

Economic Policy in the Age of Globalisation

In the age of globalisation, both domestic and foreign economic policies play an important role in determining firms' strategies. Understanding such policies is an essential part of the cultural background of managers at all levels of a firm. At the same time, firms' choices have a greater impact on economic policymaking in a global economy, as the range of alternatives open to them expands. In this book, Nicola Acocella analyses both sides of this relationship. Special emphasis is placed on current issues in policymaking on the basis of social choice principles and the normative and positive theory of economic policy, and on issues concerning the establishment of international public institutions that can match the global reach of the private institutions (markets and firms) that generate many of today's economic challenges. Broad in scope, this book is aimed at students who have completed an introductory course in both microeconomics and macroeconomics.

NICOLA ACOCELLA is Professor of Economic Policy in the Department of Public Economics at the University of Rome 'La Sapienza'. His publications include *Foundations of Economic Policy: Values and Techniques* (Cambridge, 1998).

Cambridge University Press
0521540380 - Economic Policy in the Age of Globalisation
Nicola Acocella
Frontmatter
[More information](#)

Economic Policy in the Age of Globalisation

Nicola Acocella

Translated from the Italian by
Brendan Jones



Cambridge University Press
0521540380 - Economic Policy in the Age of Globalisation
Nicola Acocella
Frontmatter
[More information](#)

PUBLISHED BY THE PRESS SYNDICATE OF THE UNIVERSITY OF CAMBRIDGE
The Pitt Building, Trumpington Street, Cambridge, United Kingdom

CAMBRIDGE UNIVERSITY PRESS
The Edinburgh Building, Cambridge, CB2 2RU, UK
40 West 20th Street, New York, NY 10011-4211, USA
477 Williamstown Road, Port Melbourne, VIC 3207, Australia
Ruiz de Alarcón 13, 28014 Madrid, Spain
Dock House, The Waterfront, Cape Town 8001, South Africa
<http://www.cambridge.org>

Originally published in Italian as *Politica economica e strategie aziendali*,
2nd edn., by Carocci, Roma, 2003.

First published in English by Cambridge University Press 2005 as
Economic Policy in the Age of Globalisation
English Translation © Nicola Acocella 2005

This book is in copyright. Subject to statutory exception
and to the provisions of relevant collective licensing agreements,
no reproduction of any part may take place without
the written permission of Cambridge University Press.

First published 2005

Printed in the United Kingdom at the University Press, Cambridge

Typeface Times NR SF 10/13 pt. System L^AT_EX 2_ε [TB]

A catalogue record for this book is available from the British Library

Library of Congress Cataloguing in Publication data
Acocella, Nicola, 1939–
[Politica economica e strategie aziendali. English]
Economic policy in the age of globalization / Nicola Acocella ; translated from the Italian
by Brendan Jones.
p. cm.
Includes bibliographical references and index.
ISBN 0 521 83282 9 (alk. paper) – ISBN 0 521 54038 0 (pbk. : alk. paper)
1. Economic policy. 2. Globalization – Economic aspects. I. Title.
HD87.A28513 2005
338.9 – dc22 2004051110

ISBN 0 521 83282 9 hardback
ISBN 0 521 54038 0 paperback

The publisher has used its best endeavours to ensure that the URLs for external websites
referred to in this book are correct and active at the time of going to press. However, the
publisher has no responsibility for the websites and can make no guarantee that a site will
remain live or that the content is or will remain appropriate.

Cambridge University Press
0521540380 - Economic Policy in the Age of Globalisation
Nicola Acocella
Frontmatter
[More information](#)

To Valerio and Roberta

Contents

<i>List of boxes</i>	<i>page</i> xv
<i>List of tables</i>	xvii
<i>List of symbols, abbreviations and acronyms</i>	xix
<i>Preface</i>	xxv
1 Introduction	1
1.1 Economic policy	1
1.2 Economic reality and social preferences	3
1.3 Outline of the text and organisation of the discipline	4
1.4 Summary	5
Part I The market, efficiency and equity	
2 Market failures: microeconomic aspects	9
2.1 The role of the market and government	9
2.2 Criteria for the choice of institutions: efficiency and equity	10
2.3 Pareto efficiency and competitive equilibrium: the first fundamental theorem of welfare economics	12
2.4 Efficiency and equity: the second fundamental theorem	14
2.5 Market failures and the first theorem of welfare economics	14
2.6 Perfect competition and markets in the real world	15
2.6.1 Numerosity of agents and returns to scale	16
2.6.2 Free market entry and exit	17
2.6.3 The other assumptions of perfect competition	20
2.7 Incomplete markets and externalities	20
2.8 Externalities and the Coase theorem	23
2.9 Public goods	26
2.10 Transaction costs and asymmetric information	32
2.11 Perfect competition and ‘imperfections’: the theory of the second best	35
2.12 Income distribution and equity	38
	vii

viii	Contents	
	2.13 Merit wants	40
	2.14 Dynamic efficiency and market failures	41
	2.15 Dynamic efficiency and market forms	42
	2.16 Summary	43
	3 Market failures: macroeconomic aspects	45
	3.1 The instability of a capitalist market economy: macroeconomic failures	45
	3.2 Unemployment	46
	3.3 Inflation	50
	3.4 The short-run analysis of unemployment and inflation	54
	3.4.1 The theory of Keynes and Kalecki	54
	3.4.2 ‘Natural’ unemployment and the limits of government according to Friedman	60
	3.4.3 The ineffectiveness of government intervention in new classical macroeconomics	65
	3.4.4 Some recent theories of involuntary unemployment	69
	3.5 Growth and development	73
	3.6 Market failure in growth theories	76
	3.6.1 The Harrod–Domar growth model	76
	3.6.2 Neoclassical and post-Keynesian growth models	77
	3.6.3 Endogenous growth theories	78
	3.7 The balance of payments	80
	3.8 Summary	84
	Part II Normative and positive theory of economic policy	
	4 The normative theory of economic policy	89
	4.1 The government as a rational agent	89
	4.2 Planning	89
	4.2.1 Meaning and foundation	89
	4.2.2 The constituent elements of the plan	90
	4.2.3 An example	91
	4.3 Economic policy objectives	92
	4.3.1 Fixed targets	93
	4.3.2 The priority approach	94
	4.3.3 Flexible targets: social welfare function with variable MRS	95
	4.3.4 Flexible targets: social welfare function with constant MRS	97
	4.4 The instruments of economic policy	99
	4.4.1 Definition	99
	4.4.2 The different types of instrument	100
	4.5 The model	106

	Contents	ix
4.5.1 The structural form of the model		106
4.5.2 The reduced form model		108
4.6 Limits and extensions of the classical approach		110
4.7 The Lucas critique		111
4.8 Summary		114
5 Government failures: elements of a positive theory of economic policy		116
5.1 Representing social groups		116
5.2 Agency problems: the objectives of politicians and the political business cycle		119
5.3 Agency problems: bureaucracy		123
5.4 Social groups, institutions and economic policy		126
5.5 Market and ‘non-market’ failures		127
5.6 The process of defining government intervention		130
5.7 The decentralisation of central government functions and the federal state		131
5.8 Independent authorities		133
5.9 Summary		135
Part III Microeconomic policies		
6 Property rights, corporate governance and public enterprises		139
6.1 Introduction		139
6.2 Making the market work: the minimal state and the attribution of property rights		140
6.3 Property rights and corporate governance		140
6.4 Public enterprises and privatisation		147
6.5 Non-profit institutions		155
6.6 Summary		156
7 Competition policies; policies for externalities and public goods		158
7.1 Competition policy instruments: market liberalisation and international opening		158
7.2 Regulation		159
7.3 Regulation and deregulation of entry; regulation of effective competition		160
7.4 Competition legislation		163
7.4.1 Foundations and nature		163
7.4.2 Antitrust legislation in the United States		164
7.4.3 EU competition legislation		165
7.4.4 Competition legislation in EU member states		173
7.4.5 International coordination of national legislation		173
7.5 Other competition policy instruments; price controls and public enterprises		174

7.5.1	Price controls	174
7.5.2	Public enterprises and competition policies	177
7.6	Externalities, public goods and public policies	178
7.6.1	Taxation	178
7.6.2	Incentives for eliminating external diseconomies	179
7.6.3	Tradable permits to produce diseconomies	180
7.6.4	Regulation	181
7.6.5	Financing and producing public goods	182
7.7	Summary	183
8	Industrial and regional policies; redistributive policies	185
8.1	Dynamic efficiency and industrial policies	185
8.2	The evolution and the tools of post-war industrial policy	186
8.3	Public demand management policies	189
8.4	Regional policy	193
8.5	Redistribution policies and the welfare state	197
8.6	Summary	207
9	Social choice and cost-benefit analysis	209
9.1	Choice criteria in private and public projects	209
9.2	Identifying the effects of a project	214
9.3	Evaluating the effects	215
9.4	Shadow prices	216
9.4.1	Shadow prices in non-competitive markets	217
9.4.2	Shadow wages	217
9.4.3	Choosing the social discount rate	218
9.5	Valuing non-marketed goods	219
9.5.1	Valuing life	219
9.5.2	Valuing the environment	220
9.5.3	Valuing time	225
9.5.4	Cost-effectiveness	225
9.6	Summary	226
Part IV	Macroeconomic policies	
10	Macroeconomic schemes of analysis in an open economy	231
10.1	The balance of payments, the foreign exchange market and the exchange rate	231
10.1.1	The balance of payments and the exchange rate	231
10.1.2	Foreign exchange transactions	235
10.2	Theory of the balance of payments	237
10.2.1	The current account and capital account (movements of goods)	237

	Contents	xi
10.2.2 Capital movements		239
10.2.3 The balance of payments		240
10.3 International openness, analytical frameworks and economic policy		240
10.4 The Mundell–Fleming model		241
10.5 The limitations of the Mundell–Fleming model and ways to overcome them		246
10.6 Summary		248
11 Macroeconomic objectives and monetary policy		249
11.1 Objectives, instruments and models of macroeconomic policy		249
11.2 The monetary economy		250
11.3 Financial intermediaries		251
11.4 Money as a liability of financial intermediaries		253
11.5 The central bank and monetary base		255
11.6 Banks and deposits		263
11.6.1 Banks’ balance sheet and the deposit multiplier		263
11.7 Controlling monetary base and the money supply		268
11.8 (Final) objectives and agents of monetary policy		272
11.9 Monetary policy under fixed and floating exchange rates		274
11.10 The operation of monetary policy; indicators, operative and intermediate targets		277
11.11 Considerations on the effectiveness of monetary policy		280
11.12 Summary		282
12 Macroeconomic objectives and fiscal policy		284
12.1 The budget and its components		284
12.2 Income, employment and taxes		286
12.2.1 Lump-sum taxation		287
12.2.2 Proportional taxation		287
12.2.3 Progressive taxation		288
12.3 Expenditure financing		290
12.3.1 Balancing the budget		290
12.3.2 Deficit financing		291
12.3.3 Monetary base financing		292
12.3.4 Debt financing		296
12.4 Fiscal policy under fixed and floating exchange rates		298
12.5 Public debt		302
12.5.1 Historical developments in selected countries		302
12.5.2 The determinants of the growth in public debt		302
12.5.3 Limits to debt growth		304
12.5.4 Debt-reduction policies		305
12.6 Summary		307

xii **Contents**

13	Incomes and price policies	308
13.1	Introduction	308
13.2	Income distribution, full cost and incomes policy	308
13.3	Coercion and incomes policies	311
13.4	Statist policies	311
13.5	Market-based policies	313
13.6	Institutional policies	314
13.7	Incomes policy and productivity policies	315
13.8	Incomes policy in the real world	315
13.9	Summary	320
14	Balance-of-payments policies	321
14.1	Balance of payments: equilibrium and disequilibrium	321
14.2	Automatic adjustment mechanisms	322
14.2.1	Price changes	322
14.2.2	Income changes	323
14.3	Adjustment policies and the causes of disequilibrium	324
14.4	Policies for adjustment of capital movements	325
14.5	Adjustment policies for excess or insufficient demand	328
14.6	Policies for competitiveness	328
14.7	The controllability of the exchange rate	329
14.8	The effectiveness of exchange rate adjustment	330
14.8.1	Demand elasticity conditions	330
14.8.2	The pass-through of exchange rate variations to prices	332
14.8.3	The elasticity of supply	334
14.8.4	The effect lag: the <i>j</i> -curve	335
14.8.5	The effect on capital movements	335
14.9	The asymmetric effects of a variation in the exchange rate	336
14.10	Internal and external equilibrium: decentralisation and the appropriate assignment of instruments to targets	337
14.11	Summary	341
15	Trade policies: free trade and protectionism	343
15.1	Trade policies and the foundation of free trade	343
15.2	Protectionist instruments	345
15.3	The effects of tariff and non-tariff protection	346
15.4	Protecting ‘infant industries’	348
15.5	Protection as a tool for improving the terms of trade	351
15.6	Protection from cheap labour and social dumping	352
15.7	Protection as an employment policy	353
15.8	Industrial policies and trade policies	354
15.9	Summary	355

Part V Public institutions in an international setting

16 Monetary systems and exchange rate regimes	359
16.1 Monetary systems	359
16.2 The Gold Standard	359
16.3 The Gold Exchange Standard and the International Monetary Fund	362
16.4 Centrally created reserves	365
16.5 Floating exchange rates and the evolution of the IMF	366
16.6 The European Monetary System	371
16.6.1 Objectives	371
16.6.2 Objectives and achievements	372
16.6.3 European Economic and Monetary Union	373
16.6.4 Nominal and real exchange rates in the European Monetary System	374
16.7 Fixed versus flexible exchange rates: reflections from experience	376
16.8 Summary	377
17 Development and trade organisations	379
17.1 The system of cooperative institutions created in the post-war period	379
17.2 The World Bank	380
17.3 Multilateral governance of trade: GATT and the WTO	382
17.3.1 GATT	382
17.3.2 The Uruguay Round	383
17.3.3 The WTO	385
17.4 The impact of domestic economic policies and international cooperation on trade	387
17.4.1 Foreign investment and multinational companies	388
17.4.2 Environmental policy	388
17.4.3 Competition policies	388
17.4.4 Social dumping	389
17.5 Inequality of starting points among countries and permissive and distortive policies	389
17.6 Summary	390
18 Regional public institutions: The European Union	392
18.1 European integration	392
18.2 The institutions of the European Union	393
18.3 The operation of a monetary area	394
18.4 Monetary policy	396
18.4.1 Institutions and organs	396
18.4.2 Tasks, functions and status of the ESCB	397

18.4.3	Modes of intervention and monetary policy instruments of the ESCB	398
18.4.4	The structure of the financial sector	403
18.4.5	Considerations on the monetary policy arrangements of European Monetary Union	404
18.5	Exchange rate policy	406
18.6	Fiscal policy	407
18.7	The structural funds and redistributive policies	411
18.8	Industrial and trade policies	412
18.9	Environmental policy	415
18.10	Summary	416
 Part VI Globalisation and the quest for a new institutional setting		
19	The internationalisation of private institutions: the globalisation of markets and production	421
19.1	Forms of globalisation	421
19.2	The new features of globalisation	426
19.3	The causes of globalisation	427
19.4	The impact of globalisation	430
19.5	Globalisation and competitiveness	431
19.6	The consequences of globalisation for economic policy	434
19.7	Summary	435
20	The challenges of globalisation for public policies	437
20.1	International payments imbalances since the 1970s	437
20.2	The role of capital mobility	440
20.2.1	Nature and size of international capital movements	440
20.2.2	Speculative capital movements and currency crises	444
20.3	The role of international institutions in recent currency crises	446
20.4	The case for international coordination	448
20.5	International coordination in formal terms	460
20.6	International coordination (multilateralism) and regionalism	463
20.7	Summary	464
	<i>Bibliography</i>	465
	<i>Author index</i>	492
	<i>Subject index</i>	498

Boxes

2.1. Global public goods: the environment and sustainable development	<i>page</i> 27
4.1. Time inconsistency: fixed rules and discretionary intervention	102
6.1. Corporate governance and the role of financial markets; the function of takeovers	143
6.2. The welfare impact on consumers of British privatisations	151
7.4.3 Defining the relevant market: imports and recycled products and the ‘cellophane fallacy’	167
7.2. The antitrust paradox	169
7.3. A case study: the General Electric–Honeywell merger	170
7.4. Yardstick competition as an instrument for dealing with information asymmetry	177
8.1. Tools of selective and horizontal industrial policy	188
8.2. Automatic and discretionary incentives	189
8.3. Industrial policy in France and Japan	190
8.4. Regional development policy in Italy	194
8.5. Empirical studies of the effectiveness of the welfare state	200
8.6. The impact of the welfare state on efficiency	203
9.1. Valuing the benefits of conservation of the Fès Medina	221
11.1. Financial regulation: why and how?	255
11.2. Supervising financial activity: how many regulators should there be?	260
13.1. Wage bargaining in Europe since the 1980s	316
16.1. SDR valuation, 30 April 2003	366
16.2. The IMF’s regular financing activities	369
16.3. The IMF’s financing mechanism	370
17.1. The European Union, the WTO and the ‘banana war’	385
18.1. Collateral in financial transactions and credit in the ESCB	401
18.2. The Stability and Growth Pact: proposals for reinterpretation or amendment	408
19.1. The division of labour within a transnational corporation	424
19.2. Transnational corporations, entry barriers and market concentration: three examples from the United Kingdom	432

Cambridge University Press
0521540380 - Economic Policy in the Age of Globalisation
Nicola Acocella
Frontmatter
[More information](#)

xvi	List of boxes	
20.1.	Financial stability as a global public good and policy attitudes	441
20.2.	International cooperation to protect the environment	449
20.3.	Complementarity or substitutability between protecting the environment and fighting hunger?	452
20.4.	Globalisation and tax policy	455

Tables

1.1 An overview of the discipline of economic policy	page 5
2.1 Limitations of justifications of the market economy based on the first theorem of welfare economics	15
2.2 Prisoner's dilemma and public goods	31
2.3 Global poverty regional breakdown, 1987, 1990, 2000	40
3.1 Unemployment as a percentage of the total labour force in selected industrial countries, various years	47
3.2 Average annual percentage change in consumer prices in selected industrial countries, various years	52
3.3 Balance of payments of the euro area, 1997–2002	83
4.1 Misery indices in selected OECD countries, 1970–2003	98
5.1 Main independent authorities in selected Western hemisphere countries	134
6.1 Public enterprises: employment, value-added and gross capital investment as a percentage of the non-agricultural market sector, 1991	148
6.2 Privatisation receipts in selected European countries, 1992 and 2000	148
6B.1 Price indexes, 1974–1999	152
8B.1 Corrected family income distribution, United States, 1984	200
8B.2 Relative poverty rates, circa 1991	201
11.1 The balance sheet of a bank: I	264
11.2 Stages of the deposit multiplication process	266
11.3 The balance sheet of a bank: II	267
11.4 Effectiveness of expansionary monetary policy on income under different exchange rate regimes and different degrees of capital mobility	277
12.1 Effects of an increase in prices and income in the presence of progressive taxation	289
12.2 Total expenditure, current revenues and overall general government budget balances as a percentage of GDP in the seven leading industrial countries, 1970–2003	293

xviii	List of tables	
	12.3 Effectiveness of expansionary fiscal policy on income under different exchange rate regimes and different degrees of capital mobility	302
	12.4 The public debt in various European countries, 1970–2003	303
	15.1 Comparative costs	344
	16B.1 SDR valuation, April 2003	366
	19.1 Exports as a percentage of GDP in selected developed countries, 1950, 1973, 1998	422
	19.2 International movements of bank capital as a percentage of world GDP, international trade and gross fixed capital formation, 1964, 1980, 1991	422
	19.3 Cross-border transactions in bonds and equities as percentage of GDP, 1975–1998	422
	19.4 Growth in FDI and multinational companies, 1960–2002	426
	19.5 Exports as a percentage of GDP in selected developed countries, 1870, 1913, 1929, 1998	426
	19.6 Changes in transport and communications costs, 1930–1990	428
	19.7 Duties as a percentage of the value of manufactured goods, 1913, 1950, 1990, 2004	428
	19.8 Trade barriers, convertibility and capital movement rules in the main developed countries in the twentieth century	429
	20.1 The benefits of cooperation in a ‘prisoner’s dilemma’ setting	461

Symbols, abbreviations and acronyms

Symbols

a	coefficient measuring sensitivity of investment to interest rate
A	autonomous expenditure
b_a	cyclically adjusted budget balance as a percentage of GDP
b_s	total budget deficit or surplus as a ratio of GDP
b_t	benefits at time t
B	total discounted benefits; in a different setting, public debt
B_s	total budget deficit or surplus
BMB	bank monetary base (bank reserves)
BP	deficit or surplus on the balance of payments in real terms
BP_m	deficit or surplus on the balance of payments in monetary terms
c	marginal (and average) propensity to consume
c_t	costs at time t
C	total discounted costs; in a different setting, consumption
C_g	government consumption
CA	current and capital account (movements of good) in real terms
CA_m	current and capital account (movements of goods) in monetary terms
CR	loans
D	deposits
e	nominal exchange rate
e_r	real exchange rate
ε_m	import elasticity
ε_x	export elasticity
g	gross mark-up rate
G	government expenditure
G_p	primary government expenditure
h	ratio between currency in circulation and deposits
i	nominal interest rate
I	private investment
I_g	government net investment

xx	List of symbols
<i>INT</i>	interest on public debt
<i>j</i>	ratio between bank monetary base and deposits
<i>k</i>	fraction of income held as monetary balances
<i>K</i>	capital
<i>KA</i>	net capital movements
<i>l</i>	government spending multiplier
<i>L_s</i>	money supply
<i>LF</i>	labour force
<i>M</i>	imports
<i>m</i>	propensity to import
<i>M_w</i>	Rest of the World imports
<i>m_w</i>	Rest of the World propensity to import
<i>MB</i>	monetary base; in a different setting, marginal benefit
<i>MC</i>	marginal cost
<i>MR</i>	marginal revenue
<i>MRS</i>	marginal rate of substitution
<i>MRTS</i>	marginal rate of technical substitution
<i>MRT</i>	marginal rate of transformation
<i>N</i>	employment
<i>p</i>	price or absolute price level (in the home country)
<i>\dot{p}</i>	inflation rate
<i>p^e</i>	expected price
<i>\dot{p}^e</i>	expected inflation rate
<i>p_m</i>	import price expressed in terms of foreign currency
<i>p_x</i>	export price expressed in terms of domestic currency
<i>p_w</i>	absolute price level in the foreign country
<i>P</i>	population
<i>PMB</i>	the public's monetary base or currency in circulation
<i>π</i>	average labour productivity
<i>q</i>	quantity consumed or supplied in a given period
<i>q_x</i>	quantity exported
<i>q_m</i>	quantity imported
<i>Q</i>	quantity produced since the beginning of production
<i>r</i>	real interest rate
<i>R</i>	profits
<i>S</i>	savings
<i>t</i>	time; in a different setting, tax rate
<i>T</i>	time horizon; in a different setting, total transactions; in still another setting, taxes or current revenues; sometimes used to indicate taxes less transfers
<i>Tr</i>	total government transfers
<i>Tr_c</i>	current transfers less interest on public debt
<i>Tr_k</i>	capital transfers

Tr_h	transfers to households
TT	terms of trade
u	unemployment rate
U	total unemployment
v	sensitivity of speculative demand for money to interest rate
V	money velocity of circulation
w	wage rate or unit labour cost
W	welfare function (or level); in a different setting, wages
X	percentage decided by the regulator to be subtracted to the rate of change in the retail price index; exports in a macroeconomic setting
Y	income as output or demand
Y_n	natural rate of employment income
Y_w	Rest of the World income
\bar{Y}	Full employment income

Abbreviations and acronyms

ACP	African, Caribbean and Pacific
ASEAN	Association of South East Asian Nations
BIS	Bank for International Settlements
BIT	Bureau International du Travail
CAP	Common Agricultural Policy
CBA	Cost-benefit analysis
CET	Common external tariff
CSF	Community Support Framework
CVM	Contingent valuation method
DCE	Domestic credit expansion
DSB	Dispute Settlement Body (GATT)
EAGGF	European Agricultural Guidance and Guarantee Fund
EC	European Community
ECB	European Central Bank
ECSC	European Coal and Steel Community
EEA	European Economic Area
EEA	European Environment Agency
EEC	European Economic Community
EFF	Extended Fund Facility (IMF)
EIA	Environmental impact assessment
EIB	European Investment Bank
EMI	European Monetary Institute
EMS	European Monetary System
EMU	European Monetary Union
EONIA	Euro Overnight Index Average
EP	European Parliament

xxii **List of symbols**

ERDF	European Regional Development Fund
ERM	Exchange Rate Mechanism
ESCB	European System of Central Banks
ESF	European Social Fund
EU	European Union
FDI	Foreign direct investment
FIFG	Financial Instrument for Fisheries Guidance
FSA	Financial Services Authority
FTA	Free trade area
FTAA	Free Trade Area of the Americas
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GEF	Global Environmental Facility
GRA	General Resources Account (IMF)
GHG	Greenhouse gas
GNP	Gross national product
HDI	Human Development Index
IBRD	International Bank for Reconstruction and Development
ICN	International Competition Network
ICT	Information and communication technology
IDA	International Development Association
IFC	International Finance Corporation
ILO	International Labour Office
IMF	International Monetary Fund
IPR	Intellectual property rights
IRR	Internal rate of return
IT	Information technology
LDC	Less-developed country
MFA	Multifibre Agreement
MFN	Most favoured nation
MIGA	Multilateral Investment Guarantee Agency
MNC	Multinational corporation
NAFTA	North American Free Trade Area
NBFI	Non-bank financial intermediary
NCB	National Central Banks
NCM	New classical macroeconomics
NPV	Net present value
NTB	Non-tariff barrier
OECD	Organisation for Economic Cooperation and Development
OMA	Orderly market agreement
OMO	Open market operation
PPP	Purchasing power parity

QMV	Qualified majority voting
QR	Quantitative restriction
R&D	Research and development
REH	Rational expectations hypothesis
SDR	Special Drawing Rights (IMF)
SEA	Single European Act
SEM	Single European Market
SGP	Stability and Growth Pact
SRF	Supplemental Reserve Facility (IMF)
SSA	Sub-Saharan Africa
SWF	Social welfare function
TARGET	Trans-European Automated Real-time Gross Settlement Express Transfer
TEU	Treaty on European Union
TFP	Total factor productivity
TIP	Tax-tied incomes policies/Tax-based incomes policies
TNC	Transnational corporation
TRIMs	Trade-Related Investment Measures
TRIPS	Trade-Related Aspects of Intellectual Property Rights
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
VER	Voluntary export restraint
WTO	World Trade Organisation

Preface

Some forty years ago, there were rather simple and commonly accepted justifications for government intervention in the economy.

Market failures at both the microeconomic and the macroeconomic level were considered so widespread and deep as to justify programmed action by government. In the late 1940s authors such as R. Frisch, J. Tinbergen, H. Theil and others began to develop the so-called ‘theory of economic policy’. On the basis of fixed targets or a social preference function, as well as an analytical model of the economy and the assumption of rational policymakers, consistent levels of policy instruments were derived for static and dynamic settings.

This theory had to face two main challenges. The first was advanced on theoretical grounds by economists such as Coase, Friedman, Lucas and adherents of the theory of ‘public choice’, who tended to reaffirm the virtues of the ‘invisible hand’ while underscoring numerous ‘non-market failures’. This challenge was largely met by the theory of economic policy, which, on the one hand, recognised the possible existence of government failures and, on the other, was reformulated in a way to overcome charges of inconsistency.

The second challenge to the theory of economic policy has come more recently from the evolution of reality, with the globalisation of markets and production. Globalisation has induced major changes in society, the economy and economic policy. Globalisation has given rise to a considerable change in the distribution of income both among and within countries, often creating economic and social problems that governments have struggled to address. In addition, globalisation has increased the exposure of economies to external shocks by increasing their degree of international openness. Most importantly, globalisation tends to reduce the *decisionmaking independence* of a country, since its economic conditions cannot diverge significantly from those in other economies. A specific aspect of this reduction in national policymakers’ independence derives from the fact that almost no policy has only domestic effects. Exposure to the global market thus constrains divergent behaviour by public (as well as private) agents in the country in question. In particular, countries are exposed to the negative consequences of *permissive economic policies* in other countries that seek to encourage consumers and firms to move in. More generally, each national government faces

constraints in the short term on its freedom to expand demand or to adopt structural policy measures that increase the short-term costs of agents located in that country, even if such measures could produce positive effects in the long term.

At the root of the problems that globalisation poses to the effectiveness of public corrective action to remedy microeconomic and macroeconomic market failures is the separation that it creates between the geographical scope of private institutions (markets and firms), which are increasingly planetary in reach, and that of public institutions, which largely remain national – or, at most, regional – often hampering the effectiveness of their action at the global (multilateral) level. This separation underlies the growing problems of controlling public action, but these problems do not leave firms unscathed, as they may reduce performance, at least in the long term.

This book has a dual purpose: first, to assess the impact on public conduct of private action in a global context; second, to offer an overview of the difficulties of public action in a globalised environment, and of trends within national governments and regional and multilateral international organisations. It is addressed to students of business courses, seeking to give them a framework in which to set corporate strategies with an awareness of the terms on which public choices are made.

Part I of the book is devoted to a brief discussion of the arguments both for and against the market. The analysis of microeconomic failures is completed by a discussion of market failures that, given the present state of the discipline, can be best analysed from a macroeconomic standpoint.

Part II of the book is devoted to a restatement of the ‘classic’ normative theory of economic policy developed by Frisch, Tinbergen, Theil and others and to examining criticism of this position, from the Lucas critique to the theory of political business cycles and the theory of bureaucracy. Non-market failures are then discussed and, to a certain extent, compared with market failures.

Taking both market and non-market failures into account, an analysis of specific policy targets and instruments follows in part III, which deals with microeconomic policies. The problems analysed in this part concern property rights, corporate governance, public enterprises and privatisation; competition policies; policies for externalities and public goods; industrial and regional policies, redistributive policies; social choice and cost-benefit analysis (CBA).

Part IV considers macroeconomic policies in an open economy, dealing with monetary policy, fiscal policy, incomes and price policies and general balance of payments policies.

Part V is concerned with the role of public institutions in an international setting. It analyses public institutions, in both the multilateral sphere (such as international monetary systems and exchange rate regimes; development and trade organisations) and at the regional level (the European Union).

Part VI deals with the internationalisation of private institutions – i.e. the globalisation of markets and production, the challenges of globalisation for public policies and the quest for a new institutional setting.

This textbook is intended for students who have completed at least a full year’s study of both microeconomics and macroeconomics. No calculus is required, except for a very few passages. Some boxes are added to most chapters to deal with specific issues, often of a practical nature. Each chapter is completed by a summary. A detailed subject index makes the book a helpful resource for consultation by the educated public in general. A list of symbols, abbreviations and acronyms used in the text is provided at the beginning of the book.

The terms **emboldened** in the text are key economic terms that the reader must absorb as fundamental building blocks for their understanding of the subject.

This English edition owes much to a number of people or institutions who contributed to it in various ways. Maria Pianta wrote one of the boxes. For other boxes, I drew extensively on works by Scott Barrett, Massimo Florio, Vito Tanzi and Jelle Visser. Other boxes reproduce parts of official documents of the ECB, IMF, UNCTAD, World Bank and WTO. Luciano Milone, Alessandro Noce and Pietrantonio Valentino read parts of the text or gave their advice for improving it.

This book would have been impossible without the financial support of the Cassa di Risparmio di Pescara in meeting the costs of translation.

Veronica Fedeli contributed her time and effort with generosity. Brendan Jones translated the book with care and skill. Nicola Burton efficiently assisted in preparing the volume and Chris Harrison carefully steered the book along its path and provided me with valuable suggestions. I give my heartfelt thanks to all.

The book is dedicated to my children, Valerio and Roberta, who, as globetrotters, can be thought of as living examples of globalisation.

I would be very grateful to readers who report any errors they may find or who wish to offer suggestions and comments (nicola.acocella@uniroma1.it).

Nicola Acocella
University of Rome ‘La Sapienza’