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newsletter

Leverhulme Centre for Research on Globalisation and Economic Policy

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Leverhulme Centre
for Research on Globalisation and Economic Policy

SIR RICHARD BROOK VISITS LEVERHULME GLOBALISATION CENTRE

Leverhulme Trust Director, Sir Richard Brook visited the Leverhulme Centre for Research on Globalisation and Economic Policy in May, to meet the research team based in Nottingham and to learn about the Centre's research and dissemination programmes.

During a round table meeting involving a large number of internal researchers within the Centre he was given the opportunity to hear in some detail the work being conducted and to question the researchers. Holger Görg outlined the current work on multinational firms while Ben Ferrett spoke about the theoretical models of greenfield versus brownfield FDI he has developed. Richard Kneller reviewed the work being conducted on exports and firm performance, while Peter Wright spoke about immigration in the UK and Spain. Alan Duncan outlined emerging themes in the Internationalisation of Economic Policy Programme, including those which featured in a recent conference at Tulane University.

Commenting on his visit to Nottingham, Sir Richard said "The Leverhulme Trust takes particular pleasure in those of its awards which can make a demonstrable difference in the way in which a subject is perceived in the research world. It is accordingly splendid to see the combination of purpose, energy and authority which the team at Nottingham is bringing to the crucial study of globalisation and its impact."

Sir Richard Brook

World Commission on the Social Dimension of Globalisation

Workshop on ***Globalisation and Labour Market Adjustment in Developing Countries***

Department for International Development, 8th April 2003

The International Labour Organisation's *World Commision on the Social Dimension of Globalisation* (WCSDG) was initiated in February 2002, to identify pro-growth poverty reducing measures to ensure that the benefits of globalisation are more evenly spread. The Workshop was a contribution to the deliberations of the Commission, sponsored by the Department for International Development and held in London. The Workshop was convened and facilitated by David Greenaway and Oliver Morrissey, with some 30 participants (academic, government and civil society) from ten different countries. The Chair of the ILO's Governing Body, Lord Brett, and DFID's Chief Economist, Professor Adrian Wood, were involved in the proceedings.

The initial discussion concentrated on what economists would generally predict the effects of globalisation on labour markets to be and why these predictions may not have been realised in practice. A specific issue was that policy-makers concerned with managing the effects of globalisation need to concentrate on mitigating the short-run adjustment costs. Typically, adjustment costs are highest in those countries least able to bear them – the poorest countries facing the greatest constraints on supply response – and these are also the countries that appear to benefit least from globalisation. The Workshop was especially concerned with what have been the experiences of, and implications for, low-income countries.

The benefits from globalisation in any country tend to be biased towards technology-intensive firms and relatively skilled labour (which disfavours the poorest countries), with implications for labour relations. There is increasing fragmentation of labour as work is seen as an individual rather than collective activity; workers compete for casual low-paid employment. Stronger labour market regulations are portrayed as weakening competitiveness, thus undermining growth of employment and production. This relates to casualisation of labour as globalisation has been associated with lessened security of tenure while the technology bias and pressure to raise productivity have tended to reduce manufacturing employment. Most of the discussion concerned identifying appropriate policy responses to these pressures on employment levels and standards.

Despite the diversity of participants at the Workshop and the rich agenda of issues covered, there was considerable agreement on a range of policy implications and even some recommendations. These are summarised below.

- Globalisation - the growth in trade, cross-border investment and migration - over a very long period of time has been associated with increased income and reduced poverty in a large number of countries. Although there are differences between the present wave of globalisation and past waves, there are also similarities. There are therefore opportunities for benefits.

- Globalisation in itself is not sufficient to guarantee a better growth performance, even in the long run. Other complementary policies are essential, both economic (such as macroeconomic policies) and non-economic (for example, to provide a stable and transparent institutions). Some of these policies will relate to labour, at least supporting basic worker rights.

- It is essential to distinguish between the short run and long run. Policies which are intended to promote integration with the world economy (like trade liberalisation) can impose short run costs, which can include reductions in employment and/or in real wages of those employed in import competing activities. These adjustment costs are not evenly dispersed - they tend to be concentrated on vulnerable groups and especially in the poorest countries.

- The existence of adjustment costs is not in itself an argument against change. One can plausibly argue that adjustment costs are the price we must pay for change. However, that price need not be taken as a given and policy intervention should be tailored to minimising adjustment costs and smoothing the transition from the short run to the long run. In particular, it is possible to identify who is most likely to bear these costs and to design social protection mechanisms. Timing, sequencing and implementation should all be fashioned by the policy context in general and the characteristics of the labour market in particular.

- Evaluation of labour market conditions should not only take into account pre-existing unemployment but also structural characteristics related to racial, cultural and gender based segmentation. Appropriate interventions must be tailored to the specific country context.

- Compensation mechanisms have a role to play, both in a multilateral and national context. With regard to the former, continued transfers from the richest to the poorest countries are clearly important. With regard to national mechanisms, there is considerable experience with a range of schemes in the North though few are evidently transferable to the poorest countries, given their high costs. They are therefore probably only relevant in the very short run.

- Retraining programmes have a role to play and this is clearly an area where targeted investment from the multilateral agencies is vital. The development of mechanisms to underpin national qualification standards has enjoyed success in a number of countries, as have schemes to support enterprise level training schemes.

COLLECTIVE ACTION AND TRANSNATIONAL TERRORISM

The September 11th attacks in the US highlighted a number of the problems governments face when trying to deal with terrorist action. The question is what they do to overcome the collective action problem. ***Todd Sandler*** *is Robert and Katheryn Dockson Chair of International Relations and Economics at the University of Southern California and an External Fellow of GEP. This is a summary of a GEP working paper 2003/13 and is based on the* Leverhulme Globalisation Lecture *given by Todd in March 2003.*

The purpose of this paper is to investigate the nature of transnational terrorism and some of the collective action issues that it poses in the aftermath of 9/11. In particular, rationality is investigated from alternative viewpoints that include the terrorist group's leaders, suicide bombers, and the targetted government. Additional difficulties, associated with the deterrence and pre-emption dilemmas of targetted governments, are discussed. These governments' cooperative failures are shown to play into the hands of networked terrorists, who utilise their collective strengths to augment these governments' inadequate and non-cooperative responses. Other collective action failures on the part of governments that involve intelligence and duplication of efforts are investigated. Another purpose is to identify what works and what does not against terrorism. Finally the costs of terrorism are addressed for a globalising society.

The analysis demonstrates that terrorists have been adept at solving their collective action problem owing to their weakness and their need to pool resources, intelligence, training, and even personnel. In addition, the terrorists are relatively united in their hatred of a few countries – the United States, Israel and the United Kingdom. Terrorists take a long-term view of their struggle and consider their interactions with other groups as continual. This long-term viewpoint fosters their cooperation. In contrast, governments take a short-term view (limited by the election period) of the terrorist threat and do not necessarily consider their interaction with other governments as continual. Governments place great weight on the importance of their autonomy over national security and this inhibits their ability to cooperate with other governments. In addition, countries perceive their risks differently – that is, some are worried about being the target of an attack and others are not – and possess economic interests that may be at odds with addressing the terrorist threat.

Terrorists utilise their ability to cooperate and the governments' inability to cooperate to their advantage by prodding for the weakest defense among governments. Once this weakest-link is uncovered, the terrorist dispatch their best team to exploit this weakness. Obviously, governments must cooperate to a greater extent if they want to be effective against the terrorist threat.

Throughout the paper, such cooperative failures are exposed.

"Terrorists utilise their ability to cooperate and the governments' inability to cooperate to their advantage by prodding for the weakest defense among governments. Once this weakest-link is uncovered, the terrorists dispatch their best team to exploit this weakness."

Workshop Summary Contd…..

- Education more generally is, of course, the single most important policy initiative not only to the capabilities of the current stock of human capital but more importantly to human capital accumulation. As many adjustment issues are fundamentally controversial because of inter-generational redistribution, there is a second order long term benefit here.

- Employment on demand schemes or labour-intensive public works can be effective in reaching the poor, but only offer low levels of pay. Nevertheless, these can be an important means to mitigate adjustment costs in poor countries.

- There is little evidence that minimum wages are helpful in poor countries. Typically, the minimum is actually very low, only benefits a few workers and constrains growth of the formal sector (which is needed to drive growth).

- Trade Unions do have an important role to play but this is most effective if they accept the need to negotiate labour market flexibility to address the challenges, rather than if they try to resist pressures associated with globalisation.

- A relaxation of hiring and firing legislation is more likely to be acceptable and effective if combined with social protection mechanisms. Labour market regulation often fails in poor countries because it is difficult to ensure compliance.

- Ultimately, it is sustained economic growth that offers the greatest potential for increasing employment, labour conditions and incomes. Globalisation offers opportunities. The challenge is how the poorest can be helped to benefit from these opportunities and share in growth.

David Greenaway & Oliver Morrissey

Conference: Trade and Labour Perspectives on Worker Turnover

University of Nottingham

June 27th - 28th 2003

Richard Upward

In June 2003 *GEP* hosted an international conference on *Trade and Labour Perspectives on Worker Turnover*, jointly organised by Richard Upward and Peter Wright (GEP and Nottingham University), and Carl Davidson and Steve Matusz (GEP and Michigan State University). The conference attracted participants from North America and Europe as well as the UK.

Trade economists and labour economists have tended to treat the movement of workers between jobs, or between employment and unemployment, very differently. Trade economists have relied on general equilibrium models which describe the long-run outcomes for workers before and after any adjustment. Labour economists, in contrast, have focused on the process of adjustment itself, and on the potential costs of adjustment in terms of, for example, unemployment or loss of earnings. The conference drew together economists specialising in both trade and labour economics to discuss these issues in the context of increasing international trade, cross-border investment and migration.

Several papers attempted to integrate models of trade with more realistic models of the labour market. John McLaren (University of Virginia) *The simple analytics of trade and labour mobility* (with Subham Chaudhuri) presented a model which allowed for large gross flows as well as net flows of labour. Steve Matusz (Michigan State University) *Trade and turnover: theory and evidence* (with Carl Davidson) test a model which relates patterns of trade to worker turnover in a search model. They show that turnover itself may be an important component of comparative advantage.

More realistic models of the labour market also recognise that unemployment is a pervasive phenomenon. Udo Kreickemeier (GEP) *Efficiency wages and unemployment in a global economy* and Carsten Eckel (University of Passau) *Labour market adjustments to globalisation: unemployment versus relative wages* both presented models of the impact of trade in the presence of unemployment which arises because wages cannot be reduced to clear the labour market.

In addition to unemployment, workers may also take jobs in the so-called “informal” sector, with reduced worker benefits and protection. Nina Pavcnik (Dartmouth College) *The response of the informal sector to trade liberalisation* (with Pinelope Goldberg) analysed the impact of changes in trade policy and labour market liberalisation on the number of workers in this sector.

The process of worker turnover may also affect the preferences which workers have about trade policy. Scott Bradford (Brigham Young University) *Protection and Unemployment* and Chris Magee (Bucknell University) *Trade, Turnover and Tithing* (with Carl Davidson and Steve Matusz) both showed that workers in industries whose jobs are less “safe” (because the have higher turnover rates) are less likely to lobby for protection, or receive less trade protection because, essentially, they have less to lose from increased international competition.

The modern analysis of labour markets focuses on the flows of workers that result from the creation and destruction of jobs and the resulting search behaviour of workers and firms. Scott Schuh (Federal Reserve Bank of Boston) *Permanent and temporary job flows and the real exchange rate* (with Michael Klein and Robert Triest) showed that, contrary to earlier work, the real exchange rate has a significant impact on the creation and destruction of jobs within narrowly-defined industries. Olga Kupets (Kiev Mohyla Academy) *Trade liberalisation and employment effects in Ukraine* (with Atanas Christev and Hartmut Lehman) and David Brown (Heriot-Watt University) *Inter-establishment reallocation, productivity growth and the effects of privatisation and liberalisation* (with John Earle) presented analyses of the job flows resulting from the massive liberalisation and trade “shocks” experienced by Russia and the Ukraine in the last 20 years.

Two papers considered the labour market flows associated with the growth in demand for certain types of skilled labour. Richard Upward (GEP) *Snakes or ladders: skill upgrading and occupational mobility* (with Peter Wright) showed that “skill upgrading” may have had some positive impact on workers in lower skill groups by increasing their chances of promotion. Barbara Dluhosch (Hamburg) *Trade exposure, fragmentation and labour market flows* considered the flows of labour which result from trade-induced technological change, and presented a model which can account for the simultaneous increase in demand for both high- and low-skill service workers.

An additional aspect of labour mobility is that between countries, which has become quantitatively and socially more important in recent years. Nicolas Schmitt (University of Geneva) *International brain mobility and intra-industry trade* (with Jean Mercenier) analysed the movement of skilled workers, and showed that in certain industries even relatively small numbers of workers moving between countries can have large effects on the pattern of production.

Further information and copies of the papers presented at this conference can be found on the GEP website at http://www.nottingham.ac.uk/leverhulme/conferences/june03.html

Issues in the Design of Regional Trade Agreements (RTAs)

*There has been a marked increase in the popularity of Regional Trade Agreements over the last few years. In this article **Mark Melatos** considers under what conditions countries will agree to form RTAs, and what form will they take. Mark is a Lecturer at the University of Sydney, Australia. This article was written during Mark's visit to Nottingham in June 2003.*

In the last twenty years RTAs have increased in popularity. This trend appears to be accelerating: according to the WTO, since 1995 the number of RTAs has more than doubled. These agreements usually take the form of free trade areas (such as the North American and ASEAN FTAs) or, less often, customs unions (such as the European Union and MERCOSUR in South America). The main difference between free trade areas and customs unions is that, in the latter, members agree to set a common external tariff (CET) on imports from non-members; in the former members set their external tariffs unilaterally.

Our research focuses on the broad question: what are the likely characteristics of observed RTAs? In the event that a number of countries agree to form a customs union, how will they choose their preferred CET rate and how will they redistribute the revenue so raised among themselves? More generally, under what conditions will prospective partners agree to form a free trade area in preference to a customs union (or vice versa)? In what follows, I discuss some results from our research on customs union formation.

From the policymaker's point of view, issues such as these are vitally important. Their resolution can provide strategic guidance on whether a particular country should enter into a preferential trading relationship, the form this agreement should take and the types of partners it should seek. Moreover, an understanding of the forces which influence such decisions can furnish the domestic policymaker with crucial insights into the likely behaviour of foreign rivals.

While important in their own right, the answers to such questions promise to shed more light on some of regionalism's outstanding and most controversial issues. For example, whether RTAs are a help or hindrance in the pursuit of global free trade may well depend (among other things) on their design. Therefore, a rigorous framework for modeling the formation of RTAs is crucial in order to resolve such vexing policy issues.

The regionalism literature has yet to provide definitive answers to the questions posed above. For example, while free trade areas are more commonly observed in reality, theory invariably predicts that countries seeking to establish an RTA should prefer to form a customs union. The union's CET effectively merges members' trade policies with respect to non-members. This creates significant monopoly power benefits that are not exploitable under the unilateral external tariff-setting environment of a free trade area.

There is also little agreement in the literature as to how customs union members select their preferred CET rate. This is an important issue if members are asymmetric since agreement is unlikely. Furthermore, it has been shown that when non-members have the ability to respond optimally to the union's choice of CET, it may be in the interests of some union members to delegate authority over CET choice to their partner. The issue of internal transfers has also received little attention. Yet this is closely related to the choice of CET. After all, the external tariff rate will help determine the customs union's total tariff revenue which must then be shared among members according to some mutually agreed set of transfers.

Recognizing that RTAs are merely trade contracts between consenting nations, we seek to address a number of the issues raised above. A three-country, three-good perfectly competitive general equilibrium model of the trading world is simulated. Customs union members choose the CET and internal transfers so as to maximize a union social welfare function (a weighted sum of individual member utilities). Within this framework, we develop an algorithm for identifying the set of 'plausible' customs union agreements (defined as those that are Pareto efficient relative to the situation in which all countries stand alone).

It is found that customs unions characterized by seemingly intuitive CET choice rules are often Pareto inefficient. Even when they are efficient, there are invariably numerous alternative union contract designs that appear equally plausible. Customs unions characterized by such problematic CET choice rules are widely assumed in the literature and are usually justified on the basis of intuitive appeal. Examples of intuitive CET choice rules that often prove implausible include: members sharing responsibility for CET choice in proportion to their respective GNPs; members completely delegating external tariff authority to one partner; and the largest (smallest) member having complete control over CET choice.

> *"With the planned expansion of the European Union to incorporate former Eastern Bloc States, this model suggests that the EU will need to increase its reliance on the GNP levy to finance transfers."*

An especially intriguing result is that often the set of plausible customs unions is characterized by negative weights on one member's utility in the union's social welfare function.

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ISSUES IN THE DESIGN OF REGIONAL TRADE AGREEMENTS CONTD…..

Until now, this possibility has been ruled out in the literature. We show, however, that negatively weighting one member's utility may be a *necessary* condition for the formation of a customs union. In other words, it may be in the interests of a union member to actively discount its own welfare!

The inclusion of optimal transfers in the model permits an analysis of how members share CET revenue. A common assumption in the literature is that members keep for themselves the CET revenue raised at their border with the rest of the world. This is a very special sharing rule that precludes discretionary transfers between union members. However, our simulations confirm that discretionary transfers are often necessary to ensure the formation of a customs union. This is more likely the more asymmetric union members are.

While this result demonstrates the importance of transfers from a theoretical perspective, the practical issue of financing is also explored. Consistent with observed practice in the European Union, we find that plausible customs union contracts often require one member to pay a transfer to its partner in excess of the CET revenue raised at its border with the rest of the world. Again, this is more likely the more asymmetric members are. The policy implication is that as union membership diversifies transfers are more likely to be financed, at least partly, out of the payer's GNP. With the planned expansion of the European Union to incorporate former Eastern Bloc States, this model suggests that the EU will need to increase its reliance on the GNP levy to finance transfers.

There is potential for further research into many of the issues raised in the preceding discussion. For example, it would be useful to determine conditions (expressed in terms of model parameters) under which various CET choice rules are plausible.

European Trade Study Group

Annual Conference 9-11 September 2004

will be hosted by the Leverhulme Centre for Research on

Globalisation and Economic Policy

and held at the

University of Nottingham

Greenfield Investment versus Acquisition

*What determines the equilibrium form of FDI? From an industrial-economic perspective this question is interesting because inflows of greenfield-FDI and acquisition-FDI generate distinct host-country market structures (at least in the short run) with (possibly) distinct welfare properties: whereas greenfield-FDI adds an extra plant to the host country, acquisition-FDI changes only the ownership pattern of existing plants. In this article **Ben Ferrett** considers the modelling structure appropriate to answer this question. Ben is a Research Fellow in GEP.*

The research programme described in this article exploits a tension between two stylized facts, one about the real world and the other about recent academic research:

- Foreign direct investment (FDI) is in reality a heterogeneous flow of funds, composed of both greenfield-FDI ('greenfield investment') and acquisition-FDI (cross-border mergers and acquisitions).
- Previous game-theoretic analyses of equilibrium FDI flows have concentrated exclusively on one type of FDI (e.g. Horstmann and Markusen, 1992, on greenfield-FDI; and Horn and Persson, 2001, on acquisition-FDI).

Because neither type of FDI flow is empirically trivial (e.g. UNCTAD estimate that the ratio of acquisition-FDI to greenfield-FDI in aggregate global FDI flows was 4:1 in the late 1990s, and since then cross-border M&A flows have collapsed), the first stylized fact begs the question: 'What determines the equilibrium form of FDI?' From an industrial-economic perspective this question is interesting because inflows of greenfield-FDI and acquisition-FDI generate distinct host-country market structures (at

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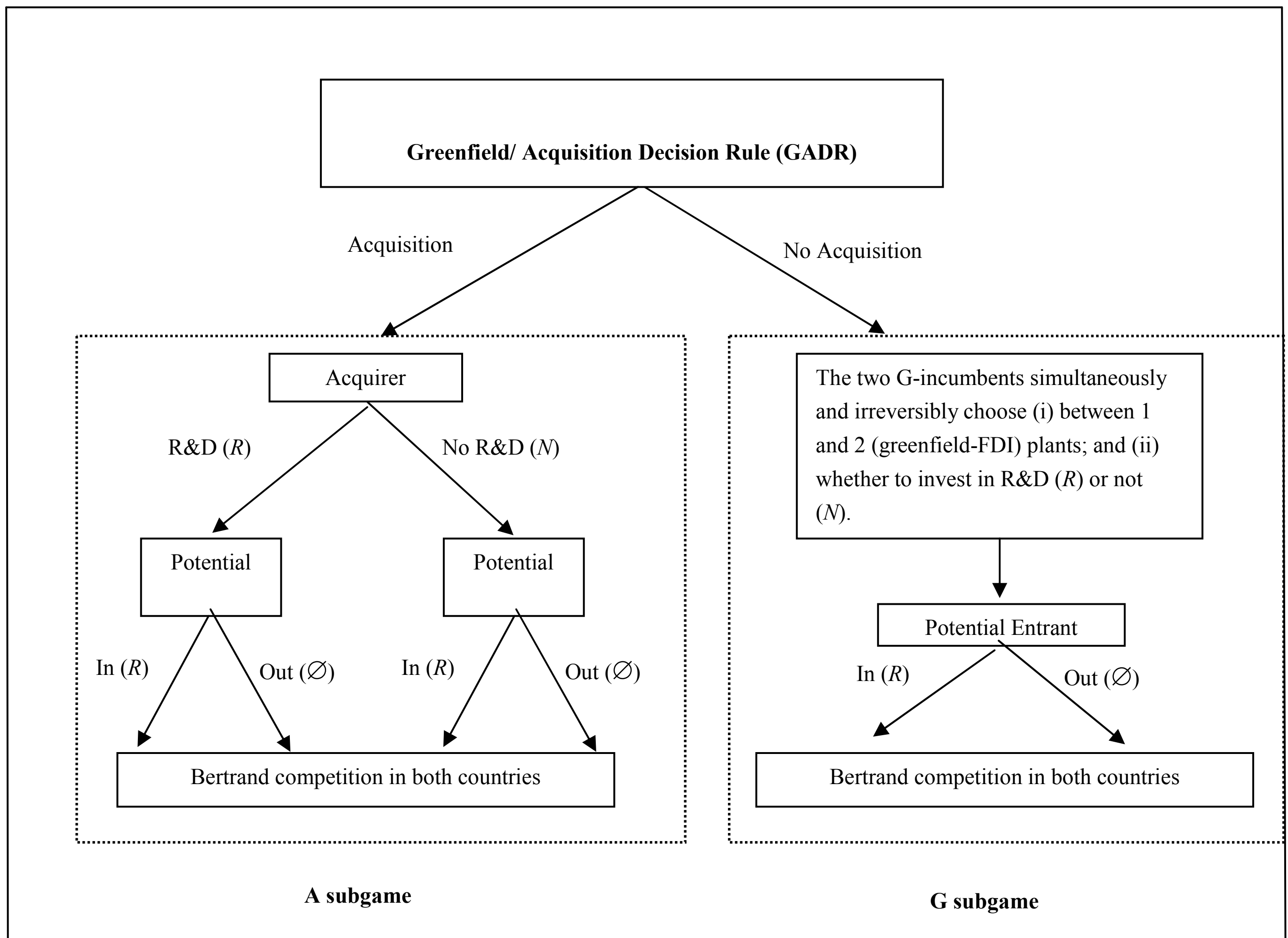
Figure 1: Game Tree of GADR Problem



GREENFIELD INVESTMENT VERSUS ACQUISITION CONTD…..

least in the short run) with (possibly) distinct welfare properties: whereas greenfield-FDI adds an extra plant to the host country, acquisition-FDI changes only the ownership pattern of existing plants. Isolating the determinants of the equilibrium form of FDI requires the development of a modelling structure where the form of FDI is endogenously selected (rather than exogenously imposed), which is the original contribution of this research programme (from the second stylized fact).

To gain insight into what affects the equilibrium form of FDI, we model the equilibrium industrial structures of a concentrated (two-incumbent) global industry that spans two (perfectly segmented) national product markets (i.e. an 'international oligopoly'). Firms' FDI decisions (i.e. whether to produce abroad and what form of FDI to choose) and process R&D decisions are made endogenously, and potential entry into the industry is allowed for.

The game has four stages (see the figure). In stage one, one of the incumbents may purchase the rival incumbent, thereby generating an international flow of acquisition-FDI. If an acquisition occurs, we then enter the Acquisition (A) subgame: in stage two the integrated incumbent (which owns a plant in each country) chooses how much to invest in process R&D. If no acquisition occurs in stage one, we enter the Greenfield (G) subgame: in stage two the incumbents non-co-operatively choose (i) whether to undertake (tariff-jumping) greenfield-FDI and (ii) how much to invest in process R&D. Stages three and four are identical in both the A and G subgames. In stage three the potential entrant decides whether to enter the industry by undertaking process R&D. In stage four market equilibrium in both countries is established via Bertrand competition. The A and G subgames are solved backwards (from stage four to stage two) to isolate their subgame perfect Nash equilibria (in pure strategies). (The equilibria of the G subgame are examined at length elsewhere). The stage-one choice between the A and G subgames is determined by the decision rule (which I refer to as the 'Greenfield/ Acquisition Decision Rule' for convenience) conventionally used in co-operative merger games: acquisition-FDI occurs if and only if it is (strictly) profitable for the incumbents relative to the equilibrium of the G subgame ('threat point').

Two features of our modelling structure generate significant interest. First, the inclusion of *potential entry* means that the choice between the A and G subgames is not a (trivial) comparison of monopoly and duopoly profits. Allowing for a single potential entrant is also the simplest way of making industrial structure endogenous because a key industry characteristic is the number of rival firms. Furthermore, the effect of the entry threat on the incumbents' decisions to sink investments in FDI and R&D can be investigated . Second, the inclusion of *endogenous R&D* decisions implies that monopolization via acquisition-FDI could (logically) increase consumer welfare if R&D is undertaken in the A subgame but not in the G subgame. This in turn allows investigation of a common justification for acquisition-FDI in public policy (the 'failing firm' defence). These welfare issues will be examined in detail in furture work but preliminary results suggest that when the A subgame is played in equilibrium a welfare comparison of the A and G equilibria generally involves a Williamson (1968)-type trade-off between profits and consumers' surplus at a global level. However, when the A equilibrium is selected in small markets it can Pareto dominate the G equilibrium (thus verifying the 'failing firm' defence in special circumstances).

Key positive findings are that acquisition-FDI arises in medium-sized markets (where entry, which would dissipate the integrated firm's profits, does not occur in the A subgame) and that necessary conditions for greenfield-FDI are a large market and a small sunk cost of additional plants. The use of greenfield-FDI to deter entry in the G subgame may prevent acquisition-FDI from arising in equilibrium by bolstering the incumbents' 'disagreement profits' and rendering an acquisition unprofitable. This finding illustrates the importance of analysing both forms of FDI simultaneously: the option of undertaking greenfield-FDI makes acquisition-FDI unprofitable in equilibrium, a point that would be missed in models concentrating exclusively on one form of FDI. The association between trade costs and equilibrium acquisition-FDI can be either positive (as is the association between trade costs and equilibrium tariff-jumping greenfield-FDI) or negative, depending on the probability that R&D investments are successful. The complex association between trade costs and equilibrium acquisition-FDI arises because increases in trade costs offer heightened protection to rival national firms in their home markets, thus (potentially) rendering integration unprofitable. A more general conclusion of this research programme is that greenfield-FDI and acquisition-FDI are theoretically quite distinct (in terms of both the positive and the normative aspects of the industrial structures that they are associated with), which casts severe doubt on the legitimacy of many analyses that treat FDI as a homogeneous flow of funds.

Visitors to GEP 2002/3

November	December	January
Dr Joakim Gullstrand *Lund University* Dr Catia Montagna *Dundee University* Dr Fredrik Sjöholm *Stockholm School of Economics*	Professor Alan Deardorff *University of Michigan*	Professor Ray Riezman *University of Iowa*
March	**April**	**May**
Professor Carl Davidson *Michigan State University* Professor Todd Sandler *University of Southern California*	Dr Joakim Gullstrand *Lund University*	Bob Anderton *European Central Bank* Professor Steven Matusz *Michigan State University* Catia Montagna *University of Dundee* Professor Wolfgang Keller *University of Texas*
June	**October**	**November**
Professor Richard Freeman *Harvard University* Mark Melatos *University of Sydney*	Professor Marc Melitz *Harvard University*	Professor Kala Krishna *Penn State University*

Joint GEP/Murphy Institute Conference on:

The Political Economy of Policy Transfer, Learning and Convergence

On 11-12 April 2003, the Leverhulme Centre for Research on Globalisation and Economic Policy (University of Nottingham) and the Murphy Institute of Political Economy (Tulane University) jointly hosted a conference on the Political Economy of Policy Transfer, Learning and Convergence, bringing together researchers from Universities in the US, the UK and Australia as well as from the International Monetary Fund, the World Bank, the Organization for Economic Cooperation and Development and the World Trade Institute. The interdisciplinary workshop targeted three specific themes; (i) theoretical and methodological issues in the study of policy transfer and convergence; (ii) policy transfer and co-ordination in trade, macroeconomic and development policy; and (iii) evidence and lessons from the internationalisation of public policy.

The Conference began with John Stephens (University of North Carolina) presenting his paper "State Economic and Social Policy in Global Capitalism" (joint with Evelyne Huber). This paper examines the extent of globalisation and the interactions between domestic and international economic and political forces in determining policy reform in OECD and selected Latin American countries. While there is evidence that nearly all countries responded to, more-and-less serious, economic crises with policy reforms, these reforms varied widely across countries and appear not to have produced convergence in policy outcomes. More importantly for the themes of this conference, there is little evidence that common international shocks ("globalisation") play a significant role in explaining either the onset of policy problems or the form of response taken. In a complementary paper, Kevin Grier (University of Oklahoma), in "Convergence: Concepts, Tests and Evidence", critically surveyed research on convergence in macroeconomic performance, concluding that the evidence supporting convergence is, at best, very weak.

The other three papers in the first group were conceptual in nature. Doug Nelson (Tulane University and GEP) presented a paper, jointly authored with Oliver Morrissey (University of Nottingham), "Characterizing International Policy Learning", which develops a suite of models based on statistical decision theory to characterize policy learning in a globalized environment. Where the Morrissey-Nelson paper sought to simplify radically, the other two papers stressed the complexity of policy transfer as it is actually experienced. David Dolowitz (University of Liverpool) used an examination of policy transfer in the EU context to

Leverhulme Centre for Research on Globalisation and Economic Policy
and
Murphy Institute of Political Economy

Conference on
Political Economy of Policy Transfer, Learning, and Convergence

11-12 April 2003
Diboll ConferenceCenter
Tulane University, New Orleans

The **Leverhulme Centre for Research on Globalisation and Economic Policy (GEP)** at the University of Nottingham and the **Murphy Institute of Political Economy** at Tulane University jointly organised a two-day workshop on the Political Economy of Policy Transfer and Convergence, held at Tulane University, New Orleans on 11th and 12th April 2003.

The workshop provided an opportunity for experts in the fields of public, social and trade policy and political economy to present their views on policy transfer and the internationalisation of policy, and drew speakers from universities in the UK (Nottingham, Liverpool, Warwick), the United States (North Carolina,Wisconsin,Tulane, Syracuse, Rutgers) and Australia (ANU), and from international organisations around the world (IMF, OECD, World Bank, the World Trade Institute).

Robert Walker, Professor of Social Policy at the University of Nottingham, addresses the Tulane policy transfer conference

The interdisciplinary workshop targetted three specific themes;
(i) theoretical and methodological issues in the study of policy transfer and convergence; (ii) policy transfer & co-ordination in trade, macroeconomic & development policy; and (iii) evidence & lessons from the internationalisation of public policy.

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TULANE CONFERENCE SUMMARY CONTD…..

develop a number of distinctions stressing the importance of complexity. Similarly, Graham Wilson (University of Wisconsin), "Importing Cooperation in Environmental Policy", considers the case of attempts by two governments (UK and Wisconsin) to transfer environmental policies from abroad to their local polities. Wilson emphasizes the difficulty of transplanting policies which are successful in one set of political and economic institutions to environments with different institutions.

The next set of papers focus on policy transfer and coordination in trade, macroeconomic and development policy. Richard Hemming (IMF), in "Policies to Promote Fiscal Discipline", considers a number of policies, primarily related to transparency and fixed rules, which promote fiscal discipline. In particular, he examines the spread of such rules in OECD and developing countries and the role of institutions such as the IMF in promoting such rules. Robert Franzese (University of Michigan), in "Modelling Spatial Relationships in International and Comparative Political Economy: An Application to Globalization and Capital Taxation in Developed Democracies" (jointly authored with Jude Hays also of the University of Michigan), seeks to develop some new econometric techniques to examine questions closely related to those raised in John Stephens presentation. Applying these methods, Franzese reported strong evidence of globalization effects that appear to be consistent with increased global mobility of capital and international tax competition. Thomas Prusa (Rutgers University) and Chris Milner (University of Nottingham) consider adoption of common policies among Northern and Southern countries, respectively. Prusa, in "Retaliation as an Explanation for Antidumping" (jointly authored with Susan Skeath, Wellesley College), provide an empirical evaluation of four hypotheses that might account for the global pattern of antidumping filings, concluding that strategic behaviour is a major explanator of such behaviour while attempts to regulate "fairness" are not. Milner, in "Learning, Herding and Coercion: The Case of the 'Trade Policy Revolution' in Africa", concludes that, given the limited impact of reforms, it would be difficult to conclude that learning effects are particularly strong, while "coercion" in the form of policy conditionality seems to have been significant in a large number of cases. The final paper in this group, by Julian Clarke, Simon Evenett (both World Trade Institute) and J. David Richardson (Syracuse University), "Recent Cross Border Competition Policy: Transfer and Convergence", describes current attempts to document the spread of competition laws and mechanisms supporting/inducing that spread in a way that parallels the discussion of trade policy reform in the Milner paper.

The last set of papers focus on international policy transfer and learning for a number of cases of domestic policies: welfare, income support, pension reform and funding for higher education. Across a wide range of issues related to welfare policy reform, Robert Walker (University of Nottingham) and Michael Wiseman (George Washington University), in "Refreshing Reform: Ideas from British Welfare Strategy", examine the possibilities that the lessons of British welfare reform could be used to advance current debate in the US on similar topics. In a closely related paper, Alan Duncan (University of Nottingham), Mark Pearson (OECD) and John Karl Scholz (University of Wisconsin), "Is There an Emerging Consensus in Making Work Pay Policies?", examine the interaction between policymakers in the US and the UK in developing income support for working families. Similarly, in David Greenaway (University of Nottingham) and Bruce Chapman's (Australian National University), "Learning to Live with Loans? Policy Transfer and the Funding of Higher Education", the authors trace the interaction between the UK and Australia in developing new funding strategies for higher education. All three of these papers suggest the relative ease of policy transfer in between countries sharing common language, political institutions, and economic organization. At the same time, this raises interesting questions about systematically characterizing and measuring such similarity. The final paper, Mitchell Orenstein's (Syracuse University) "Mapping the Diffusion of Pension Innovation", like Franzese, is interested specifically in the question of measuring policy diffusion. Where Franzese attempts to exploit spatial autocorrelation in a formal econometric framework, Orenstein uses more informal (essentially graphical) methods to examine the spread of adoption of pension systems and then the adoption of specific reforms of those systems.

In addition to the need for more of the focused case studies that permit attention to details of learning, persuasion and adaptation, we believe that there will also be substantial gains from improvements in the characterization of policies and countries in ways that permit more subtle econometric work on policy transfer and convergence. Finally, the focus at this Conference was primarily on countries and policies, with only tangential emphasis on international institutions. We hope to organise a conference in the near future to focus directly on the important role of international institutions in policy transfer.

Doug Nelson

International Factor Mobility and Indeterminacy: the Role of Labour Market Rigidities

*Perhaps one of the aspects of the globalisation process neglected so far in research is the impact on macroeconomic volatility. This article considers how labour market institutions affect countries' macroeconomic stability under different regimes of trade and capital movements. This is a summary of "International Factor Mobility and Indeterminacy: the Role of Labour Market Rigidities", forthcoming in the 2003 GEP Working Paper series, by **Marta Aloi** (Nottingham University and GEP) and **Teresa Lloyd-Braga** (Catholic University of Lisbon and CEPR).*

Over the last decade, much research has been devoted to the labour market effects of globalisation and, particularly, to the correlation between unemployment and globalisation. Although the evidence on the incidence of increased trade integration on labour markets in developed countries is by no means conclusive, most researchers share the view that labour market rigidities, coupled with increased trade integration, contributes to the rise in unemployment. Less research, on the other hand, has been devoted to studying the macroeconomic effects (e.g. on employment and output volatility) of increased financial globalisation. Increased financial openness can produce unwanted disturbances to economies in that domestic capital becomes more responsive to changes in international prices and, correspondingly, magnifies the amplitude of fluctuations in real wages or employment levels. A direct implication of the increased volatility brought by international capital market liberalisation is that the macroeconomic risk is mainly borne by internationally immobile factors (namely, labour). It is, indeed, a peculiarity of the recent wave of globalisation that increased integration in goods and capital markets is accompanied by increased restrictions in labour movements. Surprisingly, so far very little research has been devoted to analysing the macroeconomic implications of such an asymmetry in the integration process of the world economy. One problem is that the importance of international flows of factors is largely overlooked in standard general equilibrium (neoclassical) trade theory according to which factor mobility and trade in goods can be lumped together via the factor price equalisation theorem. If countries only differ in their factor endowments and/or productivity, free trade (or, alternatively, free factor mobility) is enough to level out divergences across countries and everyone is better off than under autarky. In the 'real' world, however, countries' differences go far beyond differences in factor endowments and/or productivity and the interactions between international trade in goods and factor movements should not be overlooked.

One, much debated, source of difference across countries lies in labour market institutions. Take, for instance, the widely studied case of Europe versus the USA. It is often claimed that Europe (particularly, EMU members) should move towards a North American labour market structure to achieve higher employment and to reduce the destabilising effects of globalisation in product and capital markets. The EU and EMU experiences are, undoubtedly, pointing towards a fundamental tension between labour market regulation and economic integration. On the one hand, mounting competition in product markets and rapid capital movements make it harder to sustain existing levels of regulation. On the other hand, the lack of labour mobility and fiscal re-distributive mechanisms in the EU budget, together with the higher exposure to market risks, generate the need to maintain, if not to increase, the level of regulation in labour markets.

Our work is aimed at addressing some of these issues. In particular, our purpose is to analyse how labour market institutions affect countries' macroeconomic stability under different regimes; namely, under free trade and free capital movements (but no labour movements) and under complete liberalisation of goods and factor movements. We develop a dynamic model in which there are no imperfections in output and capital markets, there is no trade based on comparative advantages a la Heckscher-Olin and the world is made up of two countries identical in everything except for their labour market structure. In one country the labour market is perfectly competitive, wages are flexible and there is full employment. In the other country, real wages are rigid and there is unemployment. We interpret macroeconomic instability (stability) as equilibrium indeterminacy (determinacy). Under indeterminacy, endogenous variables (such as employment and output) may become volatile due to changes in expectations that end up being self-fulfilling, implying that there exists a continuum of equilibrium trajectories converging to a steady state. Our set up is such that, in the rigid-wage country only, the equilibrium level of employment in each period is influenced by expecta-

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tions of future interest rates through the workers' reservation wage. Considering, first, the closed economy equilibrium, we show that, under plausible restrictions on technology parameters, the flexible wage country always converges to a stable (determinate) equilibrium, whereas the other country displays equilibrium fluctuations in output and employment. Opening up the economy to free trade and free capital movements may bring indeterminacy to world markets and the flexible-wage country may also experience output fluctuations. In a financially integrated world, changes in expectations of future interest rates in one country affect the other through the no arbitrage condition in the capital markets. If there is equilibrium indeterminacy in world markets, then capital flows between countries can be reversed, i.e. depending on expectations of future interest rates each country can be either a net importer or a net exporter of capital. A by-product of our analysis is that such a macroeconomic instability is less likely to occur when workers in the rigid-wage country earn positive rents. In this case, changes in expected interest rates affect workers' earnings by more than if wages were set under perfect competition, reducing the chance of appearance of equilibrium output fluctuations.

Allowing also for free labour movements strengthens further these results. Under both capital and labour mobility, changes in expectations of future interest rates in one country affect the other through the no arbitrage conditions on interest rates and wage rates. When labour markets are perfectly competitive it turns out that labour movements reinforce the effects of capital movements on interest rates, making equilibrium indeterminacy very likely to occur. If, on other hand, workers in the rigid wage country earn positive rents the world economy may achieve stability and full employment. In this case, unemployed workers living in the rigid wage country will be willing to move to the flexible-wage country since they anticipate a salary above their reservation wage (via the no arbitrage condition in the labour market). To conclude, our results suggest that, in an integrated world with free capital and labour movements, wage rigidities (such as unions or efficiency wages) are not harmful. On the contrary, they may prevent macroeconomic fluctuations at the world level.

Inaugural Lecture

Professor Doug Nelson

Tulane University and GEP University of Nottingham

'Political Economy Problems'

4th November 2003

University of Nottingham

Conference on

Exporting and Firm Level Adjustment

University of Nottingham

Monday 6th October 2003

Speakers include:

David Greenaway and Richard Kneller (University of Nottingham)
Joakim Gullstrand (Lund University)
Hege Medin (Norwegian Institute of International Affairs)
Marc Melitz (Harvard University)
Joachim Wagner (University of Luneburg)

For further details, contact Sue.Berry@nottingham.ac.uk

Leverhulme Globalisation Lectures

Martin Wolf

Associate Editor and Chief Economics Commentator, *The Financial Times*

19th February 2004

Leverhulme Globalisation Lectures

Adrian Wood

Chief Economist, Department for International Development

'Making Globalisation Work for the Poor'

20th October 2003

At the University of Nottingham

No tickets required, all welcome

Paul Collier

Chief Economist, World Bank

'Globalisation and Civil War'

18th November 2003

At the University of Nottingham

No tickets required, all welcome

For further details, contact Sue.Berry@nottingham.ac.uk

Second GEP Postgraduate Conference: A Summary

The 2nd GEP Postgraduate Conference was held the 10th April 2003 at the University of Nottingham. The objective of the conference was to bring together young PhD scholars to present their ongoing work and to meet other researchers in their field. In addition, the Conference had the feature of providing the students with the opportunity to have their paper discussed by one of the Nottingham research team.

This year, six European institutions were represented: Antwerp University (Belgium), HEC School from Lausanne University (Switzerland), the London School of Economics (U.K), the University of Modena (Italy), Nottingham University (U.K) and the University of Paris 1-Panthéon-Sorbonne (France). Eight papers were presented and discussed and seven other papers were part of posters sessions.

The Conference was centred around the two major issues of Trade and Development. In the Trade sessions, the students gave presentations on subjects such as Labour Market Adjustment, Exporting and Productivity as well as Multinationals and Regionalism.

In Development sessions, topics such as Market Institutions (in finance, labour and governments), Growth theories but also Freedom and Taste for Revolution were also presented.

The papers from the Conference can be downloaded from the Leverhulme Centre website.

Speakers Included:

Michel Dumont (University of Antwerp)

Chiara Strozzi (University of Modena)

Zhihong Yu (GEP, University of Nottingham)

Mauro Pisu (GEP, University of Nottingham)

Sylvie Montout (University of Paris)

Valentine Henrard (University of Paris)

Michael Henry (GEP, University of Nottingham)

Sylvia Pezzini (London School of Economics)

Daniel Mirza

College of Europe/University of Nottingham

Conference on

EU Interests in WTO Negotiations on the Doha Development Agenda

Bruges, Monday 8/9th January 2004

details from Sue Berry: Sue.Berry@nottingham.ac.uk

GEP Seminar Series

Autumn 2003

Date	Speaker
22 September	Richard Kneller (GEP, Nottingham)
29 September	Michael Gasiorek (Sussex)
6 October	No seminar due to Exports Conference
13 October	Tony Venables (LSE)
20 October	Toby Kendall (Birmingham)
27 October	Paola Conconi (Warwick)
3 November	Mike Devereux (Warwick)
10 November	Peter Neary (UCD)
17 November	Kala Krishna (Penn State)
24 November	Robert Read (Lancaster)
1 December	Marta Aloi (GEP, Nottingham)
8 December	Rob Elliott (Birmingham)

For more information on the GEP Seminar Series and to download the papers see the Leverhulme GEP website: www.nottingham.ac.uk/economics/leverhulme

To participate in the series, contact Ben Ferrett, 0115 846 7347 or

Ben.ferrett@nottingham.ac.uk

New GEP Research Papers

http://www.nottingham.ac.uk/economics/leverhulme/research_papers/

2003/22	Sourafel Girma, Richard Kneller and Mauro Pisu	Do Exporters Have Anything to Learn from Foreign Multinationals?
2003/21	Sourafel Girma, Richard Kneller and Mauro Pisu	Exports versus FDI: An Empirical Test
2003/20	Holger Görg and Aoife Hanley	International outsourcing and productivity: Evidence from plant level data
2003/19	Zhihao Yu	Why Take on the Tobacco Industry: the Political Economy of Government Anti-smoking Campaign
2003/18	Paul A. de Hek and Arijit Mukherjee	On Foreign Market Entry Under Uncertainty
2003/17	Alexander Hijzen	Fragmentation, Productivity and Relative Wages in the UK: A Mandated Wage Approach
2003/16	Wilhelm Kohler	Factor price frontiers with international fragmentation of multistage production
2003/15	Joseph Francois and Douglas Nelson	Globalization and relative wages: Some theory and evidence
2003/14	Richard Kneller and Philip A. Stevens	Absorptive Capacity and Frontier Technology: Evidence from OECD Manufacturing Industries
2003/13	Todd Sandler	Collective Action and Transnational Terrorism
2003/12	Patricia S. Pollard and Cletus C. Coughlin	Pass-Through Estimates and the Choice of an Exchange Rate Index
2003/11	Marius Brülhart and Rolf Traeger	An Account of Geographic Concentration Patterns in Europe
2003/10	P.K.M. Tharakan and I. Van Beveren	Exports and Distance in a Digitized World: Gravity Model Applied to the Indian Exports of Software
2003/09	Ismael Sanz and Francisco J. Velázquez	Has European integration approximated the composition of government expenditures?
2003/08	A. Mukherjee	Foreign market entry and host-country welfare: a theoretical analysis
2003/07	S. Girma, D. Greenaway and R. Kneller	Export Market Exit and Performance Dynamics: A Causality Analysis of Matched Firms
2003/06	D. Greenaway and C. R. Milner	Effective Protection, Policy Appraisal and Trade Policy Reform
2003/05	G. Dewit, D. Leahy and C. Montagna	Employment Protection and Globalisation in Dynamic Oligopoly
2003/04	D. Mirza	How Much Trade Contributes to the Formation of Market Structure
2003/03	W. Keller and S. Yeaple	Multinational Enterprises, International Trade and Productivity Growth: Firm-Level Evidence from the United
2003/02	B. Ferrett	Greenfield Investment versus Acquisition: Positive Analysis
2003/01	L. Fontagné and D. Mirza	The Role of Demand in the Adjustment of Employment to Trade

2002/34	U. Kreickemeier and S. Schoenwald	A General Model of Fair Wages in an Open Economy
2002/33	S. Barrios, H. Görg and E. Strobl	Multinationals' location choice, agglomeration economies and public incentives
2002/32	R.E. Falvey and U. Kreickemeier	Globalisation and Factor Returns in Competitive Markets
2002/31	H. Görg and D. Greenaway	Is there a potential for increases in FDI for Central and Eastern European countries following EU acces-
2002/30	H. Görg	Fancy a Stay at the 'Hotel California'?: Foreign Direct Investment, Taxation and Firing Costs
2002/29	D. Greenaway, G.V. Reed and N. Winchester	Trade and Rising Wage Inequality in the UK: Results from a CGE Analysis

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for Research on Globalisation and Economic Policy

The Leverhulme Centre for Research on Globalisation and Economic Policy was established in the School of Economics in 2001. It subsumes the research programmes and activities of the former *Centre for Research on Globalisation and Labour Markets*. The Centre's funding derives from two programme grants to the value of over £3m awarded by the Leverhulme Trust. Researchers in GEP have also received funding from the ESRC, European Union and British Academy. The Centre is under the Directorship of Professor David Greenaway.

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There is also a website containing more information and a complete set of downloadable research papers:

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