The University of Nottingham

GEP Leverhulme Centre for Research on Globalisation and Economic Policy

Newsletter

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Financial Crisis and the Macroeconomic Policy Response in the UK

Professor **David 'Danny' Blanchflower**, member of the Bank of England Monetary Policy Committee and Professor of Economics at Dartmouth College in the US, gave a *Leverhulme Globalisation Lecture* at Nottingham to discuss the current financial crisis. He had previously consistently predicted the UK would pay a heavy price and fall into a lengthy downward spiral if the Bank failed to slash interest rates to stimulate the ailing economy.

The Bank of England economist whose predictions of recession were ignored used a major speech at GEP to warn that Britain's slump would deepen in 2009.

Professor David 'Danny' Blanchflower said the UK's monetary policy needed to be "loosened further and quickly" if the country's problems were to be tackled effectively.

He told a packed audience: "Forward-looking surveys suggest the severity of the recession will sharpen in 2009.

"There is now a plausible possibility that the current UK recession may be even more severe than the recession in the early 1980s."

He visited GEP on 29th January, the day Chancellor Alistair Darling gave the Bank the go-ahead to buy up financial assets to pump cash into banks' balance sheets for them to lend on.

Professor Blanchflower told students: "For the first time in your lifetime the Bank of England has the power to print money, to raise the money supply.

"I'm not going to speculate about whether we are going to do it or when we are going to do it. Hopefully, if and when we do it, it will be very effective."

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Nottingham's Professor Alan Duncan (left) with Professor Danny Blanchflower

Professor Blanchflower's isolated stance among MPC members placed him at the centre of one of the highest-level policymaking disputes ever made public.

He consistently warned the UK would pay a heavy price and fall into a lengthy downward spiral if the Bank failed to slash interest rates to stimulate the ailing economy.

Yet it was only amid the panic and seismic financial aftershocks generated by the dramatic collapse of giant investment bank Lehman Brothers that action was finally taken.

Professor Blanchflower has been described as the MPC's "maverick" – a position illustrated by his voting record on interest-rate changes throughout much of 2008.

In May and June, when he called for a 0.25% reduction, his fellow MPC members opted for no change. The same thing happened in July, except one member even voted for a 0.25% increase.

By September Professor Blanchflower was advocating a 0.5% cut, only for the other members again to vote for no change.

He told GEP: "With the Bank Rate at an historic low of 1.5 per cent, we must consider the options available to monetary policymakers in case we approach the zero bound in the near future."

He refused to criticise his fellow MPC members but admitted: "I would have preferred us to have cut earlier than we did and not have to play catch-up. Life would have been better. My experience is that doing too much too early is better than doing too little too late."

Professor Blanchflower acknowledged the world faces a "synchronised downturn" in most of its major economies.

He said: "We must allow ourselves to consider the possibility that the UK will experience a prolonged period of poor economic performance."

But he added that the rapid fall in UK employment might mean most job losses were suffered at the start of the downturn – clearing the way for a more rapid recovery.

Professor Blanchflower is the Bruce V Rauner Professor of Economics at Dartmouth College in New Hampshire.

He is a Research Associate at the National Bureau of Economic Research and a Research Fellow at the University of Munich's Centre for Economic Studies and the University of Bonn's Institute for the Study of Labour.

He has advised a number of international bodies, including the International Labour Organisation and the OECD, and won Princeton University's Richard A Lester Prize for his book *The Wage Curve*.

His lecture at GEP, *Macroeconomic Policy Responses in the UK*, received media coverage around the world. He is due to retire from the MPC in June and will be replaced by David Miles, JP Morgan's Chief UK Economist.

GEP Conference on

Product Transactions in International Trade

on

19th October, 2009

For details, see www.gep.org.uk

or contact sue.berry@nottingham.ac.uk

Blanchflower Lecture: A Student’s Perspective

Professor Blanchflower’s lecture attracted a packed audience of students, faculty members, colleagues from the local business community and journalists, all keen to hear his thoughts on and insights into the plight of the UK and world economies. Among those present was **James McClymont**, who gives his view of the event.

Professor Blanchflower began his lecture with a candid assessment of the less than favourable prospects for both the UK and global economies, conceding: “It has become apparent that an especially severe contraction in output and unemployment has taken place and is set to intensify in 2009.”

Citing a range of survey material, from the construction industry to the manufacturing and services sectors, he argued that all the data pointed to worsening prospects for the UK economy.

He was similarly pessimistic regarding the world economy, stating it was “now clear a synchronised global downturn has begun”. The deterioration of economic conditions in America was “staggering”, he said, and the euro zone and Asian economies had also fallen into decline.

Emphasising the global nature of the downturn, Professor Blanchflower insisted the notion that certain economies had “decoupled” from the rest had been resoundingly disproven by events. “Those arguments,” he said bluntly, “are dead.”

As evidence he introduced the Baltic Dry Index, which tracks the cost of shipping dry goods such as iron ore and wheat and so can be used as a proxy to measure how much international trade is taking place. His chart – which, as he said, “I like to use with every lecture I give” – was indeed a sight to behold. The squiggly line on the graphic illustrated the cost of shipping had fallen, quite astonishingly, around 95% from its peak in May 2008.

Professor Blanchflower went on: “In considering the likely causes, magnitude and persistence of the current recession and the appropriate monetary and fiscal policy responses, I would have liked to offer you some insightful observations from the cutting edge of modern macroeconomic research.

“It may surprise that the standard assumption in economic research is that the financial sector has priced all assets efficiently at all times in the past and will continue to do so over the infinite future.”

Professor Blanchflower went on to warn that the mistake so often made by forecasters in previous recessions – initially underestimating the potential severity of economic downturns – should be avoided. Macroeconomists, he said, had frequently assumed unforeseen shocks to the economy would soon dissipate when in fact they might actually have intensified. Professor Blanchflower said this error was “quite understandable”, since the nature of these shocks is ill-understood.

But what could be done? Professor Blanchflower took time to discuss the notion, advanced by some, that the financial crisis had rendered interest-rate cuts useless in fighting recession. He argued that, although the crisis had disrupted the transmission mechanism, interest rates still had an important effect on the economy. “Isn’t it better,” he asked, “to have interest rates at the current level rather than four or five per cent?”

Professor Blanchflower then focused on the “unconventional policies” that could help rejuvenate the economy with the normal transmission mechanism of monetary policy partially impaired. He distinguished between two particular types of policy.

Firstly, the Bank of England could engage in a programme of “credit easing” involving the purchasing of certain assets from banks. By changing the composition of assets and liabilities on commercial banks’ balance sheets, liquidity premia could be reduced, thus encouraging “more favourable lending to firms and households”.

The second type of policy open to the Bank, Professor Blanchflower said, was “quantitative easing” – a process that focuses on the quantity of bank reserves in an economy. The central bank literally creates money (it doesn’t print it these days: it uses a computer instead – all very sophisticated) before injecting it into commercial banks in the hope of kick-starting lending.

Professor Blanchflower suggested these policies, if successful, “may even have a greater impact on lending than cuts in the Bank Rate itself”.

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Schools Conference Highlights Growing Interest in Economics

The booming interest in economics in light of the global financial crisis is set to be demonstrated when GEP hosts its annual Sixth-Form Conference later in June.

The event was first staged in 2006 and quickly became so popular that last year it had to be doubled in size to accommodate the number of students wanting to take part.

Record numbers of budding economists are now expected to attend this year's back-to-back one-day conferences, which will take place on 22nd and 23rd June.

As ever, the idea is to give sixth-formers interested in studying economics a genuine idea of what is involved, courtesy of GEP's world-renowned team of academics.

This year's event comes at a time when, thanks to the global credit crunch and financial meltdown, the subject is attracting more attention than ever before.

It seems the stereotypical image of a deadly-dull academic manipulating complex equations has been blown apart by the all-enveloping drama of the crisis.

The University of Nottingham's School of Economics, which houses GEP, has seen a 29% increase in undergraduate applications from the UK.

There has also been a notable rise in applications from overseas as students clamour to learn the ins and outs of the global financial system – and where it all went wrong.

Professor Alan Duncan, Head of the School, said: "Our Sixth-Form Conferences have repeatedly shown the strength of interest in economics among students.

"But the level of curiosity has recently become quite extraordinary – and for that we can thank the crunch for raising the subject's profile sky-high.

"More and more people are realising economics can be exciting and that the stakes are sometimes incredibly high. There is nothing boring about trying to save the world from meltdown."

GEP founder and long-time Director Professor David Greenaway – now the University's Vice-Chancellor – spear-headed the idea of the Sixth-Form Conference.

The inaugural event was so successful that the conference was enlarged in 2007. When even this produced a reserve list, two one-day conferences were introduced in 2008.

Each year a series of lectures and practical exercises gives students valuable insights into themes including globalisation, offshoring, trade and the environment, outsourcing and migration.

Professor Duncan said: "There's no doubt that the conference is already firmly established as one of GEP's core events, and we're extremely proud of the role it plays.

"It's also worth remembering that an economics degree can open up a range of careers, so even students who ultimately don't go on to economist jobs will benefit."

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In conclusion, Professor Blanchflower summarised the UK's likely economic prospects. He said: "Past recessions have typically been associated with five quarters of negative growth. It has usually taken around three years to regain the pre-recession level of output, and the deterioration in labour market conditions has been even more protracted. There appears to be little reason to expect a more favourable outcome this time around." He added that, although the policy responses to the recession so far had been "a step in the right direction", more needed to be done.

On a more uplifting note, he stressed: "We should bear in mind that the economy will eventually recover. In the past the UK economy has proved resilient to economic shocks, and there is no reason to believe it won't be resilient in the future."

Perhaps, then, this was the most important point – that the economy will recover and there is no benefit in being "unduly pessimistic".

For the video of Professor Blanchflower's talk, please visit www.gep.org.uk

* James McClymont is a student in the Nottingham School of Economics.

Asian Growth Under the Spotlight at Malaysia Conference

GEP held its second international conference at the University of Nottingham, Malaysia, in January, which was complemented by presentation of the 2009 *The World Economy Asia Lecture* by Professor Danny Quah (LSE).

Leading researchers on the economies of Asia took part in a major international conference at GEP's Malaysia branch. Entitled *Globalisation, Growth and Development in Asia*, the two-day event examined the region's ever increasing role in the worldwide economy.

The conference took place at the University of Nottingham, Malaysia, on 14th and 15th January. Trade agreements and reforms, production networks and the rise of China and India were among the issues under the spotlight.

Delegates from the UK were joined by fellow academics from Malaysia, Singapore, Korea, Indonesia, China, Taiwan and Japan .

The conference also hosted *The World Economy Asia Lecture,* delivered by Danny Quah, Head of Department and Professor of Economics at the London School of Economics. His address, *Will Asia Save the World?,* examined the region's growing importance in the wake of the financial meltdown that has rocked the West. Malaysian-born Professor Quah has delivered lectures at the United Nations, the Hay Festival Segovia, the World Science Forum and 10 Downing Street. He has been studying growth in East and South-East Asia since the 1990s, as well as the dramatic rise of China during the past 30 years of economic reforms.

Chris Milner, a Professor of International Economics at GEP, also presented work on differences in trade patterns across the regions of China, while Daniel Bernhofen, another GEP Fellow, looked at the opening up of the Japanese economy.

Professor Rod Tyers, from the Australian National University, focused on the link between China's industrial reforms, mainly competition policies, and China's current account surplus. He argued that the substantial Chinese current account surplus is associated with China's declining share of consumption in GDP and the rising inequalities.

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Participants at the GEP Conference in Kuala Lumpur, January 2009

The Globalisation Process: Lecture by John Sutton

In February we were delighted to welcome **Professor John Sutton** (LSE) to GEP to present the 2009 *Nottingham Lectures in International Economics*, on the theme of 'The Globalisation Process'.

John Sutton

We were delighted that Professor John Sutton agreed to present the 2009 Nottingham Lectures in International Economics. This annual lecture series was established in 2004 to attract highly esteemed colleagues to present a series of three advanced lectures for staff and postgraduate students on a topic related to globalisation.

Professor Sutton's lectures discussed the globalisation process in the context of competition between firms that differ in their capabilities. Capability, in this context, refers to a generalisation of the notion of productivity to a setting in which products differ in their levels of quality (as measured by buyers' willingness to pay).

Professor Sutton's first lecture covered history and theory. He explained that globalisation is a process that has been going on for 150 years. Three key phases of rapid advance stand out: the late nineteenth century; the post-WWII decades; and the present phase, which took off around 1990. Each of these phases was dominated by a different economic mechanism, and each in turn has led to a new set of economic models. This lecture introduced the new 'quality and trade' literature that seems to offer the best vehicle for understanding the present phase of the process.

The second lecture focused on quality and trade. The globalisation phase that we have witnessed since 1990 is best seen as a three-stage process. The first phase involves trade liberalisation, whose impact effect may be negative for some countries, as was the case in Eastern Europe in the early 1990s. But it is just those countries that are most vulnerable in the initial phase that benefit most from the second phase of the process, in which capabilities are transferred from high-wage to low-wage countries. The third phase, of global industrial restructuring, is already in progress.

The issue of capability transfer formed the basis of the third and final lecture. Professor Sutton explained that capability transfer, which lies at the heart of the current globalisation process, is complex and involves several channels (FDI, outsourcing, supply chains etc) whose relative importance and effectiveness vary widely across different industries. Understanding the determinants of the speed and effectiveness of these transfers is now the most interesting analytical challenge in this area.

* Professor Sutton's presentations are available on the GEP website at:

http://www.gep.org.uk/leverhulme/events/public_lectures.php

or see Professor Sutton's owm website for related papers:

http://personal.lse.ac.uk/sutton/

Profile

John Sutton is the Sir John Hicks Professor of Economics at the London School of Economics. A graduate of University College Dublin and Trinity College Dublin, he taught at the University of Sheffield before joining LSE in 1977.

He has written widely in the areas of microeconomic theory and industrial organisation. His books include *Sunk Costs and Market Structure* (MIT Press, 1981), *Technology and Market Structure* (MIT Press, 1998), and *Marshall's Tendencies: What Can Economists Know?* (MIT and Leuven University Press, 2000).

He has been a consultant for the World Bank since 2000 and served on the Advisory Committee on Access to the Japanese Market (Tokyo) from 1995 to 2002. He served as a member of the Group of Economic Advisors to the President of the European Union from 2001-2004 and of the Enterprise Strategy Group (Ireland), which reported in 2004. He is a Fellow of the Econometric Society and the British Academy and was President of the Royal Economic Society from 2004 to 2007.

Shujie Yao

Yao's Study Ignites Global Debate on Chinese Economy

GEP's leading Chinese economist sparked a major debate in the Far East after predicting China is about to become the world's second-largest economy.

Professor Shujie Yao, co-ordinator of GEP's *China and the World* Economy research programme, made headlines around the world with his suggestion that the credit crisis has handed the country a "once-in-a-century" chance to cement superpower status.

The story, originally published in *China Daily*, China's most prestigious English-language newspaper, was quickly picked up by other publications throughout the region.

It was later reported around the globe and generated fierce and widespread online debate, as well as attracting interest from senior figures in both politics and economics.

Using World Bank and IMF figures for GDP and output growth rate, Professor Yao estimated China's economy would overtake Japan's in 2009 – and might even have done so already.

His research also revealed the US, Japan, Germany and the UK are unlikely to recover to their 2007 output levels until 2011 or 2012 – whereas China is expected to grow at up to 8%.

Professor Yao believes the crippling effects of global downturn may even see China catch up with the US within the next 20 years, so completing its rapid rise to pre-eminence.

China Daily reported his findings beneath the headline "Nation may top Japan GDP in '09", adding: "Yao predicted two years ago that China would become the second-largest economy in 2018.

"But the current economic crisis gives China a 'once-in-a-century' opportunity to achieve a much speedier economic convergence with the world's largest industrialised economies, he says."

From there the story quickly snowballed, earning Professor Yao's research coverage not just across the Far East but in Europe and North, Central and South America.

One important issue it helped highlight is the stark difference between China's total GDP and its per-capita GDP, which remains outside the top 100 in the world.

Fan Jianping, Director of the Economic Forecasting Department at China's State Information Centre, agreed with Professor Yao that it was "just a matter of time" before China overtook Japan. But he told *China Daily*: "However big our economic output is, it won't change the fact that China's per-capita GDP is very low."

Online debate has also compared Professor Yao's prediction to that of the US's National Intelligence Council, which only recently suggested China's economy would surpass Japan's by 2025.

Praising Professor Yao, one poster wrote: "Fifteen years off the mark in just three months. How can President Obama do anything good with such shoddy 'intelligence'?"

Professor Yao originally made his prediction in *Chinese Economy 2008: A Turbulent Year Amid the World Financial Crisis*, a discussion paper for policymakers both in China and the UK.

Professor Yao acknowledged China did not escape the financial meltdown in 2008, which saw it mark 30 years of the economic reforms that have transformed the nation.

Yet it suffered far less than its competitors and possesses the best fiscal conditions in the world, with its debt accounting for only 20% of GDP – compared with around 60% in Europe and 80% in the US.

Professor Yao believes this, coupled with continued growth prospects, means the government can carry out "bold and expansionary" policies to target an 8% economic growth rate.

He said: "The immediate problem now is how to survive the next few months amid a severe global recession by using a stimulus package most efficiently and effectively.

"If China can handle the crisis well it has the opportunity to shorten the time needed to catch up with the more advanced economies and so enhance its status."

Albert Hu

Competition and Foreign Patenting in China

Protection of intellectual property rights is one of the most challenging issues faced by foreign firms expanding into developing countries such as China. Using a unique dataset of Chinese patents, **Albert Hu** (National University of Singapore) reveals the reasons behind the recent foreign patenting surge in China.

What determines a firm's decision to seek patent protection for its proprietary technology in a foreign jurisdiction? This is an important question for both business managers and policymakers. Business managers are primarily concerned with the effective appropriation of the returns to the technology. Policymakers in the foreign jurisdiction are interested in both the technology diffusion that is implied by the patenting decision of the foreign inventor and the restrictive access to the technology dictated by the patent. These concerns assume greater complexity when innovation is deployed in places where the traditional appropriation mechanisms are relatively ineffective.

The explosive growth of foreign applications for patents issued by China's State Intellectual Property Office (SIPO) provides a natural setting to investigate the determinants of a foreign inventor's decision to file patent applications in a foreign jurisdiction. From 1995 to 2004, Chinese patents granted to foreign — primarily OECD and the newly industrialised countries — inventors have been growing at over 30 per cent a year. Of these patents granted by the Chinese SIPO to foreign inventors, over 90 per cent have claimed foreign priority, which implies that patent applications had earlier been filed for the invention with a foreign jurisdiction.

Chinese firms' imitation tracks the invention patents granted to inventors from Japan, Korea and Taiwan rather than the US and Germany.

Thus most of these patents are for technologies that have been invented outside China. Therefore increasing applications for Chinese patents is an indication of foreign inventors' growing propensity to seek Chinese patent protection rather than more innovation activity in China.

There are four potential explanations of increasing foreign propensity to patent in China: strengthening of patent protection in China over time; expansion of foreign economic activities in China — foreign direct investment (FDI) and trade; imitative and innovative threat from domestic Chinese firms; and competition from other foreign firms in the Chinese market.

It is hard to assess how the efficacy of patent rights enforcement in China has evolved over the years. While reported incidences of IPR violation indicate the severity of the problem, it might also be a result of strengthened enforcement that leads to better detection of violation. In the empirical analysis, I allow for changes in the enforcement effectiveness over time.

As foreign firms expand their engagement with the Chinese economy, whether through FDI or trade, the risk of exposing their intellectual property to potential imitators increases. Deepening and broadening their economic activities in China may also necessitate the introduction of newer and more sophisticated technology over time. Therefore the propensity of foreign firms to patent in China is expected to go up over time. I summarise this as the market covering hypothesis.

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A firm's decision on whether to apply for patents in a foreign jurisdiction is also dependent on its competitors' patenting decisions in the same jurisdiction. To the extent that a Chinese patent helps to secure the return to a foreign technology introduced in the Chinese market, such return will depend on whether and what competing foreign or Chinese technologies have been or will be introduced and patented in the same market. If the competing technology is imitation in nature, this would prompt foreign firms to raise their Chinese patenting efforts. When competitors introduce bona fide innovations, foreign firms may or may not seek more Chinese patents in the same market. This is the competitive threat hypothesis.

Increase in competing imports leads a foreign industry to increase its patenting in China.

I use a data set that provides applicant and technology class information of all of the 1.37 million patents that China's SIPO has granted from 1985 to 2004. These patents are then assigned to International Standard Industry Classification (ISIC) manufacturing industries using the OECD Technology Concordance, a variant of the Yale Technology Concordance. I also create a corresponding sample for the US Patent and Trademark Office granted patents. Using these data sets, I investigate the validity of the market covering and competitive threat hypotheses in explaining the increasing foreign propensity to patent in China.

There is significant correlation between the propensity to seek Chinese patent protection by foreign inventors and their Chinese counterparts. Using utility model as a measure of imitation, I find that Chinese firms' imitation tracks closely the invention patents granted to inventors from Japan, Korea and Taiwan rather than the US and Germany. That China imitates the technologies of its East Asian neighbors also suggests that the latter's technology may be more appropriate than those of the US and Germany for Chinese firms to adopt given their under-developed absorptive capacity.

These patterns of correlation are consistent with what the patterns of bilateral trade between China and these countries would have predicted. I relate foreign patenting in China to China's imports from these countries. A robust result is that increase in competing imports leads a foreign industry to increase its patenting in China, lending support to the competitive threat hypothesis. The estimates imply that competition between foreign imports can account for 36 per cent of the annual growth of foreign patenting in China. On the other hand, after controlling for competition from other foreign industries, there is no evidence that expansion of an industry's own sales in China increases its propensity to patent — that is, there is no support for the market covering hypothesis. The incentive to seek patent protection for an industry's increasing sales in the Chinese market could be offset by the market power of the industry, which may encourage it to put off introducing new technologies in China.

Strengthening intellectual property rights protection has increasingly become a precondition for developing countries to integrate into the global network of trade and investment. A policy implication of the findings here is that maintaining a competitive market environment, in addition to its effect on product market competition, may further ameliorate the costs of instituting a stringent IPR regime by accelerating the adoption of new technologies in the developing country by developed country firms.

Continued from page 3 (GEP Conference in Malaysia)

In particular, he showed that savings by corporate firms, especially State-owned ones, are the major contributor to the current account surplus in China. Based on an oligopoly model of the Chinese economy calibrated with GTAP data, he proposed several policies that may help moderate the Chinese surplus account, targeting the national saving rate, or alternatively the oligopolistic structure of the competition.

In two different papers, Professor Jayant Menon, from the Asian Development Bank, and Professor Innwon Park, from the Korea University, focused on the "spaghetti bowl" effect of regional trade agreements (RTAs). Both authors noted that the number of bilateral and multilateral regional trade agreements has significantly increased in recent years and stressed that this "spaghetti bowl" phenomenon generates substantial costs and welfare losses due to trade diversions and the complexities caused by differing rules of origin and requirements across agreements.

Professor Park's work showed how RTAs create trade between members but divert trade from non-members. This study recommends that RTAs should be established under the GATT article and should fully cumulate the Rules of Origin.

Professor Menon analysed different remedies to Professor Park and proposed an assessment of their efficiencies. He concluded that multilateralisation is the preferred remedy because it produces the most significant limitation of distortions and because of its need for a limited time period to achieve this outcome.

The papers presented at the GEP Conference in Kuala Lumpur are available at:

http://www.gep.org.uk/leverhulme/events/

Leverhulme Globalisation Lectures 2009

Alan Winters

Chief Economist

Department for International Development

and University of Sussex

on **20th October 2009**

Andrew Witty

Chief Executive Officer

GlaxoSmithKline plc

on **3rd November 2009**

Both events in lecture theatre A48,

Sir Clive Granger Building, University Park

For further details, contact sue.berry@nottingham.ac.uk

GEP Conference on

'Trade Costs'

19th and 20th June, 2009 at the University of Nottingham

co-funded by CESifo

Confirmed speakers

Jeff Bergstrand (University of Notre Dame)
Ingo Borchert (The World Bank)
Fabrice Defever (GEP)
David Donaldson (LSE)
Peter Egger (University of Munich)/Daniel Bernhofen (GEP)
David Greenaway/Chris Milner (GEP)
Sugata Marjit (University of Calcutta)
Arijit Mukherjee (GEP)
Peter Neary (Oxford University)
Dennis Novy (Warwick University)
Alexandre Skiba (University of Wyoming)
Nikolaus Wolf (Warwick University)

Conference Convenors:

Professor Daniel Bernhofen (GEP)
Professor Peter Egger (University of Munich)
Professor Rod Falvey (GEP)

The Conference will be complemented by the presentation of

The World Economy Annual Lecture 2009

by

Peter Neary, University of Oxford

on 'Two-and-a-Half Theories of Trade'

Lecture sponsored by Wiley-Blackwell

For further details of the conference or public lecture, see the GEP Events website or contact sue.berry@nottingham.ac.uk

Chew Ging Lee

English Language and Economic Growth

Does English proficiency matter for the economic growth of developing countries? **Chew Ging Lee** (University of Nottingham Business School, Malaysia) provides some new evidence for this intriguing question.

The linkage between the accumulation of knowledge and economic growth is one of the debated issues in economic growth literature. There are two channels through which human capital can affect economic growth: (a) the direct channel where human capital is assumed to be the key input to the R&D sector, which generates new ideas or products that lead to the expansion of the economy, as presented in the model by Romer (1990)*; and (b) the indirect channel where human capital facilitates the adoption of knowledge developed by others, as postulated by Nelson and Phelps (1966)**. This paper focuses on the latter, the indirect channel: the linkage between English language and economic growth.

English language has become an effective means of getting access to knowledge. English language also affects our daily activities. Machinery usually comes with instructions or manuals in English. Without a basic understanding on English, we are generally unable to use this machinery in productive activities.

English proficiency will positively affect the economic growth if it is supported by a minimum threshold of physical capital, technology, political stability, good governance and other factors.

Recognising that English language has become an international language of communication, this paper proposes that the knowledge absorptive capabilities of a country depend on the fraction of the population in a country that is fluent in English. This group of households will gain access to the new knowledge, and then they can translate the learned knowledge into the local language to allow the learned knowledge to be spread to a wider audience. This is mainly because the majority of new knowledge is created by countries in which English has enjoyed a special status; most of the important creations and discoveries published a in language other than English have also been translated into English.

The main difficulty of this study is the choice of proxy for English proficiency. The mean score of TOEFL examinees is selected as the proxy for English proficiency of the fraction of population that can speak English, but it is not a perfect proxy for English proficiency. It is the best proxy among the worst. Since the number of examinees for the TOEFL varies from one country to another, those countries with a low number of examinees are excluded. The countries in which English has held or continues to hold a special status as either the primary language or second language have also been omitted, because these countries are generally recognised as the main creators of knowledge.

Recognising that endogeneity problems may arise in this research due to the reverse causality between economic growth and English proficiency, initial English proficiency is used as an independent variable. Since it is not possible to obtain long enough data for the mean score of TOEFL for panel data estimation methods because of the changes in TOEFL tests, the Barro-type growth cross-sectional specification is estimated. Using a cross-country data from 43 countries and after controlling for other conventional determinants, the empirical results demonstrate that there is no correlation between initial English proficiency and economic growth because of misspecification of model, treating the effects of initial English proficiency as homogeneous across continents.

To capture the heterogeneous effects of initial English proficiency, regional dummy variables are created for different regions based on the classifications of TOEFL and Score Data Summaries. These regional dummy variables are not used as intercept dummy variables, which are commonly used in existing empirical literature.

They are allowed to interact with initial English proficiency to form regional slope dummy variables in this Barro-type cross-country regression framework. Based on our knowledge, no study in economic growth has investigated the effect of English on economic growth empirically with regional slope dummy variables. This paper is probably the first to address this.

Using Latin American countries as the base category, the initial English proficiency and the interaction terms of initial English proficiency with African countries are statistically insignificant. The results suggest that initial English proficiency has a positive impact on the economic growth of Asian and European economies only. To check whether the results of initial English language variables are robust to the inclusion of other common independent variables, and to prevent the misspecification of model, initial average years of schooling and the interaction term between initial average years of schooling and initial English proficiency are used as additional explanatory variables. A similar conclusion has been obtained.

English proficiency can be seen as a necessary but not sufficient condition for economic growth.

We are unable to find unanimous evidence to support the positive contribution of initial English proficiency to economic growth across all continents. These results suggest that initial English proficiency will positively affect the economic growth if it is supported by a minimum threshold of physical capital, technology, political stability, good governance and other factors. The improvement in English proficiency without sufficient accumulation of physical capital, technology and social capital will be wasted. Hence, English proficiency can be seen as a necessary but not sufficient condition for economic growth.

To have a satisfactory understanding on the effect of English language on economic growth we have to appreciate how the formation of institutions, stability and certainty can encourage the accumulation of knowledge. It is important not to forget the fact that even if this study is able to find a positive relationship between the proficiency level of English and the growth rate in a cross-sectional data, establishing this relationship can be very difficult under a different empirical framework and different measures for the proficiency level of English.

** Nelson R. and Phelps, E (1966) Investment in Human, Technological Diffusion, and Economic Growth, *American Economic Review*, LVI, 69-75.

* Romer, P.M. (1990), Endogenous Technological Change, *Journal of Political Economy*, Vol. 98, No. 5.

GEP to host Department for Work and Pensions

Work Pensions and Labour Economics (WPEG) Conference 2009

Monday 13th July to Wednesday 15th July

Further details here: http://wpeg.group.shef.ac.uk/conference.htm

The 2nd Annual Conference of the International Forum for Contemporary Chinese Studies (IFCCS)

Beyond Revolution and Reforms: The People's Republic Looks Forward at 60

7th to 9th September, 2009, at the University of Nottingham

Organised by the Nottingham School of Contemporary Chinese Studies (with its China Policy Institute and Nottingham Confucius Institute).

Co-sponsored by: GEP; The Office of the Chinese Language Council International (HANBAN); British Academy

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Annual GEP PhD Conference Maintains High Standard

GEP hosted its eighth Annual Postgraduate Conference in March. The event was an opportunity for postgraduate students worldwide to present and discuss their work. In this conference report the organisers, Tom Ivlevs and Liza Jabbour, comment on the themes of the papers presented and their main findings. Tom and Liza are GEP Post Doc Research Fellows.

GEP hosted the Eighth Annual GEP Postgraduate Conference on 26th and 27th March 2009. The Conference offers an opportunity for PhD students to present and discuss their research work. This year the programme included 22 empirical and theoretical papers covering issues related to foreign direct investment, international trade, migration and labour markets. The 22 presenters came 16 universities in six countries in Europe and Asia.

The success of the previous GEP Postgraduate conferences, and a large number of high quality submissions, led us to expand this year's programme to two full days. The keynote lecture was delivered by Dr Udo Kreickemeier (GEP), Associate Professor of Economics at the University of Nottingham. Dr Kreickemeier presented his recent work on redistributing gains from globalisation.

As in the previous two years, the Conference awarded a prize for the best paper. This year, a committee comprising Professor Daniel Bernhofen and the Conference Organisers gave the award to Cheng Chen (Hitotsubashi University) for his paper 'Information, Incentives and Multinational Firms'.

The conference programme comprised seven sessions. To give a flavour of the high quality work that is being undertaken by the young researchers, we report on some selected papers. The prize-winning paper was presented by Cheng Chen (Hitotsubashi University) in the session on international outsourcing. Cheng builds a theoretical model of firm's choice of organisation in international markets. Firms engaged in offshoring activities face two organisational choices: international outsourcing (contracting the production to a foreign supplier) and vertical FDI. In Cheng's theoretical framework firms face a trade-off between asymmetric information, associated with outsourcing, and costly monitoring, associated with FDI. The problem of asymmetric information occurs because the productivity of the foreign supplier is unobserved by the firm. The firm needs to pay information rents (design an incentive compatible contract) in order to induce the foreign supplier to reveal the true level of its productivity. In the case of FDI, the firms faces monitoring costs related to the geographical distance between the firm and the workers located in the foreign country. For this reason, integrated multinationals will have to pay a higher wage to make the foreign employees work hard. The model shows that in labour-intensive industries international outsourcing is the optimal organisational mode, while in capital-intensive industries FDI is preferable. The paper corroborates the findings of the Antràs (2003) paper but provides an alternative economic intuition.

In the session on migration, Philipp an de Meulen (RWTH Aachen University) presented a theoretical model on labour and capital flows between 'young' and 'old' countries. Explicitly accounting for labour mobility constraints in industrialised countries and capital expropriation risk in developing countries, Philipp investigates whether efficiency gains from factor movements are likely to be realised. He shows that in a one-period two-country general equilibrium model the age structure affects the political-economy equilibrium. Large age differences between the migrant sending and receiving countries encourage admitting more migrants but the cost of integrating immigrants plays a crucial role for the size of labour flows. At the same time the effect on FDI is ambiguous.

In the session 'globalisation and labour markets', Priscila Ferreira (University of Essex) presented her work on the sources of inter-industry wage differentials in Portugal. Priscila finds significant and persistent inter-industry wage differentials when she controls only for observed worker and firm characteristics. However, the estimated wage structure is greatly attenuated when she controls for unobserved worker heterogeneity, suggesting that the raw differentials are due to the concentration of high wage workers in certain industries. A complete decomposition, obtained from models that simultaneously control for unobserved worker, firm and match heterogeneity, suggests that firm effects on average explain 70% of the industry wage premia and that genuine and sizeable inter-industry wage differentials exist.

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Cheng Chen

Information, Incentives and Multinational Firms

How does asymmetric information between multinational firms from the North and local suppliers in the South affect the patterns of FDI and outsourcing? In this article, **Cheng Chen** (Hitotsubashi University) summarises the findings from his paper, which was awarded the Best Paper Prize at the 8th GEP PhD Conference held at Nottingham in March.

Recent years have witnessed rapid growth of Foreign Direct Investment (FDI), intra-firm trade and Multinational Enterprises (MNEs). In the real world, FDI and intra-firm trade are conducted by MNEs, which play a key role in today's international economy. Other than FDI, when going to developing countries for the production of intermediate goods, MNEs can use outsourcing as the production pattern of intermediate goods. Outsourcing has expanded dramatically in the past two decades also, especially in international trade of intermediate goods. Antràs (2003 points out, in the comparison between FDI and outsourcing, there is one important finding from the empirical work: "Intra-firm trade (FDI) is heavily concentrated in capital-intensive industries." In order to reveal the economic forces behind this, Antràs (presents an elegant model. But, as the assumption in Antràs that the ex ante investment is relationship-specific is not always true in every case, much more work needs to be done.

In reality, the asymmetric information problem about southern products' quality and southern suppliers' productivity is becoming more and more serious.

This paper tries to give an alternative explanation of the phenomenon found in Antràs. In reality, the asymmetric information problem about southern products' quality and southern suppliers' productivity is becoming more and more serious. In 2007 it was reported that a large amount of lead-poisoned toys was found among exports from China to the US. At the beginning of 2008 dumplings exported to Japan by Tianyang food corporation Ltd, a Chinese company, were found to be poisonous. The most recent and serious case is the melamine-tainted milk-powder crisis in September 2008. Sanlu and other major Chinese milk-powder makers use melamine, which is used in the plastics industry but is toxic for humans, to produce milk-powder for children. It is natural to think that all these quality problems are due to the consideration of pushing costs of products down. After all, if Sanlu and other related companies could not reduce their costs by making inferior products, why would they make poisonous milk-powder? Very interestingly, the New Zealand dairy conglomerate Fonterra, which already held a 43 per cent stake in Sanlu before the crisis, reportedly tried to buy the whole company afterwards. This case study reveals that the best way to eliminate the asymmetric information problem is to integrate the southern firm itself.

In my model I focus on the comparison of two types of production: outsourcing in the south and FDI. In the outsourcing case, the asymmetric information problem occurs when the productivity of intermediate goods' production is the supplier's private information and the MNE cannot acquire the information of southern firms' production costs freely. Accordingly, the multinational firm is faced with an adverse selection problem, which means that all southern suppliers want to claim that their production costs are high in order to obtain more transfers from the MNE, even if some of them are actually very productive. Intuitively, when the MNE and the stand-alone supplier negotiate the transfer pricing of intermediate goods, it is impossible for the MNE to get all the profits generated by the production, since the MNE has to transfer rents to elicit a truthful report of its productivity from the supplier. Due to this, the MNE has to pay information rents, which constitutes the disadvantage of outsourcing. The trade-off between outsourcing and FDI is that, although the multinational firm has to pay information rents when outsourcing, the unit labour cost in this case is lower compared with the FDI case. This is because southern owners of the stand-alone supplier can

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monitor southern employees using a relatively lower cost. On the other hand, when the multinational firm decides to integrate the supplier in the south, the information about the supplier's productivity will become clear. It will become more costly for northern owners of the supplier to induce southern employees to work hard, however, as the monitoring from the north is more costly.

The explanation for this is that, as there are language differences and cultural barriers between people from different countries, northern owners usually need to spend more money in communicating with their southern employees compared with southern owners in the outsourcing case. This extra cost includes the cost of hiring interpreters, translating documents and miscommunication etc. Intuitively, as the monitoring across borders is more costly, the northern owner will choose a lower monitoring intensity and higher wage rates to make southern employees work hard. As a result, the total unit labour cost equals the sum of the unit monitoring cost and the wage rate is higher in the FDI case.

The multinational firm is faced with an adverse selection problem, which means that all southern suppliers want to claim that their production costs are high... even if some of them are actually very productive.

The main result of this paper is that in the equilibrium the MNE outsources the production of intermediate goods that are labour-intensive and uses FDI to produce capital intensive intermediate goods. The intuition behind this result is that, although the adverse selection problem is not related to the capital intensity of production, the importance of costly monitoring and higher labour costs in the FDI case is crucially affected by the capital intensity.

In other words, higher labour costs hurt firms producing labor intensive intermediate goods more, as firms do not have to give any incentive to capital. From the above reasoning, it is straightforward to see that, while the main result of my paper is the same as those of Antràs (2003, 2005), the economic intuition contrasts markedly. You can also find other papers, such as Horstmann and Markusen (1996) and Lu and Huang (2009), with similar ideas as mine but different focuses.

This paper has many empirical implications. As the south in my model is referred to all developing countries that are heterogeneous in various aspects, one should expect without surprise that the outsourcing should be commonly seen from the trade pattern in developing countries that have better accounting systems, as better accounting systems will alleviate the uncertainty of the southern supplier's productivity. The fact that intra-firm trade is commonly seen from the bilateral trade pattern for the northern and southern country pair that use the same language is not surprising, as monitoring costs are small in such cases.

References:

Antràs, Pol (2003), 'Firms, Contracts and Trade Structure', *Quarterly Journal of Economics* 188, 1375-1418.

Antràs, Pol (2005), 'Incomplete Contracts and the Product Cycle', *American Economic Review* 95, 1054-1073.

Horstmann, Ignatius and James Markusen (1996), 'Exploring New Markets: Direct Investment, Contractual Relations and the Multinational Enterprise', *International Economic Review* 37, 1-19.

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The 'International Trade Theory and Methods' session included a paper on trade liberalisation and self-control problems, by Jennifer Abel-Koch (University of Mannheim). Jennifer analyses the welfare effects of trade liberalisation when individuals suffer from self-control problems. Considering a classic Ricardian model of trade, she argues that, in the importing country, individuals lose from trade if the degree of self-control is low; and in the exporting country all individuals unambiguously gain from trade. However, within a new trade model, individuals with self-control problems in both countries can lose. This happens if the average degree of self-control in the open economy is larger than the average degree of self-control in the closed economy.

In the session 'Foreign Direct Investment, Trade and Public Policies, Valeria Merlo (LMU Munich) presented a paper that analyses the location of foreign multinationals within Germany. The paper focuses on the influence of tax policies on firms' location choice. The main contribution of Valeria's paper is to analyse this question at a sub-national level using data on tax rates and multinationals location at the municipality level within Germany. At the sub-national level it is possible to evaluate the role of tax differences within a homogenous institutional framework and thus to account for the differences of tax policies within countries. Valeria applies count data models and shows a negative impact of tax rates on the location decision of foreign multinationals.

The session 'Globalisation and Firm Performance' included a paper by Danny McGowan (GEP, University of Nottingham). His paper focuses on the link between the exit decision and productivity at the firm level. Danny analyses the case of the Japanese economy that has witnessed a slow productivity growth in the 1990s. Are globalisation and multinationals responsible for the poor productivity performance of Japan? Multinationals have the possibility of closing productive plants in the home country and of delocalising production to foreign low cost locations. Danny's paper shows that plant exit is not responsible for the slow productivity growth in Japan. Plants that are closed have a below-average level of productivity. A decomposition of the aggregate productivity indicates that the slow within-plant growth rate is the main reason for Japan's 'lost decade'.

New GEP Research Papers
www.gep.org.uk/research_papers

2009/09

Meng Lu, Chris Milner and Zhihong Yu: *Regional Heterogeneity and China's International Trade: Sufficient Lumpiness or Not?*

Summary: This paper explores whether there is sufficient unevenness or lumpiness in the relative endowments of China's regions to affect trade patterns. It finds that China was lumpy as recently as 2004.

2009/08

Dan Luo and Shujie Yao: *World Financial Crisis and the Rise of Chinese Commercial Banks*

Summary: This paper explains why Chinese state-owned commercial banks become the biggest winners of the financial crisis by overtaking their American and European counterparts to be the largest banks in the world.

2009/07

Wolfgang Keller and Stephen R Yeaple: *Global production and Trade in the Knowledge Economy*

Summary: This paper presents and tests a new model of multinational firms to explain a rich array of multinational behaviour. The analysis shows that accounting for costly technology transfer within multinational firms is important for explaining the structure of trade and multinational production.

2009/06

Wilhelm Kohler and Gabriel Felbermayr: *WTO Membership and the Extensive Margin of World Trade: New Evidence*

Summary: The paper estimates a gravity model allowing for the possibility of zero trade. Including the extensive margin does not generate robust additional evidence of a trade-promoting effect of GATT/WTO membership.

2009/05

David Greenaway, Alessandra Guariglia and Zhihong Yu: *The more the better? Foreign Ownership and Corporate Performance in China*

Summary: We examine the relationship between the degree of foreign ownership and performance of recipient firms, using of panel of Chinese firms over the period 2000-2005. Our findings suggest that joint-ventures perform better than purely domestic and wholly foreign owned firms.

2009/04

Liza Jabbour and Maria Pluvia Zuniga: *Drivers of the Offshore Outsourcing of R&D: Empirical Evidence from French Manufacturers*

Summary: This paper investigates the drivers of offshore outsourcing of R&D activities by French manufacturing firms. It shows that French firms engaged in the offshore outsourcing of R&D are outward oriented essentially through exports. Further, technological sourcing seems to be leading this phenomenon more than cost-opportunities motivations.

2009/03

Adam Blake, Ziliang Deng and Rod Falvey: *How does the Productivity of Foreign Direct Investment Spill over to Local Firms in Chinese Manufacturing?*

Summary: This paper empirically examines productivity spillovers from foreign firms to local firms in Chinese Manufacturing. Four spillover channels are considered - exports, labour-turnover, forward and backward linkages, and horizontal effects

New GEP Research Papers (continued) www.gep.org.uk/research_papers

2009/02

Spiros Bougheas, Richard Kneller and Raymond Riezman: *Optimal Educational Policies and Comparative Advantage*

Summary: We consider the optimal education policies of a small economy with a limited government budget. Sometimes it is optimal to choose the new policy so that it reverses comparative advantage.

2009/01

Wilhelm Kohler and Gabriel Felbermayr: *Can International Migration Ever Be Made a Pareto Improvement?*

Summary: The paper shows that efficiency gains (surplus) from immigration cannot be turned into a Pareto improvement for receiving-country-natives, unless the tax-cum-subsidy mechanism of compensation is allowed to discriminate against immigrants.

2008/46

Soumyananda Dinda and Arijit Mukherjee: *International Outsourcing, tax and Patent Protection*

Summary: We show that, in the case of a vertical technology transfer, if there is imperfect knowledge spillover under a weak patent protection, the strong patent protection in the developing country increases the profit of the developed-country firm if there is a uniform tax rate in the developing country. If there is either perfect knowledge spillover under weak patent protection or the developing country charges discriminatory tax rates, the profits of the developed-country firms are the same under weak and strong patent protections in the developing countries.

2008/45

Arijit Mukherjee and Yingyi Tsai: *International Outsourcing and Welfare Reduction: An Entry-deterrence Story*

Summary: We show that international outsourcing may reduce welfare of the outsourcing country by deterring market-entry, thus showing a new effect which is different from the employment and the quality effects creating negative impacts of outsourcing. Entry deterrence under outsourcing reduces domestic welfare if both the profit extraction and cost saving from outsourcing are sufficiently small.

2008/44

Richard Kneller and Zhihong Yu: *Quality Selection, Chinese Exports and Theories of Heterogeneous Firm Trade*

Summary: This paper develops a new heterogeneous firm model of international trade in which firms differ in their product quality and vary their prices across according to the level of competition. This new model is consistent with evidence that we present on the spatial distribution of Chinese export prices.

2008/43

Justin Yifu Lin, Arijit Mujkherjee and Yingyi Tsai: *Why do Firms Engage in Multi-sourcing?*

Summary: We provide an explanation for multi-sourcing, which is often found in the real world and refers to the situation where a final goods producer acquires homogenous components from different suppliers. In the presence of imitation under outsourcing, multi-sourcing helps to deter entry by the suppliers into the final goods market and enhances profit-ability of the outsourcing firm.

2008/42

David Greenaway, Richard Kneller and Xufei Zhang: *Exchange Rate Uncertainty and Export Decisions in the UK*

Summary: Using data on UK manufacturing firms, we examine the effects of exchange rate uncertainty on firm decisions on export entry and export intensity. The use of micro data and new measures of exchange rate uncertainty enable us to test for hysteresis effects in a new way and to test the sensitivity of results to a range of different measures.

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