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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).

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Translated from the Italian by

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To Valerio and Roberta

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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

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

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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
$\overline{Y}$	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

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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

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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

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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

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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.

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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).

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