AUSTRALIA IN THE GLOBAL ECONOMY

2024

Tim Dixon • John O'Mahony

TOPIC 1

THE GLOBAL ECONOMY

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Focus

The focus of this study is the operation of the global economy and the impact of globalisation on individual economies.

Issues

Topic 1 economic issues questions can ask you to:

- Examine the effects of globalisation on economic growth and the quality of life, levels of unemployment, rates of inflation and external stability
- Assess the potential impact on the environment of continuing world economic development
- Investigate the global distribution of income and wealth
- Assess the consequences of an unequal distribution of global income and wealth
- Discuss the effects of protectionist policies on the global economy

Skills

Topic 1 skills questions can ask you to:

- Analyse statistics on trade and financial flows to determine the nature and extent of global interdependence
- Assess the impact on the global economy of international organisations and contemporary trading bloc agreements
- Evaluate the impact of development strategies used in a range of contemporary and hypothetical situations

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Topic 1

Introduction

This section (chapters 1 to 3) covers Year 12 Topic 1 *The Global Economy* and focuses on the structure of the global economy and the key features of globalisation. To understand the Australian economy we need to start with a global perspective. Topic 1 is critical to the rest of the course because it provides the overall perspective for when we later examine other topics such as Australian economic issues and policy.

Chapter 1 provides an overview of the global economy. It discusses the main components of the global economy – international trade, international flows of finance and investment, and the role of technology and people movements in strengthening links between individual economies. These links are highlighted with a review of international and regional business cycles.

Chapter 2 examines the main economic theory that underpins globalisation – the concept of free trade and the economic benefits that trade brings. Chapter 2 then examines the reasons for countries restricting trade and protecting their own industries, and how recent years have seen many international agreements to reduce barriers to trade. This chapter concludes with a look at the role of international organisations and government economic forums in managing the global economy.

Chapter 3 examines the divisions within the global economy. Understanding the gaps in the living standards between rich and poor nations is essential to an analysis of the global economy. This chapter looks at the distinction between economic growth and economic development. It discusses the main categories into which different economies are grouped and examines the global and domestic factors that contribute to inequality. Chapter 3 also discusses the impacts of globalisation on economic development.

Topic 1 concludes with case studies of Brazil and Indonesia. Understanding the impacts of globalisation on individual economies is an important complement to any analysis of globalisation at the global level and is a requirement of the Year 12 Economics Course.

Brazil is one of the four largest emerging economies in the world. Like Australia, Brazil is a major commodity exporter, but unlike Australia it has not opened up its economy fully to global forces, and it has had significant economic problems in the past decade. As a case study, Brazil highlights the opportunities and challenges of increased economic integration.

Indonesia is the largest emerging economy of South-East Asia – a region that experienced rapid industrialisation and improvements in economic development in recent decades. The increasing linkages between Indonesia and Australia make understanding the Indonesian economy especially valuable for future Australian economists.

The case studies may complement another country that you choose to study. You may decide to compare the impacts of globalisation on these two economies or you may choose to make either Brazil or Indonesia your case study in 2024.

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Introduction to the Global Economy

1

1.1 The global economy
1.2 Globalisation
1.3 The international and regional business cycles

1.1 The global economy

The study of economics has traditionally focused on how individual economies operate. While countries have always traded with each other, economic theories have generally assumed that economies operate separately from each other and that the structure and performance of economies is mainly the result of local developments and influences.

This way of looking at economics no longer describes the real world. Today we live in a **global economy** – where the economies of individual countries are linked to each other and changes in a single economy can have ripple effects on others. For many advanced and developing countries, the value of what they buy and sell from overseas is often greater than half of the value of the economy's annual output. When conditions in the global economy change, these changes can have an impact on the economies of far-flung countries almost immediately. The importance of global factors in driving economies has been starkly illustrated in the 2020s by the COVID-19 pandemic and the war in Ukraine. Both of these events resulted in global economic impacts on supply chains, production and prices.

In many respects there is nothing new in the fact that major economic developments can have impacts across the world. For example, the Great Depression of the late 1920s and 1930s had a global impact with many countries experiencing a severe economic downturn. On the other hand, economies are more closely integrated now than at any previous time. The linkages between economies are deeper and more far-reaching than ever before. There are few aspects of life that have not been affected by the waves of global influences washing across the world. This is especially the case in a smaller economy such as Australia, which has embraced the global economy and pursued policies to integrate its economy with those of its region and around the world.

In the past three decades, **globalisation** has become a dominant economic, political and social theme. Globalisation is the integration between different countries and economies and the increased impact of international influences on all aspects of life and economic activity. Unlike many previous times in world history when one major empire often dominated the relationships between economies, globalisation in recent decades has involved layers of influences in all directions. The United States is still the leading world economy, but its power is increasingly constrained by China and other major economies.

Globalisation refers to the integration between different countries and economies and the increased impact of international influences on all aspects of life and economic activity.

Globalisation is also a phenomenon with increasing impacts on national politics. Recent years have seen a backlash against globalisation in many countries. Numerous leaders (such as Donald Trump, who was President of the United States from 2017 to 2021) have come to power promising to strengthen their country against global economic forces. The COVID-19 pandemic added to public concerns about the impact of globalisation, as

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travel between countries accelerated the spread of the coronavirus, and countries ran short of medical supplies because of their reliance on global supply chains. Some economists describe the past decade as "slowbalisation" because of low growth in trade volumes, increased restrictions on trade, and rising geopolitical tensions.

From an economic point of view, the major indicators of integration between economies include:

- international trade in goods and services
- international financial flows
- international investment flows and transnational corporations
- technology, transport and communication
- the movement of workers between countries.

There are many dimensions to globalisation and there are many statistics that can be used as measures of globalisation. For example, some indication of the extent of globalisation can be gained from examining the proportion of programming on television networks and streaming services that is made in Australia versus made overseas; or similarly, the proportion of music downloads that are local versus overseas artists. These would be classified as social or cultural indicators of globalisation. Each of these indicators provides an insight into the way in which economies are now linked to each other and re-shaping the global economy.

> "Even in the face of substantial shocks over the last few years, international flows have shown great resilience. By 2021, global flows of trade, capital, and information had surpassed their pre-pandemic levels. And while people flows were stagnant in 2021, they made progress towards recovery in 2022. To be sure, today's geopolitical tensions are reshaping some types of flows, and the war in Ukraine and worsening macroeconomic conditions have caused the growth of international flows to slow. But international activity shows no sign of a retreat.
>
> …
>
> As leaders have confronted the possibility of deglobalization, some have begun to call instead for reglobalization. This does not refer to a mere reversion to earlier growth trends, or even a return to prior policy approaches. Instead, the focus is on reforming globalization to make it work better, expanding its pool of beneficiaries and better managing its challenges.
>
> …
>
> As policymakers continue to confront major global and national challenges, one of the clear lessons from the Covid-19 pandemic is that international connections dramatically expand our capacity to solve problems."
>
> *– Steven A. Altman and Caroline R. Bastian*
> *"DHL Global Connectedness Index 2022"*
> *15 March 2023*

1.2 Globalisation

Trade in goods and services

Gross World Product (GWP) refers to the sum of total output of goods and services by all economies in the world over a period of time.

International trade in goods and services is an important indicator of globalisation because it is a measure of how goods and services produced in an economy are consumed in other economies around the world. The value of exports of goods and services has grown rapidly in recent decades, increasing from US$4.3 trillion (19 per cent of global output) in 1990 to over US$27.9 trillion (29 per cent of global output) in 2022. The size of the **Gross World Product (GWP)** – the aggregate value of all goods and services produced worldwide each year in the global economy – is now 9 times its nominal level in 1980, but the volume of world trade has grown to over 12 times its 1980 level.

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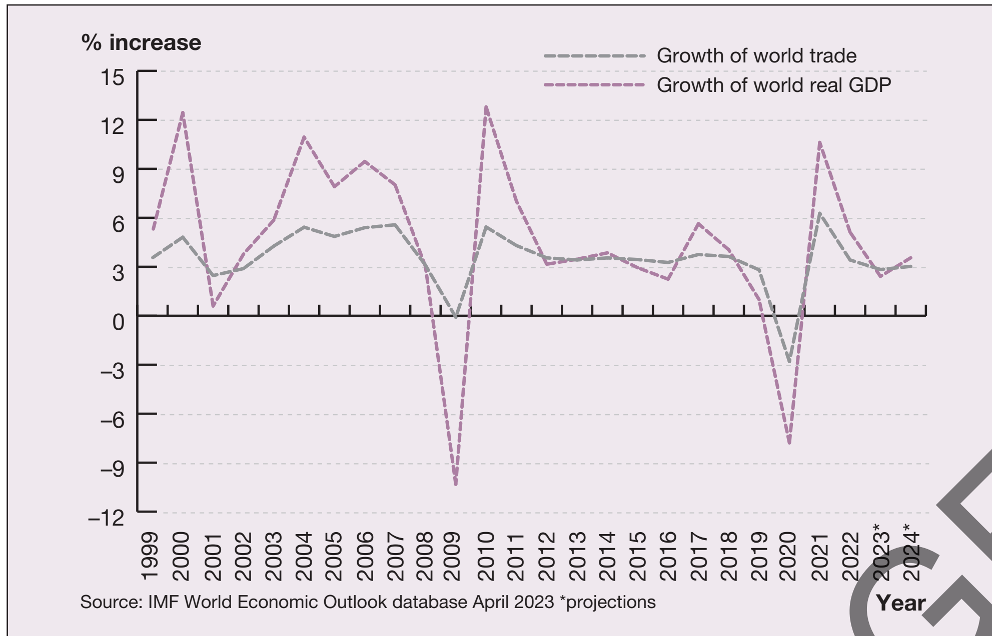

Figure 1.1 – Gross World Product and world trade

Annual growth in the value of trade has generally been around the same level as world economic growth since the global financial crisis. During economic downturns, such as in the early and late 2000s and in 2020, the growth of global trade has contracted faster than world economic output, highlighting the **greater volatility** of trade compared with the GWP. The impact of the COVID-19 pandemic on supply chains, tourism and international education led to a contraction in global trade of 7.8 per cent, followed by a strong rebound in 2021.

The high volume of global trade reflects the fact that economies do not produce all the items they need, or they do not produce them as efficiently as other economies, and have to import goods and services. Global trade grew strongly for decades because of new technology in transport and communications, which reduced the cost of moving goods between economies and providing services to customers in distant markets. Over the same period, governments have encouraged trade by removing barriers and joining international and regional trade groups such as the **World Trade Organization (WTO)**, European Union (EU), and the Association of South-East Asian Nations (ASEAN). These developments have been a major force behind increasing global trade.

World Trade Organization (WTO) is an organisation of 164 member countries that implements and advances global trade agreements and resolves trade disputes between nations.

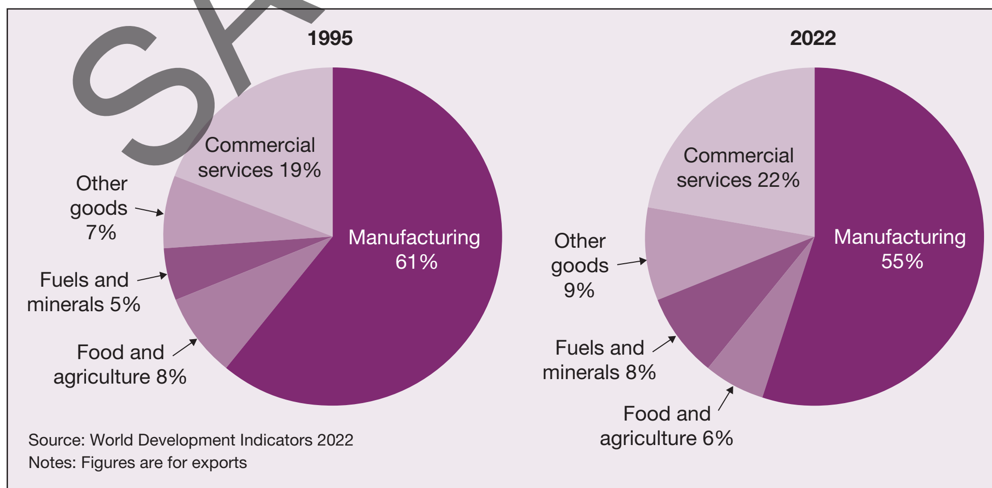

Figure 1.2 – Composition of global trade, 1995 and 2022

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The mix of what goods and services are traded, known as the **composition of trade,** can have an impact on individual economies. Figure 1.2 shows that global trade is dominated by manufactured goods, such as vehicles, clothing and electronic goods. Trade in services, such as finance and communication, is the fastest-growing category of trade and makes up two-thirds of global output, but it currently makes up less than one-quarter of global exports. In particular, digital service exports are likely to be strong future drivers of global trade growth, already tripling in value since 2005 according to the WTO. Countries such as Australia should continue to benefit from the growth in services trade because countries with highly educated workforces are best positioned to compete in growing global markets for services. Nevertheless, the COVID-19 pandemic resulted in a change in the composition of world trade, at least in the short term, with services sectors such as tourism and international education severely affected by travel restrictions.

The **direction of trade flows** has changed in recent decades, reflecting the changing importance of different economic regions. Between 1995 and 2020, high-income economies (concentrated in North America and Western Europe) saw their overall share of global trade fall from 85 per cent of exports to 64 per cent, as shown in figure 1.3. Over the same period, the fast-growing economies of East Asia and the Pacific region (which includes China, Indonesia and Vietnam) experienced the most rapid increase in trade, with their share of global trade surging from 6 per cent to 20 per cent.

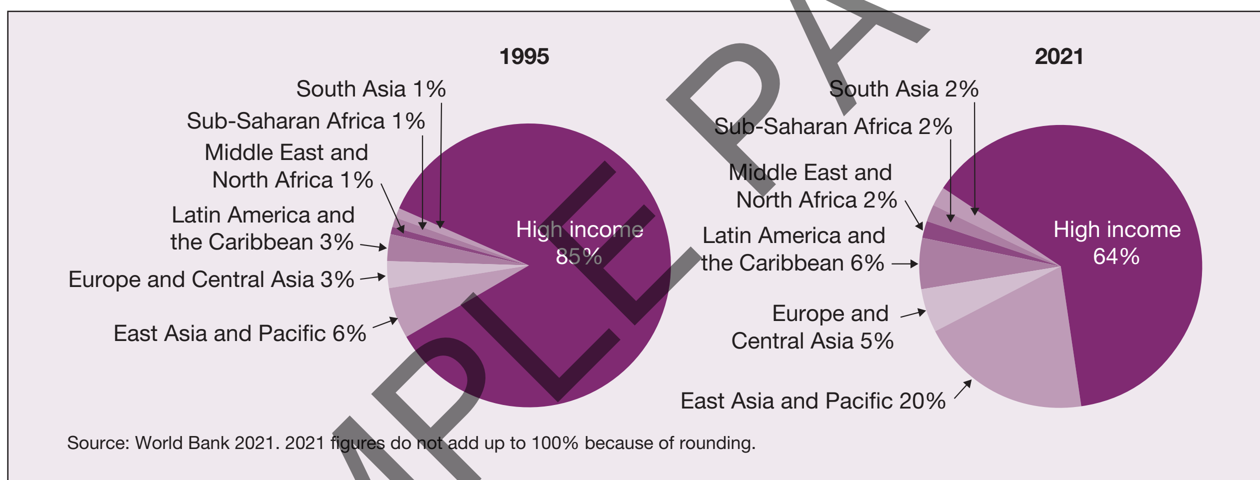

Figure 1.3 – Share of world's exports by region, 1995 and 2021

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Trends in the direction of trade can also have an impact on individual economies. For example, recent decades have witnessed strong growth in the Chinese economy, resulting in stronger trade relationships and inter-linkages in global supply chains. Countries such as Australia have prepared for stronger economic relations with China by encouraging students to learn Mandarin at school. At the same time, concerns about Australia being too reliant on exports to China are a factor in Australia's growing emphasis on expanding trade with India and other growing economies in the region.

reviewquestions

1. Explain TWO reasons for the increase in trade in goods and services in the global economy.
2. Describe trends in the composition and direction of trade flows in the global economy.
3. Discuss the impacts of changes in global trade flows on economies.

Financial flows

International finance now plays a leading role in the global economy. Because finance is crucial to so many aspects of how modern economies work, the globalisation of finance has had a major impact in terms of linking economies around the world. Finance is the most globalised sector of the world economy because money moves between countries more quickly than goods and services or people.

International financial flows expanded substantially following financial deregulation around the world, which in most countries occurred in the 1970s and 1980s. Controls on foreign currency markets, flows of foreign capital, banking interest rates and overseas investments in share markets were lifted. Technological change also played an important role. New technologies and global communications networks linked financial markets throughout the world, allowing events in major international markets such as New York, Tokyo, London and Hong Kong to produce immediate results.

While there is no single measure of international financial flows, all have shown a dramatic increase during the globalisation era. Figure 1.4 shows the growth of exchange-traded derivatives, which are a major instrument in global financial markets. The volume of financial flows fluctuates in response to global conditions. Sharp falls in financial flows have been followed by strong recoveries in 2008 (with the global financial crisis), 2013 (with the Eurozone crisis) and 2020 (with the COVID-19 pandemic).

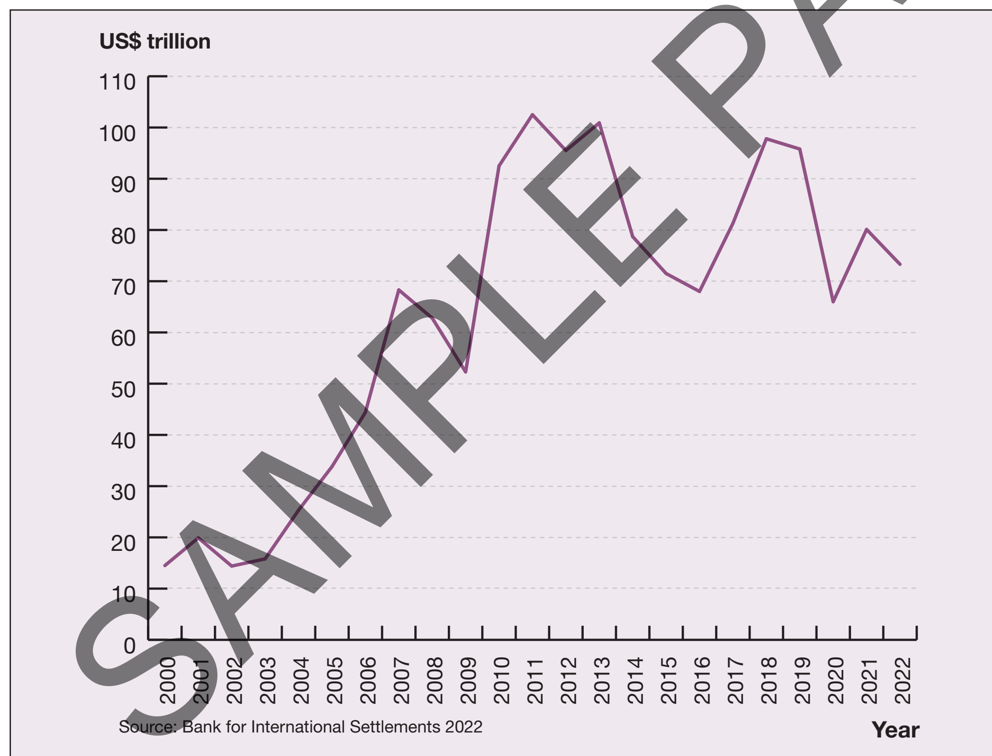

Figure 1.4 – The growth of global financial flows: exchange-traded derivatives

An important feature of international finance is **foreign exchange markets** (or forex markets), which are networks of buyers and sellers exchanging one currency for another in order to facilitate flows of finance between countries. Foreign exchange markets have experienced extraordinary growth in recent years, with average daily turnover reaching over US$7.5 trillion by 2022, up from US$4 trillion in 2010. The value of a currency is expressed in terms of another currency and is known as the **exchange rate** between two currencies. As will be discussed in chapter 5, most countries determine the value of their currency through the interaction of the forces of supply and demand in foreign exchange markets.

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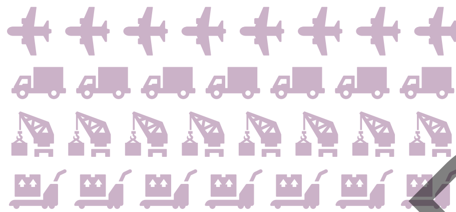
> **Speculators** are investors who buy or sell financial assets with the aim of making profits from short-term price movements. They are often criticised for creating excessive volatility in financial markets.

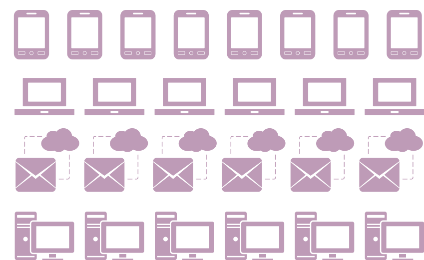
The main drivers of global financial flows are **speculators and currency traders** who shift billions of dollars in and out of financial markets worldwide to undertake short-term investments in financial assets. Based on data from the Bank for International Settlements' (BIS) Triennial Survey of foreign exchange transactions, only a small share is for "real" economic purposes such as trade and investment. The vast majority is for speculative purposes – to derive short-term profits from currency and asset price movements – or for technical purposes, such as hedging against future exchange rate movements and swapping funds between currencies. International investment banks and hedge funds, often based in the United States, are generally responsible for most of these transactions. The aim of these transactions is either to gain from short-term movements in asset prices – namely currency and share price fluctuations – and to generate profits, or to hedge against future movements and minimise the risk of losses.

GLOBAL INVESTMENT
US$1.58 TRILLION
FOREIGN DIRECT INVESTMENT



GLOBAL COMPANIES
104 THOUSAND
TRANSNATIONAL CORPORATIONS

GLOBAL LABOUR
164 MILLION
MIGRANT WORKERS



GLOBAL COMMUNICATIONS
5.3 BILLION
INTERNET USERS

SOURCES: World Bank, Bank for International Settlements, International Telecommunications Union, United Nations Conference on Trade and Development, International Organization for Migration. Excludes migrants who have taken citizenship in their new country.

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The main benefit of greater global financial flows is that they enable countries to obtain funds that are used to finance their domestic investment. In particular, investors in countries with low national savings levels would not otherwise be able to obtain the necessary finance to undertake large-scale business and investment projects if their economies were closed off to global financial flows. In this regard, global financial flows may enable a country to achieve higher levels of investment (and therefore economic growth) than would otherwise have been possible if finance from overseas were not available.

However, changes in global financial flows can also have significant negative economic impacts. Speculative behaviour can create significant volatility in foreign exchange markets and domestic financial markets. This is because speculators are often accused of acting with a herd mentality, meaning that once an upward or downward trend in asset prices is established it tends to continue. Speculative activity has been blamed for large currency falls and financial crises in several countries over the past decade, including Britain in 2016, Türkiye in 2021 and repeatedly in Argentina. As discussed further in chapter 2, the **International Monetary Fund (IMF)** is responsible for the overall stability of the global financial system. One of its roles is to stabilise individual economies experiencing currency crises or financial turmoil, in order to prevent flow-on effects to other economies.

International Monetary Fund (IMF) is an international agency that consists of 190 members and oversees the stability of the global financial system. The major functions of the IMF are to ensure stability of exchange rates, exchange rate adjustment and convertibility.

reviewquestions

1. Account for the trends in international financial flows during the globalisation era.
2. Examine the role of speculators and currency traders in global financial markets.
3. Discuss the impact of global financial flows on economies.

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Investment and transnational corporations

Another indicator of globalisation is the rapid growth of investment between countries over the past two decades. Since the 1980s, the global economy has witnessed rapid growth in movements of capital. While there are similarities in the growth of global finance and global investment, the two concepts can be distinguished by describing the shorter-term, speculative shifts of money as *finance*, and the longer-term flows of money to buy or establish businesses as *investments*.

One measure of the globalisation of investment is the expansion of **foreign direct investment (FDI)**, which involves the movements of funds that are directly invested in economic activity or in the purchase of companies. Reforms in developed and developing countries led to a surge in FDI flows from the 1980s onwards. Figure 1.5 demonstrates the dramatic increase in FDI flows over the past three decades. FDI flows are strongly influenced by the level of economic activity. The global recession in the late 2000s reduced FDI flows sharply, but they gradually recovered and the 2010s decade saw sustained high levels of FDI. The COVID-19 pandemic caused another sharp downturn in FDI flows in 2020, with UNCTAD recording a fall to under US$1 trillion for the first time in almost two decades, but this was a brief downturn, with FDI flows recovering quickly the following year.

Foreign direct investment (FDI) refers to the movement of funds between economies for the purpose of establishing a new company or buying a substantial proportion of shares in an existing company (10 per cent or more). FDI is generally considered to be a long-term investment and the investor normally intends to play a role in the management of the business.

FDI flows have traditionally favoured developed nations. With greater industrial capacity and larger consumer markets, economies in Europe, North America and Japan were the natural destination for foreign investment during the globalisation decades of the 1990s and most of the 2000s. But this dominance has changed, with the share of FDI destined for developing and other economies significantly exceeding the developed world's share since 2020. The majority of FDI inflows to developing countries flow to economies in Asia. Of the US$916 billion inflows to developing countries in 2021, US$662 billion went to

Asia ($307 billion to China and Hong Kong, $141 billion to Singapore and $49 billion to India). The increase in FDI inflows to developing countries since 2020 reflected stronger returns on FDI, relative to the returns on investment in developed countries.

Developing economies have also become a major source of investment funds in the global economy. In 2021 these economies contributed 31 per cent of global FDI funds, compared to around 15 per cent in the mid-2000s.

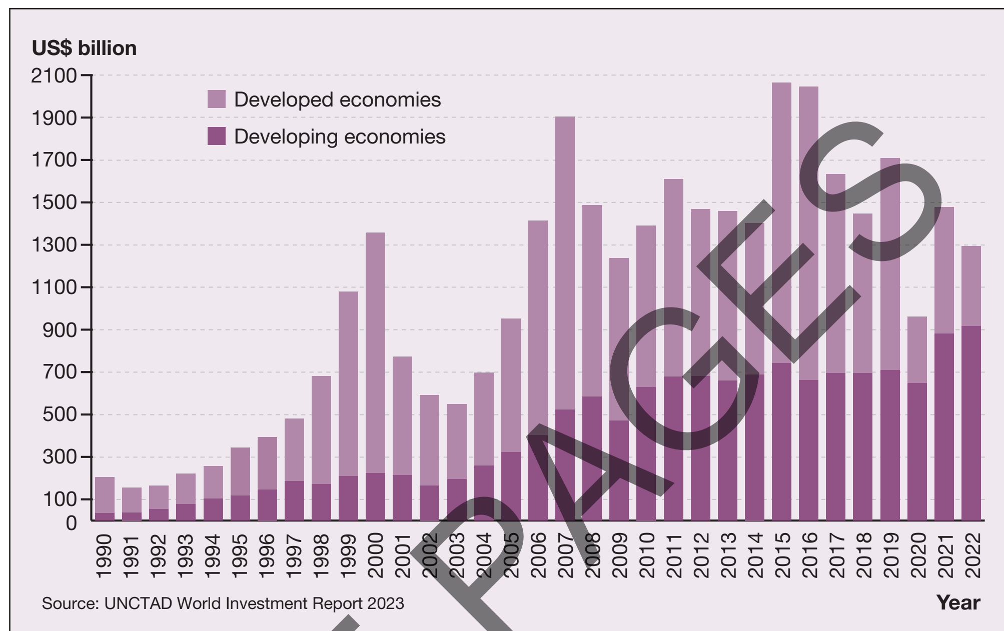

Figure 1.5 – Total world FDI inflows

Transnational corporations (TNCs) play a vital role in global investment flows and account for roughly one-half of global trade. Often, they will have production facilities in countries around the world, sourcing inputs from some countries, doing most of the manufacturing in another country, and doing other packaging and marketing tasks in another country. Around 80 per cent of trade occurs in global value chains, according to UNCTAD analysis.

As TNCs such as Apple, Amazon and Tesla establish or expand production facilities in a country, they bring foreign investment, new technologies, skills and knowledge. Because of the capital and job opportunities they bring, governments often encourage TNCs to set up in their country through supportive policies like subsidies or tax concessions. Since the early 1990s, the number of TNCs has grown from 37,000 to 104,000, and the number of affiliates to TNCs has grown from 170,000 to over 1,116,000. Foreign affiliates of TNCs employ over 83 million people globally.

TNCs in digital industries have experienced particularly rapid growth due to increased adoption of digital solutions during the pandemic. Total sales for the top 100 digital TNCs grew 159 per cent over the five years to 2021, four times faster than the top 100 traditional TNCs. As TNCs continue to increase in both volume and significance, there has been an associated increase in cross-border cartels between large corporations, which reduces competition in economies and disadvantages local consumers. Global fines for cartels were $4.6 billion in 2021. However, many cartel arrangements are never uncovered by regulators, and fines are unlikely to fully capture the true cost of harm caused by cartels.

A significant cause of the growth of international investment is the increased level of international mergers and takeovers. During recent decades, there has been a spate of mergers between some of the world's largest corporations – most recently between technology companies Salesforce and Slack, pharmaceutical companies AstraZeneca and Alexion Pharmaceuticals, and media companies Walt Disney Company and 21st Century

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Fox. These mergers have seen the formation of companies worth hundreds of billions of dollars and reduced the number of truly global companies in different product markets. The peak year for cross-border mergers and acquisitions (M&As) was 2007, when US$1 trillion of mergers took place, as shown in figure 1.6. International M&As typically move in line with changes in global economic conditions – investment falls when economic growth is lower. In 2022, M&As stood at US$706 billion.

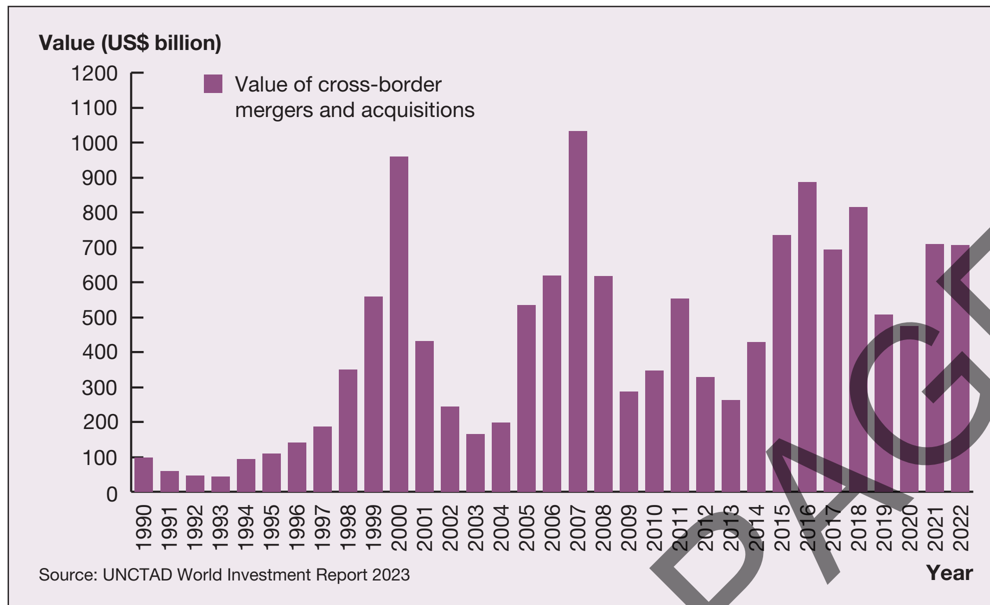

Figure 1.6 – Cross-border mergers and acquisitions

In overall terms, most investment in economies around the world still comes from domestic sources. FDI typically accounts for less than 20 per cent of total investment, meaning that over 80 per cent of investment still comes from within national economies.

reviewquestions

1. Distinguish between global financial flows and global investment flows.
2. Outline trends in the growth and direction of FDI flows.
3. Explain the role that TNCs play in global investment flows.

Technology, transport and communication

Technology plays a central role in globalisation. In part, this is because technological developments facilitate the integration of economies. Consider the following examples:

- Developments in freight technology, such as the use of micro warehouses nearer customers to improve "last mile" logistics and increased use of blockchain technology to simplify tracking and facilitate greater trade in goods. The WTO has estimated that the digitisation of trade has the potential to cut trade costs by 6 per cent.
- Cheaper and more reliable international communication through high-speed broadband allows for the provision of commercial services to customers around the world. A 2023 OECD study estimated that digital connectivity is having a three times larger impact on reducing trade costs today than in 1995. The proportion of the global population using the internet increased from 7 per cent in 2000 to 67 per cent in 2022.

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- In finance and investment, technology plays a key role in facilitating globalisation through secure, high-speed networks that allow money to move around the world in a fraction of a second.
- Smartphones and mobile internet access are fundamentally changing the structure of many industries, from retail and transport sectors to education, leisure and professional services. Technology is causing disruptive change to the structures of many of these industries as huge populations embrace online technologies. The number of mobile phone subscriptions is now over 8 billion, which is roughly equal to the number of people in the world.
- Advances in transportation, such as longer non-stop flights and high-speed rail networks, allow greater labour mobility between economies and increased accessibility to tourism and travel for consumers.

Technology is one of the strongest drivers of globalisation because it allows integration at a depth unthinkable in previous decades and centuries. OECD research in 2023 found that a 1 per cent increase in bilateral digital connectivity increases both domestic trade (2.1 per cent) and international trade (1.5 per cent). Economies that adapt to new technologies rapidly also tend to be the economies that are most closely integrated with other economies in their region or around the world. The COVID-19 pandemic also highlighted the disparity in access to technologies between countries, a phenomenon known as the "digital divide". Countries where digital technology use was high (such as Israel, the Netherlands and Australia) were better able to cope with the physical lockdowns necessary to prevent the spread of the virus by continuing normal activities through digital marketplaces, virtual meetings and online learning.

SOCIAL MEDIA AND GLOBALISATION

Social media platforms have accelerated globalisation at many levels. By creating new online communities, social media platforms such as Facebook, Instagram, TikTok, YouTube and Twitter connect individuals on an unprecedented scale. Of all internet users, over 90 per cent are active on social media. Facebook, for example, claims 2.9 billion members.

As well as accelerating the globalisation of cultures, social media platforms have major economic impacts. Social media is central to marketing consumer products and services. Firms may use professional networks such as LinkedIn to source the best talent from global labour markets. Google Chief Economist Hal Varian has even suggested that word-search data for terms like *unemployment benefits* and *holidays* could be used to predict trends in consumer confidence and economic conditions.

Social media platforms are also worth vast sums. Elon Musk bought Twitter for US$44 billion in 2022. Google earned over US$280 billion in 2023, mostly from advertising revenue. Apple Inc. became the world's first trillion-dollar company by selling the phones, tablets and laptops through which people access social media. Social media platforms can rise and fall quickly (TikTok, for example, launched globally in 2017 and had over 3 billion downloads by 2023), but they are reshaping the economics of many sectors beyond media and telecommunications.

Another way that technology influences globalisation is as a driver of growth in trade and investment. For the leading technology innovators and exporters, technology represents a major trade opportunity. The United States earns substantial export revenues from its global leadership in many areas of new technologies. This reflects the geographical distribution of the top 100 digital TNCs' headquarters, with 59 per cent in the United States. Other countries rely on importing technology from a small group of developed economies with the hope that, over time, as they adopt new technologies, they can become innovators and develop their own technology exports as countries such as India, South Korea and Israel have done in recent years. Trade, therefore, spreads new technologies. Because innovation is an ongoing process, the leading country can often retain its technological superiority for a long period of time.

Business corporations that play a leading role in developing new technologies will often move directly into overseas markets in order to sell their products and services direct to local buyers. For example, leading information and communications technology corporations such as Google, Salesforce and IBM all have extensive global operations. These corporations bring extensive know-how into a new market and will often invest substantially in the new countries that they enter, particularly in education and training. In this way technology drives increased foreign investment. This is particularly apparent for digital TNCs, which have less reliance on physical assets. E-commerce TNCs increased their greenfield investments (a type of FDI that involves building a foreign subsidiary from the ground up) by 120 per cent in 2020 and a further 10 per cent in 2021.

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The internet provides a communications backbone that links businesses, individuals and nations in the global economy. This not only allows greater communication within and between firms but also reduces business costs that have in the past been a barrier to integration between economies. The World Information Technology and Services Alliance (WITSA) has estimated that the global marketplace for information and communications technology is worth almost US$5 trillion. The surge in worldwide internet usage to five billion users highlights the rapid spread of technologies across countries in recent years and the increasingly interconnected nature of the global economy. COVID-19 accelerated this trend, with international internet traffic roughly doubling in 2020. At the same time, as online information flows have become more globalised, regulations have been required to mitigate cybersecurity attacks, which, around the world, increased by almost 40 per cent in 2022. Figure 1.7 shows the number of internet users in selected countries.

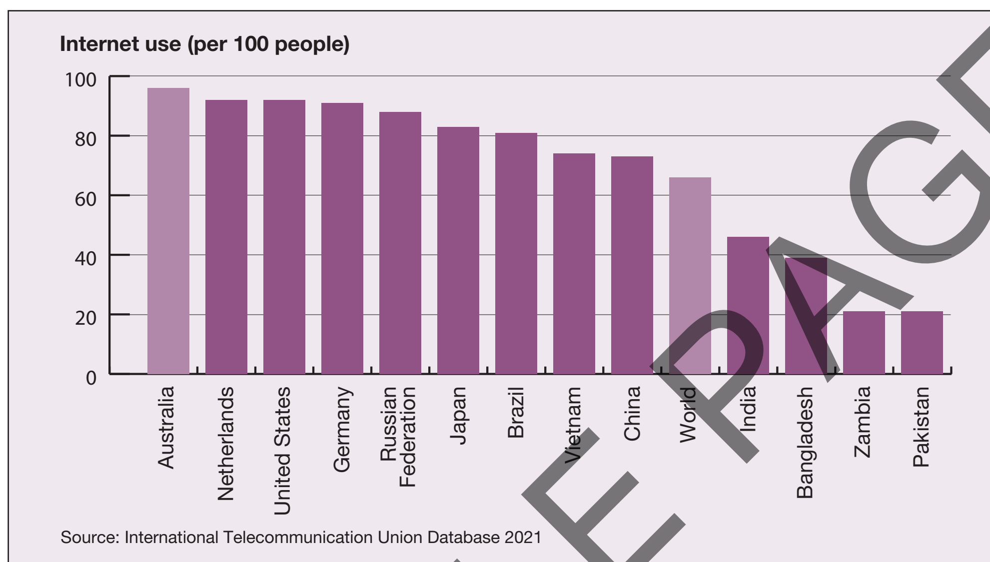

Figure 1.7 – Internet users in selected countries

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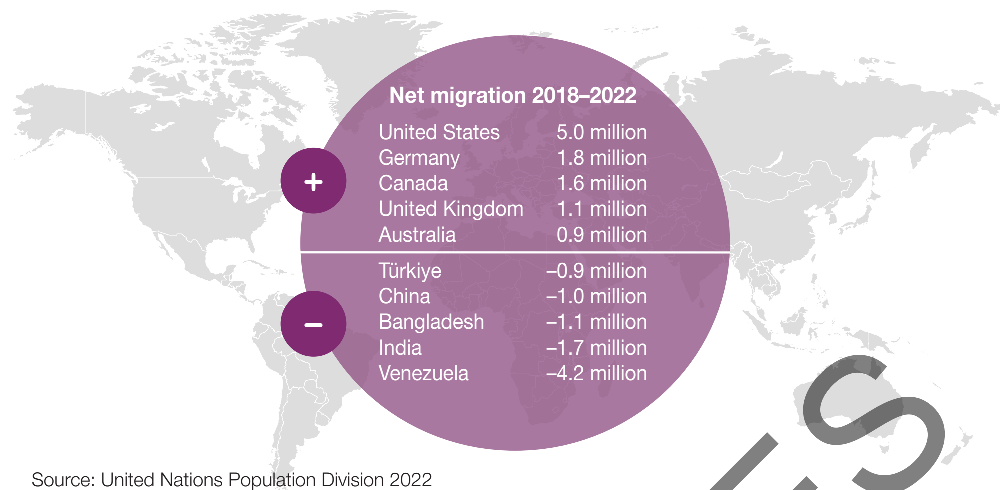
International division of labour and migration

Labour markets differ from markets for goods and services, finance and investment, in that they are far less internationalised. While money can move around the world in fractions of a second, goods and services can move in days and investments can be made in weeks, people do not move jobs quite as freely. In fact, in recent years, the industrialised world has become more restrictive about immigration of people from poorer countries.

Nevertheless, more people than ever before are moving to different countries to take advantage of the better work opportunities that other countries offer. The World Bank estimates that 184 million people are living outside their country of nationality, with around half coming from low- and middle-income countries. The International Labour Organisation (ILO) estimates that around 164 million people (around 2 per cent of the world's population) are migrant workers. Labour migration into Organisation for Economic Co-operation and Development (OECD) member countries fell because of reduced job opportunities following the global financial crisis, gradually recovering during the 2010s. The number of migrants has continued to grow despite the impacts of COVID-19, reflecting both 'push' factors (such as people leaving their country because of conflict and violence) and 'pull' factors (the demand for workers in many countries). The net migration statistics in figure 1.8 show that with rare exceptions, the number of people on the move across the world remains low relative to country population sizes. In 2023, over 8 million Ukrainians were displaced because of war.



Source: United Nations Population Division 2022

Figure 1.8 – Net migration by region and country (over past five years)

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The movement of labour between economies appears to be concentrated at the top and bottom ends of the labour market. At the top end, highly skilled workers are attracted to larger, higher-income economies, such as Europe and the United States, because of the higher pay and better job opportunities available in these countries. The ILO estimates that two-thirds of international migrant workers have moved to high-income economies. Smaller advanced economies, such as Australia and New Zealand, suffer from a "brain drain" of some of their most talented and skilled workers, who are attracted to other countries by greater rewards. In effect, there is a global market for the most highly skilled labour.

At the bottom end of the labour market, low-skilled labour is also in demand in advanced economies where it may be difficult to attract sufficient people born locally to do certain types of work. Jobs that only require basic skills (and perhaps do not require advanced language skills) are often filled by migrants. In the United States migrants are predominantly from Latin America; in European countries migrants are mainly from Eastern Europe and Africa; in richer Asian countries migrants are mainly from lower-income economies in the region. Low-skilled labour migrants often remit their earnings from countries with higher wages back to their families at home. Economies received remittances from overseas of US$614 billion in 2021, with India, Mexico and the Phillipines the main destinations.

International division of labour is how the tasks in the production process are allocated to different people in different countries around the world.

These trends in migration reflect an **international division of labour** whereby people move to the jobs where their skills are needed while the globalisation of the labour market is increasing but there are still significant barriers to working in other countries. These barriers include immigration restrictions, language, cultural factors and incompatible educational and professional qualifications. Most people would prefer to stay in the country of their birth, where their family and friends live, and where they are most familiar with the language and culture. Against this preference, domestic instability and geopolitical turmoil may force people to flee their countries, with the UNHCR estimating that 103 million people were forcibly displaced by mid-2022, the highest figure on record.

The international division of labour is also evident from another aspect of the world economy – the shift of businesses between economies, rather than the shift of people. Just as people may move countries in search of the best job opportunities, corporations shift production between economies in search of the most efficient and cost-effective labour. In a globalised business environment, many producers operate what is called a global supply chain (or global value chain), with production facilities in several countries. The process called "offshoring" allows companies to shift production between countries to reduce costs. In 2022, research by the IMF found evidence that global supply chains had

BRAIN DRAIN OR BRAIN GAIN?

Around 169 million people worldwide have migrated because of work. The proportion of these "economic migrants" who are highly skilled heavily outnumbers those who are low-skilled in almost all countries. In some countries, like Haiti and Jamaica, more than 80 per cent of the skilled labour force has moved overseas. Not even high-income countries are immune to the brain-drain problem, with Hong Kong and Ireland losing between one-third to one-half of their college graduates.

Brain drains have traditionally been perceived as a negative outcome for an economy in terms of both development and welfare. High levels of skilled labour emigration increase the technological gap between developed and developing countries as human capital flows towards more advanced economies and the source country may experience shortages of skilled workers. For example, health systems in developing countries can suffer when qualified doctors and nurses move to high-income economies where they are in demand.

On the other hand, economies experiencing outwards migration can benefit from remittance inflows, interconnected business networks and increased sharing of technological developments. The World Health Organisation (**WHO**) and the EU recently launched a project focused on the migration of health workers: From Brain Drain to Brain Gain. The program aims to manage and improve the flow of health workers from developing economies in Sub-Saharan Africa and Asia to maintain health standards and ensure that source countries retain some ability to deal with potential medical crises.

Sources: IZA World of Labor; WHO Health Workforce Alliance and the Health Workforce Department

SAMPLE PAGES

operated successfully during the COVID-19 pandemic, with less-affected countries able to supply goods when other countries were harder hit. Nevertheless, in many countries governments have taken steps since the COVID-19 pandemic to reduce their reliance on global supply chains and promote "on-shoring" of essential industries. While offshoring has been occurring for decades, particularly for labour-intensive manufacturing processes, recent years have also seen services functions such as IT support, data management and accounting move to more competitive locations to reduce costs.

The international division of labour reflects the economic concept of "comparative advantage" that is discussed in chapter 2. This theory states that economies should specialise in the production of the goods or services that they can produce at the lowest opportunity cost. Developing economies have a large population of workers with only basic labour skills and education levels, giving them a comparative advantage in labour-intensive manufacturing. Advanced economies have generally shifted away from labour-intensive manufacturing to focus on specialised service aspects of the economy that use more highly skilled workers who are in greater supply in advanced economies.

reviewquestions

1. Explain the role of innovations in technology communications and transport in driving the process of globalisation.
2. Outline key trends in migration in recent years.
3. Explain how migration and offshoring reflect an international division of labour between different economies.

Business cycle refers to fluctuations in the level of economic growth due to either domestic or international factors.

Gross Domestic Product (GDP) is the total market value of all final goods and services produced in an economy over a period of time.

1.3 The international and regional business cycles

The level of economic activity in individual economies is never constant (that is, never in a state of equilibrium). Economic growth usually moves in cycles – in other words, instead of sustaining a steady rate of growth from year to year, most economies go through periods of above-average growth that then lead into periods of below-average growth. These ups and downs of the **business cycle** (that is, the general level of economic activity) are caused by changes in the level of aggregate supply and demand. This is shown in figure 1.9, which also shows that economies usually experience an overall trend of growth in output (measured by increases in **Gross Domestic Product**).

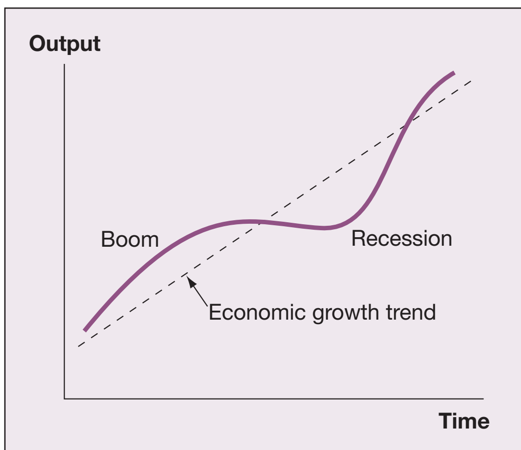

Figure 1.9 – The business cycle

Just as individual economies experience stronger and weaker periods of economic growth, so too does the global economy. This ebb and flow of world economic growth is known as the **international business cycle**, which refers to the changes in the level of economic activity in the global economy over time. Although the levels of economic growth each year often differ greatly between countries, for most countries economic growth is stronger when the rest of the world is growing strongly, and weaker when other countries are experiencing a downturn. The extent of synchronisation of economic growth levels across individual economies is highlighted by the global recession resulting from the COVID-19 pandemic. Even countries where the pandemic was less severe still suffered immense economic damage, in part because of the flow-on effects of the recession in other countries.

International business cycle refers to fluctuations in the level of economic activity in the global economy over time.

Figure 1.10 highlights the strong relationship between the economic growth performances of the world's major economies. The United States, the Euro Area economies, Japan and Australia all experienced a long period of moderate growth during the 2000s, followed by a sharp collapse in growth after 2008. Each of these advanced economies experienced slower rates of growth during the 2010s before the severe impact of the COVID-19 recession in 2020.

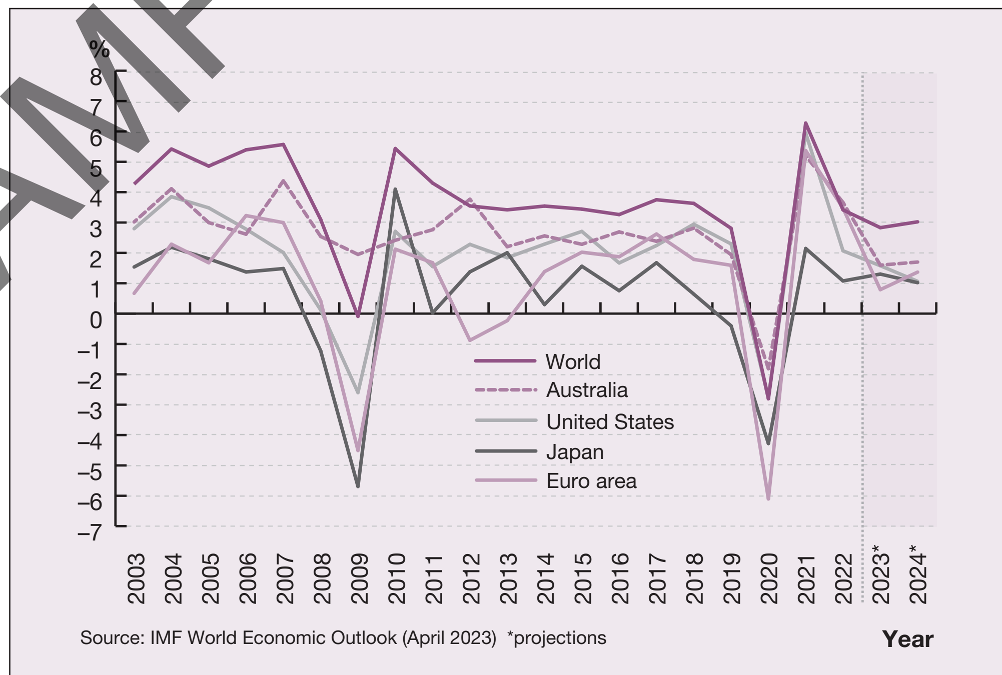

Figure 1.10 – Economic growth performance of major economies

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The world economy rebounded strongly from the pandemic in 2021 with 6.2 per cent growth in output, before growth rates stabilised at around pre-pandemic levels from 2022. Emerging and developing economies outperformed the advanced economies, with 6.9 per cent and 5.4 per cent growth in GDP, respectively.

As a small open economy, the Australian economy is particularly affected by economic growth rates overseas. Research by the Reserve Bank of Australia (RBA) has found that 63 per cent of changes in the level of output in Australia can be explained by the changes in interest rates, growth levels and inflation rates in the Group of Seven (G7) largest industrialised countries. This means that for Australia, domestic factors have half as much influence as international factors on economic growth in any given year.

The transmission of economic conditions from one country to another is made more immediate by the increased integration of economies during the globalisation era:

- **Trade flows**: If there is a boom or recession in one country, this will affect its demand for goods and services from other nations. The level of growth in an economy will have significant flow-on effects on the economic activity of its trading partners.
- **Investment flows**: Economic conditions in one country will affect whether businesses in that country will invest in new operations in other countries, affecting their economic growth. For example, Brazil's weak economic performance in the past decade has meant that it has invested less in other economies. On four occasions since 2015, its annual FDI outflows have been negative.
- **Transnational corporations**: TNCs are an increasingly important means by which global upturns and downturns are spread throughout the global economy. For example, following reductions in the headcounts of major US technology companies Microsoft, Amazon, Google and Meta, in 2023 Australian technology company Atlassian also reduced its total staff by around 5 per cent.
- **Financial flows**: Short-term financial flows also play an important role in transmitting the international business cycle. A 2019 Reserve Bank Bulletin identified that Australia has benefited from being open to global capital markets, but that the financial integration of advanced economies exposes the Australian economy to shifts in their financial conditions.
- **Financial market and confidence**: Consumer confidence and the "animal spirits" of investors are constantly influenced by conditions in other countries. This is highlighted by the strong correlation between movements in share prices of the world's major stock exchanges – that is, they tend to go up and down at the same time. Events that threaten global stability – such as an increased risk of war, sovereign debt default or the collapse of a major business – can spark an immediate downturn in share values. This effect was seen in 2023 when the collapse of Silicon Valley Bank in the US and Credit Suisse in Switzerland sparked fears of another banking sector crisis, and prompted debate about regulation adequacy.
- **Global interest-rate levels:** Monetary policy conditions in individual economies are strongly influenced by interest-rate changes in other countries. If higher economic growth makes it necessary for the central bank to increase interest rates in the United States, this places pressure on central banks in other economies to follow suit. Inflationary pressures across the world in 2022 saw central banks raising interest rates. The Reserve Bank of Australia followed suit, with interest rate rises in 2022 and 2023.
- **Commodity prices:** The prices of key commodities such as energy, minerals and agricultural products are set by global markets. Their prices, in turn, influence the levels of inflation, investment, employment, growth and other features of the international business cycle. Historically, changes in oil prices have had major impacts on international growth (with lower prices boosting growth overall). In 2022, global sanctions against Russia, the world's second largest supplier of oil,

SAMPLE PAGES

resulted in the largest global energy price increases in half a century, following contractions to worldwide supply. As a result, the World Bank reduced its growth forecast for 2022 by one percentage point.

- **International organisations**: International forums such as the Group of Twenty (G20) or Group of Seven (G7) economies can play an important role in influencing global economic activity. Discussions of global economic conditions at summit meetings mean that the G20 or G7 can act as the unofficial forum for coordinating global macroeconomic policy, especially during periods of economic uncertainty. These meetings can also resolve tensions between countries that threaten the economic outlook.

FACTORS THAT *STRENGTHEN* THE INTERNATIONAL BUSINESS CYCLE

- Trade flows
- Investment flows and investor sentiment
- Transnational corporations
- Financial flows
- Technology
- Global interest rates
- Commodity prices
- International organisations

FACTORS THAT *WEAKEN* THE INTERNATIONAL BUSINESS CYCLE

- Domestic interest rates
- Government fiscal policies
- Other domestic economic policies
- Exchange rates
- Structural factors
- Regional factors

Nevertheless, it is important to note that despite these linkages between economies, the pattern and the pace of economic growth differ between countries. Even countries that are at similar stages of economic development, such as the United States and European economies, experience differing levels of economic growth. Despite the global linkages described above, many of the factors that influence the business cycle reflect distinctive national conditions:

- **Interest rates** have a significant impact on the level of economic activity, and interest rates differ between countries (or regions, in the case of European countries that share a common interest-rate policy). Higher interest rates will dampen economic activity while lower interest rates will stimulate economic activity.
- A government's economic policy decisions can influence their economic growth rate. For example, the UK's decision to leave the EU in 2016 reduced the rate of economic growth as investor confidence in Britain's economy fell. **Fiscal policies** also have a significant effect upon the level of economic growth in the short to medium term. If a government in one country raises taxes while the government in another country cuts its taxes, economic growth is likely to move in opposite directions in those two countries.
- **Exchange rates** differ between countries and impact on the level of trade competitiveness and confidence within economies. In turn, these factors will influence the level of economic growth. The BIS has noted that exchange rates are having an increased impact on domestic economies, particularly in the past decade as government policy has less ability to target economic shocks.
- **Structural factors** differ between economies. For example, countries have different levels of resilience in their financial systems; different levels of innovation and takeup of new technologies; different attitudes towards consumption and savings; different population growth rates and age distribution; different methods of regulating labour markets, educating and training employees and regulating businesses. These structural factors influence the competitiveness of economies and their level of growth.
- **Regional factors** between economies differ. Some economies are closely integrated with their neighbours and are therefore very influenced by the economic performance of their major trading partners. Research by Colombian academics found that regional business cycles in emerging markets experience different levels of synchronisation depending on factors such as the productive structure and trade integration of the country. For example, whilst Mexico has a high level of synchronisation with North America, economic conditions from nearby Latin American countries have a lower impact on Mexico's activity due to less trade integration.

In summary, there is an international business cycle and when there is a substantial economic downturn, such as in the mid-1970s, the early 1990s, the late 2000s and early 2020s, this downturn is shared across almost all countries. However, the factors influencing individual economies differ and the level of world economic growth is one of several factors that influence economic conditions.

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Regional business cycles

Similar to the international business cycle, the term **regional business cycle** refers to the changes in economic activity in a particular region. In the same way that countries' activity can be affected by global changes, they can also be affected by regional changes. While changes in the US economy will have ripple effects around the world, they can have more pronounced impacts on the nearby economies of Canada and Mexico, which are most closely integrated with the US economy. Likewise, many of the 27 economies of the **EU** are influenced by activity levels in Europe's largest economies, Germany and France.

Regional business cycles are the fluctuations in the level of economic activity in a geographical region of the global economy over time.

In the **East Asian region**, economic conditions are dominated by the influences of China and Japan – the world's second- and third-largest economies. While the regional business cycle in Asia has been weaker than in other regions, it has strengthened in recent years because of increased integration between Asian economies. On the other hand, as growth rates in China and Japan slowed down in recent years, the region continued to experience stable growth due to moderate upswings elsewhere in the region.

Other regions around the world have a higher proportion of developing or low-income countries, and they tend to be less regionally integrated. In **Sub-Saharan Africa**, for example, many economies such as Chad, Uganda and Sierra Leone are dependent on high-income economies for more than 80 per cent of their exports, and are therefore as likely to be influenced by conditions in the world economy as they are by neighbouring African economies. In the **South Asia and Latin American regions**, regionally dominant economies such as India and Brazil respectively play a key role alongside influences from outside the immediate region.

While regional business cycles tend to be dominated by the largest and most globalised economies, it is also important to recognise the complexity of conditions at the regional level. In the early 2010s, economic conditions in European economies were weakened by financial turmoil in the relatively small economy of Greece. A financial crisis in Argentina and the severe impact of COVID-19 in Brazil weakened economies in **Latin America** in 2020. The war in Ukraine in 2022 reduced growth, trade and economic policy across **Europe and Central Asia**. In this way, smaller economies can affect the performance of regional economies even if they are not dominant economies or strongly integrated.

Clearly, regional business cycles can be quite different from patterns in global economic activity, with some regions performing more strongly than others and fluctuating more independently from other regions. However, regional cycles are also part of the phenomenon of globalisation because they result from increased cross-border integration. These business cycles of different regions interact in complex ways to influence the level of economic activity around the world.

SAMPLE PAGES

reviewquestions

1. Define the terms *international business cycle* and *regional business cycle*.
2. Using the example of a specific economy, discuss the extent to which this economy's performance has reflected economic growth trends globally and in its region.
3. Outline the factors that strengthen and weaken the relationship between the economic cycles of individual economies.

chapter summary

1. **Globalisation** refers to the integration between different countries and economies, leading to the increased impact of international influences on all aspects of life and economic activity.

2. The **global economy** is a way of describing the activities of all the economies of the world as a whole, reflecting the fact that they are now increasingly linked together into one larger economic system.

3. The **gross world product** is the sum of the total output of goods and services produced by all economies in the world over a given period of time.

4. The growth of **world trade** is an important indicator of the extent of globalisation. During the period of rapid globalisation in the decades to 2010, trade grew at a much faster rate than world economic growth. In the 2010s, trade grew at close to the same level as overall economic growth.

5. The pattern and direction of world trade has changed to reflect the increasing importance of advanced technology and services and the growth of the Asia Pacific region.

6. The process of globalisation has occurred most rapidly in global finance which faces few barriers and is driven mostly by speculative activity (that is, investors seeking to make short-term profits out of fluctuations in exchange rates, interest rates and other financial indicators).

7. **Foreign direct investment (FDI)** is the injection of funds into an economy to establish a new business or purchase an existing business. FDI flows are driven by **transnational corporations (TNCs)** and often involve the transfer of technological innovations between economies.

8. **Technology, transport and communication** have driven increased economic integration by facilitating linkages between businesses individuals and nations in the global economy.

9. Globalisation has also contributed to the **international division of labour** in part because of the migration of workers to countries where jobs are plentiful or better paid, and also because of the shift of business between economies in search of the most efficient and cost-effective labour.

10. The concept of **international and regional business cycles** refers to the extent to which economies tend to experience a similar pattern of boom, downturn and recovery at similar times. Although the shape and the length of the business cycle differs from one economy to the next, the level of economic growth between different economies is closely related, and recessions and booms tend to occur around similar times.

SAMPLE PAGES

chapter review

1. Explain what is meant by *globalisation*, using recent trends to illustrate your answer.
2. "Just as the COVID-19 pandemic spread fast because of the contagious nature of the coronavirus, the COVID-19 recession spread fast because of the connected nature of the global economy." Discuss what this statement is saying about the global economy in the 2020s.
3. Describe the role of trade flows in globalisation.
4. Summarise recent changes in the direction and composition of international trade in goods and services.
5. Explain how technology drives growth in the trade of goods and services.
6. Explain the difference between *investment flows* and *financial flows*.
7. Outline the role of foreign-exchange markets in international financial flows.
8. Discuss the role played by transnational corporations (TNCs) in globalisation.
9. Discuss the impact of globalisation on the international division of labour.
10. Explain how changes in the level of economic growth in one economy can impact on economic growth in other economies.

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2 Trade in the Global Economy

2.1 Advantages and disadvantages of free trade
2.2 Reasons for protection
2.3 Methods of protection
2.4 Trade agreements
2.5 International organisations
2.6 Government economic forums

Trade has played a critical role in the expansion of the global economy. The periods of the fastest growth in the global economy have also been periods of rapid growth in trade. In the 21st century the world's fastest-growing economies are typically economies with rising levels of trade. Trade has brought countries together, created wealth and re-shaped the structure of many economies.

This chapter examines the economic theory behind trade relationships, government policies that have restricted and facilitated trade, and the role played by international institutions in trade flows, financial flows and foreign investment.

2.1 Advantages and disadvantages of free trade

Comparative advantage is the economic principle that nations should specialise in the areas of production in which they have the lowest opportunity cost, and trade with other nations so as to maximise both nations' standards of living.

Opportunity cost represents the alternative use of resources. Often referred to as the "real" cost, it represents the cost of satisfying one want over an alternative want. This is also known as economic cost.

Among economists, there is widespread agreement on the principle that economies will achieve higher levels of growth in a free trade environment. Although barriers to trade remain significant (even rising in recent years), the world has experienced a long-term trend towards greater free trade in the global economy.

Free trade can be defined as a situation where governments impose no artificial barriers to trade that restrict the free exchange of goods and services between countries with the aim of shielding domestic producers from foreign competitors.

The argument for free trade is based on the economic concept of **comparative advantage**. The principle of comparative advantage states that even if one country can produce all goods more efficiently than another country, trade will still benefit both countries if each specialises in the production of the good in which it is comparatively more efficient. This comparative efficiency is measured by the **opportunity cost** of producing each good within that country. Thus, if the opportunity cost of producing iron ore in Australia is lower than in China (that is, in order to produce an extra tonne of iron ore, Australia gives up producing a smaller quantity of smartphones than does China), then Australia is said to have a comparative advantage in iron ore production. At the same time, if the opportunity cost of producing smartphones in China is lower than in Australia, then China is said to have a comparative advantage in smartphones.

SAMPLE PAGES

ADVANTAGES OF FREE TRADE

- Trade allows countries to **obtain goods and services that they cannot produce themselves** or in sufficient quantities to satisfy domestic demand. This would generally occur because of a lack of adequate resources. For example, a country may lack the necessary technology to produce certain manufactured goods.
- Free trade allows countries to **specialise** in the production of the goods and services in which they are most efficient. This leads to better resource allocation and increased production within countries and throughout the world.
- Free trade encourages the **efficient allocation of resources**. Resources will be used more efficiently because countries are producing the goods in which they have a comparative advantage.
- A greater tendency for specialisation leads to **economies of scale**, which will lower average costs of production while increasing efficiency and productivity.
- **International competitiveness** will improve as domestic businesses face greater competitive pressures from foreign producers, and governments will encourage domestic industrial efficiency.
- Free trade **encourages innovation** and the adoption of new technology and production processes throughout the world.
- Free trade leads to **higher living standards** as a result of lower prices, increased production of goods and services and increased consumer choice, as countries have access to goods that a lack of natural resources may otherwise prevent. The opening up of global markets leads to higher rates of economic growth and increased real incomes.

Free trade is a situation where there are no artificial barriers to trade imposed by governments for the purpose of shielding domestic producers from foreign competitors.

DISADVANTAGES OF FREE TRADE

- An increase in **unemployment** may occur as some domestic businesses may find it hard to compete with imports. The short-term rise in unemployment should correct itself in the long term as the domestic economy redirects resources to areas of production in which it has a comparative advantage. Nevertheless, some specific industries, workers and regions may lose out in the longer term as a result of free trade.
- It may be more difficult for less advanced economies to **establish new industries** if they are not protected from larger foreign competitors.
- Production surpluses from some countries may be **dumped** (that is, sold at unrealistically low prices) on the domestic market, which may hurt efficient domestic industries.
- Free trade may encourage **environmentally irresponsible production methods** because producers in some nations may win markets by undercutting competitors' prices – only because they also undercut environmental standards. For example, they may use production methods which add to pollution in the air and in river systems.
- **National security** may be undermined if an economy is dependent on trade in a time of emergency, such as war or pandemic. If supply chains are disrupted, it may not be possible to source essential items such as defence equipment and vaccines.

reviewquestions

1. Explain the principle of comparative advantage.
2. Describe how the idea of comparative advantage supports the arguments in favour of free trade.
3. Define *free trade*.
4. Examine the costs and benefits of free trade.

Appendix B:
For more information on the economic theory of comparative advantage and gains from trade, go to section B.1 in the Advanced Economic Analysis appendix at the back of the textbook.

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2.2 Reasons for protection

Protection refers to government policies that give domestic producers an artificial advantage over foreign competitors, such as tariffs on imported goods.

Protection can be defined as any type of government action that has the effect of giving domestic producers an artificial advantage over foreign competitors. The main protectionist measures include tariffs, import quotas and subsidies.

Despite the economic benefits of free trade and the costs associated with protecting domestic industries, historically, most countries have tended to use at least some forms of protection to assist local producers in the face of foreign competition. A number of arguments have been put forward to justify why countries impose protectionist barriers to trade, including the need to assist infant industries, protecting industries from overseas firms dumping goods, reducing unemployment and arguments for self-sufficiency for some essential areas of production.

Infant industries

New industries generally face many difficulties and risks in their early years. They usually start out on a small scale with costs that are relatively higher than those of established competitors in other countries. These "infant industries" may need to be shielded from competitors in the short run to enable them to build capacity, establish markets and achieve economies of scale so that they can compete in the global economy. This approach to the development of new industries has been used by many emerging economies in recent decades.

The key test for economic credibility of the infant industry argument is whether industry protection is removed over time. If protectionist policies are not removed, there will be no real incentive for the industry to reach a level of efficiency that would enable it to compete without protection. This means that governments should provide temporary assistance only to industries that have a good chance of achieving some comparative advantage in the long run so they can compete in the global economy.

Historically, many industries that have received assistance as infant industries have continued to rely on this assistance for many years (for example, national airlines in the global aviation industry). The infant industry argument has been used to support many industries that would never have survived otherwise. For this reason, economists are generally reluctant to accept businesses seeking protection based on the infant industry argument. Today, when governments provide help to new industries (such as manufacturing batteries for electric vehicles), this tends to involve direct assistance and lasts for a limited period of time.

Prevention of dumping

Dumping is the practice of exporting goods to a country at a price lower than their selling price in their country of origin.

Dumping occurs when foreign firms attempt to sell their goods in another country's market at unrealistically low prices (that is, below the price charged in the home country's market). The practice of dumping may be used to dispose of large production surpluses or to establish a market position in another country. These low prices are usually only of a temporary nature but can harm domestic producers. Local firms that could normally compete with such foreign producers may be forced out of business, causing a loss in a country's productive capacity and higher unemployment.

The only gain from dumping is that it results in lower prices for consumers in the short term, but this does not last as foreign producers will put up their prices once the local competition is eliminated. Under such circumstances it is generally in the economy's best interest to impose restrictions on such imports. Using protectionist methods to prevent dumping is the only reason for protection that is widely accepted by economists. However, in recent years the World Trade Organization has questioned whether countries might be unfairly accusing efficient low-cost foreign producers of dumping and abusing "anti-dumping" processes in order to protect their domestic industries.

SAMPLE PAGES

More than 6500 anti-dumping complaints have been lodged by WTO members since the WTO was formed in 1995, with India and the United States responsible for the highest number. By 2023, there were around 4500 anti-dumping measures (such as duties) legally in force. The sectors where anti-dumping measures are most common are base metals, chemicals, plastics, resin and rubber. Australia has lodged a relatively high number of complaints – sixth in the world (with over 375 complaints initiated). Figure 2.1 identifies the countries that have initiated the largest number of anti-dumping actions and the countries which have had the most dumping claims made against them.

Top five economies initiating anti-dumping measures	
India	1130
United States	860
European Union	547
Brazil	438
Argentina	418
Top five exporting economies affected	
China	1565
South Korea	487
Taiwan	335
United States	318
India	270
Source: WTO Dec. 2022	

Figure 2.1 – Anti-dumping actions in force under WTO system

Protection of domestic employment

One of the most popular arguments in favour of protection is that it saves local jobs. If local producers are protected from competition with cheaper foreign imports, the demand for local goods will be greater and this will create more domestic employment. This argument tends to gain strongest public support during times of recession when unemployment is rising, even though technology and automation often play a more significant role in job losses than trade.

However, there is little support among economists for this argument. Protection will tend to distort the allocation of resources in an economy away from areas of more efficient production towards areas of less efficient production. In the long run this is likely to lead to higher levels of unemployment and lower growth rates. On the other hand, by phasing out protection it is hoped that better and more lasting jobs will be created in other sectors within the economy that are internationally competitive. Furthermore, if a country protects its industries it is possible that other countries will retaliate and adopt similar protectionist policies. The net result could be that the economy might have higher employment in less efficient protected industries but lower employment in more efficient export industries.

Defence and national security

Countries sometimes have non-economic reasons for wanting to retain certain industries. For example, major powers generally want to retain their own defence industries so that they can be confident that in a time of conflict they would still be able to produce the equipment needed for their national security.

In recent years concerns about threats to national security from China have prompted Australia and other countries to restrict Chinese telecommunications giant Huawei's involvement in building 5G mobile telecommunications networks. This is despite Huawei's technology being regarded as cheaper and more advanced than that of its competitors.

The argument for self-sufficiency of medical supplies as well as energy, food and essential manufactured goods has become much stronger in recent years in the wake of recent global crises such as the war in Ukraine and the COVID-19 pandemic. Concerns about food security following Russia's invasion of Ukraine led to restrictions on agricultural exports in several countries, with 101 export restrictions still in force in 2023, representing over 11 per cent of food trade.

In the wake of the COVID-19 pandemic, governments changed policies to build greater domestic capacity to produce vaccines and supply essential medical needs (including Australia, which announced plans to establish a local mRNA vaccine production facility). The disruptions to "just in time" global supply chains caused by the pandemic led to a re-think of how both governments and suppliers need to be better prepared for future disruptions. This is challenging for the Australian economy because of its integration with global supply chains, reliance on imports and limited domestic manufacturing capacity.

SAMPLE PAGES

RISING BARRIERS TO TRADE

The past decade has brought an end to a long period of expanding free trade stretching all the way back to the post-Second World War era. Many countries have been experiencing a backlash against globalisation for decades, but the new era of "deglobalisation" and rising protectionism has come about in response to the vulnerabilities in supply chains that were exposed during the COVID-19 pandemic and the war in Ukraine. An IMF report in 2023 suggested that this trend towards deglobalisation and increasing fragmentation in world trade could ultimately cost the global economy 7 per cent of its output.

While the basic principles of free trade are still widely embraced and global tariff levels remain low, governments have become more concerned about the way in which open trade makes them more dependent on other economies, and more vulnerable to overseas developments. Governments are focusing on improving the resilience of their supply chains by increasing inventories, expanding local production capacity through increased subsidies, and giving greater priority to security interests over comparative advantage. Beyond protectionist policies, the trend towards "deglobalisation" may also be reflected in greater restrictions on migration and foreign direct investment, and a weaker commitment to international cooperation.

At the heart of the trend towards deglobalisation is the "decoupling" between the economies of the United States and China. In 2023, President Biden introduced export restrictions to limit China's access to semiconductor chips and technology, while also announcing US$11 billion in grants and subsidies to support the transition to green technologies and industries across rural areas. These measures were introduced to strengthen national security and reduce risks arising from the interdependent relationship between the US and Chinese economies. The Boston Consulting Group has estimated that with these measures in place, trade between the US and China will decrease by US$63 billion in the years to 2031.

SAMPLE PAGES

Other arguments in favour of protection

Several other arguments are also used in favour of protecting local industries. For example:

- Because of the **differentials in wage levels** between higher- and lower-income economies, some economists argue that producers should be protected from competition with countries that produce goods with low-cost labour. They argue that labour costs are artificially low in many developing economies because of weak labour standards (such as restrictions on the rights of workers to form unions and low safety standards).
- A growing awareness of the existence of **modern slavery** in global supply chains in recent years has led governments to prohibit the trade of goods produced using forced labour such as prison workers and child labour. These restrictions are generally accepted as a legitimate regulation on trade that can prevent human rights abuses, even though it can have protectionist consequences. For example, in 2021 Australia restricted certain imports from China because of concerns about the use of forced labour in Xinjiang.
- Countries sometimes block trade in goods because of **environmental factors**, such as the environmental harm involved in the production of certain goods. Overseas producers may be able to produce some items cheaply because the producers are environmentally irresponsible and do not have to comply with the tougher environmental standards that apply in advanced economies. In recent years some countries have proposed introducing "carbon tariffs" on goods produced in countries that are making slower progress on reducing carbon emissions.

reviewquestions

1. Outline the major reasons why nations may argue in favour of introducing protectionist policies.
2. Identify which argument in favour of protection is most accepted by economists and explain why.

2.3 Methods of protection

Although we live in an era of relatively free trade globally, most countries use at least some measures to shield their domestic producers from foreign competition with protectionist policies. There has been a shift from traditional protectionist measures, such as tariffs and subsidies, towards less visible measures, such as administrative barriers and industry assistance plans.

Tariffs

Tariffs are taxes on imported goods imposed for the purpose of protecting Australian industries.

A **tariff** is a government-imposed tax on imports. It has the effect of raising the price of the imported goods, making the domestic producer more competitive. The effects of a tariff are shown in figure 2.2.

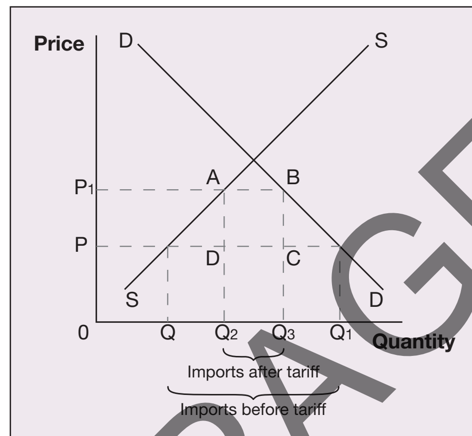

Figure 2.2 – The effect of a tariff

Figure 2.2 reveals the following:

- The curves SS and DD represent domestic supply and demand.
- 0P is the price of imported goods if there was **no tariff** applied (that is, in a situation of free trade). At this price consumers demand $0Q_1$, domestic producers supply 0Q and the quantity imported would be QQ_1.
- If a tariff of PP_1 is imposed, all of which is passed on to the consumer, demand will contract to $0Q_3$, domestic supply will expand to $0Q_2$ and imports will fall to Q_2Q_3.
- Following the imposition of the tariff, the government will raise revenue of ABCD.

ECONOMIC EFFECTS OF A TARIFF

- Domestic producers supply a greater quantity of the good. Therefore, the tariff **stimulates domestic production and employment**.
- More domestic resources are attracted to the protected industry. This leads to a **reallocation of resources towards less efficient producers** (that is, those who are unable to compete on an equal footing with foreign producers), causing world GDP to decline. A 2019 IMF study estimated that if tariff rates of 15 per cent were imposed on $300 billion of Chinese goods and China imposed similar measures on imports, it would cause world GDP to decrease 0.8 per cent, equivalent to $700 billion.
- Consumers pay a **higher price** and receive **fewer goods**. This redistributes income away from consumers to domestic producers. Economic modelling published by the Productivity Commission suggested that for every $1.00 increase in Australian tariff revenue, economic activity in Australia would fall by $0.64. GDP would be lower by over 1 per cent each year, equating to a loss of around 100,000 jobs, and the average household would face a drop in income by around $1500 per year.
- The tariff raises **revenue for the government** but that is not the primary objective. In fact, the more successful the tariff as a protectionist policy (that is, the more imports it restricts), the less revenue it will raise. In 2023–24, the Australian Government expected to collect $1.5 billion in tariff revenue, which is roughly 0.3 per cent of its total revenue.
- A tariff can provoke a **retaliation effect**, where a trading partner imposes some kind of trade barrier against a country imposing a tariff on its exports. For example, after Australia imposed a 144 per cent tariff on Chinese steel imports in 2014 (as an anti-dumping measure), China imposed tariffs on several Australian exports, including barley in 2018 (at a rate of 74 per cent) and wine in 2020 (at a rate of more than 200 per cent).

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Quotas

Quotas refer to restrictions on the amounts or values of various kinds of goods that may be imported.

An import **quota** controls the volume of a good that is allowed to be imported over a given period of time, normally for the purpose of protecting domestic production. It may also be used to reduce the quantity of undesired goods entering a country. For example, in 2018 Australia implemented a quota system for the importation of hydrofluorocarbons (HFCs), commonly used in refrigeration, in response to environmental concerns. Quotas guarantee domestic producers a share of the market. The effects of a quota are shown in figure 2.3.

Figure 2.3 reveals the following:

- The curves SS and DD represent domestic supply and demand.
- 0P is the price at which the imported goods would sell if there was **no quota** imposed. At this price, consumers demand $0Q_1$, domestic producers supply 0Q and the quantity imported would be QQ_1.
- If the government imposed a quota restricting imports to Q_2Q_3, this would have the effect of raising the price of imported goods to $0P_1$. This price would allow domestic supply to expand to $0Q_2$.

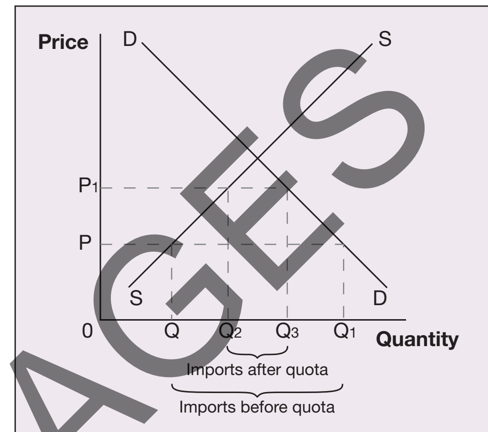

Figure 2.3 – The effect of an import quota

Countries sometimes use a system of **tariff quotas**. Under this system, goods imported up to the quota pay the standard tariff rate, whereas goods imported above the quota pay a higher rate. In the past many of Australia's most highly protected industries (for example, textiles, clothing, footwear and motor vehicles) were shielded from foreign competition in this way.

SAMPLE PAGES

ECONOMIC EFFECTS OF A QUOTA

- Domestic producers supply a greater quantity of the good. Therefore, the quota stimulates **domestic production and employment** in the protected industry.
- More resources in that economy are attracted to the protected industry, leading to **reallocation of resources** from other sectors of the economy (where production and employment will fall). For example, the European Union (EU) imposes an import quota allowing no more than 7150 tonnes of high-quality beef imports. This provides certainty for producers in European countries because they can supply any demand in excess of the 7150 tonnes of imports, even if their costs are higher than those of overseas producers.
- Consumers pay a **higher price** and receive **fewer goods**. This redistributes income away from consumers to domestic producers in the protected industry and results in lower overall levels of economic growth.
- Unlike tariffs, quotas **do not directly generate revenue** for the government. However, governments can sometimes raise a small amount of revenue from quotas by administering the quota through selling import licences allowing firms to import a limited number of goods.
- As with tariffs, the imposition of a quota on imports can **invite retaliation** from the country whose exports may be reduced because of the quota. This can result in lower exports for the country that initiated the import quota.

Subsidies

Subsidies involve financial assistance to domestic producers, which enables them to reduce their selling price and compete more easily with overseas producers. In figure 2.4 this is shown by a rightward shift of the domestic industry's supply curve from SS to S_1S_1, which results in a lower market price. Businesses will be able to sell a higher quantity of their product on both domestic and global markets. The quantity produced increases from Q to Q_1. The size of the subsidy in per unit terms is the vertical distance between S and S_1.

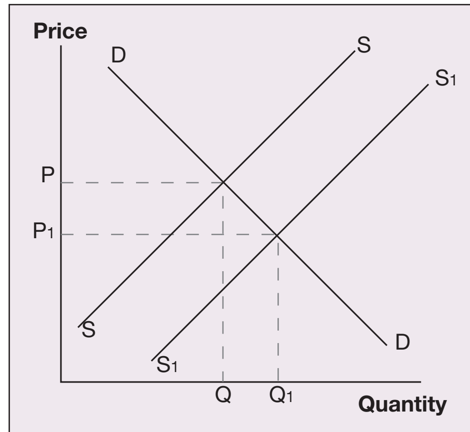

Figure 2.4 – The effect of a subsidy

Subsidies are cash payments from the government to businesses to encourage production of a good or service and influence the allocation of resources in an economy. Subsidies are often granted to businesses to help them compete with goods and services produced overseas.

ECONOMIC EFFECTS OF A SUBSIDY

- Domestic producers supply a greater quantity of the good. Therefore, the subsidy stimulates **domestic production and employment** in the protected industry.
- More resources in that economy are attracted to the protected industry, leading to **reallocation of resources** from other sectors of the economy (where production and employment will fall).
- Consumers pay a **lower price** and receive **more goods** because the subsidy shifts the supply curve for the sector to the right. However, consumers still pay indirectly for subsidies through higher taxes.
- Subsidies impose **direct costs on government budgets** because they involve payments from the government to the producers of goods and services. This means that governments have fewer resources to allocate to other priorities such as education and health care. For example, in the 2023–24 Budget, the Government increased the Fuel Tax Credits Scheme (Australia's biggest fossil fuel subsidy) by $2.1 billion to $9.6 billion, which is expected to cost $41.1 billion over the next four years.
- While economists are opposed to protectionist policies, they often prefer a subsidy to a tariff because subsidies tend to be abolished more quickly – since they impose costs on the budget rather than generating revenue.

Local content rules

Local content rules specify that goods must contain a minimum percentage of locally made parts. In return for guaranteeing that a certain percentage of a good will be locally made, the imported components may not attract a tariff. Australia has a longstanding requirement that a majority of free-to-air television content broadcast from 6:00 am to midnight is locally produced (a minimum of 55 per cent of content under current rules). In 2023, the Australian Government announced plans to introduce local content requirements for streaming services such as Netflix, Stan and Binge as part of its Revive National Cultural Policy.

Export incentives

Export incentive programs give domestic producers assistance such as grants, loans or technical advice (such as marketing or legal information) and encourage businesses to penetrate global markets or expand their market share. The popularity of such programs has grown considerably in recent years as nations have moved to a greater focus on capturing foreign markets rather than protecting import-competing businesses as a strategy to achieve higher rates of economic growth and employment. For instance, Australia has

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a program known as the Export Market Development Grant (EMDG) that has assisted over 51,000 businesses in promoting and marketing their exports. Technically, export incentives do not protect businesses from foreign competition in the domestic market, but they are nevertheless regarded as a barrier to free trade. World Trade Organization rules restrict the use of export incentives but countries can still provide some forms of export assistance to local producers.

OVERALL ECONOMIC EFFECTS OF PROTECTIONISM

In addition to the effects that protectionist policies have on domestic economies outlined previously, they can also have overall impacts on the global economy.

Protectionist policies **reduce the overall level of trade between nations**. For an individual economy, protectionism means that exports and imports will be a smaller share of the national economy. A Boston Consulting Group report for the B20 group of business leaders, which provides input to the G20, estimated that the cost of major economies imposing protectionist policies following the COVID-19 pandemic could reduce global economic output by as much as $10 trillion by 2025 on the level it would otherwise reach.

Overall, protectionist policies **reduce living standards** and **reduce global economic growth** by shielding inefficient producers. A major study released in 2019 by the International Monetary Fund, *The Macroeconomic Consequences of Tariffs*, concluded that over the medium term, countries that raise tariffs experience lower output, weaker productivity, increased unemployment and increased inequality. The study examined the tariff policies of 151 countries over 50 years and noted that tariff increases tend to lead to an exchange rate appreciation, which can worsen the balance of trade. It also concluded that an average tariff increase (of 3.6 per cent) contributed to an average 0.4 per cent reduction in GDP over five years, with a larger fall of 1 per cent in GDP in advanced economies.

Protectionist policies make it **more difficult for individual economies to specialise** in production in which they are most efficient. Businesses are less able to achieve economies of scale and therefore have lower profits and lower dividends. With fewer competitive pressures, prices for goods and services in individual economies are higher. This leads to slower economic growth in individual countries.

The negative economic impact of the protectionist policies of trading blocs tends to be larger (relative to the size of those economies) for **developing economies** that are often excluded from access to the markets of advanced economies. In making its case against protectionism, the World Bank has highlighted that increased trade helps reduce global poverty. Between 1990 and 2017, developing economies increased their share of global exports from 16 per cent to 30 per cent, while the number of people in extreme poverty globally fell from 36 per cent to 9 per cent.

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reviewquestions

1. Describe how subsidies affect the price and quantity of goods sold in a market.
2. Discuss the impact of tariffs, quotas and subsidies on firms, individuals and the government in the domestic economy.
3. Discuss the impact of increased protectionism on the global economy.

2.4 Trade agreements

As trade has grown and economies have become more integrated, countries have in recent years forged agreements and trading alliances to expand their trade opportunities and avoid being excluded from emerging trading blocs.

Free trade agreements (or **trade agreements**) are formal agreements between countries designed to break down barriers to trade between those nations. When the agreement is between two countries it is said to be **bilateral**, and when the agreement is between three or more economies, it is said to be **multilateral** or regional. While these agreements are generally described as “free” trade agreements, it is often more accurate to call them

preferential trade agreements because, in effect, they give more favourable access to goods and services from one nation or a group of nations compared to another. Sometimes they can even make it harder for nations outside the preferential trade agreement, especially developing economies, to trade. In this respect they may not create better conditions for free trade at all, particularly for developing economies that struggle to access global markets. Australia's bilateral and multilateral trade agreements are discussed further in chapter 6. In contrast, global free trade agreements conducted through the **World Trade Organization** (WTO) are designed to remove barriers to trade uniformly across all economies.

A **trade bloc** occurs when a number of countries join together in a formal preferential trading arrangement, to the exclusion of other countries, such as the European Union (EU) and the United States-Mexico-Canada Agreement (USMCA).

A trade bloc occurs when a number of countries join together in a formal preferential trading agreement, to the exclusion of other countries.

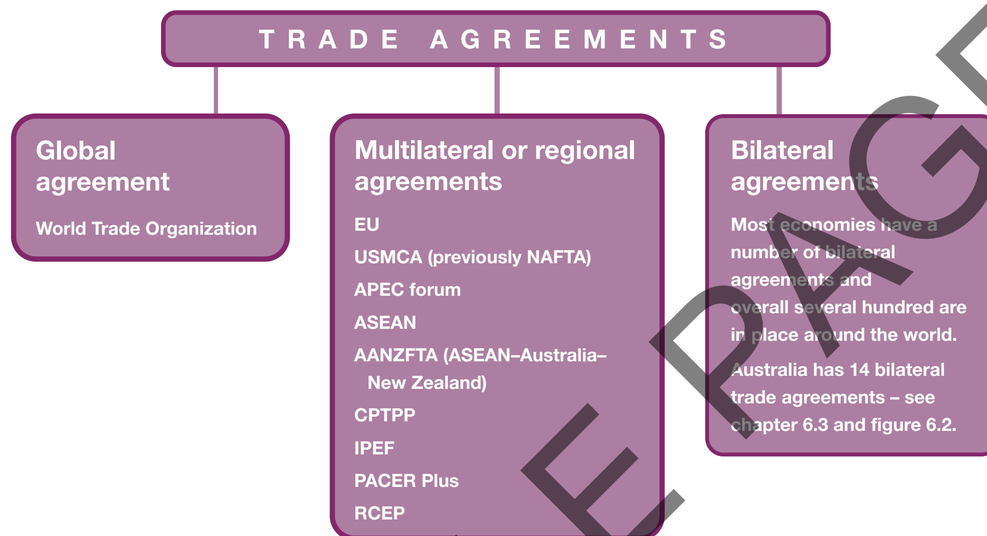

Figure 2.5 – Types of trade agreements

Regional trade agreements have multiplied in recent decades, with the number of agreements registered with the WTO jumping from 27 in 1990 to 585 in 2023. More than half of international trade is now covered by regional trade agreements. The proliferation of these agreements has led to some economists arguing that regionalisation is as important as globalisation in understanding current developments in global trade relations. While trade usually increases faster between countries that have trade agreements, there are concerns that this can result in **trade diversion**, where a country's imports of a good or service switch from the most efficient producer to a less efficient producer with whom a regional trade agreement exists.

Trade diversion is where a country's imports of a good or service switch from coming from the most efficient producer to another country because of the impacts of a trade agreement's provisions, such as tariff levels, import quotas or other rules.

The extent to which countries trade with other economies within their regional trade blocs varies between regions. Around 60 per cent of the exports of European Union economies go to other members of the EU. On the other hand, for ASEAN economies around three-quarters of trade occurs with countries outside their region, reflecting that they are smaller emerging economies and their economic growth strategies have focused on exports to industrialised economies. The economies of the United States-Mexico-Canada Agreement and ASEAN Free Trade Area in recent years have substantially increased the level of trade among themselves compared to trade with countries outside their trade area (although both continued to grow). While there are economic efficiencies in trading with neighbouring countries (due to lower transport costs), there are also risks that regional trade blocs could result in global trade fragmenting into self-contained regions, hindering the spread of global free trade.

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STRAINS IN THE CHINA–US RELATIONSHIP

"The US–China economic and trade relationship is one of profound consequence. As the two largest economies in the world, the bilateral relationship affects not just the two participants, but the entire globe. The Biden Administration acknowledges that this relationship is complex and competitive."

– United States 2023 Trade Policy Agenda, March 2023

As China's economic power has grown in recent decades, it has come into increasing conflict with the US, which argues that China engages in unfair and illegal trading practices. China and the US are the world's two largest trading nations, but a large trade imbalance exists between the two economies, with the US buying US$537 billion of Chinese exports in 2022, while China bought just US$154 billion of American exports.

Under President Trump, the US and China imposed hefty sanctions on each other's trade, at one stage threatening an all-out trade war. By the time the Trump Administration left office at the end of 2020, America's average tariffs on Chinese products had risen from around 3 per cent to 20 per cent, according to calculations by the Peterson Institute of International Economics. China has meanwhile imposed tariffs on more than half of imports from the US.

While the US has adopted a more open approach to trade under President Biden, tariffs on billions of dollars of Chinese imports have been retained. The Biden Administration is seeking to reduce its reliance on Chinese imports in key areas of technology and manufacturing, including advanced computer chips and clean energy.

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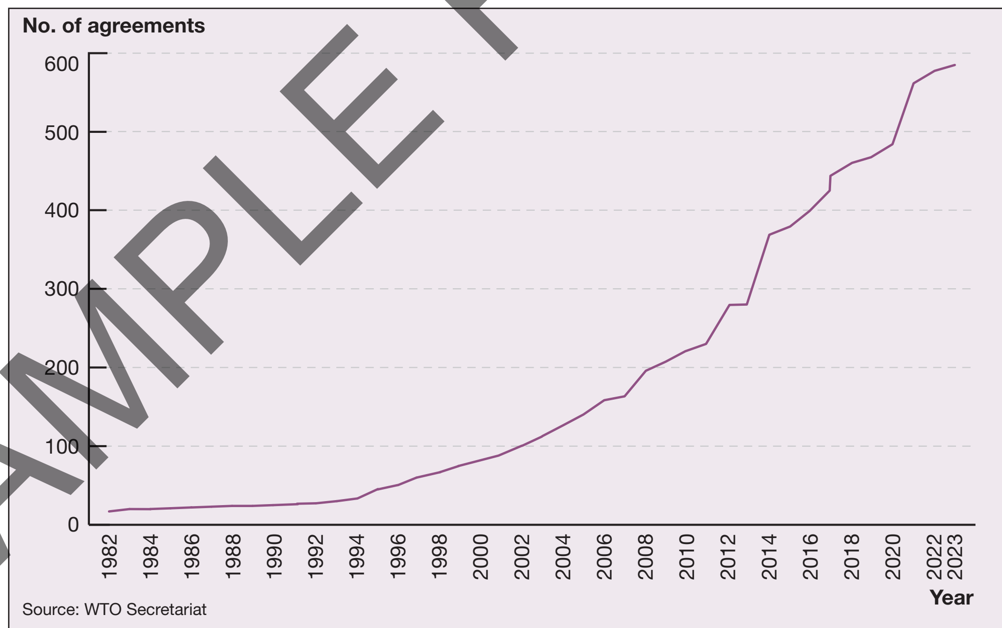

Figure 2.6 – The growth of bilateral and multilateral trade agreements

Trans-Pacific Partnership (CP-TPP or TPP-11)

The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (commonly known as both the CP-TPP and the TPP-11) is a multilateral trade agreement among 11 Pacific Rim countries that was formally signed and ratified in March 2018. Its 11 members (Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam) represent 14 per cent of global economic output and around 15 per cent of global trade, with a market of over 500 million people. Even though the 11 TPP-11 economies only make up around 6 per cent of the global population, their contribution to global trade is significant, especially for Australia's economy, representing 22 per cent of all Australian trade.

REGIONAL AND BILATERAL TRADE AGREEMENTS: STEPPING STONES OR STUMBLING BLOCKS?

Economists disagree on the extent to which regional and bilateral trade agreements assist or obstruct progress towards global free trade. Some say that regional and bilateral trade agreements slice the world into separate trading areas, hindering progress towards global free trade. Others argue that the regional trade agreements act as a stepping stone towards free trade, initially convincing economies to reduce their protection barriers against a small group of economies but eventually encouraging them to remove those barriers for the whole world. Meanwhile, in the post-COVID era the momentum for trade liberalisation has weakened, with governments focusing on ways to make their supply chains more secure, including by increasing local production.

The practical benefits of FTAs

"The Australia–United Kingdom Free Trade Agreement (A–UKFTA) ... [is a] gold-standard trade agreement [that] will deliver unprecedented benefits to Australian businesses and create new well-paying jobs … there will be no tariffs on over 99 per cent of Australian goods exports to the UK, opening up new export opportunities … Savings of approximately $200 million a year will be made as tariffs on imports from the UK are eliminated. After five years, all UK imports will enter Australia duty free, helping ease cost-of-living pressures for households and input costs for Australian business."

Don Farrell, Minister for Trade and Tourism
Media release: "Historic trade deal with the United Kingdom", 4 May 2023

The greater benefits of multilateral agreements

"RTAs can complement multilateral efforts, and their success in tackling new and traditional issues provides lessons that WTO members can apply in the multilateral context. But despite their benefits, RTAs cannot be a perfect substitute for the multilateral trading system. In a multipolar world economy, with multiple problems of the global commons, such as we've seen with the pandemic, we need effective multilateral governance. Attempting to solely rely on trade agreements with selected partners is a recipe for sub-optimal outcomes."

– Ngozi Okonjo-Iweala, Director-General, World Trade Organization
"100th session of the Committee on Regional Trade Agreements", 22 June 2021

Second thoughts on trade liberalisation

"We've been doing FTAs for almost 40 years now. And while some sectors of the economy have benefited, many know that the traditional approach to trade — marked by aggressive liberalisation and tariff elimination — also had significant costs: concentration of wealth; fragile supply chains; de-industrialisation; offshoring; and the decimation of manufacturing communities.

Heightened economic insecurity, the pandemic, and Russia's invasion of Ukraine have pushed us to re-examine our approach to trade. To get this right, trade has got to be about more than just unfettered liberalisation, cheap goods, and maximizing efficiencies."

– Katherine Tai, United States Trade Representative speech to the Roosevelt Institute's Progressive Industrial Policy Conference, October 2022

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The CP-TPP was designed as one of the world's most ambitious trade agreements, but its significance was reduced after the withdrawal of the United States in 2017, shortly before it came into effect. The TPP-11 nevertheless went ahead with the agreement, with the ambition of lowering 18,000 tariffs, representing over 98 per cent of all tariffs within the free trade area. However, the TPP-11 lacks a clear implementation timeline and some members have up to 10 years to implement their commitments. The TPP-11 agreement also includes controversial provisions that give corporations the right to sue governments for policy decisions that might harm their investments.

To add to the complex web of regional agreements, in 2022 President Biden announced the formation of a new economic pact, the Indo-Pacific Economic Framework (IPEF), comprising mostly the same members as the TPP. The IPEF is intended to focus less on tariffs and market access (which would require approval from Congress), and more on strengthening supply chains, promoting infrastructure investment, cooperating on tax rules and fighting corruption.

Regional Comprehensive Economic Partnership

The Regional Comprehensive Economic Partnership is the world's largest multilateral trade agreement, with its economies representing a larger share of the global economy than the TPP-11, the EU or USMCA. The RCEP commenced in 2022, and was in effect for all of its 15 members by June 2023, after almost a decade of negotiations. Estimates by the World Economic Forum suggest that the RCEP will remove 91 per cent of tariffs on goods traded in the region, while UNCTAD has estimated that it will boost intra-regional trade by 2 per cent as a result of both creating new trade worth US$17 billion, and diverting existing trade worth US$25 billion.

The membership of the RCEP comprises 15 economies, including China (which led its formation), all ASEAN nations, Japan, South Korea, Australia and New Zealand. India was also engaged in many of the negotiations but withdrew in 2019. RCEP economies account for one-quarter of global trade and 30 per cent of both the world's population and GWP. Ten out of Australia's top 15 trading partners are members of the trade agreement, and together with the other six participating countries, they account for 59 per cent of Australia's two-way trade, 17 per cent of two-way investment and 73 per cent of Australia's goods and services exports.

Asia-Pacific Economic Cooperation (APEC) forum

In the early 1990s countries in Australia's region established the Asia-Pacific Economic Cooperation (APEC) forum in response to the formation of trading blocs in other areas of the world such as the EU and NAFTA. The 21 member economies of the forum are: Australia, Brunei, Canada, Chile, China, Hong Kong, Indonesia, Japan, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, the Philippines, Russia, Singapore, South Korea, Taiwan, Thailand, the United States and Vietnam. Although the APEC forum has only 21 member economies, it accounts for almost 40 per cent of the world's population (2.9 billion people), over 60 per cent of world GDP and makes up around three-quarters of Australia's total trade in goods and services.

The APEC forum's original vision of establishing free trade among member countries by 2020 was not achieved. Its relatively minor role in advancing free trade during the past three decades is exemplified by a 2019 report by PricewaterhouseCoopers that noted almost $800 billion of non-tariff trade barriers remain in place across APEC nations. Nevertheless, APEC has contributed to progress on trade liberalisation. UNCTAD (the United Nations Conference on Trade and Development) has estimated that average tariff rates of APEC member states had been reduced from 10.2 per cent in 1999 to 5.2 per cent in 2020. Total merchandise trade for APEC nations increased sevenfold during this period, with two-thirds taking place between member countries. Although APEC meetings have never resulted in a regional trade agreement, they have created a forum for annual meetings of the leaders of member countries to discuss geopolitical priorities and have helped develop other trade agreements such as the CP-TPP. During the COVID-19 pandemic, APEC focused on improving the distribution of vaccines and essential medicines. The APEC forum has operated differently to other trade groupings in adopting the principle of non-discriminatory arrangements, which means that nations will trade with countries outside of the grouping on the same basis as members of the forum if they are prepared to give equal access to their markets. This contrasts with trade blocs such as the EU, which increase trade barriers for external countries.

Association of South-East Asian Nations (ASEAN)

Established in 1967, the ASEAN group covers emerging and developing economies in South-East Asia. ASEAN has acted as a counterweight to the APEC forum, which tends to be dominated by the large economies such as the United States, China, Japan and South Korea. ASEAN has become the most effective force for trade negotiations within the Asia Pacific region.

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The ASEAN Free Trade Area (AFTA) comprises Indonesia, Thailand, Malaysia, Singapore, Philippines, Vietnam, Brunei, Burma, Cambodia and Laos. The **ASEAN-Australia-New Zealand Free Trade Area** (AANZFTA) agreement came into effect in 2010 with ASEAN nations committing to lowering and eliminating tariffs on 96 per cent of Australian exports to the region (compared to 67 per cent prior to the agreement). Until the signing of the RCEP in 2020, this group of nations was collectively Australia's second-largest trading partner. Collectively the ASEAN region has a population of 690 million across 12 countries and a combined GDP of $4.5 trillion, equivalent to almost 5 per cent of the global economy. In 2021, ASEAN nations represented 11 per cent of Australia's two-way trade volumes.

Pacific Agreement on Closer Economic Relations Plus (PACER Plus)

The Pacific Agreement on Closer Economic Relations Plus is a multilateral trade agreement comprised of 11 Pacific Island Forum members: Australia, Cook Islands, Kiribati, Nauru, New Zealand, Niue, Samoa, Solomon Islands, Tonga, Tuvalu and Vanuatu. Unlike most other trade agreements, PACER Plus places a specific emphasis on economic development, integrating foreign aid programs from Australia and New Zealand to assist with agricultural development, financial stability, trade infrastructure and implementation of the agreement itself. Although the member economies only account for 32 million people, at the time of ratification it represented $2.1 trillion in GDP and $30 billion of Australia's two-way trade.

The European Union

The European Union (EU) is the most important trade bloc in the world economy. Its 27 member countries span across the European continent, with a population of 450 million that account for around 15 per cent of world trade in goods, a market similar in size to the United States. At present there are eight additional candidate countries that have begun negotiating potential membership of the EU: Albania, Bosnia and Herzegovina, Moldova, Montenegro, North Macedonia, Serbia, Türkiye and Ukraine. Although the EU represents

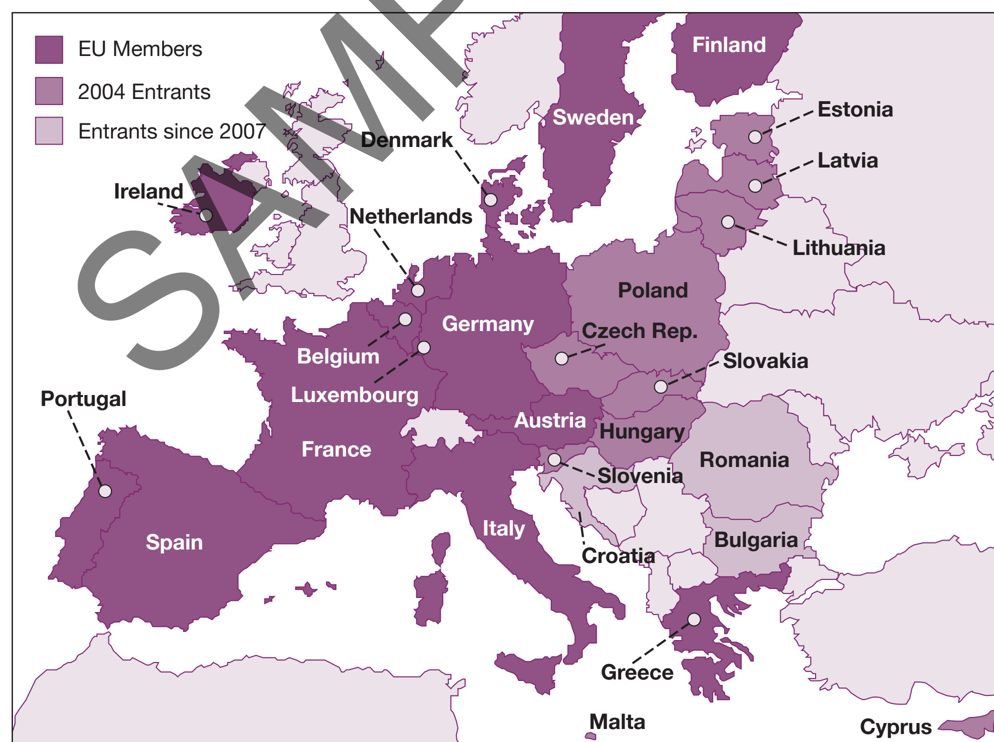

Figure 2.7 – European Union member states 2023

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17 per cent of global GDP, in recent years it has been weakened by the departure of one of its largest members, the United Kingdom.

The formation of the EU (formerly the European Economic Community (EEC)) in the late 1950s helped to dismantle trade barriers within Europe. A single market for European goods and services was established in 1992, and this has helped drive strong trade growth within the EU. However, the EU has frequently used tariff barriers against non-member countries, resulting in accusations that the EU is a closed trading bloc. In particular, the EU has applied high rates of protection to agricultural products, with direct subsidies and rural support under the EU's Common Agricultural Policy absorbing around one-third of the EU's total budget at a total cost of US$436 billion between 2021 and 2027. The United States has justified its continuation of farm subsidies on the EU's Common Agricultural Policy, which has for decades been criticised by smaller agricultural trading countries around the world, including Australia.

Within the EU, 20 member countries also participate in a voluntary monetary union that is commonly known as the eurozone. The monetary union involves the adoption of a common currency (the euro) and common interest rates, and it has played a major role in economic integration among the eurozone economies. While successful in promoting trade and economic integration among member countries, slower growth rates in EU economies (averaging just 1.1 per cent per year in the decade to 2022) have meant that its share of world output, while large, has almost halved since 1980.

Other regional agreements

In addition to the EU, two other regional agreements play key roles on other continents:

- The US-Mexico-Canada Agreement (USMCA) is a three-country trade deal previously known as the North American Free Trade Agreement or NAFTA. NAFTA contributed to the value of trade more than tripling between the three economies in the 25 years after its introduction. The NAFTA agreement was renegotiated and re-branded as the USMCA, coming into effect from 2020 with minor revisions addressing issues such as digital trade, corruption and intellectual property.
- The African Continental Free-Trade Area (AfCFTA) has the largest number of member economies of any regional trading agreement, bringing together 55 countries and 1.3 billion people with a combined GDP of US$3.4 trillion. AfCFTA came into force in 2021, with the goal of eliminating 90 per cent of tariffs between member economies. The World Bank estimates that the agreement will boost the regional economy by 7 per cent by 2035, lifting GDP by $450 billion and bringing 30 million people out of extreme poverty. However, its impact depends on successful implementation in each country.

Bilateral trade agreements

In addition to global and regional agreements, economies also enter into bilateral agreements. Australia's most far-reaching bilateral agreement is the **Closer Economic Relations Trade Agreement (CERTA)** with New Zealand, which began in 1983 and is one of the most comprehensive free trade agreements in the world. CERTA prohibits all tariffs and export restrictions, and has gradually been extended in recent years to include the harmonisation of business regulations and tax laws between New Zealand and Australia. Since 1983 it has contributed to an average annual increase in trade between Australia and New Zealand of around 7 per cent and is widely regarded as being successful in both countries.

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Bilateral trade agreements have experienced a resurgence in recent years. This reflects a number of factors, including the loss of momentum around multilateral agreements and the United States' increased use of its economic power to negotiate more favourable trade relationships on a country-by-country basis. These agreements are often as much concerned with shoring up open trading arrangements against a backdrop of rising protectionism as they are a means of unlocking new trading opportunities. In the past decade, Australia has concluded nine new bilateral agreements with Malaysia (2013), South Korea (2014), Japan and China (2015), Peru, Hong Kong and Indonesia (2020), India (2022) and the United Kingdom (2023).

Like regional trade agreements, economists are divided over the extent to which bilateral trade agreements assist or obstruct progress towards global free trade. A Productivity Commission study in 2017, *Rising protectionism: challenges, threats and opportunities for Australia,* noted that although governments often claim that bilateral trade agreements will deliver large increases in trade, in fact their impact is often much smaller because benefits are often exaggerated and the costs of establishing and implementing the agreements are underestimated. The report also noted that bilateral agreements can contribute to greater "trade diversion" – not adding to overall world trade, but simply diverting it to nations that are party to an agreement.

Nevertheless, pursuing further bilateral trade agreements remains a key component of Australia's trade policy. Against the backdrop of a weakened WTO in recent years, Australia has given priority to negotiations on bilateral agreements, most recently with the Australia-UK Free Trade Agreement that came into effect in 2023, with 99 per cent of tariffs on Australian exports to the UK eliminated. The economic impact of the UK agreement is likely to be relatively small, with the UK estimating it would add just 0.08 per cent a year to GDP by 2035. One of the advantages of negotiating bilateral agreements is that they are generally much faster to conclude than multilateral agreements (although the 10 years of negotiations preceding the China-Australia FTA shows this is not always the case). Australia's experience with China has also highlighted that bilateral agreements do not guarantee a harmonious relationship. Nothing in its bilateral agreement was able to prevent a series of punitive tariffs and trade barriers imposed by China in recent years on Australian exports of barley, wine, coal, timber and lobster.

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reviewquestions

1. Assess the impact of regional and bilateral trade agreements on the global economy.
2. Account for the growth of bilateral trade agreements in recent years.
3. Describe the recent developments in trade negotiations in Australia's region.

2.5 International organisations

The major institutions of the global economy are the **World Trade Organization,** the **International Monetary Fund** and the **World Bank**. Both the IMF and the World Bank were established at the Bretton Woods conference in 1944, which designed the postwar global economic system. However, the enormous changes in the global economy since World War II have forced these institutions to adapt to new circumstances without necessarily being equipped to deal with the more complex flow of capital and goods across borders that has characterised the globalisation era.

In addition, there are several other organisations with substantial influence in the global economy, such as the **Organisation for Economic Cooperation and Development** and the **United Nations**.

For further information on international organisations visit the websites of the **WTO**, **World Bank**, **IMF**, **UN**, **OECD** and **The Global Goals**.

World Trade Organization

The role of the WTO is to implement and advance global trade agreements and to resolve trade disputes between economies. The WTO was formed in 1995 and is the first international organisation with powers to enforce trade agreements across the world.

Prior to the formation of the World Trade Organization, the responsibility for developing trade agreements was borne by the **General Agreement on Tariffs and Trade (GATT)** process that began in 1947. The GATT process involved regular rounds of trade negotiations but lacked an enforcement mechanism. This meant that many countries only implemented parts of the GATT agreements. In 1993, GATT was replaced with a new global trade organisation with enforcement powers.

The formation of the **World Trade Organization** was significant not only because it had power to resolve trade disputes but also because its reach extended beyond trade in goods to include trade in services (such as insurance and banking) and intellectual property (such as patents, copyright, electronic circuits and trademarks).

One of the most important features of the WTO is its role in settling disputes between countries. A country that believes that it is suffering harm as a result of another country's failure to comply with its WTO obligations can lodge a complaint with the WTO. A process of **dispute resolution** is then commenced and if no agreement can be reached directly a WTO panel will hear the complaint and then issue a decision. If the country involved does not comply with the WTO's directive, the other country or countries may then impose trade sanctions that may include high tariffs on goods imported from the offending nation. Since 1995, 617 disputes have been brought to the WTO and over 350 rulings have been issued.

The WTO has proved effective in resolving disputes between smaller countries, although it has been less effective in resolving disputes between the two largest forces in the global economy – the United States and the European Union. Although the US and the EU have not formally refused to comply with WTO determinations, they have delayed and continued to lodge appeals rather than accept WTO decisions.

The WTO's membership includes 164 member countries and 25 further "observer" countries negotiating to join the WTO. Since its formation in 1995, the WTO has overseen a halving in average tariff rates among member economies and has had some success in negotiating further agreements to free up world trade. For example, in 2014 the WTO formally agreed on a binding Trade Facilitation Agreement, which aimed at reducing the cost of trade by 10 to 15 per cent by making customs procedures simpler and more efficient. In a 25-year anniversary media publication in 2020, the Director-General of the WTO identified this as one of the WTO's most important achievements. Some WTO members have also signed voluntary agreements to reduce trade barriers in financial services, information technology, telecommunications and shipping.

While the WTO has been effective in resolving disputes and making progress on a series of voluntary agreements, its efforts to conclude a comprehensive global trade agreement since 2001 have been unsuccessful. The **Doha Round** of trade liberalisation talks – named after the city in the Middle Eastern nation of Qatar in which they were launched – began with ambitious goals to reduce agricultural protection, lower tariffs on manufactured goods and reduce restrictions on trade in services. It was claimed that trade liberalisation could create annual welfare gains of US$90 to US$200 billion per year and lift over 140 million people out of poverty in the developing world.

The Doha Round failed due to disagreements on access to agricultural markets, restrictions on the production of pharmaceutical medicines, disputes between developed and developing nations, and arguments relating to manufacturing protection. More generally, the past two decades have seen declining public support for free trade in many countries.

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Nevertheless, the Doha negotiations produced some results, such as the Nairobi Package, a voluntary agreement in 2015 to reduce export subsidies for farm exports.

A quarter of a century after its establishment, the WTO's role has been weakened by a rise in protectionist sentiment globally. Historically, the United States was the leading advocate for freer trade and the WTO, but this has changed in recent years. Successive US governments have been critical of the WTO's use of its enforcement powers, in particular accusing the WTO of failing to stand up to China's breaches of trade rules. Since 2019, the US (under both the Trump and Biden Administrations) has refused to approve any replacement judges on the WTO's appeals body, with the US wanting the WTO's enforcement powers weakened. As a result, the appeals body cannot enforce WTO rules, and instead nations can only resolve their disputes through informal arbitration. Nevertheless, the WTO has still made progress on specific issues, such as with agreements at its ministerial council meeting in 2022 to override patent rights for COVID-19 vaccines and to reduce fishing subsidies.

International Monetary Fund

The International Monetary Fund (IMF) is one of the most important institutions in the global economy. It has 190 members, covering almost all nations. Its role is to **maintain international financial stability**, particularly in relation to foreign exchange markets. In earlier times the role of the IMF was to oversee a system of fixed exchange rates that would stabilise economic relationships between economies. When the system of fixed exchange rates collapsed in the 1970s, the IMF's role widened to ensuring global financial stability. In situations where a financial crisis occurs in an economy, region or even across the world, the IMF plays a critical role in minimising the crisis.

The IMF's role in ensuring stability in global financial markets was highlighted by its interventions following the COVID-19 pandemic in 2020. In response to the initial onset, the IMF established a new Short-term Liquidity Line aimed at providing one-off payments and interest-free loans to assist developing and emerging economies in designing policy responses to COVID-19, following requests from over 100 countries by May 2020. In July 2021, the IMF approved its largest-ever relief package, a $650 billion emergency aid fund, to assist developing economies in buying and rolling out vaccines and paying down debt accrued during the pandemic. After Russia's invasion of Ukraine in February 2022, the IMF approved a four-year Extended Fund Facility of US$15.6 billion as part of a US$115 billion total support package to help Ukraine manage the economic impacts of the war.

In the longer term, the IMF aims to support the free trade of goods and services and the free movement of finance and capital throughout world markets. The IMF often requires countries to change their economic policies and open up their markets before they receive financial assistance. These **structural adjustment** policies include reducing the size of government, privatising government businesses, deregulating markets and balancing government budgets. The impact of the IMF's policy approach is increased by the fact that many international banks and other private lenders require that countries adopt IMF-supported policies before they are willing to lend to those countries. Additionally, the IMF often tailors these policies to wider economic priorities, with a growing focus on climate risk given the harsher impact of climate change on many of the world's most financially vulnerable countries.

The IMF plays a central role in addressing financial crises in individual countries. However, the IMF has often attracted criticism during financial crises where its policies appeared to make conditions worse for the economies affected. After widespread criticism about the negative impact of some of the reforms demanded by the IMF after a financial crisis in Asia in the late 1990s, the IMF adopted a different approach during the global financial crisis of the late 2000s, supporting expansionary macroeconomic policies and giving borrowing countries more freedom to increase their spending to avoid recession. In 2010 the IMF

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also altered its governance structure to give developing and emerging economies (many of whom receive IMF assistance) a greater say over IMF policies.

Another criticism of IMF interventions – highlighted in the 2010s sovereign debt crisis in Europe – is that the IMF's demands harm the most vulnerable groups in society, while protecting financial institutions. An IMF audit report in 2016 acknowledged that the measures demanded by the IMF upon Greece during the crisis disproportionately affected the most vulnerable groups and intensified a recession. However, a broader IMF evaluation of its 133 lending programs in operation between 2011 and 2017 was more positive in concluding that three-quarters of IMF programs were successful or partially successful in achieving their objectives. The IMF has also been criticised for moving too slowly and cautiously, such as in the COVID-19 pandemic, resulting in proposals for reforms to the IMF's lending practices so it can move faster to provide low-interest loans to economies in crisis situations.

World Bank

The World Bank's primary role in the global economy is to help poorer countries with their **economic development**. The official title of its main organisation, the International Bank for Reconstruction and Development, gives an indication of its focus: to fund investment in infrastructure, to reduce poverty and to help countries adjust their economies to the demands of globalisation. The World Bank also has a number of organisations that provide specific assistance to lower-income countries including:

- the International Development Association, which provides "soft loans" (that is, loans at little or no interest to developing countries)
- the International Finance Corporation, whose role is to attract private sector investment to the Bank's projects
- the Multilateral Insurance Guarantee Agency, which provides risk insurance to private investors
- the International Centre for Settlement of Investment Disputes, which provides conciliation and arbitration of investment disputes between states, and between states and corporations.

The World Bank's two major goals are:

- reducing the rate of extreme poverty to less than 3 per cent of the world's population by 2030 (in contrast to current forecasts of 6 to 9 per cent of the world's population living on less than $1.90 per day by 2030). At the 3 per cent level those in poverty will mostly be experiencing "frictional poverty", that is, poverty related to short-term disasters such as extreme weather events rather than being in long-term poverty. This goal supports the United Nations Global Goals, although it is more narrowly focused.
- reducing inequality by fostering income growth for the world's bottom 40 per cent.

The World Bank is funded by contributions from member countries and from its own borrowings in global financial markets. It makes loans to developing nations, at rates that are below standard commercial rates, to fund infrastructure projects such as power plants, roads and dams. For example, in response to the COVID-19 recession, the World Bank committed $157 billion for over 100 lower-income countries that accounted for 70 per cent of the world's population. This funding helped countries to obtain vaccines, and strengthen health systems and reduce economic damage from the pandemic. The value of the World Bank's active portfolio of investments exceeds US$300 billion, with record lending commitments of US$105 billion in 2022.

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In overall terms, the World Bank's global importance as a lender to developing countries has declined as private lending markets have expanded in recent decades. However, it played an important role in partnering with the International Finance Corporation to provide US$47 billion for credit support after the onset of the COVID-19 pandemic in 2020, when private credit markets seized up.

One of the most important actions of the World Bank in the past two decades has been its support of the Heavily Indebted Poor Countries Initiative, in which it aims to reduce debt by two-thirds in the world's poorest countries in Africa, South Asia and Latin America, whose debt levels are considered unsustainable. By 2023, 37 countries had received debt relief estimated to have saved them over US$100 billion. The World Bank also plays a role in the global transition away from fossil fuels, with 35 per cent of its investments designed to help reduce carbon emissions.

CHINA: FROM NET RECIPIENT OF INTERNATIONAL DEVELOPMENT FINANCE TO THE WORLD'S LARGEST OVERSEAS DEVELOPMENT LENDER

Surprisingly, the world's largest lender of international development finance is not one of the international organisations established to support countries with their economic development or financial stability.

> "In the past decade, China has become the world's biggest overseas development lender, way bigger than the International Monetary Fund … It's bigger than the World Bank, the IMF and all 22 members of the Paris Club put together."
>
> *– Marc Filippino and James Kynge, Financial Times, August 2022*

Since launching its Belt and Road Initiative (BRI) in 2013, China has provided US$1 trillion in support to 147 countries through construction contracts and non-financial investments. In an average year, China lends around US$85 billion for overseas development projects – more than double the lending of the US (US$37 billion). BRI support focuses on building infrastructure in the developing world, leveraging China's $3 trillion in foreign exchange reserves.

Developing countries have reaped significant benefits from China's BRI lending. Statistical analysis published in 2022 indicates that an average BRI project increases economic growth in a host country by 0.95 percentage points after two years. The analysis also found that BRI infrastructure projects can reduce economic inequality, with a 10 percentage point reduction in the concentration of economic activity within a district in a low- or middle-income country.

Despite these benefits, BRI projects also involve risks for developing countries. With expedited approvals processes and high-speed construction, BRI projects have been linked to environmental degradation, inflated costs, social issues and corruption. The BRI has also created a large-scale debt burden, with China now the world's largest bilateral lender. A growing number of countries are also facing debt distress, as rising interest rates and slower growth make it difficult to service their debts.

The World Bank has warned that the debt burden from BRI projects could trigger a series of international debt defaults on a scale not seen since the 1980s.

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United Nations

The United Nations (UN) is a global organisation whose membership includes more nations than any other political or economic organisation. The UN was established in 1945 and has grown to cover 193 member states. Its agenda is broader than any other organisation, covering the global economy, international security, the environment, poverty and development, international law and global health issues. However, its decision-making powers are limited (because it relies on the support of its member states) and the budgets for the different arms of the United Nations are small compared to national governments in many advanced economies.

The UN has historically played an important role in supporting greater linkages between economies and promoting globalisation. A range of different UN agencies have developed international standards that make it easier for trade and investment flows to occur between nations, such as standards for food safety and rules on copyright and intellectual property. Key UN agencies include the World Health Organization, the UN Development Programme, the UN Children's Fund (UNICEF), the UN Refugee Agency (also known

as the UN High Commissioner for Refugees or UNHCR), the World Food Programme, the UN Conference on Trade and Development (UNCTAD) and the UN Environment Programme (UNEP).

The UN also has overseen the development of a large number of international agreements to enforce human rights and political freedoms. Research by the World Bank has consistently shown individual freedoms strengthen a country's prospects for economic growth and development. Several of these conventions were also developed with the intention of addressing the underlying causes of poverty in developing nations.

One of the most important roles played by the United Nations in recent years is establishing a set of Global Goals (or Sustainable Development Goals), which aim to reduce global poverty and inequality between 2015 and 2030. These goals build on the Millennium Development Goals, which oversaw a reduction in the proportion of people living on less than $1 a day between 1990 and 2015 – from 29 per cent to 14.5 per cent of all people in low- and middle-income economies (chiefly as a result of rapid economic growth in China lifting 600 million people out of poverty). The Sustainable Development Goals comprise 17 goals covering global poverty, hunger, wellbeing, education, gender equality, clean water and sanitation, clean energy, economic growth, sustainable cities, climate action and sustainable use of land and oceans. They incorporate 169 targets that UN member states have pledged to take action towards during the period 2015 to 2030. At the halfway point in 2023, a progress update on the Sustainable Development Goals found that only about 12 per cent of measurable targets were on track, close to half were moderately to severely off track, and 30 per cent had seen no improvement or some regression below the 2015 baseline.

Organisation for Economic Cooperation and Development

The Organisation for Economic Cooperation and Development (OECD) is an international economic organisation of 38 mostly advanced economies committed to democracy and open markets. The primary goal of the OECD is to promote policies "to achieve the highest sustainable economic growth and employment and a rising standard of living in member countries while maintaining fiscal stability and thus contribute to the development of the world economy". In practice, the main role played by the OECD is to conduct and publish research on a wide range of economic policy issues and to coordinate economic cooperation among member nations, such as towards the development of common policy agendas. For example, the OECD provided a forum for member countries to share research and coordinate policy responses to the COVID-19 pandemic.

Alongside research conducted by the IMF and the World Bank, OECD economic research is regarded as the most reliable source of comparative economic data. The OECD publishes in-depth research and analysis of a wider range of domestic policy issues relating to advanced economies, including competition, education, employment, health, industry, innovation, migration, regulation and tax. The OECD has also influenced the global economic policy agenda in recent years. Its advocacy for "inclusive growth" strategies in the past decade has challenged traditional assumptions that policymakers must always trade off equity and efficiency (that is, inequality versus economic growth), reflecting concerns that the level of inequality in many economies has become a constraint on economic growth. The OECD also played a key role in an international agreement in 2021 to reform corporate taxation rules. This agreement involves a global minimum corporate tax rate of 15 per cent and measures to ensure companies pay tax in the places where economic activity occurs, rather than using tax havens to avoid paying tax.

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review**questions**

1. Outline recent developments in global trade negotiations.
2. Identify and discuss the role of the international organisation responsible for maintaining international financial stability.
3. Explain why the IMF has been described as the world's financial firefighter.
4. Explain why in recent years the WTO has found it difficult to negotiate further cuts in protection.

2.6 Government economic forums

Organisations that exist as forums for world leaders play an important role in coordinating policies between major economies especially during times of economic or financial crisis. The aim of these forums is to enable heads of state along with their treasurers and central bank governors to discuss global economic issues with particular attention to economic stability and growth. In the early 2020s they have played a role in fostering greater cooperation among advanced economies on major economic issues, including recovery from the COVID-19 pandemic, addressing the fallout from the war in Ukraine and cooperating on measures to address climate change.

Group of Seven Nations (G7)

In recent decades, the most important government economic forum has been the group of the seven largest industrialised nations, including the United States, UK, France, Germany, Canada, Japan and Italy. The G7 has effectively operated as the economic council of the world's wealthiest nations, meeting annually to discuss conditions in the global economy since its formation in 1976. The G7 has been the unofficial forum coordinating global macroeconomic policy because of its influence over the fiscal and monetary policies of the world's largest advanced economies. Because of the G7's status as the forum for the world's most powerful economies, its agenda has often included general political issues and current priorities such as climate change, global poverty and security.

Critics in recent years have argued that the membership of the G7 is no longer representative of the most important forces in the global economy (China and India are more important to the global economy than Canada and Italy, but they are not included in the G7). The G7's share of global GDP shrunk from 68 per cent in 1992 to 43 per cent in 2023, and the G7 nations cover only 10 per cent of the world's population. When the global economy faced the sudden onset of the COVID-19 pandemic, and the dislocation of trade, travel and economic activity, the G7 did not provide a major leadership role. In response to the war in Ukraine, the 2023 G7 summit in Hiroshima, Japan, provided a forum for coordinating responses, including issues relating to defence, energy prices and global food security, as well as securing fresh diplomatic aid for Ukraine through military assistance packages.

Proposals in recent years have addressed the possible expansion of the G7 to include observer nations (including Australia). In 2023, leaders from eight economies joined by special invitation: Australia, Brazil, Comoros, the Cook Islands, India, Indonesia, South Korea and Vietnam. Ukraine was also invited as a guest. The hosts of the upcoming G7 summits are Italy in 2024 and Canada in 2025.

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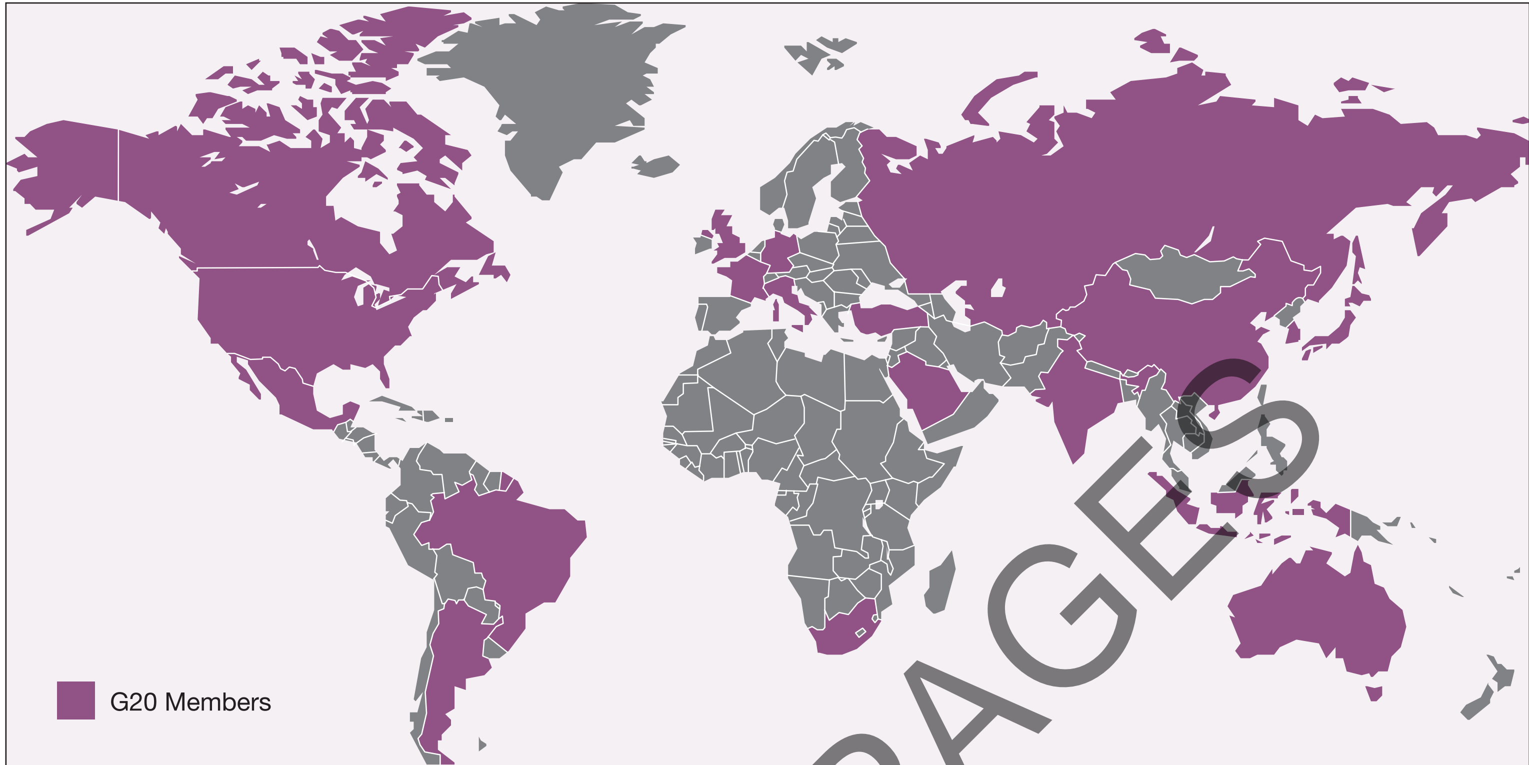

Figure 2.8 – Members of the G20

Group of Twenty Nations (G20)

The G20 includes 19 of the world's largest national economies plus the EU, covering around 85 per cent of world GDP and 65 per cent of the world's population. The G20 membership includes several emerging economies that have been a driving force behind world economic growth since 2008.

The G20 played a key role in the global response to the financial crisis in 2009 and had an important but less central role following the COVID-19 pandemic. During the global financial crisis, the G20 helped coordinate fiscal stimulus and improve supervision of the global financial system and international financial institutions. However, international economic cooperation has weakened in more recent years, with countries mostly determining their economic policy responses to the COVID-19 pandemic at a national level. In 2021 the G20 agreed on a global tax reform plan in partnership with the OECD, resulting in a minimum global corporate tax rate and measures to reduce tax avoidance. The G20 also agreed on measures to coordinate large-scale debt relief for developing countries in conjunction with the World Bank and IMF.

The extent to which the G20 group becomes the forum for international economic cooperation in future years is unclear, but at the moment the G20's main activity is its annual summit, and it does not have any permanent leadership or headquarters. The annual summit generally deals with a wide range of current issues, and does not advance specific economic goals. It therefore relies on individual heads of state to provide momentum and leadership to work together on specific global challenges.

reviewquestions

1. Explain the role of government economic forums in the global economy.
2. Discuss the role of the G7 in the global economy in recent years.

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chapter summary

1. **Free trade** is a situation where there are no artificial barriers to trade imposed by governments that restrict the free exchange of goods and services between economies.

2. **Protection** can be defined as any type of government action that has the effect of giving domestic producers an artificial advantage over foreign competitors.

3. The **arguments in favour of protection** include helping “infant industries” to establish themselves, protecting local jobs being lost because of cheaper imports, strengthening defence and national security and preventing foreign companies dumping goods on domestic markets at unrealistically low prices.

4. The **arguments against protection** are that it results in a distortion in resource allocation towards less efficient sectors of the economy and in the longer term can lead to a less internationally competitive economy, higher unemployment and a lower standard of living.

5. The main **methods of protection** are: tariffs (a tax on imports), subsidies (a payment to local producers), local content rules (a requirement that a proportion of goods are made locally), quotas (a limit on the quantity of goods imported) and export incentives (other means to encourage local production).

6. **Trade agreements** are a way of reducing barriers to trade between nations. Recent years have seen a proliferation of multilateral and bilateral trade agreements, and while they have removed some trade barriers they have also made the global trading system increasingly complicated.

7. The **World Trade Organization** is a global organisation that enforces the existing WTO agreement, resolves trade disputes and is the major forum for global trade negotiations pursuing the goal of global free trade.

8. The **International Monetary Fund** is a global organisation whose main role is to maintain international financial stability. The IMF plays a key role in monitoring the international financial system and assisting economies who face major economic crises.

9. The **World Bank** is a global organisation whose main role is to assist poorer nations with economic development through loans, development assistance and technical advice with the goal of reducing extreme poverty to 3 per cent of the global population by 2030 and raising income levels for the lowest 40 per cent of income earners.

10. The **G7** and the **G20** are the two most important forums for global economic policy coordination through annual meetings of national leaders. The G7 includes the major advanced economies, while the G20 includes the large emerging economies that have recently been driving global economic growth.

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chapter review

1. Define *free trade*.
2. Explain what is meant by *comparative advantage*.
3. Use the following terms to briefly outline the main methods of protection that can restrict free trade:
   • tariffs • local content rules • export incentives • subsidies
4. Outline the arguments supporting the following statements on protecting local industries:
   - "We should protect our infant industries so that they have a chance to establish themselves and become competitive in world markets."
   - "We should have the capacity to produce mRNA vaccines, so that in a future global pandemic Australia is not forced to go begging to other countries for critical supplies."
5. Discuss the economic arguments in response to the following justifications for protection:
   - "It's time we made Australia great again, and stopped sending jobs offshore to China."
   - "We need to protect our essential domestic industries just in case there's a war or another global pandemic."
6. Examine the role that bilateral and regional trade agreements play in contributing to free trade between economies.
7. Analyse the impact of the increase in preferential trade agreements and trading blocs on the global economy.
8. Explain how regional trade agreements in the Asia Pacific might affect Australia's economic future.
9. Compare and contrast the role of the following institutions in the global economy:
   - World Trade Organization
   - International Monetary Fund
   - World Bank
10. Explain which international organisation would be most likely to play the major role in the following situations:
    - a dispute between Australia and China about anti-dumping measures on bottled wine imports from Australia
    - construction of a major dam and irrigation project in India
    - a crisis in Latin American financial markets that poses a risk to the global economy.

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Globalisation and Economic Development

3

3.1 Introduction
3.2 Differences in income and economic growth
3.3 Differences in economic development
3.4 Categories of development in the global economy
3.5 Causes of inequality in the global economy
3.6 The impact of globalisation

3.1 Introduction

The most disturbing feature of the global economy is the very large difference in the living standards of people around the world. People born into families with high living standards in wealthy countries have very different prospects in life than those born in families with lower living standards and in low-income countries. Their opportunities in life vary significantly in terms of health, education, income and life expectancy. Despite the extraordinary technological change and progress of the past, stark inequalities persist between wealthy and poor countries, and between wealthy and poor people within countries.

While there is a large gap between rich and poor countries, it is also true that in overall terms living standards are improving in most countries, rich and poor. Evidence of progress towards overcoming global inequalities is highlighted by the following facts:

- The percentage of people now living in extreme poverty has declined significantly, with around 9 per cent of the population living below US$2.15 per day in 2019 (2017 PPP), compared to 43.6 per cent in 1981.
- The under-five mortality rate has been reduced by close to 55 per cent between 1990 and 2020.
- The global primary school net enrolment rate increased from 81 to 89 per cent between 1996 and 2018.
- Life expectancy for those born in countries with low human development increased from 50 to 61 years between 1990 and 2021.

Sources: World Bank 2023, Human Development Report 2021–22

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On the other hand, evidence also demonstrates the major gaps between the 6.6 billion people in the developing world and the 1.4 billion people in developed countries who enjoy a high level of human development.

- An estimated 685 million people live in "extreme poverty", subsisting on less than US$2.15 per day in 2022, with around 80 million people in poverty because of the impact of the COVID-19 crisis. Around two-thirds of this population lives in Sub-Saharan Africa (which has seen an increase in the number of people living in extreme poverty compared to 1990).
- Over 1.7 billion people live without access to basic sanitation and around 750 million have no access to electricity.
- It is estimated that 5 million children under the age of five died in 2021. More than 80 per cent of these deaths occurred in Sub-Saharan Africa or South Asia. An Oxfam report in 2022, *Inequality Kills: The unparalleled action to combat unprecedented inequality in the wake of COVID-19*, estimated that inequality contributes to the death of at least one person every four seconds.
- Across the world are an estimated 89 million refugees and forcibly displaced people, who fled their homes because of violence or persecution.
- In April 2023, over 13 billion COVID-19 vaccine doses had been administered globally. Low-income countries account for 9 per cent of the world population, but secured just 3 per cent of the total vaccination doses.

Sources: World Health Organization 2021, UNHCR, World Bank 2022, World Data Lab 2023, Oxfam 2022

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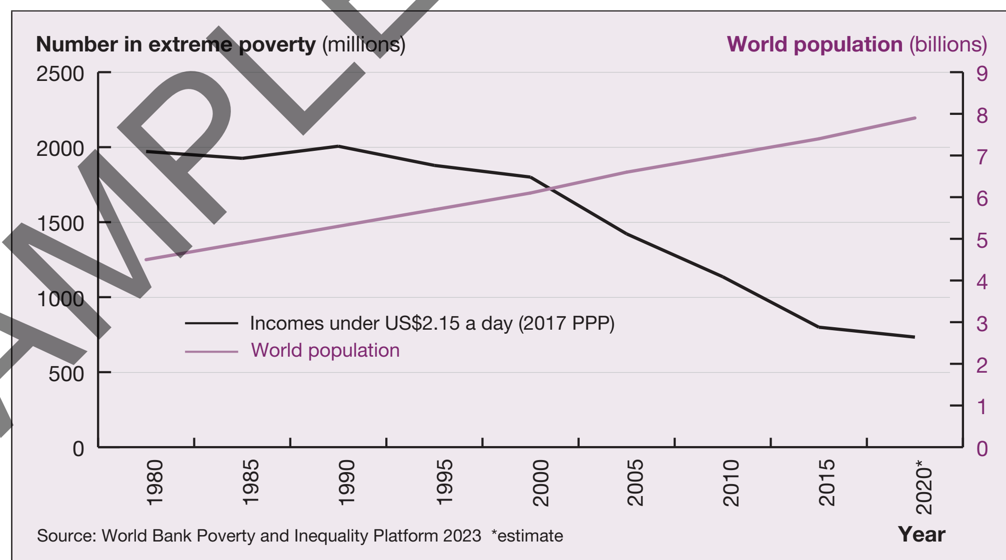
In this chapter we look at how to measure and understand differences in economic development in the context of globalisation.



Source: World Bank Poverty and Inequality Platform 2023 *estimate

3.2 Differences in income and economic growth

The most popular method for comparing living standards between different economies is income. It measures the ability of a nation's citizens to satisfy their material wants. **Gross National Income (GNI)** is the sum of value added by all resident producers in an economy, plus receipts of primary income from foreign sources. Real GNI figures are obtained by discounting GNI growth for the effects of inflation.

Figure 3.1 shows that the United States economy is by far the largest in the world. It is around one-third larger than the next largest economy, China, and almost five times the size of the third largest, Japan.

Country	GNI 2021 (US$ bn)	Ranking
United States	23,617	1
China	17,572	2
Japan	5129	3
Germany	4411	4
United Kingdom	3127	5
France	3118	6
India	3045	7
Italy	2145	8
Korea, Rep.	1974	9
Canada	1831	10
World total	**96,433**	
Source: World Bank 2023		

Figure 3.1 – The world's 10 largest economies by GNI (current US$), 2021

One of the limitations in comparing the size of economies is the exchange rate used. By using the United States dollar, we can make inaccurate comparisons about the living standards of developing countries. For example, if the prices of goods and services in developing countries are low relative to prices in the United States, then measuring GNI in terms of the United States dollar will underestimate the true income of people in these developing countries. For this reason, economists usually make an adjustment using **purchasing power parity (PPP)** before comparing GNI levels between countries. Measuring purchasing power parity adjusts measurements of the size of an economy to reflect the purchasing power of currencies within a national economy. PPP-adjusted figures provide a standard comparison of real income levels between countries.

Figure 3.2 groups the global economy into low-, middle- and high-income economies, a distinction made by the World Bank. It shows raw GNI and then the figures adjusted for purchasing power parity between these countries. Making these adjustments results in substantially higher comparative figures for developing countries, whose exchange rates tend to be undervalued.

Purchasing power parity (PPP) is a theory that states that exchange rates should adjust to equalise the price of identical goods and services in different economies throughout the world.

Grouping	Population (million)	GNI (US$ billion)	GNI measured at PPP ($ Int'l billion)
Low income	718	541	1468
Lower middle income	3398	8607	26,605
Upper middle income	2503	26,671	49,005
High income	1240	60,295	68,492
Global economy	**7888**	**96,432**	**146,002**
Source: World Bank 2023			

Figure 3.2 – Adjusted GNI for major country groups, 2021

Figure 3.2 shows that high-income economies (also known as advanced economies or industrialised economies) receive around two-thirds of the world's income as measured in raw GNI and nearly half of the world's income using PPP-adjusted GNI figures. A high level of inequality clearly exists in the global economy, given that high-income economies make up just 1.2 billion of the world population of around 8 billion. The population of low-income economies makes up 9 per cent of the global population but less than 1 per cent of the size of the global economy.

Population size and growth rates differ among economies, and play an important role in comparing one economy to another. To compare living standards between economies, we divide the real GNI of each country by its population, generating a **GNI per capita** figure.

As figure 3.3 shows, people in high-income regions (around one in six people in the world) enjoy income levels that are nearly five times those in low- and middle-income countries, even after adjusting for purchasing power parity. The table also details information about the regions where income is the lowest. Living standards in Sub-Saharan Africa and South Asia, where almost 40 per cent of the world's population lives, are exceptionally low.

Region	Population (million) 2021	GNI per capita, Atlas Method (US$) 2021	GNI measured at PPP per capita ($ current Int'l) 2021
High income	**1240**	**9291**	**55,208**
Low and middle income	**6620**	**5262**	**11,642**
Latin America & Caribbean	593	7579	15,879
Europe & Central Asia	402	8384	24,328
East Asia & Pacific	2124	9291	16,676
Middle East & North Africa	418	3409	11,298
Sub-Saharan Africa	1118	1561	3927
South Asia	1902	2076	6855
Source: World Bank 2023			

Figure 3.3 – Global comparison of living standards measured by GNI per capita

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Almost all nations have experienced some **economic growth** in recent decades, enjoying higher incomes as a result of an increase in their **Gross Domestic Product (GDP)**. While the gap in income between the richer and poorer countries appears to be lessening, the reduction of income inequality in the global economy is occurring very slowly.

Another dimension to global inequality is the unequal **distribution of global wealth**. Wealth is an important safety net for people when they do not have income and can be used to improve a person's education or find other ways to generate income. According to a 2022 report by Credit Suisse, the top 1 per cent alone owned 46 per cent of global wealth, while in contrast, the bottom 50 per cent owned less than 1 per cent. Most of this wealth is concentrated in households across Europe, North America and in Asia-Pacific countries such as Japan, China and Australia. People in Latin America, India and Africa, by contrast, hold only a small percentage of global wealth. Wealth is distributed even more unevenly than income throughout the global economy. While aggregate household wealth grew during the COVID-19 pandemic, a 2023 Oxfam report, *Survival of the Richest*, found the richest 1 per cent gained double that of the other 99 per cent combined. In the past decade, the number of billionaires worldwide has doubled and half of them reside in countries without inheritance taxes, allowing the concentration of wealth to persist across generations.

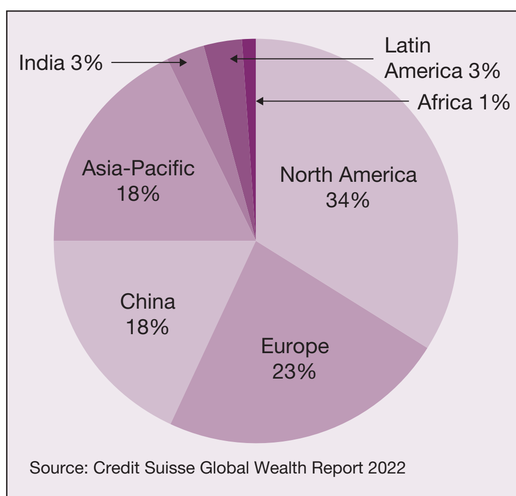

Figure 3.4 – Global distribution of wealth

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review questions

1. Explain why real GNI per capita (PPP) is used to measure income levels in the global economy.
2. Identify THREE economic regions that have low-income or middle-income levels, and state their level of GNI per capita (PPP).
3. Discuss what statistics on income levels in economies reveal about the level of inequality in the global economy.

Economic development is a broad measure of welfare in a nation that includes indicators of health, education and environmental quality, as well as material living standards.

Human Development Index (HDI) is a measure of economic development devised by the United Nations Development Programme. It takes into account life expectancy at birth, levels of educational attainment and material living standards (as measured by Gross National Income per capita).

3.3 Differences in economic development

It is important to look beyond simple measures of income and economic growth to assess the differences in living standards in the global economy. **Economic development** is a broader concept than economic growth. It attempts to measure improvements in wellbeing or welfare, rather than simply how much extra money people have. Higher incomes play a crucial role in improving wellbeing, especially for those living in poverty. However, development also takes into account other **quality-of-life indicators,** such as health standards, education levels, domestic work that is not given a financial value, the level of damage to the environment and inequalities in income distribution.

Human Development Index

A number of indicators have been developed to compensate for the limitations of economic growth measurements. The main alternative measure to GNI is the **Human Development Index (HDI)**, devised by the United Nations Development Programme (UNDP) to measure economic development. It takes into account:

- **Life expectancy at birth**. This is indicative of the health and nutrition standards in a country. High levels of longevity are critical for a country's economic and social wellbeing.
- **Levels of educational attainment**. Education is important for the development of the skills of the workforce and the future development potential of an economy. The HDI measures the average number of years for which adults aged 25 attended school and the expected years of total school attendance for school-age children.
- **Gross National Income per capita**. This measures the sum of gross value added by all resident producers in the economy, plus income from foreign sources on a purchasing power parity basis. This is used as a measure of a decent standard of living and is an essential determinant of the access that people have to goods and services.

The HDI is a score between 0 for nations with no human development and 1 for maximum human development. The 2021–22 Human Development Report gave Switzerland the highest HDI at 0.962 and South Sudan the lowest at 0.385. Australia ranked fifth after Switzerland, Norway, Iceland and Hong Kong with an HDI of 0.951. In both 2020 and 2021, the global HDI declined - the only recorded declines since records began, reflecting a reduction in life expectancy due to COVID-19. Two consecutive years of HDI decline in 2020 and 2021 erased the gains of the preceding five years.

Comparing HDI and GDP statistics reveals the differences between growth and development across the globe. The comparisons highlight the importance of a broader measure of welfare than just GDP figures.

In making these comparisons, it is important to emphasise that economic growth is still crucial for high levels of development – as illustrated by countries such as Norway, which have very high rates of both per capita income and human development.

Country	GNI per capita (2017 PPP, US$)	Human Development Index value	HDI ranking	Country	GNI per capita (2017 PPP, US$)	Human Development Index value	HDI ranking
Very high human development				**Medium human development**			
Switzerland	66,933	0.962	1	Morocco	7303	0.683	123
Norway	64,660	0.961	2	India	6590	0.633	132
Australia	49,238	0.951	5	Kenya	4474	0.575	152
United Arab Emirates	62,574	0.911	26	Solomon Islands	2482	0.564	155
Malaysia	26,658	0.803	62	Papua New Guinea	4009	0.558	156
High human development				**Low human development**			
China	17,504	0.768	79	Nigeria	4790	0.535	163
Cuba	7879	0.764	83	Ethiopia	2361	0.498	175
Mexico	17,896	0.758	86	Afghanistan	1824	0.478	180
Brazil	14,370	0.754	87	Yemen	1314	0.455	183
Indonesia	11,466	0.705	114	Chad	1364	0.394	190
Source: UNDP Human Development Report 2021–22, World Bank Data 2023							

Figure 3.5 – Comparison of GNI per capita and the Human Development Index

In some cases, countries had similar HDI levels but very different income levels. This suggests that in some countries the benefits of income are not well distributed as a result of their high levels of inequality. For example, the United Arab Emirates has a much higher income level than Australia but ranks lower in its HDI value. Australia has a GNI per capita of US$49,238, while the United Arab Emirates has a GNI per capita of US$62,574. Similarly, Cuba and Morocco have income levels around US$8,000, yet Cuba has a HDI rank of 83, while Morocco is 40 places lower at 123.

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THE GLOBAL GOALS

In September 2015 in New York, world leaders agreed to 17 new Global Goals, or Sustainable Development Goals (SDGs). The SDGs promote 15-year targets aimed at tackling poverty with a renewed focus on sustainability issues such as climate change, ecology and biodiversity, consumption and production, food security, energy provision and infrastructure. The goals listed below are supported by nearly 170 individual targets, to be achieved by 2030.

17 Sustainable Development Goals	
Goal 1	End poverty in all its forms everywhere
Goal 2	End hunger, achieve food security and improved nutrition and promote sustainable agriculture
Goal 3	Ensure healthy lives and promote wellbeing for all at all ages
Goal 4	Ensure inclusive and equitable-quality education, and promote lifelong learning opportunities for all
Goal 5	Achieve gender equality and empower all women and girls
Goal 6	Ensure availability and sustainable management of water and sanitation for all
Goal 7	Ensure access to affordable, reliable, sustainable and modern energy for all
Goal 8	Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all
Goal 9	Build resilient infrastructure, promote inclusive and sustainable industrialisation and foster innovation
Goal 10	Reduce inequality within and among countries
Goal 11	Make cities and human settlements inclusive, safe, resilient and sustainable
Goal 12	Ensure sustainable consumption and production patterns
Goal 13	Take urgent action to combat climate change and its impacts
Goal 14	Conserve and sustainably use the oceans, seas and marine resources
Goal 15	Protect, restore and promote sustainable use of terrestrial ecosystems, sustainably manage forests, combat desertification, halt and reverse land degradation, and halt biodiversity loss
Goal 16	Promote peaceful and inclusive societies for sustainable development, provide access to justice for all and build effective, accountable and inclusive institutions at all levels
Goal 17	Strengthen the means of implementation and revitalise the global partnership for sustainable development

Source: United Nations Sustainable Development Goals Report 2017

The SDGs were developed based on the previous Millennium Development Goals (MDGs) that were in place between 1990 and 2015. At the end of that period, some goals were achieved such as reducing extreme poverty, but progress was stronger in some Asian regions, particularly China, and weaker in others, such as Sub-Saharan Africa. Progress was also made in other areas, such as child mortality and improving access to safe water. However, many other targets were not met, including achieving universal primary education, eliminating gender disparity in education, and reducing maternal mortality by three-quarters.

At the halfway point to 2030, the UN Independent Group of Scientists reported that the world was not on track to meet the SDGs. While UNCTAD dedicated funds to achieve the SDGs, other factors worked against achieving the goals. COVID-19 saw a further 80 million people live in extreme poverty and 100 million children fall below minimum reading proficiency levels. Violent conflicts – the greatest number since 1945 – caused food and refugee crises. Rising interest rates further reduced the capacity of many highly indebted developing nations to spend on programs that might address the SDGs.

reviewquestions

1. Explain the difference between economic growth and economic development and discuss their relationship in the global economy.
2. Outline how the Human Development Index is calculated and assess its adequacy as a measure of economic development.

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3.4 Categories of development in the global economy

In examining economic data on living standards and development, we have referred to descriptions of high-income, middle-income and lower-income economies. In this section, we examine these distinctions in greater detail, and consider the use of other categorisations such as advanced, developing and emerging economies.

Countries are generally categorised into groups because they tend to confront similar issues according to their stage of economic development. The main categories that economists use are:

- **Advanced economies:** These countries have high levels of economic development, close economic ties with each other and liberal-democratic political/economic institutions. The 41 advanced economies identified by the International Monetary Fund (IMF) make up most of the high-income economies in the world (the others are very small nations) and comprise most of the members of the Organisation for Economic Co-operation and Development (OECD). High-income countries have Gross National Income per capita levels (PPP) above US$13,205 and are mostly found in North America and Western Europe, with a smaller number in the Asia-Pacific (such as Australia and New Zealand) and in the Latin American and Caribbean regions.
- **Developing economies**: These countries generally have low income levels, human resources with poorer education and health outcomes, and have only experienced industrialisation to a limited extent. The major consequence is that developing nations have large numbers of people living in absolute poverty (defined as less than $2.15 per day in 2017 US dollars PPP), as shown in figure 3.6. Developing countries are often divided into the two groups of low-income and middle-income countries.

Developing economies experience low living standards, low education levels and generally have agriculture-based economies with poor infrastructure and economic and political institutions.

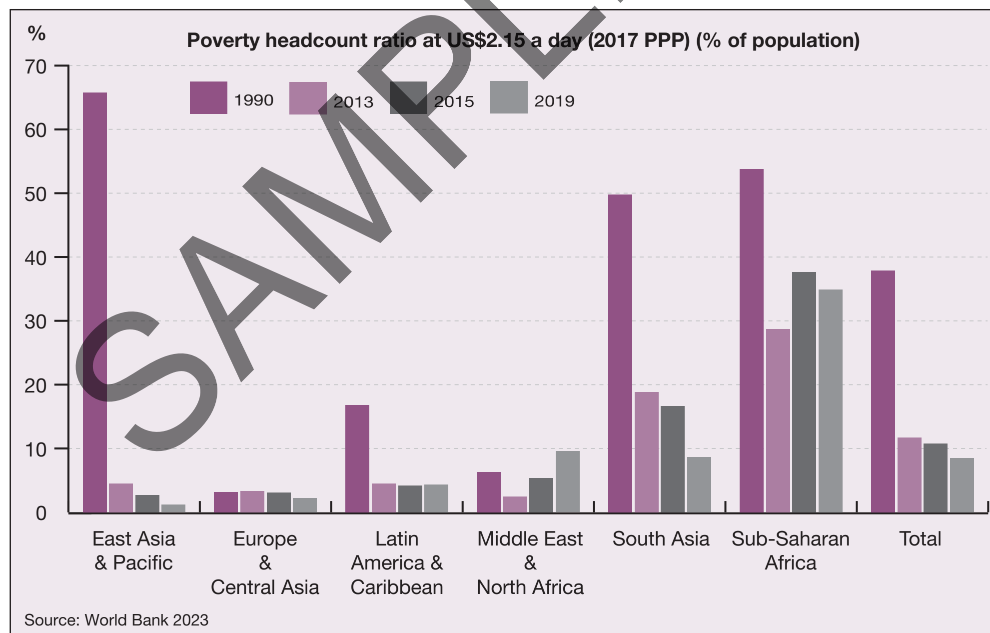

Figure 3.6 – Proportion of people in absolute poverty throughout the global economy

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While there are significant differences between developing countries, some common characteristics may include:

- high levels of income inequality within their economies
- dependence on agricultural production for income, employment and trade opportunities

- reliance on foreign aid and development assistance as a major source of income
- low levels of labour productivity, industrialisation, technological innovation and infrastructure development
- weak political and economic institutions and a high prevalence of corruption.

The United Nations Conference on Trade and Development (UNCTAD) has also identified a subgroup of the 46 **least developed countries (LDCs),** with the lowest GNI per capita levels in the world (less than US$1081 per year); weak human assets (based on health and education indicators); and high economic vulnerability (based on economic structure, size and exposure to shocks). Thirty-three of the 46 LDCs are located in Sub-Saharan Africa, highlighting what is sometimes called the "Africanisation" of poverty. As figure 3.6 shows, rapid and significant reductions in poverty have occurred in all regions (particularly in East and South Asia) except Africa.

Emerging economies are in the process of industrialisation and experiencing sustained high levels of economic growth.

Another classification for economies is **emerging economies**. These economies are in the process of industrialisation or modernisation and are experiencing sustained high levels of economic growth. This classification includes a range of economies that are neither high income, nor share the traditional characteristics of developing economies. They include the economies previously known as newly industrialised economies (such as Malaysia and the Philippines), economies previously known as transition economies, which were making the transition from socialist economies (such as China and Hungary), and developing economies with improved prospects (such as India and Indonesia).

Type of economy	Income levels	Economic growth	Structure of economy	Examples
Advanced	High income levels with GNI per capita above US$13,205	Slower growth in recent decades	Large service industries and advanced manufacturing	Singapore Portugal Czech Republic
Developing	Low income levels with around half of population in absolute poverty	Moderate growth rates but population growth also high	Heavily reliant on agriculture and (in more extreme cases) foreign aid	Madagascar Yemen Myanmar
Emerging	Income levels vary, but what these economies have in common is fast growth in income levels	Strongest growth rates in the world (5–10 per cent) and favourable prospects	Industrialising usually with substantial manufacturing sectors	China Brazil Indonesia

It is important to acknowledge the limitations of classifications systems. Classifications are very broad and can group dissimilar economies together. For example, Brazil and Indonesia might both be considered emerging economies, but they have very different living standards. Likewise, some economies do not fit neatly into one of these three categories. Bulgaria is much better off than a developing economy, yet it is not quite an advanced economy or an emerging economy. Despite these limitations, classifying economies is still an important step towards understanding the reasons for economic inequalities between nations.

reviewquestions

1. Summarise the main categories of development and the typical features for each classification.
2. List FOUR economies that have the characteristics of each of the main categories of development.

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3.5 Causes of inequality in the global economy

Understanding the reasons for differences in levels of development between nations has been a central issue of economic debate for over half a century. During the globalisation era, differences in living standards between rich and poor countries have come into sharper focus because of the increased interaction between the more prosperous and less prosperous regions of the world.

The severe and widening extent of inequalities between economies raises fundamental questions. Why have some economies succeeded in achieving rapid industrialisation and economic development while others have achieved little or no progress in reducing poverty? What factors explain this growing divergence of income, health and education outcomes between and across economies?

Such issues are the domain of **development economics**, which attempts to identify and enable the conditions required for sustainable economic growth and development. By comparing the characteristics of high-income and developing economies, development economics highlights the specific problems faced by poor countries, such as high rates of population growth, low levels of skills development, weak legal and financial institutions, and endemic corruption.

In an era of increased integration between economies, it is important to also understand how the relationships between nations, the overall structure of the global economy and the roles of international organisations influence global inequalities. These global factors are set out below, alongside the domestic factors that contribute to low levels of development.

Global factors

Many features of the global economy and the process of globalisation contribute to the inequalities between countries. Although globalisation also creates opportunities for economic growth and development, some aspects of the global economy appear to entrench rather than reduce global inequalities.

Global trade system

Several features of the global trade system work to reinforce rather than reduce global inequalities:

- Wealthy countries protect their domestic agricultural sector because it is not competitive with agricultural producers in many developing nations. Developing countries that export commodities are severely affected by high levels of global **protectionism in the agricultural sector**. While total agricultural support to producers in OECD has fallen by almost half since the mid-1980s, it remained high at US$245 billion in 2021, providing 18 per cent of income for farmers in rich economies in the European Union and double that in economies such as Japan and Korea.
- **Regional trading blocs** such as the European Union and United States–Mexico–Canada Agreement (USMCA) can exclude poorer nations from gaining access to lucrative global consumer markets. Exclusion from trade opportunities has an enormous impact on poor countries because bilateral agreements are rarely as comprehensive as regional trading blocs.
- The World Trade Organization's **Doha Round** of trade negotiations in the early 2000s was promoted as the "development round" because of its focus on trade reforms to benefit poorer nations. A major reason for its failure was that high-income nations resisted making concessions on the issues that would provide the greatest benefit to developing countries. Recent WTO negotiations have focused on much more

For further information on global aid issues, visit the website of non-government aid and advocacy organisation Oxfam International **www.oxfam.org**

Using this website, outline some of the recent policy proposals of Oxfam to address global poverty.

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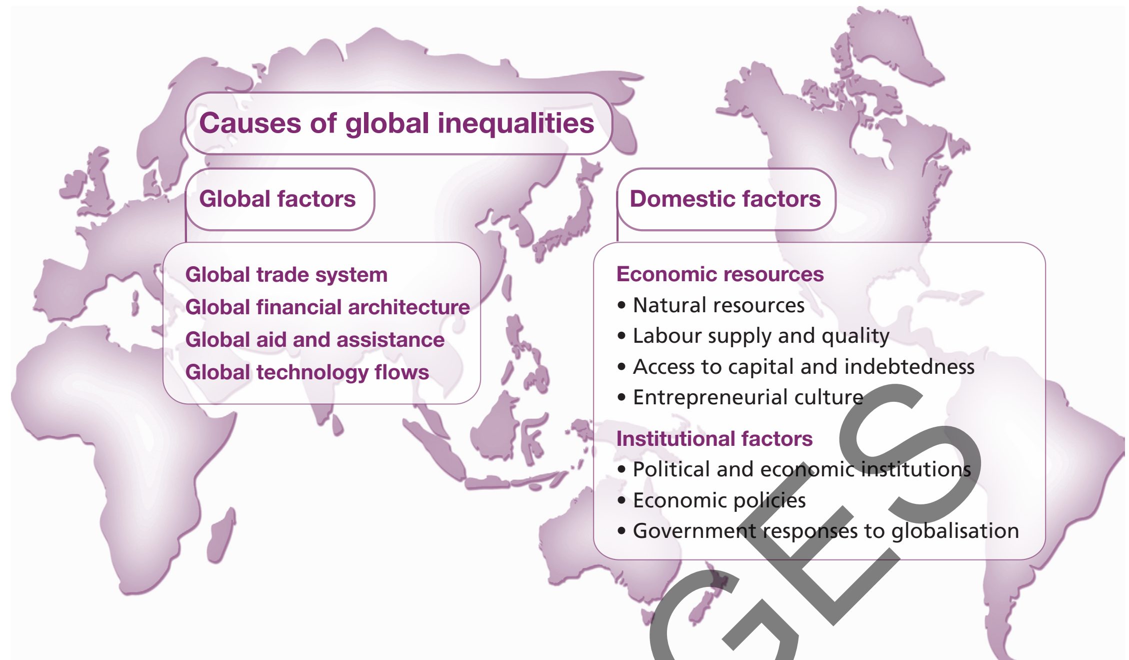

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limited reforms to expand tariff-free access for exports from the least-developed countries, leaving more ambitious reforms to future negotiations.

- The benefits of free trade agreements are often not accessible to developing nations because of the substantial cost in implementing international agreements and lodging appeals against other countries' protectionist measures. Economists at the World Bank have concluded that a 1 per cent increase in administrative costs associated with trade would decrease gross world product by US$75 billion. The complexity of many trade agreements further tilts the benefits of the global trade system towards richer countries and can entrench rather than reduce global inequalities.

Global financial architecture

Although deregulated global financial markets and the global financial system are intended to create development opportunities by enabling the free flow of funds around the world, the global financial system can also entrench global inequalities:

- Historically, long-term international flows of investment heavily favoured developed countries. This has changed since the 2000s, with developing economies receiving around half of global foreign direct investment (FDI) flows. However, faster-growing emerging economies and developing economies – such as China, Brazil, India and Russia – have benefited the most. In contrast, the world's 46 least developed countries held just 1.2 per cent of the global stock of inward FDI in 2021.
- Short-term financial inflows heavily favour the more prosperous emerging economies, which offer better financial returns for currency and stock market speculators. However, as a result, these regions are exposed to **economic volatility** as witnessed by the dramatic financial crises of East Asia in the late 1990s and of Latin America in the early 2000s. When those kind of crises occur, they can set back economic development for years while global financial market speculators simply move on to invest in other countries. On the other hand, financial liberalisation can be an important corollary of trade liberalisation. A 2019 IMF research report found that low-income countries that had stronger banking sectors were better able to manage when sudden changes in their terms of trade caused volatility in their export earnings.
- International financial rules have not kept pace with the globalisation of the economy and in some areas have tolerated loopholes that contribute to large flows

of income or wealth to those who already hold substantial wealth. According to the OECD, corporate tax avoidance cost countries up to US$240 billion in corporate tax revenue each year, with developing countries suffering disproportionately. In 2023, over 135 countries and jurisdictions were implementing a global plan to reduce tax avoidance by transnational corporations.

- The role of the IMF, the international organisation that oversees the global financial system, has been under greater scrutiny in recent years, in particular because of its impact on developing countries. The major criticism of the IMF is that the "structural adjustment" policies it advocates serve the interests of rich countries and may not be appropriate to the conditions of many developing countries. Acknowledging this concern, the IMF includes sustainable development prominently in its mandate. Since 2001, an Independent Evaluation Office (IEO) has undertaken reviews of the IMF's activities, at arm's length from management and the board. A 2023 review of the IMF's response to the COVID-19 pandemic found that it "deserves great credit for its effective and agile response to provide early financial support to a broad range of members at a time of urgent need and high uncertainty." Nevertheless, the same review found the IMF's guidance to countries on fiscal policy may have encouraged too much spending. Some countries such as Belarus, Iran, Zambia and Nicaragua did not receive funding or it was delayed because of concerns about health or economic policies, giving rise to a perception that the IMF did not treat all countries equally.
- Many developing countries have **large foreign debt burdens**. Total external debt for low- and middle-income economies was estimated at US$9.3 trillion in 2021, an increase of 8 per cent since 2020, according to the World Bank's International Debt Statistics. Interest repayments on these past loans reduce the income available for governments to promote growth and development through spending on education, health care and infrastructure. As a result, many developing countries spend more on debt servicing than public health. Prior to the onset of the COVID-19 pandemic, rising public debt levels and heightened debt vulnerabilities were already a cause for concern. This prompted the launch of debt relief initiatives for developing countries, most notably the Debt Service Suspension Initiative (DSSI).

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Global aid and assistance

The relatively small-scale efforts made by developed countries to address the problem of global inequalities are insufficient to overcome the large differences in living standards:

- The total level of development aid provided by high-income economies reached an all-time high of US$204 billion, or 0.36 per cent of Gross National Income, in 2022. However, this was still only half the level promised by high-income economies since the 1970s (0.7 per cent of GNI). The OECD Development Assistance Committee found that only five of its member countries met or exceeded the 0.7 per cent UN target in 2021. The recent boost to aid gave priority to settling refugees in new countries (14 per cent) and supporting Ukraine during the war (8 per cent).
- Critics of the aid policies of developed countries argue that a significant proportion of official development assistance is "phantom aid" – that is, aid funds that do not improve the lives of the poor. According to the OECD, almost one in every six dollars of foreign aid is "technical cooperation", which is often paid to consultants in donor countries. Another 11 per cent of aid is debt-related, such as for relieving or refinancing past loans, which does not contribute to new development. A further 5 per cent of the foreign aid budget is spent on administration. These disbursements reduce the amount available for development projects and humanitarian relief. Additionally, these figures do not reveal the proportion of aid that is "tied aid" – that is, aid that must be spent on overpriced or unnecessary goods and services that are produced by the donor country. For example, when the United States provides food support to very poor countries, it sometimes buys American crops and ships

them all the way to countries in Africa, at a far greater expense than buying those crops in the local region. A 2021 study by the European Network on Debt and Development found that the OECD Development Assistance Committee reported one in every five dollars of bilateral and EU aid was tied aid.

- Another limitation of foreign aid is that if it is granted without appropriate governance mechanisms, or not targeted to developing domestic industries, it may be wasted or have perverse impacts. For example, a former World Bank consultant, Dambia Moyo, argued that a significant amount of aid to African countries historically was misused and contributed to violent conflicts, while poverty levels increased.
- The distribution of aid by high-income countries often reflects strategic and military considerations rather than the needs of the world's poorest countries. The *Quality of Official Development Assistance* report, published by the Center for Global Development in Washington D.C., assesses the quality of aid on 10 criteria. It has consistently found that multilateral aid agencies are more effective than individual countries who provide bilateral aid. Australia ranked 21st out of 49 in the 2021 QuODA table.
- While multilateral development aid (distributed by the World Bank, IMF and United Nations) is better targeted at the world's poorest countries, it is less than one-third of the value of total development assistance from the Development Assistance Committee members. One recent initiative is the Aid for Trade program, established by the WTO to assist developing countries in overcoming the structural difficulties that limit their ability to successfully trade out of low economic development.

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Global technology flows

Technology has the capacity to contribute to closing the gaps in living standards, but it can also entrench inequalities. New technologies can be adopted much more quickly in economies that have better infrastructure, higher levels of education and that already have high penetration rates of related technologies such as broadband infrastructure. In 2022, the International Telecommunications Union estimated that around one-third of the world's population did not use the internet, and 95 per cent of those without it lived in developing economies. This means that these businesses and consumers have limited access to online opportunities to sell and purchase goods and services, which is a rapidly expanding market, and reinforcing economic isolation from the digitally connected and developed world. As the world became increasingly reliant on digital technology during the COVID-19 pandemic, the gaps in developing countries' access to these technologies (termed the "digital divide") became even more important.

New technologies are also largely geared to the needs of high-income countries because they choose the priority areas of scientific research. Much of this technology – like labour-saving devices and pharmaceuticals that deal with the health problems of ageing people in advanced economies – is of little benefit to poorer nations that have abundant labour supplies, a young population whose main health risks are common infectious diseases, and limited capital resources. For example, around 10 per cent of the global population (approximately 750 million people) did not have access to electricity in 2020, according to the World Bank.

Developing nations also find it difficult to gain access to new technologies. Intellectual property rights restrict the benefits of technological transfer to poorer countries because they cannot pay developed country prices for those technologies. The Agreement on Traded Related Aspects of Intellectual Property Rights (TRIPS), for example, has been criticised for requiring all countries to implement complex intellectual property regimes that are difficult to implement for developing economies. This issue came to light during the COVID-19 pandemic when, in early 2021, developing economies brought a case to the

World Trade Organization (WTO) arguing that the intellectual property underpinning COVID-19 vaccines be released for free. This case was opposed by the governments of several high-income nations with large pharmaceutical industries.

Domestic factors

Economic resources

The simplest explanations for contrasts in levels of development focus on the difficulties most economies face in acquiring and maintaining sufficient resources for the production process – namely natural resources, labour, capital and entrepreneurship.

- **Natural resources**: Natural resources are important inputs for production, such as non-renewable or renewable energy supplies, fertile agricultural land, water supplies and minerals. Economies that have an abundant and reliable supply of cheap natural resources clearly have better opportunities for economic development than those that do not, even if some have been spectacularly unsuccessful in using these opportunities. Oil-rich countries in the Middle East, Africa and Latin America have achieved higher growth rates than their neighbours largely as a result of their exploitation of natural resources. But an abundance of natural resources can also hamper a country's economic development if it leads to an overvalued exchange rate, a narrow export base and an over-reliance on a small number of industries to drive economic growth. Countries that rely on natural resource exports are also exposed to downturns in commodity prices, which can result in sudden falls in national income.

Natural resources include all the resources provided by nature that are used in the production process. These are often simply referred to as "land". The reward (return) to the owners of natural resources is called "rent".

- **Labour supply and quality**: Labour is an input to the production process for many sectors of the economy and therefore influences development levels. Whereas high-income countries tend to have highly educated and skilled labour resources, low-income nations are characterised by high population growth, lower levels of educational attainment and low health standards that result in lower productivity levels. In Singapore, for example, a strong commitment to creating a highly educated workforce has played a central role in the development of a sophisticated service-based economy. In South Africa, by contrast, the quality of the labour supply is diminished by inadequate education facilities and high rates of HIV/AIDS, which affects nearly one in five South Africans aged 15 to 49 years and reduces workforce participation and productivity. Barriers to girls' access to education in many developing countries also contribute to lower productivity and workforce participation.
- **Access to capital and technology**: Difficulty in gaining access to capital for investment and development contributes to lower rates of economic growth and lower living standards. Low income levels provide little opportunity for savings that can be used for investment. Poorly developed financial systems make it difficult for businesses to gain easy access to loans for investment purposes. To improve access to finance, microfinance organisations in many developing economies provide small loans to help the poorest people in the world manage their farms or start a business. Additionally, with small research organisations and limited funds for business innovation, developing countries have fewer opportunities to develop new technologies or to pay for the patents to use technologies developed in other countries.
- **Entrepreneurial culture**: While it is difficult to quantify differences in culture between economies and how this can impact upon economic performance, evidence suggests that a country's history and social institutions can impact on its economic success. In particular, strong civil society institutions, cultural disapproval of corruption, respect for the rule of law and aspirations towards work, enterprise and personal responsibility can support economic growth and development.

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- **High levels of inequality:** Large gaps in the distribution of income and wealth are a common characteristic of developing countries, and especially of countries with high concentrations of poverty. Oxford University's Poverty and Human Development Initiative has found that two-thirds of the world's poorest billion people live not in the poorest countries, but in middle-income countries. High levels of wealth concentration tend to lead to lower rates of economic growth and development. We need to examine both differences in living standards within countries and between countries if we are to understand the overall differences in living standards across the global economy.

Institutional factors

Institutional factors – ranging from political stability, legal structures, central bank independence, extent of corruption, strength of social institutions and the government's domestic and external economic policies – can affect the ability of a nation to achieve economic development.

VIEWPOINT GLOBALISATION

View on globalisation

Globalisation – Where to from here?

"Globalization was meant to bring the world closer together, enmeshing advanced and developing economies in a web of mutually beneficial economic and financial linkages. From about the mid-1980s, trade and financial flows between countries expanded rapidly as governments dismantled barriers to these flows.

Not everything went according to plan. Tensions rose as the benefits were not equally shared within or among countries. Widening economic inequality, often attributed to free trade, roiled many advanced economies and has had far-reaching political consequences. While they benefited from access to foreign markets for their exports, many emerging market countries were ravaged by volatile capital flows and the fickleness of international investors. Still, there was a broad consensus that shared economic interests would ultimately triumph and even help smooth over geopolitical frictions.

…

Foreign direct investment (FDI) flows have tended to follow trade, with corporations setting up operations abroad and investing in manufacturers as well as suppliers of various kinds of inputs, including raw materials and intermediate goods.

…

Emerging market countries benefited from globalization in multiple ways. They were able to expand markets for their products beyond their national borders, allowing them to build strong manufacturing sectors and robust middle classes

…

Globalization is not dead, but it has clearly taken a turn toward fragmentation along geopolitical lines, which could have important economic consequences for all countries.

…

For emerging market economies not politically aligned with advanced economies, lower trade and financial flows will mean fewer technology and knowledge transfers, hindering their path to development."

– Eswar Prasad
Professor of Trade Policy, Cornell University
"The World Will Regret Its Retreat From Globalization"
The Economist, *24 March 2023*

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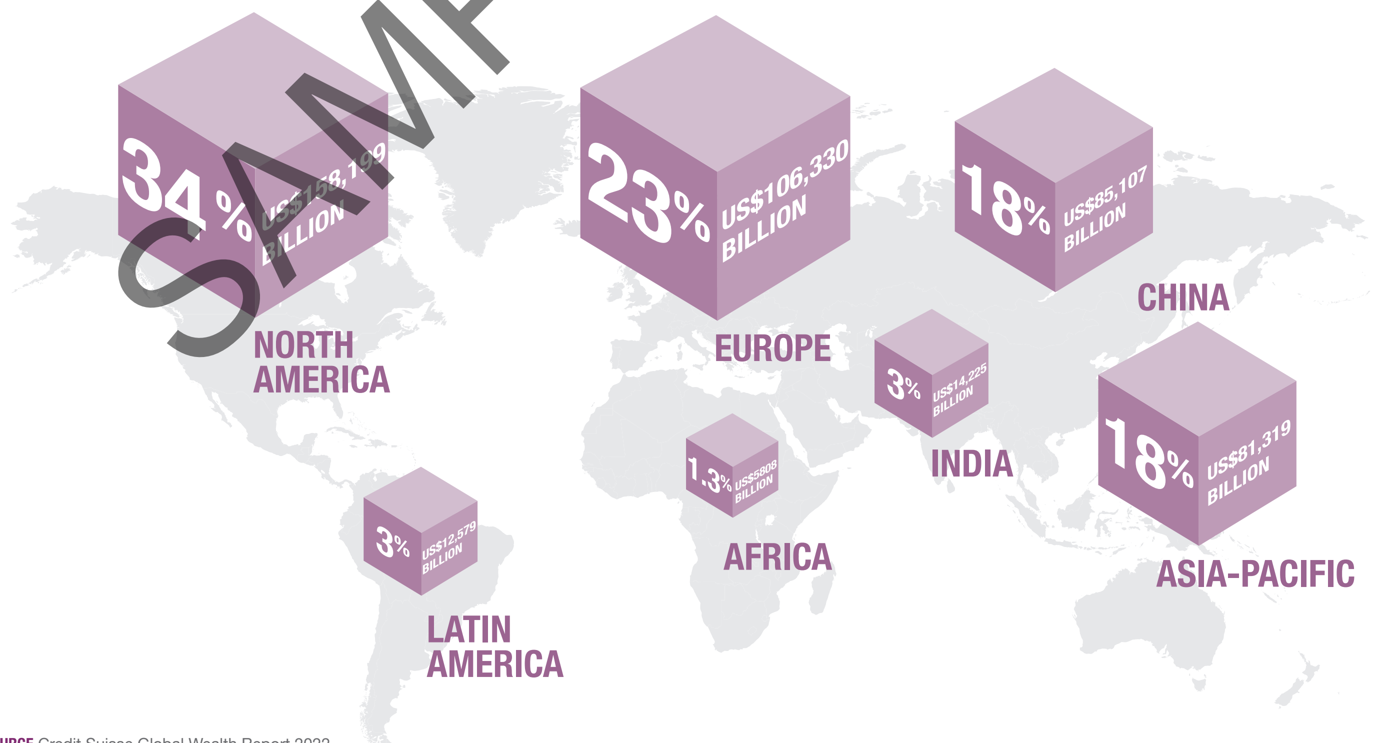
- **Political and economic institutions**: Institutional factors in individual countries can have a dramatic influence on the economic environment for businesses, investors and consumers, and thus have implications for a nation's level of economic development. Countries with high levels of institutional fragility or violent conflict will usually have lower levels of economic development. For example, it has been forecast that by 2030, 85 per cent of those in extreme poverty will live in countries with "fragile and conflict-affected situations". Today, there are 2 billion people, or roughly a quarter of humanity, living in conflict-affected areas. Political instability, corruption and a lack of law enforcement by government agencies can also undermine the confidence of investors, who will be reluctant to take risks if their business interests are threatened by an inadequate structure for resolving legal disputes, corruption or other institutional problems. The impacts of weak political institutions on economic development are difficult to quantify. One attempt to do so is the Corruption Perception Index, compiled each year by Transparency International. The Corruption Perception Index is a score between 0 for countries with a relatively high level of corruption and 100 for countries with a relatively low level of corruption. Figure 3.7 shows that developed economies have, in general, lower levels of corruption than developing and emerging economies.

Country rank	Country	Corruption Perception Index (0–100)
1	Denmark	90
2	Finland, New Zealand	87
4	Norway	84
7	Switzerland	82
13	Australia	75
24	United States of America	69
65	China	44
85	India	40
94	Brazil	38
137	Russia	28
171	Korea (North)	17
180	Somalia	12

Source: Corruption Perception Index 2022

Figure 3.7 – Corruption Perception Index, selected countries 2022

- **Cultural factors:** are often reflected in legal structures and institutions, and can influence a country's economic development. For example, gender inequality can



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contribute to lower employment levels, lower productivity and weaker social development. Cultural factors can also lead to 'horizontal inequalities' that hinder development within a nation. Gender inequality is one of the most widespread horizontal inequalities, with discriminatory laws leading to lower employment, economic productivity and social development. World Bank research published in 2022 found that the mortality ratio of women to men is 2.3 per cent lower in countries with legislation outlawing domestic violence. This has significant economic impacts. In Tanzania, those who are subjected to abuse experience 60 per cent lower lifetime earnings. The *Women, Business and the Law 2023* report concluded that, globally, women still have only three-quarters of the economic rights that men have. Further, only 34 reforms relating to women's rights were passed in 2022, the lowest in 20 years. This makes women more vulnerable to impacts of crises such as the COVID-19 pandemic, which increased the number of women in extreme poverty by 47 million.

- **Economic policies**: Government economic policies can have a substantial impact on development, in particular how governments balance the roles of market forces and government intervention in the economy. If all major decisions are left to market forces, a country may achieve a high level of economic growth, but it may not improve education, health care and quality of life. On the other hand, excessive government control over economic decision making can constrain entrepreneurship and innovation, reducing economic growth. Countries with the highest levels of human development, such as Switzerland and Australia, typically have both a strong market economy and significant government investment in human development. By contrast, when they were under communist rule between the Second World War and 1989, with a command economy rather than a market economy, Latvia and Poland experienced slower growth in development. A widely cited IMF paper, *Income Inequality and Fiscal Policy,* found that a major reason for higher inequality in Latin America compared with European economies was that developing economy governments are less able to reduce inequality because they have less comprehensive tax systems and public services. A 2022 paper from the Bank for International Settlements found that inequality increases faster and more persistently following recessions. A boom/bust cycle can impede long-term economic growth and increase inequality. On average, inequality is still higher five years after a recession when compared to pre-recession levels.
- **Government responses to globalisation**: Government responses to globalisation can have a substantial influence on a nation's ability to achieve economic development. Policies relating to trade, financial flows, investment flows, transnational corporations and the country's participation in regional and global economic organisations will influence an economy's ability to take advantage of the benefits of integration, such as economic restructuring, efficiency, access to foreign capital and technology and access to overseas goods markets. For example, East Asian economies that have been most open to trade and foreign investment have experienced the strongest rates of economic growth in recent decades. The role of government policy via responses to globalisation in influencing economic performance is discussed in both case studies after this chapter.

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reviewquestions

1. Assess the extent to which global and domestic factors cause inequality in the global economy.
2. Discuss the extent to which globalisation may increase or reduce the extent of inequality in the global economy.

3.6 The impact of globalisation

In this section, we address one of the most important questions of modern economics: what is the impact of globalisation on individual economies and the world as a whole? We look at how the forces of globalisation have affected economic growth and development, changed production processes, influenced the gap between rich and poor, and impacted on the natural environment. While the overall impact of globalisation is to foster improved economic outcomes, we also note some of the downsides to greater economic integration.

Economic growth and development

Globalisation has affected countries in different ways. Developing economies have greater opportunities to grow by producing goods for global consumer markets and can also benefit from greater access to new technologies and foreign investment. High-income economies, especially through transnational corporations, have found growth opportunities in global supply chains and new global service markets. Nevertheless many economies have not gained as much as might be expected from globalisation, and greater economic integration has caused disruptive structural changes in some regions. Moreover, the relatively free movement of people, goods and data across national borders also increases risks – from cybercrime and the hacking of computer networks to disinformation on social media and the spread of pandemics such as COVID-19.

Overall, there is evidence that globalisation has produced an acceleration of economic growth, though the effect has been distributed unevenly across geographical regions. As the world economy has become more integrated over recent decades, global real GDP growth has increased from 3.1 per cent per year during the 1980s and 1990s to 3.8 per cent from 2000 until the onset of the COVID-19 pandemic in 2020.

In recent decades, the fastest-growing economies have been emerging economies such as China and India, while the slowest-growing economies have been the advanced economies. Since 1990, a group of emerging and developing economies have been "catching up" to advanced economies, although this is not the case for many, especially when we assess per capita incomes.

- The **East Asia and Pacific** region (excluding high-income countries) has been the fastest-growing region in the world (8.7 per cent per year on average across the 1990s and 2000s, though it fell to 7.3 per cent during the 2010s). In particular, strong growth in China during this period (10.4 per cent in the 2000s, falling to 7.7 per cent in the 2010s) demonstrates the role of industrialisation and globalisation in economic growth. The region grew by 7.2 per cent overall in 2021, but this reflected much stronger growth of 8.1 per cent in China, while the rest of the region averaged growth of only 2.6 per cent. Growth was forecast to be around 4.6 per cent in 2022.
- Economies in **South Asia** also experienced successful growth, averaging 5.7 per cent since 2000, particularly with India sustaining growth after its steps towards greater integration with the global economy (6 per cent) and Bangladesh (6 per cent). South Asia contracted by 5 per cent in 2020 and rebounded by 8 per cent in 2021.
- The former socialist economies of eastern **Europe and Central Asia**, which grew by 5.1 per cent in the 2000s, and 3.1 per cent in the 2010s, made a generally successful transition to becoming market economies after experiencing a severe contraction in their economies during the 1990s (–0.9 per cent) because of the difficult process of transition. Output in the region grew by less than 1 per cent in 2022 because of the impact of the war in Ukraine.
- The **Middle East and North Africa** experienced strong economic growth (4.4 per cent) throughout the 1990s and 2000s, including in Egypt (4.7 per cent) and

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Saudi Arabia (3.6 per cent). Higher growth in the Middle East and North Africa compared with the 1980s (0.1 per cent) was underpinned by higher prices for energy resources during the globalisation era, although it did not resolve the very high levels of inequality in many economies in the region. However, political instability and a decline in oil prices has seen growth averaging only 2 per cent since 2011.

- **Sub-Saharan Africa** recorded an average growth rate of 4 per cent from 2000 to 2021, with strong growth in Ethiopia (8.7 per cent), Mozambique (6 per cent) and Nigeria (5.2 per cent). However, other African countries have been less successful, including Sudan and the Central African Republic, having growth rates so low that they are experiencing very little improvement in living standards.
- **Latin American** economies experienced strong annual growth in the first decade of the 2000s (3.1 per cent), improving from the 2.4 per cent average of the 1980s and 1990s. However, growth fell back to 1 per cent annually in the 2010s, reflecting weaker commodity prices and political instability in some countries in the region. Latin American economies experienced the greatest COVID-19 shock of any region in 2020, contracting by 6.5 per cent.
- **High-income economies** (or advanced economies) grew by just 2.1 per cent on average in the 1991–2021 period, slower than the 3.3 per cent recorded during the 1980s. Over this period, average annual growth rates were 2.4 per cent in the United States, 1.6 per cent in the European Union and only 0.8 per cent in Japan.

The implications of these trends are mixed. On the one hand, the remarkable growth experienced by emerging and developing economies that have embraced international trade, foreign investment and the participation of transnational corporations may indicate that globalisation facilitates higher rates of economic growth. For example, sustained economic growth in China and India is linked to policies in both countries that have encouraged increased trade and foreign investment.

On the other hand, the most globally integrated economies are the advanced economies, and they have experienced comparatively weak growth over the past two decades, especially since the global recession of the late 2000s. The 2010s saw a long period of lacklustre growth, despite record low interest rates and very low inflation. High levels of indebtedness constrained governments from using fiscal policy to stimulate growth. Growth rates also weakened in African and Latin American economies. The global

WAR IN UKRAINE – A TRILLION-DOLLAR INFLATIONARY SHOCK

Russia's invasion of Ukraine in February 2022 fundamentally changed the global security environment. According to United Nations figures, in 2023 more than 8 million Ukrainians became refugees due to the conflict. But the consequences of the war in Ukraine go well beyond the security and humanitarian impacts. The war brought about an inflation shock to the global economy, causing a decline in real incomes for 60 per cent of workers across the world.

World output grew 3.4 per cent in 2022, a full percentage point lower than the IMF's pre-war growth forecast. Even before the war, the global economy was struggling with post-COVID-19 supply chain disruptions and inflationary pressures. The war in Ukraine substantially worsened both, creating widespread impacts through soaring commodity prices. The cost of energy rose more sharply than at any time in half a century, with crude oil prices soaring 10 times higher than 2020 levels.

Many western European nations rely on gas from Russia. Russia reduced its supply of gas in the lead up to the war and along with economic sanctions against Russia, the global economy experienced a shock of soaring energy prices and inflation, reaching levels unseen in more than a generation. Food prices also rose sharply, due to the direct effect of disruptions to grain exports from Ukraine and Russia, and the indirect effect of increased cost-push inflation from higher costs of energy, fertilisers and shipping. By the second half of 2022, 323 million people were experiencing severe food insecurity.

The inflation surge also caused central banks across the world to quickly unwind the low interest rate policies implemented during the pandemic. Higher interest rates, in turn, added to the cost of borrowing, with 60 per cent of the poorest countries facing debt distress.

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economic contraction resulting from the COVID-19 pandemic and further impacts from the Ukraine war highlighted how more integrated economies are more exposed to the transmission of economic shocks.

While globalisation also has impacts on **economic development** or the wellbeing of individuals and societies, this influence occurs mainly because of the link between globalisation and economic growth. If globalisation lifts economic growth rates in individual economies, it also raises income levels, and provides more resources for education and health care, and for programs to clean up the natural environment. Globalisation can also have negative consequences for development if, while contributing to growth in individual countries, it also caused income inequality to increase and accelerated climate change and environmental damage. The slow global response to climate change is likely to widen the gap between growth and development indicators in coming decades, as countries will need to allocate more resources to addressing accelerating climate change impacts, such as extreme weather events.

Any statistical analysis of the impacts of globalisation during recent decades is inevitably dominated by the rising economic power of China. The rise of China is a major structural change in the global economy that is occurring in parallel to the process of globalisation. Globalisation has also contributed to the extraordinary speed of China's economic development. Trade has been central to China's rapid industrialisation since China's growth has been led by export-oriented manufacturing industries. China's growth is also accelerating the process of globalisation, by deepening trade and financial links among economies. The speed and scale of China's economic expansion dwarfs any other emerging economy.

Trends in the **Human Development Index** (which measures a combination of material living standards, education and health outcomes) show that, since the 1980s, almost all countries have experienced major improvements in economic development. There is little evidence that globalisation, on balance, contributed negatively to economic development. Declines in economic development are restricted to a handful of countries that have experienced upheaval in transition from planned systems (Russia, Moldova and Tajikistan) or serious political turmoil (Zimbabwe, Democratic Republic of Congo and Afghanistan). Figure 3.8 shows the changes in HDI levels for selected countries over the past three decades.

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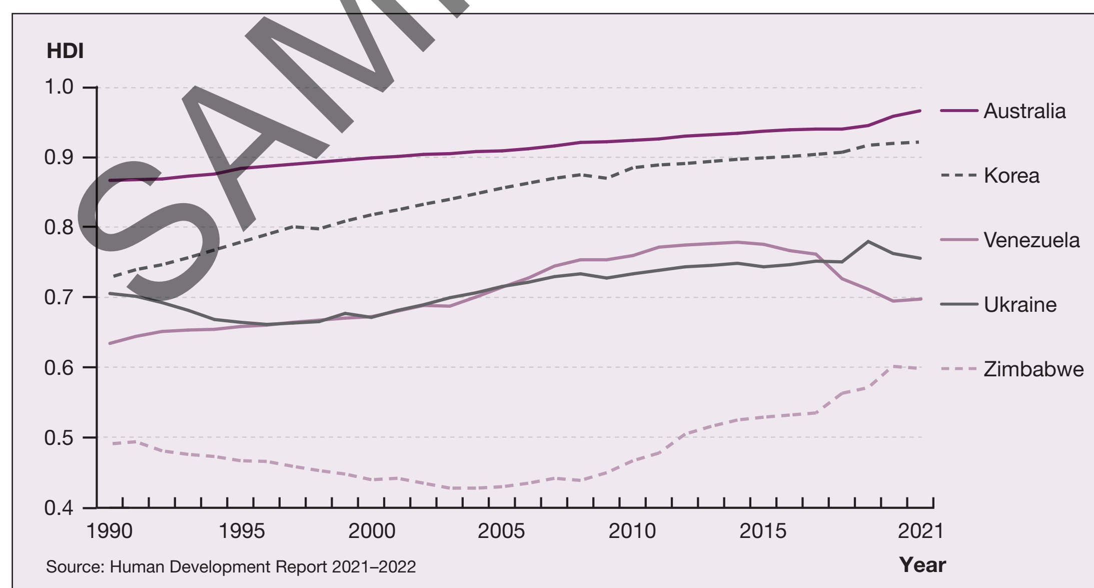

Figure 3.8 – HDI performance of various countries

Income inequality

Globalisation also has impacts on income inequalities within countries because, as trade and financial flows grow, it changes the structure of economies:

- Increased openness to trade provides more export opportunities, which can raise the incomes of "trade-exposed" or agricultural workers in developing countries. Lower tariffs on imports improve standards of living for the poor by reducing the prices of goods. In advanced economies, higher levels of trade may shift employment towards higher-paid services industries, but it may also depress the incomes of workers in import-competing sectors (for example, employees in the American motor vehicle industry have seen their incomes decline as US car producers have sought to compete against cheaper imports from Asia).
- Increased financial flows provide greater employment opportunities and fuel economic growth, but FDI flows also tend to be concentrated in higher skill and higher technology sectors, favouring those who are already better off. IMF research has found that financial globalisation increases income inequality within countries.
- Income inequality has increased in many emerging economies because the global mobility of skilled labour means that highly skilled workers may emigrate to more advanced economies with higher-paying jobs unless they receive higher pay. This contributes to large increases in pay for highly skilled workers, while incomes for other workers grow at a much slower rate.

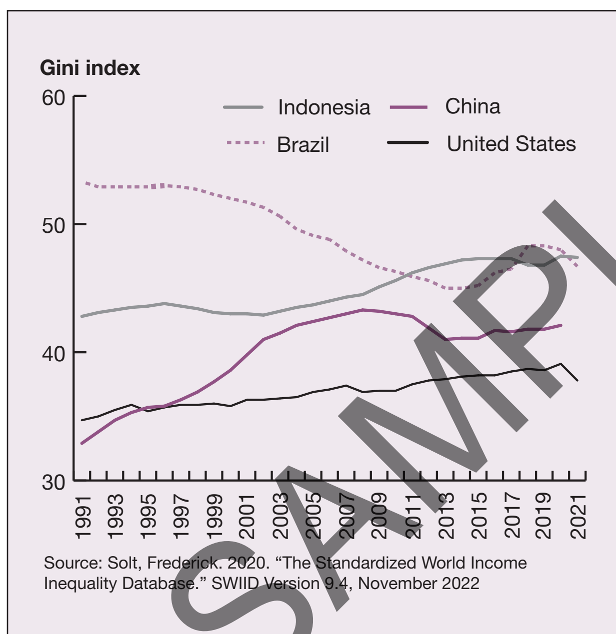

Figure 3.9 – Income inequality in selected countries

According to the IMF, income inequality rose by almost 0.45 per cent per year during the three decades up until the mid-2000s, as measured by the Gini index (a common measure of inequality where a higher number indicates a higher level of inequality). IMF studies have also found that increased inequality reduces economic development. Increases in the share of income for the top 20 per cent of households are associated with a corresponding 8 per cent fall in average growth rates over the following five years. In contrast, an increase in incomes for the lowest 20 per cent of household income leads to a 38 per cent increase in average growth rates over the same medium-term period.

The general trend of rising inequality is evident in figure 3.9. According to the IMF, about one-fifth of the increase in income inequality globally is as a result of globalisation. A major part of this increasing inequality is the impact of technological change which shifts production processes away from low-skilled labour towards higher-skilled jobs. This benefits people with higher levels of education but increases unemployment for less skilled workers.

While COVID-19 impacted advanced economies first, the greatest effects were in emerging economies, whose GDP per capita declined by more than double, 6.7 per cent, in 2020. A 2023 IMF report found that emerging economies suffered the worst impacts due to high employment in face-to-face jobs and low social security transfers.

Trade investment and transnational corporations

Globalisation has resulted in substantial increases in the size of trade flows and foreign investment, reaching a record US$32 trillion in 2022. Because of the key role played by transnational corporations (TNCs) in both trade and investment flows, TNCs are increasingly dominating business activity around the world.

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We saw in chapter 1 that international trade in goods and services continues to grow at least at the same rate as the global economy's growth in most years, and is now equal to over half of global output. All regions in the world have experienced this trend, as changes in technology and government policy have fostered trade growth. An important feature of trade growth during the globalisation era is that goods are produced through multiple stages in different economies through global value chains (or **supply chains**) where countries engage in "vertical specialisation", focusing on just one or two parts of the production process.

The different stages of production for consumer goods such as iPhones might see the manufacturing of computer chips, logic boards, camera parts, screen casings and the final assembly occurring in different countries. Figure 3.10 demonstrates how the globalisation of production processes means there could be many international trade transactions rather than just the export of a finished iPhone from one country to another. Apple's organisation and operation of the value chain allows it to capture the largest proportion of the added value (59 per cent for the iPhone X). For the first time in history, intellectual property and commercial know-how are constantly being traded across economies, while investment is expanding beyond physical capital into productivity training for labour and long-term business relationships. Since the early 1990s, trade through global value chains (as opposed to traditional trade of finished goods from one country to another) has increased from less than half to about 80 per cent of total trade.

The COVID-19 pandemic caused the most significant disruption to international supply chains of the globalisation era. Prior to March 2020, there was an assumption that supply chains would continue to become ever more interconnected. But the COVID-19 pandemic highlighted the vulnerability of countries to global chains – when every country needed respirators and personal protective equipment, they could not obtain enough supplies from China, and many economies did not have the capacity to manufacture those goods themselves. A 2022 survey by Infosys revealed 85 per cent of supply chains were impacted by the pandemic. In addition, the pandemic resulted in huge disruptions to air travel and major delays in a range of agricultural, mining and pharmaceutical supply chains. Finding alternative options for sourcing materials (or at least improving the reliability of supply chains) became a priority for both TNCs and governments since the COVID-19 pandemic.

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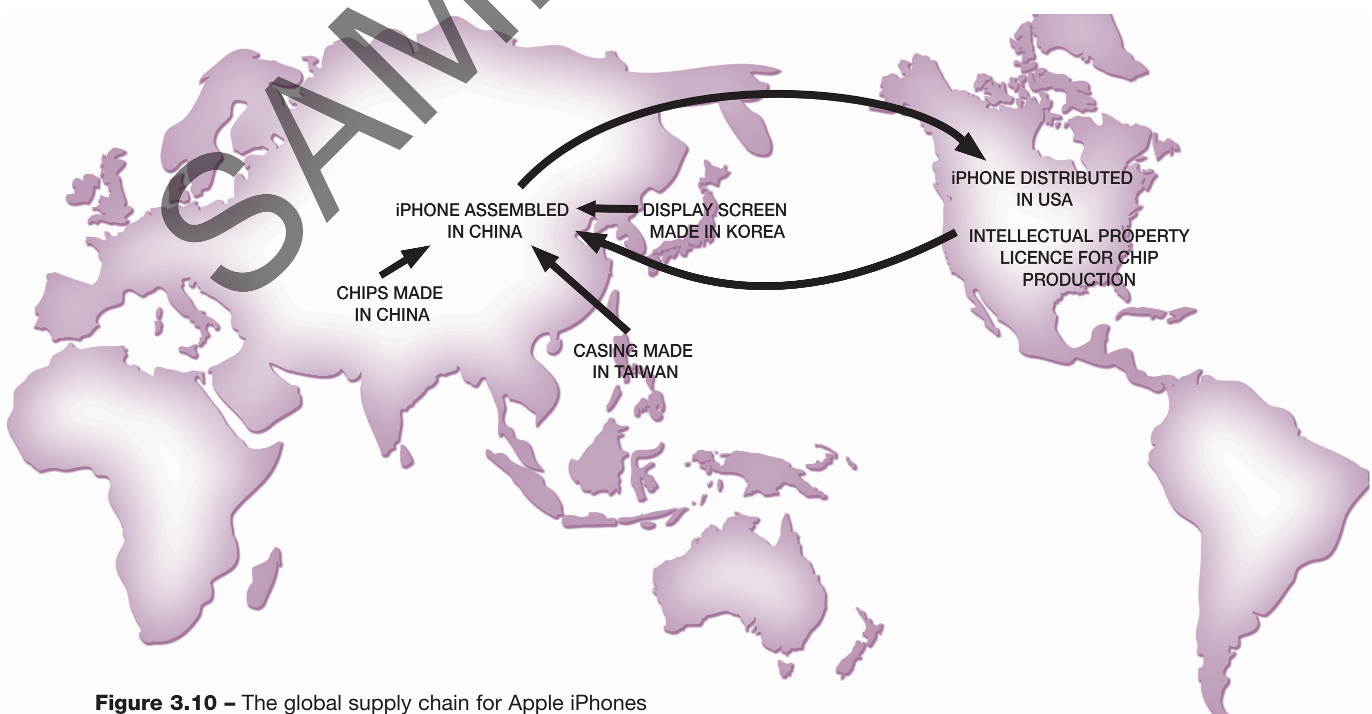

Figure 3.10 – The global supply chain for Apple iPhones

The globalisation of financial markets has seen an increased reliance on foreign sources of finance for investment. From another perspective, more countries now have greater access to overseas funds for investment than ever before. Either way, FDI is now playing a greater role in generating economic activity in every region around the world. In 2021, FDI was over nine times higher than it was in 1990 (but only 69 per cent its peak level recorded in 2007). Very large increases were recorded for high-growth emerging economies that have relaxed barriers to foreign investment. However, as discussed in Section 3.5, the benefits of increased FDI flows have mostly been enjoyed by economies with already favourable economic prospects, and there has only been a trickle of FDI flowing to the LDCs. In addition, the growth of short-term financial flows has had a destabilising impact on many economies.

For a critical view of the practices of transnational corporations (TNCs) in developing countries visit the website of CorpWatch **www.corpwatch.org**

Explain concerns regarding the conduct of transnational corporations held by this organisation. Outline one proposal to improve TNC practices.

The removal of restrictions on foreign ownership and the development of global capital markets have spurred the growth of transnational corporations (TNCs), of which there are now more than 104,000. Foreign affiliates of TNCs employ over 83 million people globally. They dominate the world's major industries such as motor vehicles, telecommunications and pharmaceuticals, and merger activity continues to concentrate the number of these companies.

TNCs generally perform better than domestic firms on a range of indicators including productivity, quantity sold, production size and export market share. However, World Bank research has found that, on average, benefits to the local community were lower as foreign firms tend to use less domestic capital and labour. The full advantages of FDI inflow can only be realised if TNCs are connected to local suppliers. Another concern relating to TNCs is that they do not operate under the laws of any one country and so can move their production facilities to countries with the weakest laws, and artificially structure their financial flows to avoid paying taxes. According to the OECD, developing economies are disproportionately affected by tactics TNCs use to avoid US$240 billion in corporate taxes each year. Lower labour standards and environmental protection laws in developing nations can also lead to the exploitation of workers and environmental degradation.

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FOUR WAYS GLOBALISATION HAS IMPACTED COMMODITY MARKETS IN THE LAST 100 YEARS

"Commodity demand (and production) has increased enormously over the past century. The largest increases have been for energy and metals as population and per capita income have grown and technological change has encouraged the use of industrial commodities … There has also been significant substitution across groups of commodities. For example: in ocean shipping, oil replaced coal; in the package and container industry, aluminum and plastics replaced tin; more recently, biofuels (an agricultural product) have been used as a substitute for fossil fuel in gasoline …

Secondly, technological advances have encouraged consumption by creating new products and new uses for commodities. They have also reduced the use of raw materials by improving efficiency in consumption and production. In addition, they have facilitated the discovery and development of new reserves and new commodities …

Third, innovation in commodity markets has often occurred in response to periods of high prices. For example, in the case of metals, technological improvements in aluminum and policy interventions in the tin market made aluminum the dominant commodity in packaging …

Fourth, a variety of interventions have been used to mitigate commodity market volatility. Interventions have taken different forms, including subsidies, production quotas, trade measures, and internationally coordinated supply management schemes."

– "Commodity Markets: Evolution, Challenges and Policies." World Bank, 2022
Edited by John Baffes and Peter Nagle

Environmental sustainability

The relationship between globalisation and environmental factors is complex. Globalisation can have negative environmental consequences for several reasons. Low-income countries that are desperate to attract foreign investment and earn higher export revenue may engage

in economic behaviour that harms the environment. Examples of how this may occur include deforestation for paper or woodchip industries; depletion of marine life through unsustainable fishing practices or poisoning of water supplies by mining operations; pollution caused by manufacturing industries; and carbon dioxide emissions from power plants, contributing to climate change. Additionally, the growth in global trade itself is increasing consumption of non-renewable fuels for transport by air, road, rail and sea.

The most significant environmental threat in the early twenty-first century is **climate change** because the warming of the atmosphere has potentially irreversible and catastrophic impacts on all aspects of the natural environment including oceans, marine life, the weather, wildlife, air quality and water supplies. While the carbon emissions that contribute to climate change come from individual countries, the impacts of climate change affect the whole world. The impacts are also disproportionate, with a World Bank report finding that the 74 lowest-income countries are the most affected by climate change despite accounting for less than one-tenth of global emissions. This means that nations need to work together to address climate change. A 2022 study by Standard Chartered estimated that globally, in addition to what is already planned, an investment of US$95 trillion will be needed to achieve net-zero targets. Developing economies with large debt obligations have limited capacity to make the investments required. The 2022 Climate Conference in Sharm, Egypt, called for developed economy parties to replenish the Green Climate Fund to assist developing economies. Although the original goal of mobilising US$100 billion per year by 2020 had not been met, some progress was made in establishing a loss and damage fund for low- and middle-income economies facing climate disasters.

Global efforts to reach agreements between economies on reducing carbon emissions are coordinated by the United Nations Framework Convention on Climate Change (UNFCCC). In 1997, the UNFCCC summit of world leaders produced the Kyoto Protocol on Climate Change, which set carbon emission reduction targets for industrialised countries. The Kyoto Protocol entered into force in 2005 and expired in 2020. The Kyoto Protocol was followed by the Paris Agreement, to keep "the increase in global average temperature to well below 2 degrees Celsius above pre-industrial levels" – the benchmark scientists believe is necessary to prevent the most dangerous impacts of climate change.

The Paris Agreement was significant because, for the first time, it included developing nations such as China and India alongside the United States, which had refused to ratify the Kyoto Protocol. In contrast to the Kyoto Protocol, the Paris Agreement included several inbuilt mechanisms for transparency and review process, with the intention of increased global scrutiny to further encourage countries to meet their respective contribution to global emissions reduction. Nevertheless, countries set their own targets to reduce emissions, which has meant that the world is still not on target to achieve the extent of reductions in carbon emissions required to achieve the agreed target. The 2021 Climate Conference in Glasgow (COP26) produced the Glasgow Climate Pact, ratified by 197 countries, which made progress in several areas and was the first climate deal to commit to reducing the use of coal. In 2023, members of the United Nations signed the historic "High Seas Treaty" which agreed to protect the ocean outside national borders (99 per cent of which was unprotected by any protocol beforehand).

Globalisation also offers opportunities to protect the world's environment from harm by forcing individual nations to address their global responsibility for environmental preservation. It makes it possible for the costs of preservation to be shared and to increase scrutiny of the environmental practices of transnational corporations. Globalisation has also facilitated the transfer of new technologies to improve energy efficiency and reduce environmental pollution. Over time, globalisation may create international mechanisms to enforce agreements on preventing environmental damage. In recent years, however, problems that have involved global environmental resources, such as fish stocks or climate, have proved difficult to tackle and progress in making agreements to combat global environmental problems has been slow.

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The role of financial markets

The influence of global financial markets on economies has increased substantially during the globalisation era. Driven by global information and communications networks, global financial markets dominate financial flows around the world. Governments have encouraged the development of global financial markets by removing "capital controls" on the flow of finance, floating their exchange rates and deregulating their domestic banking sectors.

Global financial markets can have positive impacts on economies. Countries would be unable to conduct international transactions without foreign exchange markets. Businesses would find it more difficult to access loans or attract investors if they were confined to domestic financial markets. Efficient international financial markets should encourage greater transparency of the actions of businesses and governments and should foster economic development.

However, global financial markets have also produced negative results during the globalisation era. Financial markets shift massive volumes of money around the world every day. If investor sentiment turns against a particular economy, it can result in a collapse in exchange rates, a shock to the economy and a recession accompanied by rising unemployment.

In the late 2000s global financial markets played a part in producing the worst economic crisis since the Great Depression of the 1930s. With its origins in the United States housing market, the global financial crisis of 2008 saw a collapse in worldwide investor confidence and the seizure of the global financial system. Central banks subsequently flooded financial markets with liquidity, governments guaranteed banking deposits to improve confidence and many governments provided "bail-outs" to prevent troubled banks and financial institutions from collapsing. Although these emergency measures helped avoid global economic depression, the world economy still contracted by 2 per cent.

The onset of the COVID-19 pandemic in 2020 and the invasion of Ukraine in 2022 showed how global financial markets can exacerbate volatility in economies. During the height of the pandemic, a loss of investor confidence saw US$100 billion in investment outflows from emerging economies, twice as big as outflows during the global financial crisis. As many economies cut interest rates to record lows, some economists raised concerns that government and corporate borrowers might take on more risk and create over-indebtedness problems in the future. The subsequent rise in interest rates since 2022 has placed pressure on nations that accumulated large debt stocks over the pandemic, as well as financial and non-financial institutions that failed to anticipate the rapid financial

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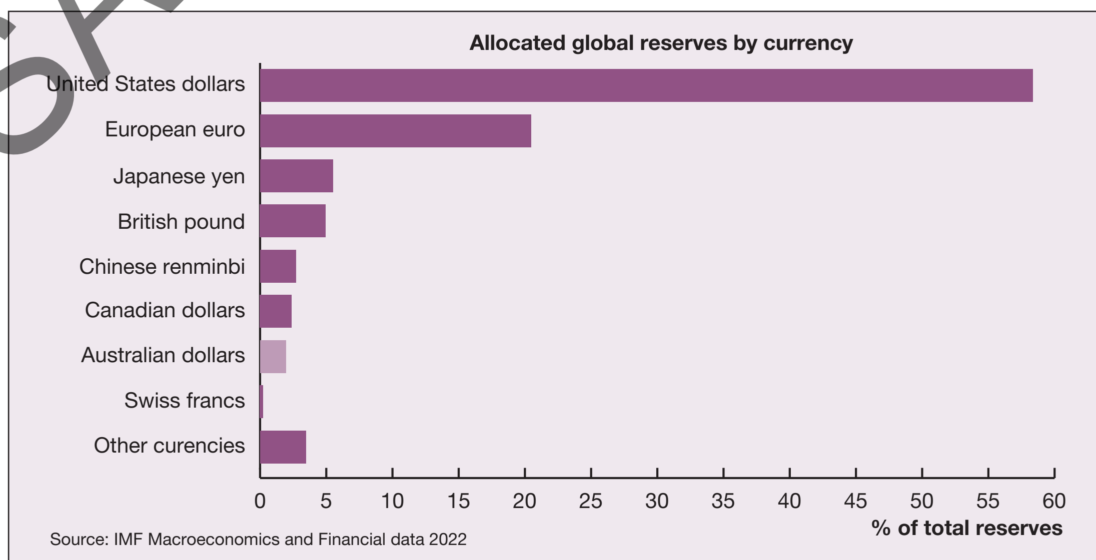

Figure 3.11 – Allocated global reserves by currency

tightening. The IMF warned in 2023 that uncertainty surrounding these events could lead to large capital outflows from emerging and developing economies, potentially reducing per capita incomes by around 15 per cent.

Despite several decades of globalisation, the US dollar remains the dominant reserve currency in global financial markets. Figure 3.10 shows that nearly 60 per cent of global reserves are in US dollars, and 20 per cent are held in euro. Reserves are held for various reasons, including exchange rate management, debt servicing and to address economic shocks. Holding reserves in US dollars has been standard practice for many nations since World War II due to its widespread use and stability. US financial markets are still the largest and most liquid, giving confidence to central banks that they will be able to access their US dollar reserves when they need it. Further, it is the most widely used currency in trade, which gives governments with US dollar reserves confidence that they will be able to use them to import necessary goods.

The international business cycle

The linkages between economies hold benefits and risks for countries in the global economy. The benefit of integration is that it allows countries to achieve faster rates of economic growth by specialising in certain types of production and by engaging in trade. Countries that have a higher level of trade also experience faster economic growth. In particular, during times when world economic growth is higher, individual economies are likely to benefit from the upturn in growth.

However, closer economic integration also makes economies more exposed to downturns in the international business cycle and to developments in their regions. One of the reasons for the strength of global economic growth in the mid-2000s was the simultaneous upswings in the United States and China that propelled the global economy to its fastest growth rates in 30 years. Equally, the closer links between economies resulted in the downturn in the US economy in the late 2000s and the economic fallout from COVID-19, spreading more quickly to other developed and developing economies. As the extent of trade and financial integration continues to increase, there is likely to be greater synchronisation of the international business cycle, intensifying both the downturns and the upswings in the global economy.

Greater synchronisation of business cycles between different countries has also increased the need for macroeconomic policies to be coordinated. Following the late 2000s recession, for example, the IMF recommended that countries use their combined budgets to stimulate the world economy by 2 per cent of global GDP in response to the global economic recession. However, economies generally do not coordinate their macroeconomic policies unless they are in a global crisis, as seen during the COVID-19 pandemic. A series of macroeconomic policies were announced by governments around the world to combat stalling economic activity as a result of the measures to curb the spread of COVID-19, with many governments copying each other's policy approaches. The COVID-19 pandemic struck at a time when global growth was already weak, making it certain that the first half of the 2020s will be a period of slower growth. Russia's invasion of Ukraine in 2022, which destabilised commodity markets and contributed to a global inflation shock, added further to the uncertainty around the economic outlook for the 2020s.

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1. Analyse the impact of globalisation on economic growth and development in the global economy.
2. Explain the impact of globalisation on environmental sustainability in the global economy.
3. Describe the role of financial markets and the international business cycle in globalisation.

chapter summary

1. The global economy is characterised by stark **inequalities**. Out of a world population of almost 8 billion, just over 1.2 billion live in high-income countries with high standards of living, while around 685 million people live on less than US$2.15 per day. While inequality between economies globally has fallen, inequality within economies has increased.

2. **Standards of living** are most commonly measured by Gross National Income (GNI) per capita adjusted for exchange rate impacts or purchasing power parity (PPP). However, economists recognise that this measure has limitations.

3. **Economic growth** is an increase in the real Gross Domestic Product over a specific time period. Per capita GDP growth is the most common traditional measure used to compare the performance of economies.

4. **Economic development** is concerned with economic growth alongside other quality-of-life factors such as income distribution in a population, education levels, health standards and quality of environment. The most common measure of economic development is the United Nations **Human Development Index** (HDI), which is based on a combination of GNI per capita, life expectancy at birth and levels of educational attainment.

5. The main two categories of economies are **developing economies** and **advanced economies**. Advanced economies are also sometimes known as high-income, industrialised, western and first-world economies.

6. **Emerging economies** are in the process of industrialisation or modernisation and experiencing sustained high levels of economic growth. This classification includes a range of economies that are neither high income nor share the traditional characteristics of developing economies.

7. While many features of individual economies can contribute to a lack of economic development, such as a lack of quality inputs to production and the nature of economic and political institutions, the globalisation era has highlighted how certain **features of the global economy** – trade, finance, foreign aid and technology – may work to entrench rather than alleviate inequalities between nations.

8. Opinion about the impacts of globalisation is divided. While globalisation does not appear to have accelerated economic growth overall, many emerging economies have experienced rapid economic growth and development through global trade and investment.

9. Globalisation has contributed to a greater synchronisation of economic growth rates through the **international business cycle**, reflecting the increased integration of economies through trade and financial flows.

10. Globalisation has increased the need for national governments to coordinate their economic policy with other nations, but recent years have seen significant failures in policy coordination, both on shorter-term issues such as tariff disputes and the longer-term threats from climate change.

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chapter review

1. Explain the difference between the concepts of economic growth and economic development.
2. List examples of indicators that measure economic growth and economic development and outline what factors they include.
3. Discuss the distribution of income and wealth in the global economy. Assess whether inequality is increasing or decreasing.
4. Identify what categories are used to group economies. Discuss the key features of these groupings.
5. Analyse the reasons for differences in levels of development between economies.
6. Explain how globalisation has changed the role of trade investment and transnational corporations in economies.
7. Discuss how globalisation has impacted on the distribution of income and wealth within countries.
8. Analyse the positive and negative impacts that globalisation might have on the natural environment.
9. Explain how globalisation has increased the need for national governments to coordinate economic policy with other nations.
10. Critically analyse the argument that the negative impacts of globalisation have been greater than its positive impacts.

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Case Study:

Economic collapse in Sri Lanka

For a brief few days in July 2022, the island nation of Sri Lanka near the southern tip of India was in the global headlines. Its economy had collapsed, the government had defaulted on debt for the first time in history, the country was declared bankrupt, and its currency had lost half of its value. With shortages of fuel and food, prices soaring and constant power disruptions, protestors hit the streets, burning cars and prompting the president to flee the country. Across the world, platforms like Tik Tok and Instagram swelled with videos of Sri Lankans breaking into the presidential palace and lapping it up in the president's pool.

Sri Lanka's economic crisis – the worst in the nation's 74-year history – offers insights into the way that global economic forces, combined with policy mistakes, can be combustive forces. In recent decades, Sri Lanka has been one of South Asia's more successful economies. But several misfortunes hit Sri Lanka, including the collapse in tourism following terrorist attacks in 2019, the COVID-19 pandemic and then the surge in commodity prices that began in 2021. Policy decisions then turned these challenges into a full-blown crisis, after the election of President Rajapaksa in 2019.

President Rajapaksa rejected conventional strategies for integrating with the global economy, instead adopting protectionist policies. To save foreign currency, Sri Lanka banned imports of fertilisers overnight (describing this as a national shift to organic farming), resulting in sharp declines in agricultural output, an urgent need for more food imports, and a worsening currency crisis. In a failed effort to boost growth, he announced huge tax cuts that emptied the treasury of revenues just as the COVID-19 pandemic struck.

Soaring global inflation along with a falling currency led to shortages in food, fuel and medicine, and record price increases. Use of a 'soft peg' approach to manage foreign exchange enabled currency outflows to exceed inflows, contributing to foreign exchange shortages. Sri Lanka's store of foreign currency reserves, worth almost $8 billion in 2019, were exhausted as the government struggled to defend its currency and service rising foreign debt. By the end of 2022, Sri Lanka's economy had contracted by 7.8 per cent, the currency had depreciated by 81 per cent and inflation was running at 57 per cent. Input shortages were most severe in the manufacturing and construction sectors, leading to half a million job losses and a doubling in the national poverty rate.

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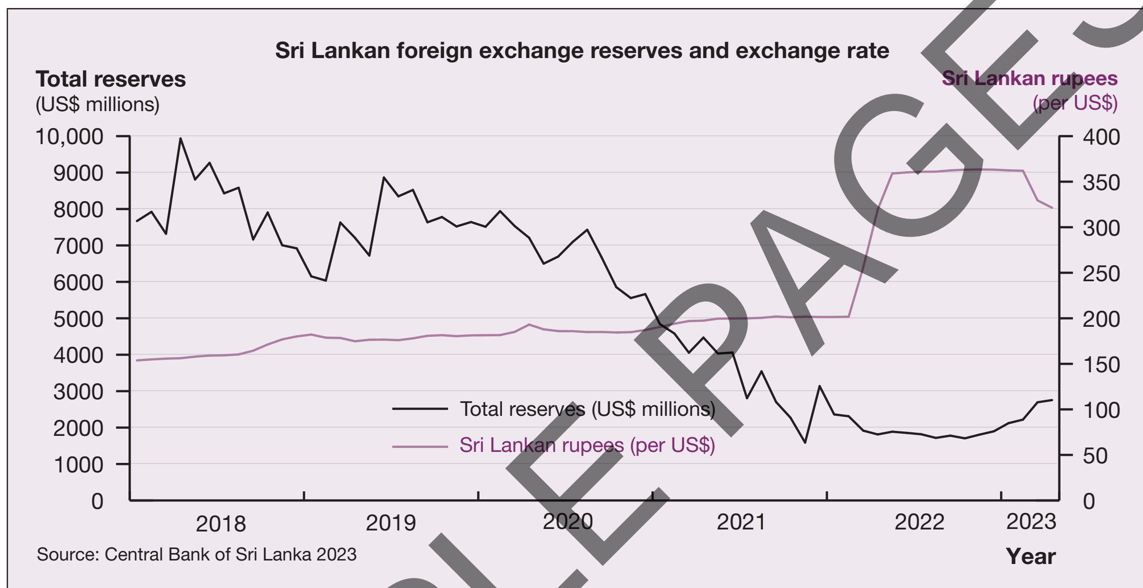
Sri Lanka's economic collapse prompted support and rescue packages from neighbours and international institutions. The World Bank lent Sri Lanka US$600 million, the IMF approved a US$2.9 billion debt relief program and India offered more than $4 billion of support through loans. The G7 group of economies also committed to helping Sri Lanka in securing debt relief, and the Export-Import Bank of China announced a two-year moratorium on its debt. The Sri Lankan Government lifted interest rates by 10 percentage points to combat inflation, increasing value-added tax to 15 per cent to lift government revenues, and cutting back on spending to lower the budget deficit. Reform of state-owned enterprises began, partly to satisfy conditions for IMF support.

The crisis in Sri Lanka shows that in the age of globalisation, simplistic policies that ignore basic principles of economics are likely to fail. The cost can be high, and for Sri Lanka, it will be a long road ahead to restore stability, confidence and living standards.



Source: Central Bank of Sri Lanka 2023

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Case Study:

Brazil

Brazil is a valuable case study in the variations between different countries' economic policies and performance. In the 2000s, Brazil was one of the fastest-growing economies, and widely seen as a success story of global economic integration. But since 2015 it has been one of the worst-performing economies in the G20.

Like other Latin American economies, Brazil has embraced globalisation more slowly than emerging economies in East Asia and elsewhere. A global commodity boom, combined with the discovery of large new resource deposits, contributed to years of strong growth and rising incomes. But this collapsed suddenly in 2014, with a deep recession as commodity prices slumped and a corruption crisis engulfed the government. Years of weak growth were followed by catastrophic mismanagement of the COVID-19 pandemic, which left Brazil among the worst-affected countries in the world.

Brazil is the world's ninth-largest economy and is the third-largest of the "BRIC" emerging economies (behind China and India but ahead of Russia). It is the world's sixth-largest country by population – and it is the world's fifth-largest country in land area. Brazil has a highly diverse population with many waves of immigration since Portuguese colonisation in the 1500s adding to over 2000 Indigenous groups.

FIGURE 1 – DEVELOPMENT INDICATORS: SELECTED COUNTRIES

	Brazil	Indonesia	China	USA	Poland	Egypt	Australia
Population (millions, 2023)	216	277	1410	335	37	104	26
Gross Domestic Product (current US$ billion, 2023)	2080	1390	19370	26850	748	404	1071
Share of Gross World Product (percent, PPP 2023)	2.3	2.5	18.9	15.4	0.9	1.1	1.0
GNI per Capita (%) (current international dollar, PPP, 2022)	17260	14250	21250	77530	41310	14590	60350
Gini index (2022, 2021*, 2020**, 2019^)	52.9*	37.9	38.2^	39.7**	28.8^	31.9^	34.3^
Mean years of schooling (2021)	8.1	8.6	7.6	13.7	13.2	9.6	12.7
Life expectancy at birth (1990, 2021)	65.3 72.8	63.3 67.6	69.3 78.2	75.2 77.2	70.9 76.5	64.6 70.2	76.9 84.5
Human Development Index (rank) (2021–22)	0.754 (87)	0.705 (114)	0.768 (79)	0.921 (21)	0.876 (34)	0.731 (97)	0.951 (5)

Sources: IMF 2023, World Bank 2021; Human Development Report 2021–22, accessed July 2023

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1. Economic performance

In the 2000s decade, Brazil emerged as a rising power in the global economy. It made significant progress in economic development, with reductions in poverty and improvements in health. Its reputation as one of the world's most unequal societies changed as innovative policies saw 40 million Brazilians climb out of poverty. It also became more open to the global economy, although trade remained a relatively small part of its economy.

However, Brazil experienced a major reversal in fortunes during the 2010s. It experienced its worst recession on record, a series of corruption crises, political instability and the mismanagement of the COVID-19 pandemic that resulted in over 700,000 deaths. This case study examines these developments as well as the reasons for Brazil's past successes, which have been partially undone in recent years. One of the challenges in understanding Brazil as a case study of globalisation is that it comprises both major successes and major failures – and it is not yet clear whether its future will see leadership of the Latin American region and an increasing role in the global economy, or a return to economic stagnation as in the 1980s and 1990s.

1.1 Social and economic progress

Brazil is a large economy with many billionaires and a substantial middle class. Its gross national income per capita of US$17,260 in 2022 puts Brazil in the category of upper-middle-income economies. However, as one of the world's most unequal societies, it has always ranked poorly for its levels of economic development. Brazil has made major progress in recent decades, but from a low starting point. The 2021–22 Human Development Report ranked Brazil well down the global league table at 87th in the world for its Human Development Index of 0.754 (up from 0.68 in 2000). This put it slightly ahead of the average levels of development for the Latin American region, reflecting improvements in health, education and income during recent years:

- Brazil's life expectancy increased from 63 years in 1980 to 76 years in 2019, before falling to 72 and a rank of 94th in the world in 2021–22 following the severe COVID-19 pandemic.
- In 2021, 94 per cent of Brazil's adult population had basic literacy skills, up from 82 per cent in 1990 (even though the average period of formal education is relatively low).
- Brazil's infant mortality rate has fallen significantly, from 53 per thousand live births in 1990 to 13 in 2021 – marginally higher than Mexico, El Salvador and Colombia due to recent slow progress compared to other emerging economies.

One of Brazil's most significant achievements is progress in **poverty reduction**. Historically, Brazilian society has been characterised by very high levels of **inequality**. Wealth inequality remains particularly high – according to 2023 Oxfam statistics, Brazil's six richest men have as much wealth as the 100 million Brazilians who make up the poorest 50 per cent of the population. Nevertheless, Brazil has made some progress: the Gini index (a measure of income inequality) fell from around 60 in 2000 to 49 in 2020, before sharply rising to 53 during the COVID-19 recession. OECD research has estimated that of the reduction in inequality in recent decades, around half was the result of economic growth, and the other half came from government policies to redistribute income in the 2000s during the first term in office of President Luiz Inácio Lula da Silva (often known simply as "Lula") from 2003 to 2010. As president, Lula prioritised policies to reduce inequality.

The flagship policy introduced in 2004 by the Lula administration was the Bolsa Família (Family Fund) program. Low-income households received small cash transfers in return for them keeping their children in school and attending preventive health care visits. These programs, known as conditional cash transfer policies, are regarded as one of the most effective economic strategies to combat poverty. Between 2002 and 2019, the percentage of Brazilians living on less than US$2.15 per day fell from 23.2 per cent to 5 per cent – the best improvement in Latin America. An IMF paper in 2020 also found that the program helped more people gain stable employment. While progress was reversed during the COVID-19 recession, which saw unemployment rise to over 14 per cent, in 2023, the new Lula administration began laying the groundwork for an expanded Bolsa Família along with tax exemptions for low-income workers. However, some economists raised questions about whether Brazil can afford the cost of this expanded program, forecast to exceed US$28 billion per year.

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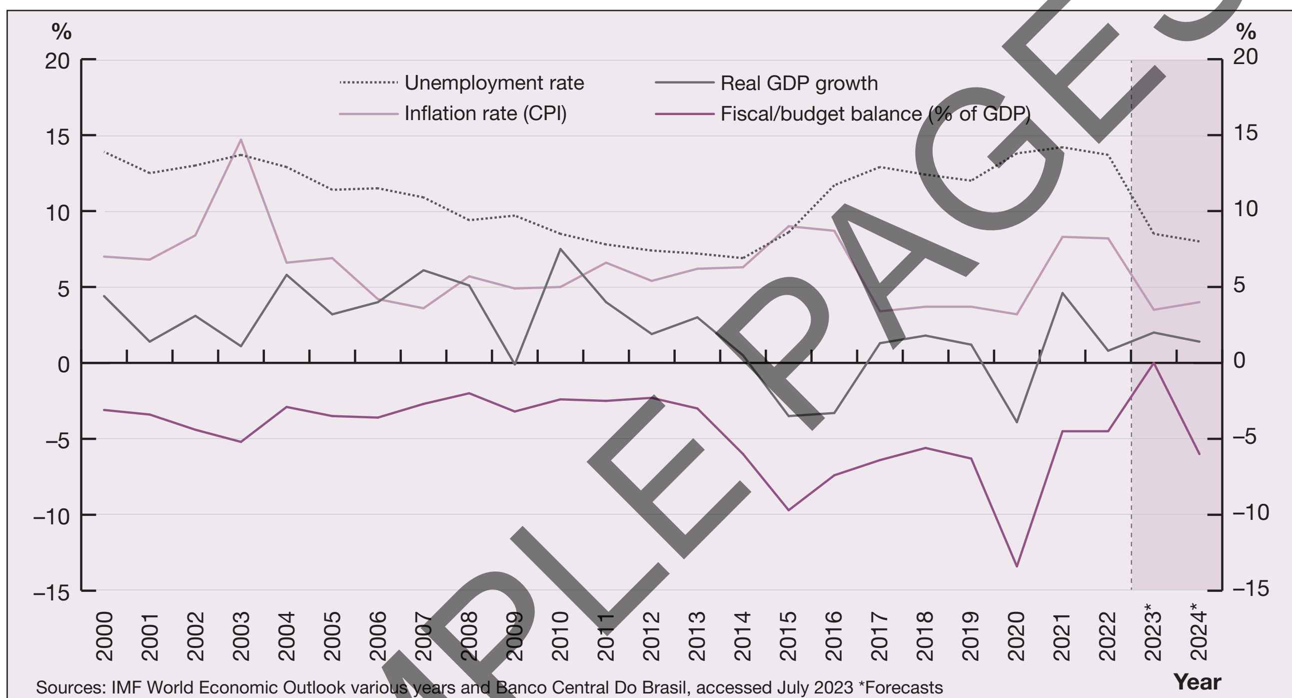
1.2 Economic recessions

In the 2000s decade, Brazil's economy grew by an average of 3.7 per cent annually and living standards rose. But the 2010s were dismal, averaging growth only fractionally above zero. The recession of 2015 and 2016 was so severe that it came close to a depression (a deep and sustained recession). Per capita incomes in 2020 had still not recovered to 2014 pre-recession levels, leading to a rise in the number of Brazilians living in poverty to 55 million by 2020, or around one in four people.

The 2010s witnessed the unusual crisis of inflation and unemployment surging at the same time (the textbook definition of "stagflation" – rarely seen in the world economy since the 1970s). Unemployment reached 13.7 per cent in 2017, leaving close to 14 million Brazilians out of work, while inflation rose to 9 per cent. Similar conditions recurred during the COVID-19 recession when unemployment surged to 14.7 per cent in 2021, while inflation jumped over 10 per cent (before falling sharply).

FIGURE 2 – ECONOMIC INDICATORS



Sources: IMF World Economic Outlook various years and Banco Central Do Brasil, accessed July 2023 *Forecasts

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In response to rising inflation in 2016, Brazil's main interest rate was raised to 14.25 per cent, giving Brazil the highest interest rates of any comparable economy in the mid-2010s. Sharp falls in tax revenues also created a vicious cycle of further cuts in spending by state and local governments – even to the point that many of Brazil's famous annual Carnival parade celebrations were cancelled in 2016.

Between 2017 and the onset of the COVID-19 recession in 2020, Brazil's economic recovery was weak. Economic growth averaged only 1 per cent with foreign investors concerned by sluggish reforms to the pension and business tax systems. While economies across the globe fell into recession in 2020 due to the COVID-19 pandemic, Brazil's recession was worsened by mismanagement of the national response, which saw the health system overwhelmed by multiple waves of infections. The economy contracted 4.1 per cent in 2020, raising unemployment to a record high and pushing 18 million into poverty.

Brazil recovered slowly from the COVID-19 recession, as the 14 per cent official interest rate raised the cost of household borrowings and the war in Ukraine disrupted Brazil's trade relationships. However, inflation rapidly fell to just 3 per cent in 2023, and forecasts for economic growth rebounded to 4 per cent on the back of strong commodity exports.

Although Brazil has now experienced two severe recessions in less than a decade, one positive feature of its performance has been the stable operation of financial markets. This was surprising to some observers, given Brazil's history of financial crises. The floating exchange rate (which fell by 50 per cent in the four years to 2016 and another third during COVID-19) helped improve the competitiveness of exports, while stronger banking regulations helped maintain confidence in the financial sector. In

THE REASONS FOR RECESSION

How did a country that had been held up as a Latin American tiger economy, and which was the first South American country to host the Olympic Games, suddenly become the G20's worst-performing economy?

Seven key factors explain the deep recession that Brazil experienced between 2014 and 2016:

1. Brazil is a major commodity exporter, so the sharp fall in the prices for oil, iron ore and agricultural output resulted in **lower export revenues and a fall in national income**. Eight of Brazil's top ten exports in 2015 were commodities. Brazil's downturn was significantly worse than other commodity exporting economies.
2. **Brazil was unprepared for a fall in commodity prices**: other sectors in the economy could not fill the gap left by the collapse in export revenue.
3. From 2014 **a major corruption scandal engulfed Brazil's business and political elites**, halting economic reforms. The investigation revealed massive bribery and corruption involving Petrobras, Brazil's large state-controlled oil company, and leading political figures. The scandal engulfed so many major businesses and politicians that Congress could not advance the government's proposals for economic reform.
4. Investors were **losing confidence in Brazil's ability to address its budget problems**. Public spending had grown at an annual average of 6 per cent per year for two decades, well above the rate of economic growth. With interest payments of almost 8 per cent of GDP, Brazil was running a massive budget deficit of 11 per cent of GDP by 2016.
5. That loss of confidence led to the **downgrading of Brazil's sovereign debt by ratings agencies** to below "investment class", making it more difficult (and more expensive) for the government to obtain loans. Public debt rose from 52 to 68 per cent of GDP between 2013 and 2016.
6. Many of the **policies implemented by the Brazilian government had failed to overcome economic problems**, including price controls that failed to rein in inflation, aggressive lending by state banks that failed to stimulate new investment and infrastructure project plans that failed to attract private investors.
7. Brazil had **made little progress on a series of deep-seated structural problems** affecting its labour productivity, transport infrastructure, education levels and reputation as a difficult place to do business. This left Brazil exposed when the favourable environment of high commodity prices disappeared.

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addition, despite the recession of the 2010s, longer-term foreign investment inflows continued. Brazil's share market also rebounded strongly after the first recession, with over a 100 per cent increase in its index between 2016 and 2019. Likewise, after a sharp slump at the onset of COVID-19 in March 2020, the stockmarket index recovered and by June 2021 had reached a record high, following a 61 per cent increase in Brazil's international commodity price index.

1.3 Brazil's environmental challenges

Between 2019 and 2022, President Bolsonaro's environmental and climate change policies received major international criticism, as Western governments urged Brazil to act on deforestation in the Amazon rainforest. Brazil has faced significant challenges in managing its natural environment, which remains central to the Brazilian economy. Like many developing economies, Brazil also suffers from a high level of water and environmental pollution. Only 37 per cent of waste water is treated, and almost half of the country's garbage and other solid waste is not collected. Around one-third of housing is not connected to sewerage, and poor sanitation also leads to worse public health outcomes.

Brazil's economic development has come at the cost of large-scale forestry clearing. Eighty per cent of Amazon deforestation has been for cattle farming, with other uses including soybean farming and mining – some of Brazil's biggest industries. Management of the Amazon has also been a polarising political issue in recent years. Former President Bolsonaro made land clearing a priority, and even promised to build a motorway through the Amazon to make logging operations easier. The fires used for land-clearing purposes under the Bolsonaro Administration contributed to the fastest rate

of deforestation since 2006, and for the first time on record, in 2021 the Amazon emitted a greater volume of carbon dioxide than it absorbed. As president, Bolsonaro also threatened to withdraw from the 2015 Paris Climate Agreement and even sacked the head of the government agency that published deforestation data.

While environmental mismanagement worsened during President Bolsonaro's term from 2019 to 2022, it has been a long-term issue in Brazil, with forest coverage declining from 72 per cent to 60 per cent between 1990 and 2020. Brazil's management of the Amazon is a major concern internationally because it is the world's largest tropical rainforest, sometimes described as the "lungs of the planet" because it produces an estimated 20 per cent of the world's oxygen supply and soaks up vast amounts of carbon dioxide (while destruction of the forest releases large quantities of carbon dioxide). On his return to power in 2023, President Lula took action to reduce land clearing, achieving a reduction of 34 per cent during his first six months in office.

In contrast to its record on deforestation, Brazil has been a world leader in the development of sustainable biofuels (ethanol and biodiesel), which assist in transitioning from fossil fuels and emit less carbon. Brazil is the world's second-largest ethanol producer (after the United States) and ethanol, which is mostly made from sugar cane, accounts for around 45 per cent of fuel usage in Brazil.

2. Influence of globalisation

2.1 Influence of trade

Despite maintaining some protectionist trade policies, Brazil has benefited from the rapid growth in international trade brought about by globalisation. Brazil supplies large quantities of commodities, which have sustained historically high prices over the last two decades. However, commodity prices are more volatile than most goods and services, and more than one-third of Brazil's export revenues come from just three commodities: iron ore, soybeans and oil. Oil exports have grown rapidly in the past two decades, following the discovery of large reserves in the "pre-salt" fields three kilometres below the ocean's surface in the 2000s. Brazil is also the world's largest exporter of beef and chicken, with five billion chickens sold annually by its largest agribusiness company, JBS (which is now also the largest meat producer in Australia).

Brazil's export revenues reflect the cycles of global commodity prices. The total value exports soared from US$55 billion in 2000 to over US$250 billion at the height of the global resources boom in 2011. After a decade of weaker growth throughout the 2010s, the surge in commodity prices in the early 2020s saw export revenues rise by more than 50 per cent over their pre-pandemic levels to a record US$335 billion in 2022.

Globalisation has increased Brazil's exposure to both the ups and downs of commodity prices and the international business cycle. Lower global commodity prices led to weaker exports and in 2014, a record trade deficit and a high current account deficit. While the trade deficit improved in subsequent years, this was achieved only through a sharp depreciation in the real and a severe recession that reduced demand for imports. Brazil also experienced a series of major disruptions to international confidence in its economy. In addition to political scandals, the "Weak Flesh" scandal in 2017 damaged confidence in meat exports, after revelations that producers were using red dye to mask putrefying meat. The collapse of the Brumadinho dam in 2017 revealed poor safety practices and caused major disruptions to Brazil's largest mining company, Vale.

2.2 Influence of external accounts

One of the few benefits of its past decade of weak economic growth is an improvement in Brazil's external accounts. While historically Brazil has struggled with external imbalances, the IMF has said that a current account deficit averaging between 1.2 and 2.0 per cent of GDP is compatible with long-term economic stability for Brazil, and in the five years to 2023, it has averaged 2.5 per cent of GDP – slightly above that range but a better outcome than many other economic indicators over the same period.

Historically, the most significant problem underlying Brazil's external vulnerability has been its high level of **foreign debt**, which was once among the highest in the developing world. Brazil's debt fell

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during the 2000s due to trade surpluses and greater fiscal discipline, before stabilising from the early 2010s. While a large debt problem may not necessarily cause economic instability, specific characteristics of the debt have made Brazil's debt a matter for concern:

- As shown in figure 3, prior to the global resources boom, the cost of servicing Brazil's foreign debt reached 89 per cent of the value of exports by 2000. After falling to 29 per cent in 2010, and rising to 66 per cent during the 2016 recession, the debt servicing ratio returned to 29 per cent in 2023.
- The IMF calculates Brazil's total public sector debt at up to 91 per cent of GDP, with persistent concerns for the sustainability of public spending.
- Servicing the foreign debt cost approximately 9 per cent of GDP in 2023, a level reflecting vulnerabilty to increases in international interest rates, particularly in the US, which is the source of a majority of Brazil's foreign borrowings.

FIGURE 3 – BRAZIL'S EXTERNAL INDICATORS

Year	Current account (% of GDP)	External debt to GDP ratio (%)	Debt servicing ratio (% of exports)
1980	–5.4	27.0	70.9
1990	–1.0	26.3	65.1
2000	–3.8	36.6	88.6
2005	1.6	19.2	55.8
2010	–3.6	12.0	29.4
2015	–3.5	18.6	55.7
2016	–1.4	18.2	65.6
2018	–2.7	16.0	50.3
2020	–1.7	18.6	42.5
2022	2.9	19.3	27.1
2023*	–2.7	16.3	29.6

Sources: Banco Central do Brasil (Time Series 11404, 11407) and IMF World Economic Outlook various years, accessed July 2023 *Forecast

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Nevertheless, Brazil has made significant progress in managing its external debt. Better current account outcomes and contractionary fiscal policy have helped stabilise foreign debt levels, and Brazil entered the 2020s with its lowest external debt levels since the mid-2000s. An important factor in this improvement was a dramatic shift from borrowings in foreign currency to borrowings in Brazilian real (down from 70 per cent in the early 2010s to 3 per cent in 2020, according to the Bank of International Settlements). Brazil also substantially increased its foreign currency reserves (to US$325 billion in 2023), which in the event of a sudden depreciation in the exchange rate can be used to buy up Brazilian currency and stabilise its value. This stock of foreign currency proved useful during a sharp depreciation in the first half of 2020 when Brazil intervened in the foreign exchange market to the tune of US$40 billion.

2.3 Influence of financial markets

Many Brazilians view the influence of globalisation through the lens of the financial shocks that have been a regular feature of recent Brazilian economic history. Some of these crises had dramatic effects, such as the early 1990s collapse of the exchange rate that saw inflation reach over 4000 per cent. The last time that a major financial crisis in the region spilled over to Brazil was in 2002, when Brazil's GDP shrunk by 40 per cent in US dollar terms, interest rates soared to 23 per cent and both unemployment and inflation rose sharply. The IMF provided an emergency loan of US$30 billion to Brazil, in return for which the Brazilian government agreed to adopt a range of economic reforms. Those reforms helped make Brazil more resilient during subsequent crises in 2008, 2014 and 2020. The IMF's intervention was successful in restoring investor confidence, and by 2005 Brazil had repaid its entire borrowings from the IMF, eight months ahead of schedule.

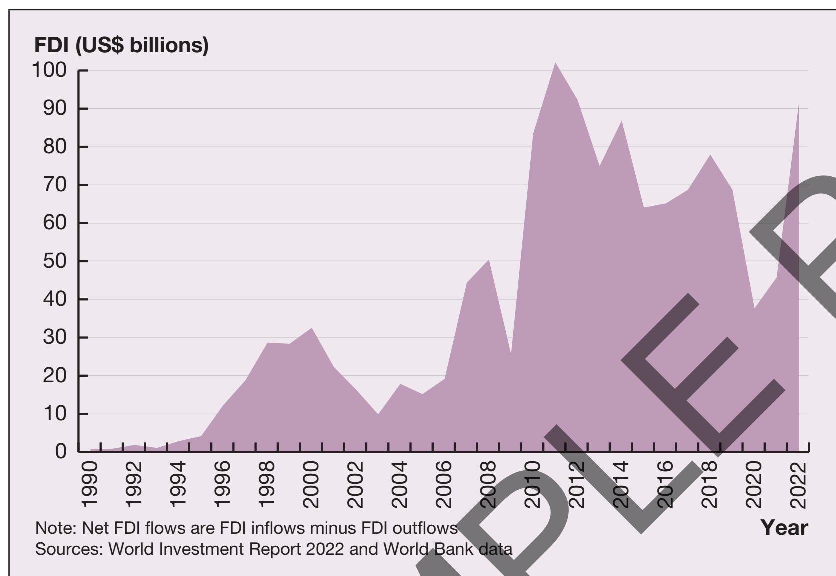
3. Brazil's response to globalisation

3.1 Brazil's approach is different from the Asian tiger economies

Like most Latin American nations, Brazil has been more cautious in embracing globalisation than many East Asian economies. Successive governments throughout the 20th century sought to create a large industrial base and minimise Brazil's dependency on imported manufactured goods in the hope of developing greater self-sufficiency. Nevertheless, Brazil relied largely on foreign borrowing to fund its industrialisation, which focused less on developing exports markets and more on substituting imports with production for the domestic market.

The higher growth rates of more open East Asian economies in the 1980s and 1990s led many observers to question the more protectionist Latin American approach. Brazil, like many of its neighbours, gradually opened its economy in the 1990s, attracting foreign investment and pursuing export opportunities. Brazil benefited from several developments in the global economy, including China's rapid growth and hunger for resources as well as growth in Latin American economies.

FIGURE 4 – BRAZIL'S NET FDI FLOWS



Brazil's model of globalisation is less reliant on export demand. Brazil values control over its natural resources, such as oil and gas, where until recently, there was a requirement that Brazil's state-owned business Petrobras must own at least 30 per cent of new projects. Brazil remains cautious about the adverse impacts of globalisation, such as unrestrained financial flows, and previously restricted short-term financial speculation by foreign investors. Brazil's political environment has also resulted in slower progress on changes recommended by international investors.

3.2 Brazil's increased openness to foreign investment

Since the 1990s, Brazil has attracted foreign investment, rather than merely borrowing funds from overseas to provide the capital for economic development. To increase its attractiveness to foreign investors, Brazil has undertaken extensive reforms, including deregulation and the privatisation of state-owned monopolies like Vale (mining) and Embraer (aircraft manufacturing). It also gave priority to low inflation as a major goal of macroeconomic policy.

These measures dramatically increased foreign investment in Brazil. Transnational corporations (TNCs) play an important role in industries such as telecommunications, pharmaceutical, and manufacturing. Brazil receives the largest share of foreign direct investment (FDI) in Latin America, with a focus on the resources, finance and construction sectors. While international confidence and FDI in Brazil fell under the Bolsonaro Administration, they recovered strongly in 2022.

Another important aspect of Brazil's response to globalisation is an **increasing level of investment** by Brazilian companies in other countries. Brazil's stock of foreign direct investment assets more than doubled in the decade between 2010 and 2020 from $173 billion to $392 billion. Brazil's TNCs are making large offshore acquisitions in the steel production, cattle, banking and construction sectors. Brazilian FDI outflows have a substantial focus on developing and emerging countries, reflecting a historic shift because FDI typically flowed from developed to developing economies.

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3.3 Brazil's economic model has been less export-focused, but it is changing

Despite Brazil's embrace of financial and investment flows, it has been relatively slow in liberalising trade flows. Up until the 1990s, Brazil implemented tariffs and subsidies to develop domestic industries that could substitute locally made goods for imports. While this approach helped to keep import levels down, it also made Brazilian industry less internationally competitive and less successful in developing export markets.

> "With exports and imports below 30 per cent of GDP, the economy is significantly less integrated into international trade than other emerging market economies of similar size … External competition is hampered by trade barriers of various forms. Average tariff levels weighted by imports are almost twice as high as in neighbouring Colombia and more than 8 times higher than in Mexico or Chile. Brazil's most frequently applied tariff rate is 14 per cent, while around 450 tariff lines are at the maximum of 35 per cent, including textiles, apparel and leather and motor vehicles. Brazil is the country with the highest number of tariff lines above 10 per cent. The high trade barriers preclude Brazil from many of the benefits of an increasingly integrated global economy."
>
> *– OECD 2020 Economic Survey of Brazil,*
> *Chapter 2, "Raising Productivity through Structural Reforms"*

Although Brazil remains more closed than many comparable economies, it has become more outward-oriented since the 1990s, substantially reducing industry protection. Between 1990 and 2020, the average level of tariffs fell from 32.2 to 8 per cent and most import quotas were abolished. Following these reforms, Brazil's economic integration increased significantly, with foreign trade increasing from just 15 per cent of GDP in 1990 to 39 per cent by 2022. This is nevertheless low by international standards, making Brazil one of the least open economies of the G20 group and the OECD.

While Brazil is under pressure to further reduce protection, and President Lula has expressed support for trade liberalisation, there are a number of issues to overcome. President Bolsonaro suspended the planned removal of trade barriers unless other countries (many of which already had fewer protection policies) did likewise. In December 2020, Brazil even imposed a 20 per cent tariff on all imports of US ethanol into Brazil. However, to combat high inflation in 2022–23, Brazil made 10 per cent tariff cuts to 87 per cent of Brazil's goods subject to tariffs, including 6000 Australian products.

Brazil's gradual integration into the global economy has contributed to modest changes in industry structure, as shown in figure 5. The manufacturing sector has become smaller as a share of the economy and there are concerns about deindustrialisation in some sectors, such as with the closure of manufacturing operations in Brazil by Ford, Mercedes-Benz, Sony and Canon. Manufactures still make up the largest share of merchandise exports, although in the two decades to 2020, their share of exports fell from 58 to 33 per cent. Other parts included in the industry category, such as mining and construction, have grown, offsetting the decline of manufacturing. Brazil's services sector makes up the largest share of its economy, but its services are domestic-oriented, generating very little export income.

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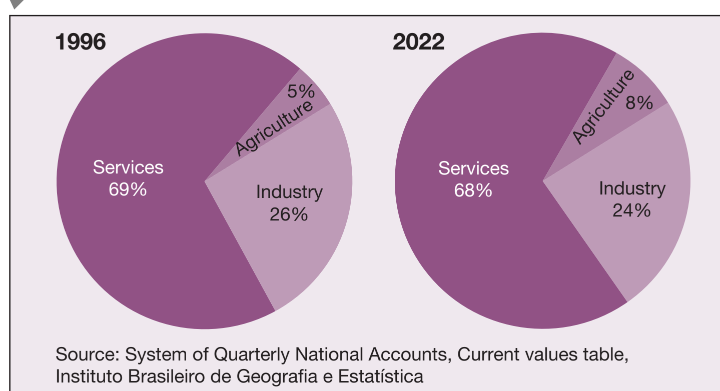
FIGURE 5 – STRUCTURE OF THE BRAZILIAN ECONOMY



Source: System of Quarterly National Accounts, Current values table, Instituto Brasileiro de Geografia e Estatística

3.4 Brazil's role in the global economy

President Lula is currently seeking to renew Brazil's role of leadership in the global economy, which diminished during the decade before he came back to office. Its poor economic performance since 2014, combined with corruption crises and political instability, have reduced its capacity for global, and even Latin American, leadership. This stands in sharp contrast to the 2000s, when Brazil and India led a bloc of developing economies pushing for a new World Trade Organization agreement (the Doha Round – which ultimately failed, but Brazil helped to advance reforms of intellectual property rules to make medicines cheaper in poorer countries).

One aspect of Brazil's role in the global economy that has been more consistent in recent decades is its support for greater **regional economic integration**, especially through preferential trade agreements. Within the South American continent, Brazil was a driving force for the formation of the Mercado Común del Sur (Mercosur), a customs union between Brazil and four other Latin American nations (Argentina, Paraguay, Uruguay and Venezuela), which came into effect in 1995. Trade within the Mercosur bloc is mostly tariff free. The Mercosur bloc concluded a trade agreement with the European Union in 2019 after nine years of negotiations that is gradually removing tariffs on 92 per cent of goods traded between the two blocs, many of which previously attracted tariffs of up to 35 per cent. Brazil also wants to negotiate a trade agreement with the US, but this would not be possible without changing the rules of Mercosur, which prevents member countries from signing bilateral trade agreements.

3.5 Brazil's currency reserves have helped stabilise financial markets

Financial instability is one of the most undesirable impacts of globalisation for developing economies. Brazil has experienced numerous exchange rate crises caused by sudden shifts of sentiment on financial markets. Those crises pointed to Brazil's high foreign debt and its exposure to changing foreign investor sentiment.

Brazil responded to its history of financial instability by floating its exchange rate in 1988 and building up its currency reserves. Floating exchange rates are generally less vulnerable to excessive speculation on foreign exchange markets than fixed exchange rates. While Brazil has continued to experience volatility in its currency during economic and political crises, these currency movements have assisted the economy in adjusting to changed economic conditions.

Since the global financial crisis of 2008, Brazil has also used foreign reserves to cushion itself from financial speculation and from the risk of further financial volatility. Brazil has built the tenth-largest

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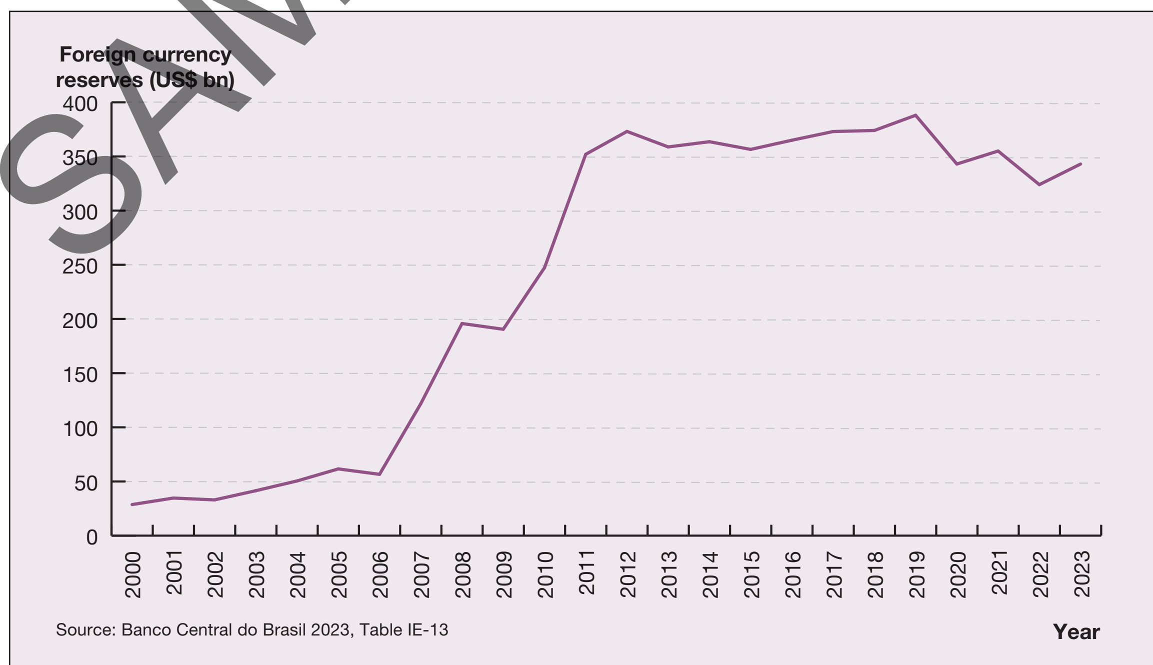
FIGURE 6 – BRAZIL'S CURRENCY RESERVES



reserves of foreign currency in the world – from just US$54 billion in 2005, these reserves in 2023 were US$343 billion. The OECD has criticised the size of the international reserves held by Brazil, noting the high cost in interest payments by the central bank, but for Brazil the reserves have provided a safeguard against instability in global financial markets.

BRAZIL'S POLITICAL CRISES: FROM IMPEACHMENT TO COVID-19

In modern economies, governments play an important role in responding to changing economic conditions and establishing policy priorities. But it is rare for political crises to have such economic impact as Brazil has seen in the past decade.

Brazil's recent political crises have seen corruption charges made against the last three presidents, with Lula da Silva serving time in prison, Dilma Rousseff losing office before her presidential term ended and Jair Bolsonaro facing several trials for his conduct as president.

Brazil's political crises began in 2014 with one of the biggest corruption scandals in modern history, involving billions of dollars in contracts from the state-owned energy company Petrobras. The scandal saw 352 of the 594 members of Congress facing criminal accusations, alongside 27 of Brazil's largest construction companies. Inevitably, the blame rested with President Rousseff, even though there was no evidence she was directly involved.

The Petrobras scandal and the extensive criminal investigation that followed brought the economy to a halt at the same time as falling commodity prices were undermining Brazil's export revenues. President Rousseff lost popular support amidst public anger over corruption, the weak economy, poor government services and rising prices. In 2016, Brazil's congress voted President Rousseff out of office. The official reason for her impeachment was that she had used accounting tricks to make the fiscal deficit look smaller than it really was, so that she could increase public spending before the 2014 election.

Instead of restoring stability, President Rousseff's removal worsened Brazil's political crisis. Within months of taking office, the new president, Michel Temer, was caught up in corruption allegations as part of the "Weak Flesh" scandal, in which meat packers had bribed politicians and officials to turn a blind eye to breaches of food safety laws. The scandal resulted in a ban on Brazilian meat exports to the US and European Union.

The popular former president Lula da Silva had been expected to win the 2018 presidential election, but was prevented from standing because of a corruption charge that was later nullified by the Supreme Court. With Lula out of the race, the 2018 presidential election was won by a populist anti-establishment candidate, Jair Bolsonaro. He was nicknamed "Trump of the Tropics".

Brazilian society has become increasingly polarised in recent years. Its political crises continued under President Bolsonaro, with a series of new scandals involving members of his family and successive resignations by senior officials and cabinet ministers. He downplayed the COVID-19 pandemic, which he described as "just a little flu" while Brazil suffered the world's fifth-highest number of deaths per capita, with over 700,000 lives lost. International confidence in Brazil was weakened when President Bolsonaro threatened to disregard the results of the October 2022 election, which former president Lula won in a run-off. Confidence was also weakened when the finance minister, Paulo Guedes, shut the IMF's representative office, saying that the IMF was not needed in Brazil and "stayed only because they like feijoada [a popular Brazilian black bean and meat stew], football, good conversation and, from time to time, to criticise and make wrong predictions".

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4. Brazil's recent policy developments

4.1 Macroeconomic policy

The key themes concerning economic management emerging from Brazil's recent economic history are:

- investor concerns about corruption and political incompetence
- poor management of **fiscal policy** due to structural problems in public finances
- better management of **monetary policy** to reduce inflation
- despite political instability, Brazil has made progress on the management of financial instability and trade liberalisation.

After rebounding from the COVID-19 recession, the primary macroeconomic challenge for Brazil is moving beyond the sluggish growth of the 2010s through implementing overdue structural reforms. The key issue with Brazil's budget is that less than 15 per cent of expenditure can be changed or removed from one year to the next (that is, is discretionary funding), while the remaining 85 per cent is fixed expenditure.

Fiscal policy is caught between the economy's need for support and the need to address a blowout in public debt levels in recent years, which has been driven by the rising cost of pensions. There are two key structural measures that address Brazil's fiscal problems. The first is the Fiscal Responsibility Law, which requires reductions in public debt and a medium-term target for the "primary fiscal surplus" (the fiscal surplus before payments on government debt). The second is a constitutional amendment passed in 2016, which imposes a spending cap that effectively freezes the national budget in real terms for 20 years. This was introduced after Brazil's credit rating was downgraded to BBB− in 2014 and slid further to BB− in 2023.

To stabilise public debt at current levels, an overall public-sector surplus of 1.1 per cent is required. Prior to the COVID-19 recession, budget forecasts pointed to a gradual decline in the deficit with continued increases in public debt. However, like other countries, COVID-19 led to emergency fiscal measures that, while accepted as appropriate by the IMF, resulted in a sharp increase in public debt of 15 per cent of GDP. The government invoked the "escape clause" of the constitutional expenditure ceiling to accommodate this exceptional spending, effectively suspending the Fiscal Responsibility Law. The fiscal measures included temporary income support to vulnerable households (bringing forward pension payments, expanding the Família program to another million households and providing cash transfers to unemployed workers), employment support (compensation to workers and incentives for firms to keep employees) and lower import levies on essential medical supplies. However, President Bolsonaro continued spending above the cap after the pandemic, which made Brazil's high inflation in 2022 even worse. The government then provided cost of living relief that also exceeded the cap.

The new fiscal framework announced by President Lula in 2023 aims to balance fiscal objectives and social responsibility. The framework limits government spending, with the goal of achieving a primary budget surplus of 1 per cent by 2026. Given President Lula's commitment to tackling inequality through increased social spending, the fiscal framework relies on revenue increases to achieve its target.

One significant reform where progress has been achieved in recent years is the structural reform of the pension system, which was approved by Brazil's parliament just before the COVID-19 pandemic. Age pension payments are an example of fixed spending because they are paid at similar rates each year. Brazil's pension system was one of the world's most generous, accounting for 56 per cent of the national budget. It became available from 54 years of age, compared to the average OECD retirement age of 66. The pension reforms increased the retirement age to 65 for males and 62 for females and require individuals to work for 40 years. It also reduces entitlements for those under 70 to encourage longer workforce participation. The reform was forecast to save US$230 billion over 10 years, although this will only stabilise spending at current levels.

During periods of high inflation, monetary policy plays a central role in Brazil's economic policy mix. This has again become necessary in the 2020s as Brazil has faced another bout of high inflation, chiefly due to global price increases. After inflation exceeded 12 per cent in 2022, interest rates rose to 13.75 per cent by August 2022, a sharp increase from the low of 2 per cent in early 2021. This proved successful with inflation forecast to be 5.6 per cent in 2023, down from 9.3 per cent the previous year. These outcomes represent significant progress given Brazil's history of high inflation, which reached a record 4500 per cent in 1994. Brazil's reliance on high interest rates risks causing a downturn in economic activity, but the sharp interest rate increases only mildly affected economic growth in 2023.

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"Economic activity is slowing due to weaker private consumption and exports. Real GDP is projected to grow by 1.7 per cent in 2023 and 1.2 per cent in 2024. Lower employment growth, still high inflation and tighter credit conditions will limit household spending capacity despite higher social transfers … Monetary policy is expected to stay restrictive … Fiscal policy remains expansionary for now, but gradual consolidation should start in 2024. Implementing a credible medium-term fiscal framework will help to restore confidence and achieve a more consistent macro-economic policy mix … Reducing the complex system of taxing goods and services would drastically reduce the current high administrative burdens on firms and has strong long-term potential to boost productivity and growth … Further progress on addressing large infrastructure gaps in transport, water and sanitation would reinforce those effects. These reforms would also boost the competitiveness of Brazilians firms, allowing them to reap greater benefits from international trade."

– OECD, Brazil Economic Forecast Update, June 2023

4.2 Microeconomic policy

Comprehensive reviews of the Brazilian economy undertaken by the IMF and OECD in recent years have set out a detailed agenda for microeconomic reform in Brazil. They highlight a set of policy challenges that Brazil needs to address to ensure the economy is on a path towards long-term, sustainable growth:

- The pension reforms mentioned above are regarded as a key microeconomic reform because of their potential to improve workforce participation and increase Brazil's low savings rate.
- Brazil remains, in the words of the IMF, "one of the most closed major economies in the world". Although Brazil is the world's ninth-largest economy, it represented just 1 per cent of the value of global trade in 2022 and, as a proportion of GDP, trade is lower in only seven other countries in the world at 39 per cent, according to the World Bank. Brazil has also been the world's third-most active user of anti-dumping actions in the WTO.
- Brazil needs to increase labour productivity, which is low by international standards and around one-third the level of its main regional competitor Argentina. Productivity growth will be the main engine of growth in the longer term. Strengthening it will require more competition in many sectors to allow labour and capital to move to activities with strong potential.
- Brazil has a young population but has had poor education outcomes in the past. The quality of education (measured by the international standard of PISA tests) is below the OECD average and is expected to deteriorate due to high drop-out rates curing COVID-19. Vocational education is especially weak, with fewer students enrolled in vocational programs than in all but three OECD economies. The share of young adults who have completed tertiary education is 23 percentage points below the OECD average (2021 data).
- More rapid progress is needed on infrastructure development. Transport infrastructure is important in a country as large and heavily populated as Brazil. Its road, rail and port quality ranks poorly according to international studies. A major 2019 IMF report noted that over the past two decades, Brazil invested an average of just 2 per cent of GDP in public infrastructure – around one-third the average level of other emerging economies.
- Reforms are needed in government itself. Political crises have revealed corruption throughout government, which has stifled economic growth. In 2022, Brazil was ranked 94th among 180 countries on Transparency International's annual corruption index.
- An overhaul of the tax system is needed to reduce the notorious cost of compliance with Brazil's tax system. The IMF has recommended that Brazil replace its complex indirect taxes with a single broad-based value-added tax and remove complexities in the tax system that make tax compliance expensive. The World Bank's 2020 "Ease of Doing Business" report ranked Brazil 124th out of 190 countries, noting for example that on average it takes almost 2000 hours for a business to prepare its tax returns in Brazil, more than any other country (and compared to an average of around 200 hours for most economies).
- Regulation more generally needs to be simplified and enforced. The OECD's Product Market Regulation Indicators report measures a nation's regulatory barriers to entrepreneurship and has found Brazil highly restrictive. Excessive regulations have encouraged a culture of "jeitinho", or

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finding a way around a law or a rule, sometimes illegally. For example, Brazil's complex system of environmental licences for developments is often criticised by foreign investors, and often evaded by local developers. In other areas, Brazil's problem has been a failure to enforce regulations. In 2018, the European Union announced a ban on imports from seven of Brazil's meat processing factories because of food safety concerns.

Brazil has nevertheless created some successful and innovative social policies, such as the Bolsa Família (Family Fund) policy, introduced in 2004 to assist poor households. The success of the Bolsa Família policy (now known as the Auxilio Brasil policy) has led to an expanded education, elderly care, health and micro-lending package called Brasil Sem Miséria (Brazil Without Misery). This program incorporated one of the previous government's cornerstone projects – the Fome Zero (Zero Hunger) program – providing monthly support to around 14 million of Brazil's poorest families. By merging a range of income distribution payments, the government aimed to target inequality more effectively, and its cost – just 0.6 per cent of GDP – is very small compared to the 14 per cent of GDP spent on pension benefits that mostly go to Brazil's less needy middle class.

5. Conclusion

"We're an increasingly unequal world, and wealth is increasingly concentrated in the hands of fewer people, and poverty concentrated in the hands of more people … we have to address the issue of world inequality. It's unacceptable that – in a meeting between presidents of important countries – the word inequality does not appear. Wage inequality, race inequality, gender inequality, education inequality, health inequality …

And we need to be clear about the following: what was created after the Second World War, the Bretton Woods institutions no longer work, and no longer serve society's aspirations or interests. Let's be clear that the World Bank leaves much to be desired in terms of what the world wants from the World Bank. Let's be clear that the IMF leaves a lot to be desired in what people expect from the IMF …

And then we need to deal with international agreements, trade agreements. Trade agreements must be fairer … we need to take a leap in quality, and invest in structural things that change the lives of countries."

– President Luiz Inácio Lula da Silva, speech at the Summit for a New Global Financial Pact, Paris, June 23 2023

Brazil is still in the process of rebuilding from a once-in-100-years pandemic that eroded the health system and left an already weak economy with political instabilty in a deep recession that was followed by high inflation and high interest rates. Nevertheless, President Lula has ambitions for Brazil to be the leading advocate for developing countries in the global economy, with an agenda to reform trade, finance, climate and globalisation itself.

First, however, President Lula must reckon with significant challenges at home, after a decade characterised by a long recession, corruption scandals and the catastrophic mismanagement of the COVID-19 pandemic. Brazil is also far more politically divided than it was when he was first in office in the 2000s. Nevertheless, for a country that only became a democracy in 1988, Brazil's institutions have endured a difficult period and proved to be strong, stable and mostly independent (with some exceptions) – all important elements of a positive environment for long-term investment and growth.

Brazil has the potential to play an important role in the future of the global economy both because of the size of its population and economy, and because of its proven potential in a diverse range of export markets including minerals, fuels, food and manufactures. If strong commodity prices are sustained, Brazil's prospects for recovery will be strengthened. But it will take time for Brazil to rebuild confidence in its economic future. To maintain investor confidence and strengthen Brazil's place in the global economy, Brazil will need to improve its educational, regulatory and fiscal performance. The events of recent years also underscore the importance of political stability, anti-corruption measures and the rule of law in providing foundations for confidence and growth.

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Case Study:

Indonesia

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The East Asian economic region has been strongly influenced by globalisation over recent decades, through increased international trade, foreign investment and rapid industrialisation. East Asian economies have become more closely integrated both at a regional level, and with economies around the world. With strong economic growth and development over recent decades, East Asia is fast becoming an economic centre of gravity to rival North America or Europe. Although North Asia has the largest regional economies – China and Japan – economies in the South-East Asian region are sustaining high rates of growth. They demonstrate the growth opportunities that come from more open markets, but also highlight the challenges of managing rapid economic change.

Indonesia is the **largest economy of the South-East Asian economic region**, with the world's fourth-largest population and sixteenth-largest economy. As it has opened its economy to global forces since the mid-1980s, Indonesia has experienced the growth of trade and investment and the increased participation of transnational corporations (TNCs) in the economy. Across a range of quality-of-life indicators, economic development has improved. However, Indonesia has also been exposed to major international economic disturbances, including a regional financial crisis in the late 1990s and ongoing volatility in global commodity markets. The severe impacts of the COVID-19 pandemic highlighted the fragility of the country's economic and social progress. Indonesia faces major policy challenges to build more competitive industries, improve its regulatory environment, and make government revenue and services more sustainable.

Indonesia is an excellent case study of globalisation because of the mixed influences of globalisation on its economy and the challenges it faces in sustaining economic development. Indonesia also has enormous long-term importance to Australia's economy and security – reflected in the fact that new Australian prime ministers usually visit Indonesia soon after assuming the role (such as Anthony Albanese did in 2022). With trade and financial linkages between the two countries growing stronger, understanding the Indonesian economy is especially valuable for Australia's economic future.

FIGURE 1 – DEVELOPMENT INDICATORS: SELECTED COUNTRIES

	Indonesia	Brazil	China	USA	Poland	Egypt	Australia
Population (millions, 2023)	277	216	1410	335	37	104	26
Gross Domestic Product (current US$ billion, 2023)	1390	2080	19370	26850	748	404	1071
Share of Gross World Product (percent, PPP 2023)	2.5	2.3	18.9	15.4	0.9	1.1	1.0
GNI per Capita (%) (current international dollar, PPP, 2022)	14250	17260	21250	77530	41310	14590	60350
Gini index (2022, 2021*, 2020**, 2019^)	37.9	52.9*	38.2^	39.7**	28.8^	31.9^	34.3^
Mean years of schooling (2021)	8.6	8.1	7.6	13.7	13.2	9.6	12.7
Life expectancy at birth (1990, 2021)	63.3 67.6	65.3 72.8	69.3 78.2	75.2 77.2	70.9 76.5	64.6 70.2	76.9 84.5
Human Development Index (rank) (2021–22)	0.705 (114)	0.754 (87)	0.768 (79)	0.921 (21)	0.876 (34)	0.731 (97)	0.951 (5)

Sources: IMF 2023, World Bank 2021; Human Development Report 2021–22, accessed July 2023

1. Economic performance

1.1 Indonesia's economy and development

With a Gross Domestic Product (GDP) of almost $US1.4 trillion, Indonesia is the world's sixteenth-largest economy. Indonesia is much smaller than the world's largest economies, such as China, which is close to 15 times as big, or the United States, which is nearly 20 times bigger. However, Indonesia is larger than other economies in its region, such as Thailand and Malaysia, whose economies are around half its size.

As well as a large economy, Indonesia has a very large population of over 270 million. Living standards in Indonesia remain low despite significant improvements. In 2022 output per capita was US$4788 (without adjusting for purchasing power, as done in figure 1. This is more than five times larger than the level recorded in 2000 (US$780)). Living standards are similar to those of some nearby economies such as the Philippines and Vietnam, but around half those of other South-East Asian neighbours such as Thailand and Malaysia. The World Bank downgraded Indonesia from an upper-middle-income country to a **lower-middle-income country** in mid-2021 following the impact of the pandemic.

Indonesia's low income levels mean that it suffers from a relatively high incidence of poverty. Absolute poverty rates are relatively low compared to the world's poorest countries, such as in Sub-Saharan Africa and South Asia, but with 2 per cent of the population living on less than US$2.15 per day, poverty rates in Indonesia are around double the average for the East Asia and Pacific regions.

Indonesia also suffers from a relatively low level of **economic development**. According to the United Nations, Indonesia's Human Development Index of 0.705 is below 113 other economies. Mostly this reflects Indonesia's low standard of living, as measured by its per capita income. Indonesia also has a relatively poor performance for other key indicators like adult literacy and life expectancy at birth. Health outcomes in Indonesia are especially low. Fourteen per cent of the population does not have access to basic sanitation facilities, and around one in ten Indonesians do not have access to basic drinking-water services. Expenditure on health, at around US$120 per person each year, is significantly lower than comparable countries in the region.

Indonesia's development indicators have nevertheless improved substantially in recent decades. Life expectancy has improved by six years since 1990. Over the same period, the under-five child mortality rate has decreased by nearly 75 per cent, from 84 deaths per 1000 births to 22 deaths.

Income inequality in Indonesia, as measured by its Gini index of 38, is similar to other economies in the region such as Malaysia and Vietnam. The distribution of income is more equal than in many countries beyond the region such as the United States and Brazil.

1.2 Indonesia is an emerging economy

In previous decades, Indonesia was considered a developing economy, and later, a newly industrialised economy. Indonesia is now considered an **emerging economy** because of its strong growth performance and prospects. This classification recognises Indonesia's success in transforming its industry structure to lift economic performance and development. In the four decades to 2023, Indonesia grew at an average annual rate of over 5 per cent. Although not as fast as some neighbouring economies in East Asia, this growth rate puts Indonesia well ahead of most economies around the world, including advanced economies in Europe and North America, and emerging and developing economies in Latin America, Central and Eastern Europe, and Africa. With a large population and continued economic growth, Indonesia is expected to join the world's largest emerging economies, the so-called BRIC economies (Brazil, Russia, India and China), in coming decades. According to projections by consulting firm PwC, Indonesia will surpass Germany and Japan to become the world's fourth-largest economy by the middle of this century.

The **international business cycle** and **regional business cycle** have also had significant impacts on the economic performance of the Indonesian economy in the past half century. While most economies experienced a downturn in growth during the 1970s because of rapid increases in global oil prices, Indonesia, as a major oil exporter, experienced an acceleration of economic growth. During the 1980s, the opposite occurred, as the glut of oil supply pushed prices down, and with them the growth rates of the Indonesian economy. During the 1990s, Indonesia was part of an economic growth boom that

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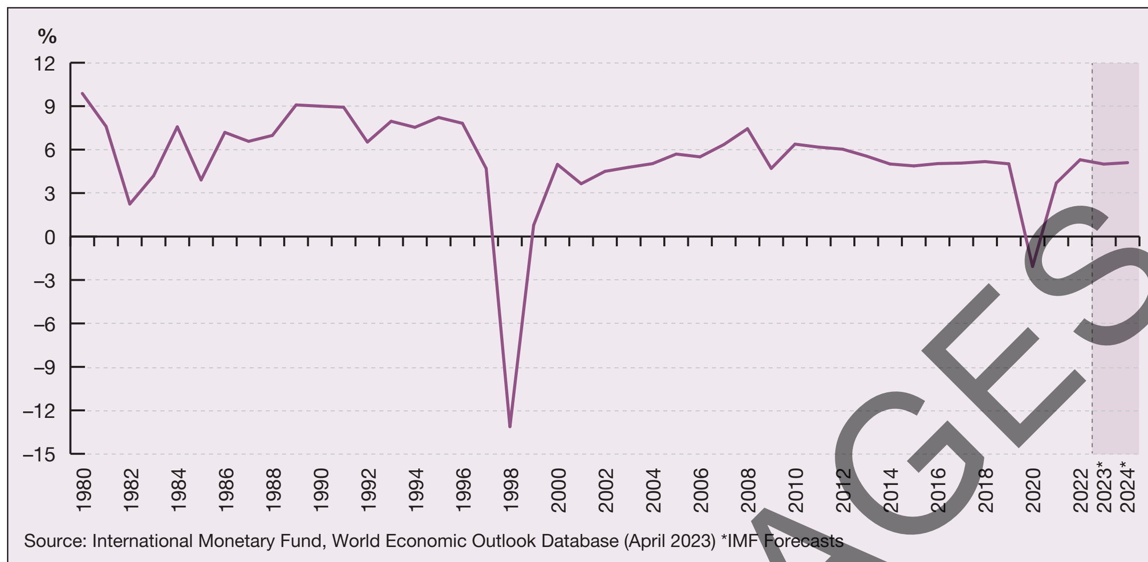
spread across East Asia after the end of the Cold War. However, this growth came to an abrupt end in 1997 with the Asian financial crisis, which saw the Indonesian economy contract by 13 per cent in the following year, with devastating consequences.

FIGURE 2 – ECONOMIC GROWTH IN INDONESIA



Source: International Monetary Fund, World Economic Outlook Database (April 2023) *IMF Forecasts

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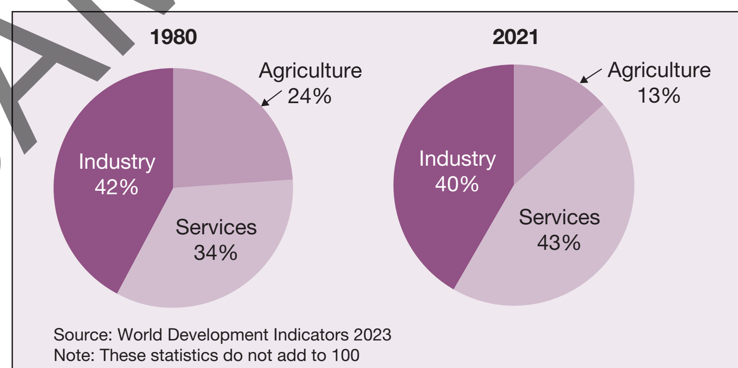
In 2020, the Indonesian economy contracted by 2.1 per cent – the first fall in annual GDP since the Asian financial crisis. The unemployment rate rose by 1.8 percentage points to be 7.1 per cent in 2020. The COVID-19 pandemic resulted in reduced consumer spending, business investment and exports. However, by the end of 2021, output had returned to pre-COVID-19 levels. Economic growth was forecast to be 5 per cent in 2023 and 2024, supported by export growth and investment. The labour market recovered rapidly, with unemployment falling to 5.9 per cent in 2022. In 2024, unemployment is expected to return to the pre-COVID-19 rate of 5.2 per cent.

One characteristic of Indonesia that is typical of an emerging economy is the transformation of its industry structure in recent decades. Like many other economies in East Asia, Indonesia has seen the economic importance of the agricultural sector fall, while manufacturing industries and services have become more important. As shown in figure 3, the past four decades have witnessed substantial structural change in the Indonesian economy.

FIGURE 3 – STRUCTURE OF ECONOMY



Source: World Development Indicators 2023
Note: These statistics do not add to 100

Indonesia's **primary industries** nevertheless remain important. Outside the formal economy, the majority of Indonesia's rural population still survives on subsistence agriculture, with wages in the form of crop shares. The main agricultural product is rice, and other crops include rubber, coffee, cocoa and spices. Unlike other economies in the region, Indonesia also has a large oil and gas industry. Until 2016, Indonesia was Asia's only member of the Organisation of the Petroleum Exporting Countries (OPEC), the international oil cartel. Palm oil, coal, petroleum oil and gas made up a quarter of total exports from 2000–2020. Indonesia's dependence on resource-intensive exports exposes it to currency volatility.

ASIAN FINANCIAL CRISIS

The Asian financial crisis of 1997 and 1998 was an early example of some of the possible negative impacts of globalisation. As the economy most severely affected by the crisis, Indonesia's experience highlights how volatile global financial markets, combined with economic mismanagement, can have devastating consequences for economic growth and development.

The rapid growth of South-East Asian economies for much of the 1990s (as shown in figure 4) had led to a flood of short-term financial inflows that were increasingly flooding into stock markets, consumer finance and real estate. Inadequate banking regulations saw finance flow to customers that did not meet normal creditworthiness standards.

In July 1997, sentiment changed as foreign investors reassessed the value of their assets and loans and suddenly withdrew their funds – known as "capital flight". Beginning with the Thai baht, the currencies of South-East Asian economies depreciated rapidly as financial outflows mounted. The financial "contagion" of the crisis also spread to other economies, including Indonesia, South Korea and Malaysia.

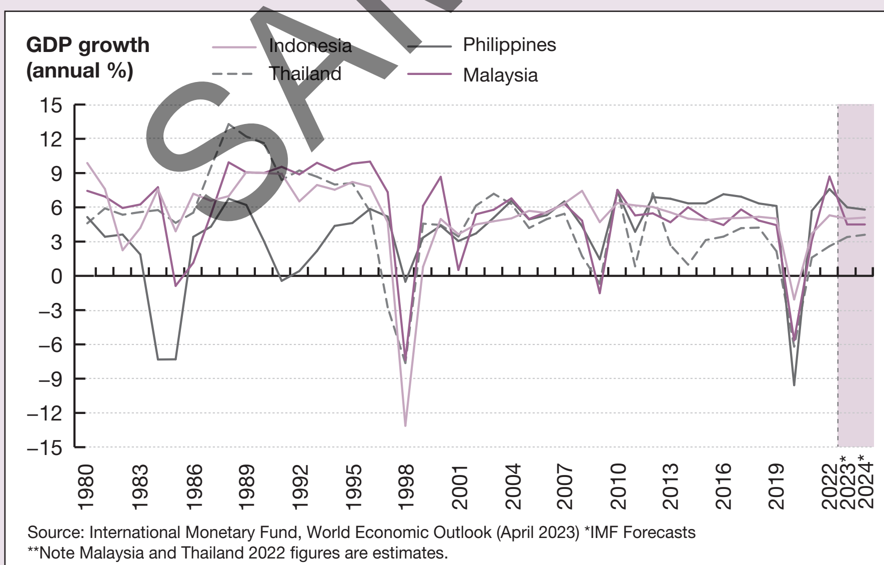
To obtain an emergency US$18 billion financial assistance loan from the IMF, the Indonesian Government was required to undertake policy measures including spending cuts, budget surpluses, dramatically raising interest rates (to 80 per cent), closing some banks, cutting fuel subsidies, and undertaking long-term structural reforms. Although designed to strengthen the Indonesian economy in the long term, these policies had the immediate effect of further undermining confidence and choking off economic activity. By mid-1998, as panic spread to Indonesia's businesses, households and other deposit holders, the rupiah had lost 85 per cent of its value against the US dollar (to be worth as little as Rp 16,000 to the US dollar) and the managed float was abandoned.

The Asian financial crisis had devastating economic consequences for Indonesia. The economy shrank by over 13 per cent. Unemployment increased and the Indonesian Government's official estimate of the number of people in poverty almost doubled from 11 per cent to 19 per cent as a result. As the exchange rate depreciated and the price of imported goods soared, inflation was recorded at over 75 per cent. Foreign debt increased to US$148 billion. In May 1998, Indonesian President Suharto was forced to step down after over 30 years in office. It took six years before living standards returned to pre-crisis levels.

Aside from the mishandling of the crisis by the IMF and the Indonesian Government, economists often cite two causes of Indonesia's problems during the crisis. The first was the combination of open financial markets with a fixed exchange rate. The rupiah became overvalued, and because it was fixed, there was no mechanism for it to adjust to its market value. A second cause of the crisis was excessive financial speculation and the poor regulation of the financial sector during a period of rapid globalisation. The Asian financial crisis in Indonesia highlights how, without an appropriate policy framework, global economic forces can destabilise an economy and cause extensive economic and social harm.

The Asian financial crisis led to major economic reforms, including the establishment of an independent central bank (Bank Indonesia), a new bankruptcy law, and measures to promote competition and improve the social safety net. The Indonesian Bank Restructuring Agency (IBRA) oversaw the reforms to the financial sector.

FIGURE 4 – EAST ASIAN GROWTH RATES



Source: International Monetary Fund, World Economic Outlook (April 2023) *IMF Forecasts
**Note Malaysia and Thailand 2022 figures are estimates.

The Asian financial crisis also forced a change in the way that the IMF responds to financial crises. In contrast to its policy prescriptions for Indonesia in the late 1990s, during the global financial crisis and the COVID-19 recession in the following two decades, the IMF recommended that economies actively stimulate growth through increased spending, lower interest rates, and boosting the liquidity of credit markets. As one of the first major crises of the modern era of globalisation, the Asian financial crisis helped shape future economic policy.

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Indonesia's **manufacturing sector** includes a large textile and garment industry and some other labour-intensive manufacturing. The sector has fallen from 31 per cent of GDP in 2002 to 19 per cent in 2021. Usually this happens when countries achieve higher income levels, according to the World Bank, but in Indonesia's case it reflects a lower level of competitiveness than in similar economies. Manufacturers confront poor infrastructure, limited access to finance, complex regulations and increased barriers to imports (which raise the cost of capital goods). Nevertheless, Indonesia has two key advantages that create the potential for growth in manufacturing: a large, low-cost labour force and a huge domestic market.

Indonesia's fastest-growing sector is its **services sector**. In 2021, the services sector made up 43 per cent of GDP, employing 49 per cent of the workforce. Indonesia's main services are tourism and retail. In the future, information and communications technology is expected to be a primary driver of growth in the services sector. Indonesia's services sector is enjoying increasing foreign direct investment (FDI) flows, with services accounting for over a third of Indonesia's investment inflow. The growth in information and communications services is evidence of the positive role of investment by foreign technology companies in helping to lift the skills of the Indonesian workforce. Nevertheless, the services sector is still held back by poor infrastructure and technology and by inadequate workforce skills, and it has trade barriers for services that are some of the highest in the world.

Indonesia did not meet all of the Millennium Development Goals (MDGs) by the target year of 2015, but made significant progress in many areas. The Indonesian Government is committed to delivering progress in the Sustainable Development Goals (or SDGs, also known as Global Goals), building on the progress achieved with the MDGs, such as reducing poverty (goal 1), promoting gender equality (goal 3), and dealing with the long-term impacts of climate change (goal 7).

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FIGURE 5 – INDONESIA'S PERFORMANCE ON THE MILLENNIUM DEVELOPMENT GOALS

Goal	Performance
1	Poverty headcount (proportion of people living below US$2.15 a day at 2017 PPP) has fallen from 69 per cent (1998) to 2.5 per cent (2022). The proportion of underweight children under five decreased from 31 per cent (1989) to 18 per cent (2018).
2	The net enrolment rate for primary children is 93 per cent, and primary school completion improved from 62 per cent (1990) to 100 per cent by 2010. The literacy rate of the population is 96 per cent (2020).
3	The proportion of males aged above 25 who have completed at least primary school is 85 per cent (2020). For females, it is 74 per cent (2015).
4	The mortality rate of children under five years has decreased from 97 (1991) to 22 (2021) per 1000 live births.
5	The maternal mortality rate has fallen from 390 (1991) to 173 (2020) per 100,000 live births. Issues with access to contraception remain.
6	The prevalence of tuberculosis decreased from 449 (2000) to 354 (2021) cases per 100,000 people, and the proportion of people with HIV/AIDS has decreased.
7	Carbon emissions are high. Eight per cent of Indonesians do not have access to safely managed drinking water, and 14 per cent do not have access to basic sanitation. The proportion of the urban population living in a slum has decreased from 51 per cent (1990) to 19 per cent (2020).
8	Foreign debt (as a per cent of gross national income) has been reduced from 69 per cent (1990) to 36 per cent (2021). The total debt servicing ratio (per cent of exports, goods, services and primary income) has been reduced from 40 per cent (1988) to 29 per cent (2021).

Source: World Bank World Development Indicators 2023

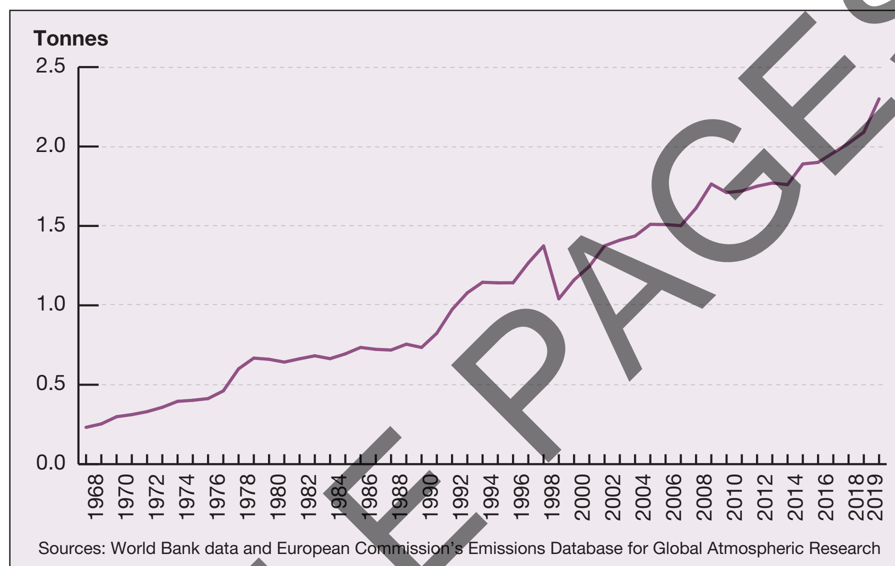
1.3 Indonesia's growth has had negative environmental impacts

Degradation of the natural environment has been a significant cost of the industrialisation and globalisation of the Indonesian economy. Indonesia has the third-largest rainforest in the world, yet is also home to one of the world's highest rates of deforestation. A 2019 study by Greenpeace showed that more than 74 million hectares of rainforest – an area twice the size of Japan – was cleared in the last half century. This is the result of commercial logging, land clearing for agriculture, mining developments

and population expansion. The Indonesian Government has a moratorium on new clearing for around 66 million hectares of primary forest and peatland. Retention of Indonesia's rainforests is important for a number of reasons, including the role they play in absorbing carbon. The forest clearing saved under the moratorium contributed 86.9 million tons of emissions reductions between 2011–2018. This is despite retaining only an average of 0.65 per cent more forest coverage than non-moratorium areas. Other key environmental concerns include loss of species and water pollution:

- Economic activity has affected natural habitats and regeneration, with 265 critically endangered animal and plant species as of 2019.
- Protection of the marine environment is a major challenge because of Indonesia's vast coastline, pollution from industry and over-exploitation of fishing stocks.

FIGURE 6 – INDONESIA'S CO_2 EMISSIONS PER CAPITA



Sources: World Bank data and European Commission's Emissions Database for Global Atmospheric Research

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Indonesia's rapid economic and population growth is placing pressure on its ability to reduce emissions. Although emissions of carbon dioxide are low in per capita terms (2.3 tonnes per year), Indonesia is the world's eighth-largest contributor to global carbon dioxide emissions (including emissions caused by deforestation). This is concerning because Indonesia is especially vulnerable to the future impact of climate change due to its high coastal population density. The World Risk Index ranks Indonesia's exposure to natural hazard-related risk as fifth-highest in the world, and climate risks have accelerated plans to move the capital from Jakarta on the island of Java to the new forest city of Nusantra on Borneo, some 1000 km away. Indonesia has already seen a sharp increase in the number of climate-related adverse weather events. The number of adverse events has risen from 82 in 2000 to 3058 in 2022, with recent examples including the 2019 land and forest fires in which 600,000 hectares were burned and 900,000 contracted respiratory illnesses, and the 2022 West Java earthquake that killed at least 335 people.

Reducing carbon dioxide emissions while maintaining economic growth will be a key environmental management challenge in the future. Indonesia has a Nationally Determined Contribution (NDC) to reduce emissions by 32 per cent by 2030 and reach net zero emissions by 2060 or sooner. These commitments will require significant policy and investment.

Indonesia is focusing on reducing its electricity sector emissions by 49 million tonnes by 2028, with a shift towards renewable sources. In 2021, Indonesia's government utility company Perusahaan Listrik Negara (PLN) committed to building no new coal-fired plants after 2022 and a phase out of all coal plants by 2056. The Indonesian Government has also committed to a 23 per cent renewable energy target by 2030. However, despite large sources and investment in geothermal and hydropower, it is unlikely to meet this target. Government efforts in renewable energy have been focused on small-scale projects, such as installing solar panels in villages. Large public investment is needed, particularly in distribution infrastructure, to ensure renewable energy can be added to the system.

Indonesia is also confronting a number of other environmental issues, particularly in relation to resource management. For example, Indonesia has the second-highest plastic waste among the world's 146 coastal countries. The Government has a policy to slash marine litter by 70 per cent by 2025 (and by 2020 had achieved a 15 per cent reduction). In 2016, the Government introduced a charge on plastic bags. Within three months, this step had reduced plastic bag use across Indonesia by 25 per cent.

2. Indonesia's path to globalisation

Since it opened up to global forces in the 1980s, globalisation has reshaped the Indonesian economy. Reforming the economy has been necessary so that Indonesia can keep pace with other economies in the South-East Asian region and avoid relying too heavily on commodity exports, whose value on global markets tends to be volatile. As the oil boom of the 1970s subsided, Indonesia needed to find more sustainable foundations for long-term economic growth, and exporting manufacturing goods was central to this strategy.

Since the mid-1980s, Indonesia has lowered protectionist barriers to trade, resulting in greater competitive pressures and making businesses more export-focused. Indonesia has taken opportunities to participate in multilateral efforts to reduce protectionism. Greater foreign investment has provided a source of capital, while also creating financial market and economic volatility. Transnational corporations have played a greater role in the economy for both traditional commodity sectors and other exports.

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2.1 Indonesia has reduced protectionist barriers since the 1980s

Trade liberalisation has been a crucial component of Indonesia's integration with South-East Asia and the global economy. In the mid-1980s, Indonesia **shifted away from a policy of import substitution towards export-led development**. In 2020, the simple mean tariff rate applied to imported goods was 6 per cent, down from 17 per cent in the early 2000s, and similar to the 5 per cent average for the East Asia and Pacific region.

Prior to the mid-1980s, Indonesia was a highly protected economy. Indonesia's oil boom in the 1970s saw the imposition of strict trade barriers to protect government-sponsored and government-owned business enterprises. The methods of protection included tariffs, licensing requirements, local content rules and import monopolies. One area that historically has faced high non-tariff barriers has been agriculture. In the mid-1980s, under the control of Indonesia's sole approved rice importer, Bulog, the country was able to achieve self-sufficiency in rice production and phase out all rice imports. The effective rate of protection for agriculture between 2011–2020 averaged 27 per cent of total consumption, which is much higher than regional peers and contributes to higher domestic prices. Many farmers are also disadvantaged by protectionism, as two-thirds buy more food than they sell (making them "net food buyers").

Indonesia's shift towards trade liberalisation began in the mid-1980s. The average level of tariffs was reduced by almost one-third. Between 1987 and 1995 the effective rate of tariff protection for the manufacturing sector fell from 86 per cent to 24 per cent. For agriculture over the same period it halved, from 24 per cent to 12 per cent. The Government has also relaxed the complicated network of import licensing restrictions. Annual deregulation and liberalisation packages aimed to reduce barriers to foreign trade and investment.

After the Asian financial crisis in 1998, Indonesia continued to pursue trade liberalisation under the auspices of an IMF program. Tariff and non-tariff barriers were reduced, together with an easing of the restrictions on foreign investment. However, in the decade to 2020, the average tariff level increased marginally.

2.2 Indonesia has joined regional trade agreements

At the same time as it has been (mostly) reducing protectionist barriers, Indonesia has become increasingly integrated with the global economy through participation in global, regional and bilateral trade agreements. Indonesia has also become more prominent on the global stage, in particular through its membership in the Group of 20 (G20) major economies.

Indonesia has been an active member of the **World Trade Organization** (WTO) since 1995. With almost a third of the population employed in the agricultural sector, Indonesia supported the failed Doha

Round of trade negotiations, hoping for reductions in agricultural protection by advanced economies. However, Indonesia also argued that "special and differential treatment" provisions must be at the heart of a negotiated agreement. This refers to provisions in WTO agreements that give developing countries special rights, such as a slower tariff reduction schedule.

The process of regional integration has seen the **Association of South-East Asian Nations (ASEAN) emerge as the most important regional organisation**. Formed in 1967 by Indonesia, Malaysia, the Philippines, Singapore and Thailand, ASEAN has since expanded membership to include Brunei, Burma, Cambodia, Laos and Vietnam. The ASEAN Free Trade Area (AFTA) agreement, signed in 1992, aims to reduce tariff and non-tariff barriers within the region. It uses a Common Effective Preferential Tariff scheme, where tariffs are less than 5 per cent for goods originating among member economies. In 2007, ASEAN leaders adopted a blueprint for the creation of the ASEAN Economic Community (AEC), intended to create a single market of around 600 million people, allowing the free flow of goods, services, capital and labour. The vision for the AEC is to enhance the attractiveness of South-East Asia as a foreign investment destination and improve the level of regional integration. While the initial plan was to establish the AEC by 2015, this was revised under the AEC Blueprint 2025, which gave members another decade to pursue the reforms and initiatives needed to achieve the vision of a highly integrated, cohesive and competitive economic region.

Indonesia is also a party to a number of other trade agreements through the ASEAN Plus Three framework. ASEAN has concluded free trade agreements with China, South Korea, Japan, India, Australia and New Zealand. Indonesia is also a member of the Asia-Pacific Economic Cooperation (APEC) forum, which has aimed to advance regional and global trade and investment liberalisation. Indonesia is also a member of the Regional Comprehensive Economic Partnership (RCEP), the world's largest trade bloc, which came into force in 2022.

The Indonesia-Australia Comprehensive Economic Partnership Agreement was signed in March 2019, reflecting the growing significance of economic relations between the two countries. Under this agreement, almost all import tariffs in both countries were reduced or eliminated, effective from 2020. Australian primary industry exports such as frozen beef and sheep meat are now being processed more quickly at the border, reducing barriers to trade. Total trade between Australia and Indonesia was A$18 billion in 2021–22, making Indonesia Australia's 14th most significant trading partner.

Indonesia also has a comprehensive bilateral trade agreement with Japan that took effect in 2008. Japan accounts for 8 per cent of Indonesia's exports and is its third-largest export destination after China (23 per cent) and the United States (11 per cent). Indonesia has agreements with South Korea, Chile, Mozambique, Pakistan and the European Free Trade Association (which itself is comprised of Norway, Switzerland, Iceland and Liechtenstein). Indonesia has also signed, or is negotiating, agreements with the EU, India, Tunisia and Türkiye, but these are not yet in force. Figure 7 outlines Indonesia's trade agreements.

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FIGURE 7 – INDONESIA'S TRADE AGREEMENTS

Global	Regional	Bilateral
Founding member of the World Trade Organization (1995)	ASEAN Free Trade Agreement (1992) Asia-Pacific Economic Cooperation forum Regional Comprehensive Economic Partnership (2020)	Japan (2008) Pakistan (2012) Australia (2019) Chile (2019) European Free Trade Association (2021) Mozambique (2022) South Korea (2023)

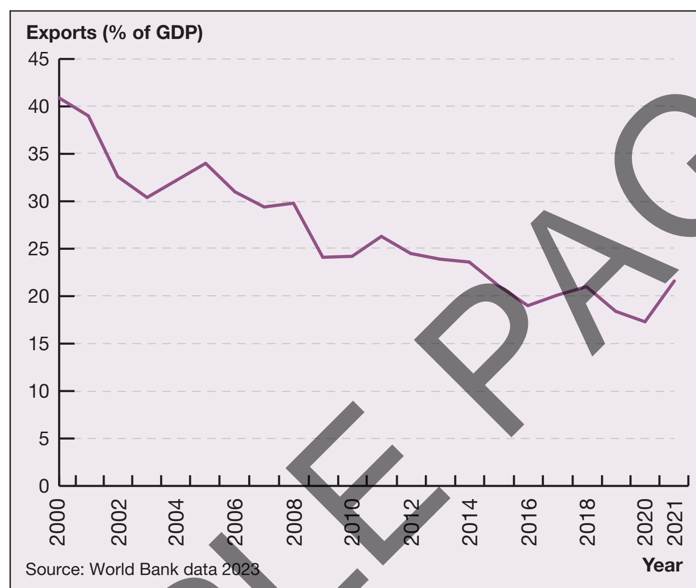
2.3 Changes in trade in goods and services

Trade liberalisation has improved Indonesia's access to overseas export markets and led to stronger economic growth. Exports of goods and services have grown at an average annual real rate of 4.9 per cent globally in the period between 1980–2020. Meanwhile, Indonesia's trade expanded by 5.2 per cent. While giving the country access to wider markets and improving export industry revenues and employment, this trade growth was low when compared with Malaysia, Thailand and the Phillipines, which grew 12-fold. The

contribution of trade to Indonesia's economy (as measured by percentage of GDP) has fallen over the past two decades. Trade in goods and services was equal to around 33 per cent of Indonesia's GDP in 2020, down from 72 per cent in 2000. A major reason for the declining contribution of trade is that Indonesia still relies on a **relatively narrow base of commodity exports**.

The contribution of trade to the Indonesian economy is lower than the regional average for East Asian and Pacific economies (56 per cent), highlighting the potential for Indonesia to expand further into international markets. Indeed, while being the 16th-largest economy with the 4th-largest population, Indonesia is only the 25th largest in exports. It also means that, through trade linkages at least, Indonesia is less exposed to the international business cycle than some other economies. Also, with nearly three-quarters of its trade being with other Asian economies, Indonesia is most closely integrated at a regional level with economies such as Japan, China, Singapore, Malaysia and South Korea.

FIGURE 8 – INDONESIAN EXPORTS



Source: World Bank data 2023

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Since the mid-1990s, Indonesia's export base has shifted back towards food and fuels, with manufactured exports falling as a share of trade. High-technology exports contribute less than 3 per cent of Indonesia's total export revenues. Unlike many other economies in the region, Indonesia has not emerged as a major low-cost manufacturer for global markets, relying instead on its commodity exports. In part, this reflects the fact that some commodity prices have remained strong. However, it also highlights Indonesia's need to do more in coming years to develop sustainable exporting industries. Service exports, particularly tourism, represent an area of potential growth for Indonesia. The Indonesian Government has also promoted the idea of "resource down-streaming" or value-adding to existing commodity exports, pointing to the success of a government ban on the export of unrefined nickel ore in 2020 that substantially increased nickel-based steel exports by 2022. Nickel is also an important component in electric vehicle batteries, and Indonesia is hoping to become by 2027 one of the world's three largest manufacturing hubs for EV batteries. Despite the economic reforms of recent decades, Indonesia's main exports are oil and gas, coal, palm oil, steel and electrical machinery/equipment.

2.4 Barriers to finance and investment have also been liberalised

Indonesia has reduced barriers to financial and investment flows during the globalisation era to encourage economic growth and development. From the mid-1980s, Indonesia pursued tax reforms, deregulation of industry sectors, and the removal of restrictions on foreign ownership. While previous decades saw FDI flow mainly to the oil and mining sectors, in the 1990s Indonesia saw an increased flow of investment into manufacturing.

While FDI reached a record level in 2022, overall FDI inflows to Indonesia remain lower than in comparable countries, owing to uncertainty about government policy settings and lower levels of international competitiveness. However, there have been occasional successes. Following the government

decision to ban raw nickel ore exports (noted above), Chinese and US companies invested in local processing facilities to shore-up supplies of nickel, a critical input to the electric vehicle production.

Encouraging FDI, along with continuing to reduce trade barriers, is important to securing export-led development. Figure 9 sets out some key features of foreign investment and integration of Indonesia with the global economy. The largest sources of foreign investment in 2022 were Singapore, China, Hong Kong, Japan and Malaysia.

FIGURE 9 – FOREIGN DIRECT INVESTMENT IN INDONESIA

Trends	FDI inflows reached a record level of US$45.6 billion in 2022 (excluding banking, oil and gas sectors), reflecting recent policies for the base metals sector.
Investment source country (2022)	Singapore (29%); China (18%); Hong Kong (12%); Japan (8%); Malaysia (7%); others (26%)
Destination region within Indonesia (2022)	Java (42%); Sulawesi (20%); Sumatra (15%); Maluku (10%); Kalimantan (7%); Bali and Nusa Tenggara (3%); Papua (3%)
Destination sector (2021)	Agriculture and mining (15%); metal goods (24%); other manufacturing (30%); services (31%)
TNCs in Indonesia	• About 220 pharmaceutical companies operate in Indonesia • Commodity sector attracts TNCs like ExxonMobil • L'Oréal and Toyota have manufacturing facilities in Indonesia
Benefits of FDI	• More investment when domestic savings are low • Employment in production and management • New technologies and business processes • Links to export markets and international supply chains
Risks of FDI	• Exchange rate and financial market volatility • Structure of FDI may limit technology and training benefits for local economy • Environmental sustainability of FDI in natural resource sector
Drivers of FDI	• Large endowment of natural resources • Large consumer market • Relatively low labour costs
Constraints on FDI	• Inadequate transport and energy infrastructure • Inadequately trained staff • Complicated regulations • Exchange rate volatility undermines investor confidence • Economically disconnected regions

Source: BKPM – Indonesia Investment Coordinating Board
Note: Numbers do not add to 100 due to rounding.

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Financial markets have also been liberalised in recent decades to encourage economic growth, beginning with the shift in Indonesia from a fixed exchange rate to a managed float in 1978. The currency, the Indonesian rupiah, was devalued during the 1980s as a deliberate strategy to improve the competitiveness of exports. The managed float was abandoned during the Asian financial crisis in August 1997, and the rupiah was allowed to float freely after the central bank's attempts to stabilise the currency were unsuccessful. The rupiah suffered a massive depreciation, causing major turmoil in financial markets and the economy.

Currency volatility is a continuing problem in Indonesia, with major shifts in the rupiah caused more by global factors than domestic factors. To reduce instability (and encourage longer-term foreign investment), the Indonesian Central Bank has strengthened capital controls in financial markets – with investors in government bonds required to hold them for a minimum of six months, slowing the pace of any "capital flight". IMF research has found currency volatility reduces private sector investment – for every 1 per cent increase in volatility, there is reduction in investment of almost 0.2 per cent.

2.5 Foreign aid and assistance have supported economic development

Economic development in Indonesia has been supported by foreign aid and assistance. In addition, the World Bank funds many active projects in Indonesia with a cumulative lending value of US$19.6 billion. These programs have targeted community empowerment, government administration, energy and infrastructure development. Australia was expected to provide Indonesia with $286 million in official development assistance in 2023–24, and also donated 8 million doses of COVID-19 vaccines during the pandemic.

3. Recent developments in economic policy

Indonesian economic policy has evolved gradually in recent years, with governments aiming to achieve macroeconomic stability, promote economic development, attract foreign capital and increase social expenditure. At one point, Indonesia set a goal of being a top 10 and middle-income economy by 2025, but a combination of disappointing economic growth rates and the recession caused by the COVID-19 pandemic made that goal impossible.

The central element of Indonesia's current economic policy framework is the 20-year development plan known as RPJMN (*Rencana Pembangunan Jangka Menengah Nasional*). The plan, which began in 2005, is in its final phase. This last phase aims to focus on improving human capital and Indonesia's international competitiveness.

The conduct of **monetary policy** is led by Indonesia's Central Bank, **Bank Indonesia**, which has been independent from the Government since 1999, and has had a medium-term inflation target of 4 to 6 per cent since 2005. During the 2010s, the main central bank interest rate moved within a band between 4 and 8 per cent. Monetary policy was loosened throughout 2016 and 2017, and after increasing rates in 2018, Bank Indonesia reduced interest rates to 3.5 per cent in 2020. Rates rose sharply in late 2022, stabilising at 5.75 per cent for the first half of 2023.

FUEL SUBSIDIES

A continuing drain on Indonesia's public resources for many years has been the large government expenditure on fuel subsidies, which have been larger than all central government social and capital spending combined. At their peak, fuel subsidies accounted for 20 per cent of government spending. Petrol prices have previously caused political turmoil, forcing a reversal of subsidy cuts in 2008, 2011 and 2018. The Government announced an intention to further lower subsidies to reduce spending on fuel subsidies to US$14 billion in 2023. Fuel subsidies mainly benefit the middle class, with the poorest 10 per cent of households receiving just 2 per cent of fuel spending.

Fiscal policy has focused on maintaining the confidence of international investors and in providing macroeconomic stability. During the 1990s, the Government achieved budget surpluses, using those surpluses to retire government debt. Spending was restrained while tax revenues increased (by around 15 per cent). In the two decades to 2019, government debt fell from 87 per cent to 30 per cent. As a result of COVID-19 stimulus spending, government debt rose to 40 per cent of GDP in 2020.

The Indonesian Government implemented a major fiscal policy response to COVID-19. The Government relaxed its self-imposed budget deficit ceiling of 3 per cent. The Indonesian Government budgeted around US$50 billion – more than 4.5 per cent of GDP – on its national economic recovery program (PEN). The PEN was split into the following areas:

- Healthcare spending (US$7 billion), including purchase of medical equipment, funds for mass vaccination and incentives for medical workers.
- Social protection (US$16 billion), including food support programs for up to 20 million families, extending the pre-employment card program for around 5.6 million impacted workers, free electricity for around 30 million customers, supporting low-cost housing and providing other support needs.
- Tax incentives and credit for business (US$8 billion), including income tax exemptions, deferring import tax and debt payments, and reducing the corporate tax rate from 25 per cent to 22 per cent.
- Economic recovery program (US$12 billion), focused on providing credit restructuring and financing for small and medium businesses.

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As Indonesia emerged from the COVID-19 pandemic, its government began the task of fiscal repair, with fiscal policy becoming contractionary. Indonesia's budget deficit fell to expected 2.8 per cent of GDP in 2023, below the legally mandated ceiling of 3 per cent. The fiscal repair task has been aided by windfall revenues from record commodity prices. However, overall spending still increased in 2022 due to subsidies for high fuel prices and the increasing interest burden from government debt.

A key constraint on the sustainability of Indonesia's fiscal policy is the narrowness of its tax base. Indonesia's ratio of tax revenues to GDP has been the lowest in the ASEAN-5 (Singapore, Malaysia, Phillipines, Indonesia and Thailand) and had been declining since 2013 up until the pandemic. This reflects factors relating to both the economy and the fact that Indonesia's tax revenues are heavily linked to the cyclical commodities sector. There are many gaps in the tax collection system, and a large number of exemptions in the tax system. Some improvements have been achieved under President Widodo reflecting tax reforms (particularly relating to tobacco) and increased compliance, as well as higher commodity prices. In 2022, the value-added tax rate (a tax on the delivery of goods and services) was increased, contributing to a 14 per cent increase in tax revenues. Measures to improve tax compliance include a tax amnesty (which allows the declaration of previously untaxed assets), the simplification of compliance processes for taxpayers, and more effective use of banking data. However, over-reliance on commodity prices to drive revenue remains a critical problem. Indonesia collected more tax in 2022 than it had for some years, partly repairing the tax-to-GDP ratio.

One of the weaknesses of current policy settings is that the tax and transfer payment system makes no overall difference to the **level of inequality**. Fiscal policy's failure to promote inclusive growth reflects low-quality spending in infrastructure, education and health, particularly evident in East Indonesia. For example, 60 to 70 per cent of people in East Indonesia lack adequate internet access. The Indonesian Government has identified the need to substantially increase spending across these areas.

The Indonesian Government has also recognised the need to increase its investment in **infrastructure**. Between 2014 and 2018, infrastructure spending grew 22 per cent a year on average. The Government has an ambitious plan to spend around US$430 billion on infrastructure in the five years to 2024. In 2019, the government announced a US$32 billion project to move its capital city from Jakarta to Borneo, officially changing over in 2024. The government hopes 60,000 people will move between the two cities by 2025, and that this will encourage foreign investment into a less-developed region of the country. However, Indonesia still has a large infrastructure deficit. Private investment will need to play a role too, but it has been hampered by regulatory issues, inadequate planning and issues in securing finance. The Government has established a Public Private Partnership Unit within the Ministry of Finance to facilitate faster project approval and delivery, and has made steps to reduce regulatory burdens. International assistance can also help address infrastructure needs, such as through a recent US$210 million project funded by the World Bank to improve protection of Indonesia's marine areas and coral fisheries.

Indonesia's expenditure on **education and health care** is inadequate for population needs. Education spending is 3.5 per cent of GDP, despite a commitment that 20 per cent of government expenditure should be spent on education. Inadequate investment in education contributes to Indonesia's high rate of youth unemployment, which is usually around four times higher than for other age groups. Educational outcomes are also relatively low, with around 55 per cent of Indonesians completing education functionally illiterate. The Government has expanded its Program Indonesia Pintar (PIP) policy, which provides a cash subsidy for school-age children in poor households, with a budget for 17.9 million students in 2023. Further, the "Merdeka Belajar" consists of 22 programs in place since 2019 to improve Indonesia's human capital, including a revision of the national exam to better align with international standards.

Public spending on healthcare is below 1.5 per cent of GDP, lower than in most South-East Asian economies, such as the Philippines or Cambodia. Improved health outcomes have been achieved since the introduction of a universal health insurance program in 2014, the *Jaminan Kesehatan Nasional* (JKN). The universal healthcare program has nearly reached 90 per cent coverage, assisted by a program in 2022 that provided 97 million low-income households extra assistance in accessing the program. The cost of JKN for individuals depends on their ability to contribute, with the poorest households having

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no requirement to contribute. Around 240 million Indonesians participate in the scheme, although in 2021 only 60 per cent were in the lowest income categories. The government has made steps to improve the scheme, including the introduction of the "Standard Inpatient Class" system in 2022. This reformed the existing tiered framework, which offered hospital wards of varying quality based on the premiums individuals paid. However, while this addresses inequalities for in-patients, attention has been drawn to JKN's inability to address high out-of-pocket expenses, which make up a third of total health expenditures (above the WHO recommendation of 20 per cent).

The most audacious attempt at structural reform in Indonesia in recent years has been the *Job Creation Act* of 2020, also known as the "Omnibus Law" because of its wide-reaching impacts on so many aspects of the economy. The legislation amended 77 other laws relating to environmental protection, spatial planning, special economic zones, small and medium enterprises, land rights, transport, energy, agriculture, fisheries and taxation, with the aim of encouraging business investment and economic growth. Labour market changes mostly reduced protections for employees. Foreign investment restrictions were reduced for hundreds of industries, including information and communications technology (ICT), energy and tourism. However, the Omnibus Law was highly contentious, prompting criticism from environmental and labour groups and even street protests. In 2021, the Constitutional Court declared the law unconstitutional. In 2023, an amended law removed three key restrictions on foreign investment and established the Indonesian Investment Authority with US$5 billion to create long-term investment opportunities in the country.

A consistent hurdle for reforming the Indonesian economy is resistance from established interest groups whose economic interests have been threatened by the removal of regulations that advantaged them. Historically, Indonesia has been associated with "crony capitalism", where economic policies were set up for the benefit of corrupt officials and relatives of senior officals and political leaders. Indonesia was ranked 110th in the world in 2022 on the Corruption Perception Index. In 2023, a US$20 billion tax scandal forced President Widodo to pledge further efforts to fight corruption. One part of his strategy over the past decade has been to shift towards a more decentralised state, with large areas of public expenditure and services being transferred from the central government to the nation's 440 local governments. However, significant reforms are still required for the legal system to improve corporate practices, with the World Bank ranking Indonesia 73 out of 190 countries for ease of doing business in 2019.

The potential dividend from economic reform and policy intervention is significant. According to the Ministry of National Development Planning (Bappenas), by 2030, policy interventions could lift fourth grade reading proficiency to 68 per cent, reduce women in child marriages from 10 per cent to 7 per cent, increase annual real GDP per capita growth to 5.4 per cent and lower the Gini index from 37 to 36. However, achieving these economic and social gains will require major investment, almost US$700 billion in annual spending on Sustainable Development Goals by 2030.

4. Conclusion: Is Indonesia a globalisation success story?

Indonesia provides a complex picture of globalisation. Since the 1980s, Indonesia has liberalised trade, investment and financial flows. Global and regional integration have delivered Indonesia substantial benefits and have allowed for progress towards reducing poverty. The severity of the Asian financial crisis in the late 1990s resulted in lasting reforms and improved governance. While growth has been strong, Indonesia has fallen short of its ambitious growth target, and reforms have been hindered by difficulties in managing the economy, with its huge population, diverse range of cultures and a population scattered across 6000 inhabited islands. Indonesia's experience highlights that globalisation is not an economic "silver bullet". To sustain growth over the long term, countries need to establish strong governance systems, build competitive industries, reform their economies and undertake major investment in education, health and infrastructure to achieve economic development.

Despite sustaining growth rates above 5 per cent in recent decades, Indonesia is faced with numerous challenges. In the short term, it must sustain economic growth that has been fuelled by higher

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commodity prices and a recovery in tourism, and which could be jeopardised by inflationary pressures, higher interest rates or weaker international conditions. Securing foreign investment will be critical to strengthening the economy and sustaining strong growth through the 2020s. While the government cannot ensure the stability of the currency, it can contribute to investor confidence. In the long term, key economic challenges will include strengthening the financial sector, reorienting government spending towards more efficient spending on education and infrastructure, improving coordination between the national and local governments and attracting more foreign investment that can diversify the Indonesian economic base.

Stronger economic growth is needed to reduce the incidence of poverty and improve quality of life. Indonesia hopes to mark its 100-year anniversary of independence in 2045 by achieving high-income status and reducing poverty to zero. This is an ambitious goal, and will require the Government to continue to provide a strong policy framework and support the development of human capital. With Joko Widodo completing his maximum two terms in office in 2024, the new president will play a central role in determining Indonesia's progress towards its economic ambitions.

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