The entire industrial structure of Cornwall would have to be changed in order to resolve this problem. Alternatively, the national or EU budget can be used to transfer income from richer regions to poorer regions.

Practical Insight 13 considers how differences between regions may also be exaggerated when comparing Western Europe with the emerging economies of Central and Eastern Europe. The reasons for the underlying differences between regions are now explored. Although a number of potential causes are identified in turn, regional disparities may reflect cumulative causation, where one factor is reinforced by another over a period of time.

Practical Insight 13: Convergence between Europe's Regions

If price differences between regions mean that some of the measures of regional differences exaggerate the disparity between regions, might this also be true of comparisons between Western Europe's high-income nations and Central and Eastern Europe's low-income nations? Although purchasing power parity data is available for these countries at the national level at a particular time, it is more difficult to estimate how prices and incomes will increase over a period time. If prices and incomes in the Central and Eastern European (CEE) countries rise rapidly to the level of prices and incomes in Western Europe, estimates of the time it will take for their economies to catch up may be exaggerated if they are based solely on real economic growth rates that ignore the changes in purchasing power parity that will come from rapid price convergence.

Question: Could it be that, for some of the CEE countries, economic convergence may come sooner than we expect?

9.5 The Changing Regional Industrial Structure

Perhaps the most important underlying reason for the regional disparities which exist in most countries is the changing industrial structure that is driven by new phases of economic development. In general terms this process can be described by what the Austrian economist, Joseph Schumpeter, called 'creative destruction', where innovative companies prosper at the expense of lagging companies in a process of continual renewal and decline. In this way, regions with a good record of innovation will progress as lagging regions decline. In the global economy industrial change can be even more fundamental as whole industries decline in Europe and North America and are reborn in Asia or Latin America. This has been the fate of the textile manufacturing and textile machinery industries and a long list of other manufacturing industries in recent years. Sometimes it happens on a continental rather than a global scale as, for example, with the European motor industry which has been gradually

drifting from Western to Central and Eastern Europe since the 1990s. This process of de-industrialization in the former manufacturing heartlands and new industrial development in the re-emerging European countries or newly industrializing countries of Asia and Latin America represents industrial restructuring on an international scale. For the former core manufacturing regions of Europe and America, it represents industrial decline, unemployment, and social deprivation. Regions that are slow to adjust to the changing industrial structure experience persistent economic and social problems.

- **The Core/Periphery Argument**

It is sometimes argued that 'core' regions have a locational advantage over 'peripheral' regions. Core regions may be the centre of political power, the centre of a large market or industry, may have good transport and communication links, or may simply be established economic or cultural centres. Many countries have core regions located around their capital cities or major industrial and commercial centres. Historically, core regions were often located in the industrial heartlands as well as around the capital; this was the case in England's northern manufacturing regions in the nineteenth century, and is still largely the case in Italy's industrial north today. On the whole, however, commercial and financial centres have taken over from manufacturing as core regions in most of the developed economies. Generally, in industries where transport costs are high, economies of scale are limited, and most industries are well established, firms and industries are more likely to remain in their historic location than to move to the core. In industries where transport costs are low, economies of scale are important, and firms are 'footloose', the pull of core regions is more powerful. In many modern industries the economic pull of the core region is therefore significant and the authorities in peripheral regions have to be imaginative in their efforts to attract industry to or improve the performance of their regions.

Core/periphery arguments have also been applied to countries, especially small countries with characteristics similar to sub-national regions. Thus, for example, Western Europe's southern and western periphery has generally performed less well than its more central core states. However, the countries on the northern periphery seem to be an exception to the argument, and Ireland became Western Europe's star economic performer in the 1990s, so cores and peripheries appear to be less relevant at the country level. Core regions may also exist on the border between two or more countries, as in the case of the *maquiladora* industries along Mexico's border with the United States where manufacturers take advantage of Mexico's low production costs and the lucrative US market within NAFTA's free trade area. In a different way, the geographical triangle linking Maastricht in the Netherlands with Liège in Belgium and Aachen in Germany (known as the Meuse-Rhine Triangle – see figure 6) provides a good example of a core cross-border region with strong business connections.

- **Economic, Social, and Political Institutions**

Thanks to the work of economists such as Douglass North, we now understand more clearly that, whatever its geographical location, the performance of a country's or region's economy is heavily influenced by its institutional structure. Economic institutions at the regional level include the transport and communication infrastructure, business and financial support networks, links with and dependence on other regions, and the quality and flexibility of a region's labour market. These institutions are both formal and informal. They are underpinned by social institutions such as the education system at the formal level and by attitudes to education, work, and business or career success at an informal level. Political institutions also play an important role at a regional level. The respective powers and accountability of

national, regional, and local government affect the type of decisions that can be made at each level and the influence of a region's electorate on those decisions. Sometimes these powers are delegated to regional development agencies; this again alters the locus of decision making. Some writers have argued that the over-centralization of political power at the national level is damaging to regional prosperity and regional equality, though too much decentralization may create institutional burdens on the local economy, especially where decision-making bodies have overlapping responsibilities.

Clearly, a region with a poor transport infrastructure or poor links with other regions is likely to struggle to develop either its own indigenous businesses or to attract investors from outside the region. At the very least, the region will have to compensate for these disadvantages in some way. Typically, this is done with the help of financial incentives, but the benefit of these incentives may be short-lived. A more lasting solution is to improve the institutional environment. Informal institutions may also act as a constraint on regional development, especially where workers are reluctant to take entrepreneurial risks or develop their own education and skills. Even a poor regional image or perception, perhaps based on a region's industrial past, may inhibit business confidence and investor interest. Germany's Ruhr region's association with heavy industry such as coal and steel, for example, has made it more difficult for the authorities to attract high-tech and service industries to the region. Examples from the Czech Republic and UK are given in Practical Insight 14.

Practical Insight 14: Image or Reality?

In a recent conversation between the author and Jan Suchaček, a regional economist from the Technical University of Ostrava in the Czech Republic, close similarities were noted between the image problems of Ostrava and the author's university town of Middlesbrough. Both towns have a legacy of heavy industry, notably steel, and their reputation and physical environment bear the scars of their industrial past. These scars sometimes affect the confidence and aspirations of their inhabitants as well as the views of outsiders.

Question: Is a region's image a real or imaginary problem? If it is real, how can it be changed?

- **Inappropriate Policies**

The most common solution to regional problems has been the provision of financial and other incentives to encourage business start-ups and attract inward investors. Often these incentives have been focused on investors in manufacturing industries in the belief that manufacturing is still the main basis of job creation in most countries. In the developed countries, however, many manufacturing industries are in long-term decline and are unlikely to continue to provide the large-scale employment they once did. A UK National Audit Office report in June 2003 found that 89% of regional assistance had gone to manufacturing firms and that, despite a number of jobs being created in disadvantaged regions, regional assistance represented 'relatively poor value for money in generating productivity improvements'. The policy emphasis on manufacturing possibly stems from the view that de-industrialization is a negative phenomenon to be resisted by governments, but evidence of the economic performance of advanced industrial economies suggests that it is more likely to be a natural consequence of industrial dynamism in a changing world.

The problem is that, while incentives help to compensate for regional disparities in the short term, they fail to tackle the underlying regional problems. Improving the infrastructure may be a more expensive option and changing perceptions and attitudes a more intractable

problem in the short term, but they may be necessary in order to correct regional disadvantages. If labour market and other institutional weaknesses are holding back regional development, ultimately the problem has to be addressed if a region is to prosper. The most appropriate policy approach is therefore to target the cause of the institutional problems rather than to compensate for them – unless the problems are genuinely insurmountable.

10. Case Study: A Regional Perspective on Eastern Slovakia

Slovakia is one of Central Europe's re-emerging market economies that joined the EU in May 2004. Although slower to engage with market reforms than some of its neighbours after its separation from the Czech Republic in January 1993, Slovakia made substantial economic progress under the government of Mikuláš Dzurinda (1998-2006). Like other countries undergoing major change, Slovakia is experiencing significant regional disparities. These are illustrated in Table 9. There is a clear contrast in terms of GDP per capita between the capital, Bratislava, and the rest of the country. Bratislava is enjoying a political, economic, and cultural renaissance now that it has become a national capital after years in the shadow of Prague. It has become a magnet for foreign direct investment, especially in the financial services sector. There is also a marked difference between three of the most westerly regions (Bratislava, Trnava, and Trenčín) and the rest of the country in terms of unemployment.

Table 9: Regional Unemployment and GDP per capita in the Slovak Republic

Area (NUTS 2)[a]	Region (NUTS 3)[a]	GDP p.c. (€, 2009)	Unemployment Rate (%, 2011)
Bratislava	Bratislava	28,443	5.5
West Slovakia	Trnava	12,928	8.6
	Trenčín	10,265	7.0
	Nitra	9,928	11.9
Central Slovakia	Žilina	10,038	13.2
	Banská Bystrica	8,425	15.8
East Slovakia	Prešov	6,654	18.5
	Košice	9,022	19.5

a. EU regions are classified according to the Nomenclature of Territorial Units for Statistics (NUTS).
Source: Statistical Office of the Slovak Republic

Eastern Slovakia is generally the least prosperous region, though the central region is not far ahead. The eastern region is the most remote not only from Bratislava but also from Western Europe. It contains Slovakia's second city, Košice, but is also close to Ukraine and Romania, where economic development has generally been slower. Eastern Slovakia includes a number of the country's poorer rural communities and has also been home to some of its older heavy industries, notably steel. The East Slovak Iron and Steel Works (now US Steel) in Košice accounted for around 10% of Slovak GDP in 1993. This industrial and rural legacy has left its mark on the region.

East Slovakia is a peripheral region, both within Slovakia and in the EU as a whole. Whilst there are historic trade links with neighbouring regions in Poland, Hungary, Ukraine, and Romania (the Carpathian region), the locus of political and economic activity in the EU is much further west. The transport infrastructure in Slovakia also leaves the eastern region somewhat isolated, with an incomplete motorway network, few direct international flights, and slow (though extensive) rail connections. Despite these disadvantages, Eastern Slovakia has a well educated, low-cost labour force and has been attracting an increasing number of

foreign investors such as US Steel, Volkswagen, Siemens, Coca Cola, and Tesco. The region also has a number of industrial parks designed to promote business activity. An interesting example is the Kechnec industrial park, located in the small town of Kechnec between Košice and the Hungarian border, which has been successful in attracting foreign investors such as Getrag-Ford, a German-US joint venture manufacturing gearboxes.

Slovakia as a whole has gone to considerable lengths to create an attractive environment for foreign investors since 1998. In particular, the political climate became more investor friendly and in 2004 a unified flat tax rate of 19% was introduced for income, corporate, and valued added taxes, providing businesses with one of the lowest corporate tax rates in Europe (see note below). Membership of the EU has also opened markets for Slovakian exporters and created a low-cost export base for foreign investors. The influx of motor industry investors provides ample evidence of these benefits, though the major motor manufacturers have so far invested in the more accessible regions in the west and north.

Table 10: Perceived Barriers to Entrepreneurship in Eastern Slovakia[a]

Region	Barriers to Entrepreneurship									
	1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Košice	4.01	3.79	2.43	2.52	4.42	4.12	2.38	3.63	3.62	3.64
Prešov	3.80	3.23	2.41	2.22	4.03	2.96	2.31	3.44	3.97	3.33

a. Respondents' weighted average scores on a scale of 1-5, where 5 = significant barrier

Key:

1. Bureaucracy
2. Corruption
3. Lack of Information
4. Export Difficulties
5. Low effective demand
6. Poor transport accessibility
7. Lack of qualified workforce
8. Taxation
9. Frequent changes of legislation
10. Law enforcement

Source: Hudec, O., Džupka, P., Urbančiková, N., Želinský, T., and Kmecová, Z. (2006), Prognóza vývoja regiónu Slovensko - Východ : Analytická časť. 1. vyd. Prešov : Prešovský samosprávny kraj, ISBN 80-969559-6-9 (Findings of the state research Project, ANPROBA: Analysis of Business Environment and Barriers of Regional Absorption Capacity, 2003-2005)

A variety of businesses are also being developed by local entrepreneurs, but smaller firms are often beset with problems and uncertainties that their larger counterparts can more easily offset. Table 10 summarizes selected results from a survey of entrepreneurs in the two administrative regions of Eastern Slovakia, conducted by researchers at the Technical University of Košice. The results indicate that the highest perceived barriers facing entrepreneurs are the low level of demand for their products, the level of bureaucracy, and in the Košice region at least, poor access to transport. However, in the majority of categories the scores are in the top half of the scale, indicating some level of concern over these barriers. Notwithstanding the particular difficulties faced by a transitional economy like Slovakia, the barriers are not untypical of the problems often faced by businesses in lagging regions.

Note: Slovakia's 19% flat tax rate is being abolished in 2013 as part of a package of budget deficit reduction measures announced in July 2012 by Prime Minister, Robert Fico.

Case Study Questions

1. What sort of political and economic conditions are likely to attract foreign direct investors to Slovakia?
2. Why are countries undergoing major change likely to experience ‘significant regional disparities’?
3. Why do you think the unemployment rate in Slovakia has been generally high since the end of the communist years?
4. How significant do you think Eastern Slovakia’s industrial heritage is as a reason for its relatively poor economic performance?
5. How important do you think core/periphery arguments are in the case of Eastern Slovakia?
6. To what extent might local clusters of foreign direct investors contribute towards agglomeration economies in places like Kechnec?
7. Why do you think a low level of demand is likely to be a problem for businesses in Eastern Slovakia?
8. The lowest perceived barriers facing businesses in Eastern Slovakia are lack of information, export difficulties, and lack of qualified workers. How would you interpret these results?