Economic Policy in the Age of Globalisation

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

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

Nicola Acocella

Translated from the Italian by

Brendan Jones

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To Valerio and Roberta
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Symbols

- $a$: coefficient measuring sensitivity of investment to interest rate
- $A$: autonomous expenditure
- $b_a$: cyclically adjusted budget balance as a percentage of GDP
- $b_t$: total budget deficit or surplus as a ratio of GDP
- $b_t^n$: benefits at time $t$
- $B$: total discounted benefits; in a different setting, public debt
- $B_s$: total budget deficit or surplus
- $BMB$: bank monetary base (bank reserves)
- $BP$: deficit or surplus on the balance of payments in real terms
- $BP_m$: deficit or surplus on the balance of payments in monetary terms
- $c$: marginal (and average) propensity to consume
- $c_t$: costs at time $t$
- $C$: total discounted costs; in a different setting, consumption
- $C_g$: government consumption
- $CA$: current and capital account (movements of good) in real terms
- $CA_m$: current and capital account (movements of goods) in monetary terms
- $CR$: loans
- $D$: deposits
- $e$: nominal exchange rate
- $e_r$: real exchange rate
- $e_m$: import elasticity
- $e_x$: export elasticity
- $g$: gross mark-up rate
- $G$: government expenditure
- $G_p$: primary government expenditure
- $h$: ratio between currency in circulation and deposits
- $i$: nominal interest rate
- $I$: private investment
- $I_g$: government net investment
<table>
<thead>
<tr>
<th>Symbol</th>
<th>Description</th>
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<tbody>
<tr>
<td>INT</td>
<td>interest on public debt</td>
</tr>
<tr>
<td>j</td>
<td>ratio between bank monetary base and deposits</td>
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<tr>
<td>k</td>
<td>fraction of income held as monetary balances</td>
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<tr>
<td>K</td>
<td>capital</td>
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<td>KA</td>
<td>net capital movements</td>
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<td>l</td>
<td>government spending multiplier</td>
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<td>L</td>
<td>money supply</td>
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<td>LF</td>
<td>labour force</td>
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<tr>
<td>M</td>
<td>imports</td>
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<tr>
<td>m</td>
<td>propensity to import</td>
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<tr>
<td>M_s</td>
<td>Rest of the World imports</td>
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<tr>
<td>m_w</td>
<td>Rest of the World propensity to import</td>
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<tr>
<td>MB</td>
<td>monetary base; in a different setting, marginal benefit</td>
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<td>MC</td>
<td>marginal cost</td>
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<td>MR</td>
<td>marginal revenue</td>
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<td>MRS</td>
<td>marginal rate of substitution</td>
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<td>MRTS</td>
<td>marginal rate of technical substitution</td>
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<tr>
<td>MRT</td>
<td>marginal rate of transformation</td>
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<tr>
<td>N</td>
<td>employment</td>
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<tr>
<td>p</td>
<td>price or absolute price level (in the home country)</td>
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<tr>
<td>ṗ</td>
<td>inflation rate</td>
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<tr>
<td>ṗ'</td>
<td>expected price</td>
</tr>
<tr>
<td>ṗ''</td>
<td>expected inflation rate</td>
</tr>
<tr>
<td>p_m</td>
<td>import price expressed in terms of foreign currency</td>
</tr>
<tr>
<td>p_x</td>
<td>export price expressed in terms of domestic currency</td>
</tr>
<tr>
<td>p_w</td>
<td>absolute price level in the foreign country</td>
</tr>
<tr>
<td>P</td>
<td>population</td>
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<tr>
<td>PMB</td>
<td>the public’s monetary base or currency in circulation</td>
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<tr>
<td>π</td>
<td>average labour productivity</td>
</tr>
<tr>
<td>q</td>
<td>quantity consumed or supplied in a given period</td>
</tr>
<tr>
<td>q_x</td>
<td>quantity exported</td>
</tr>
<tr>
<td>q_m</td>
<td>quantity imported</td>
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<tr>
<td>Q</td>
<td>quantity produced since the beginning of production</td>
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<tr>
<td>r</td>
<td>real interest rate</td>
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<td>R</td>
<td>profits</td>
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<tr>
<td>S</td>
<td>savings</td>
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<tr>
<td>t</td>
<td>time; in a different setting, tax rate</td>
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<tr>
<td>T</td>
<td>time horizon; in a different setting, total transactions; in still another setting, taxes or current revenues; sometimes used to indicate taxes less transfers</td>
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<tr>
<td>Tr</td>
<td>total government transfers</td>
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<tr>
<td>Tr_c</td>
<td>current transfers less interest on public debt</td>
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<tr>
<td>Tr_k</td>
<td>capital transfers</td>
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</tbody>
</table>
List of symbols

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

Abbreviations and acronyms

ACP African, Caribbean and Pacific
ASEAN Association of South East Asian Nations
BIS Bank for International Settlements
BIT Bureau International du Travail
CAP Common Agricultural Policy
CBA Cost-benefit analysis
CET Common external tariff
CSF Community Support Framework
CVM Contingent valuation method
DCE Domestic credit expansion
DSB Dispute Settlement Body (GATT)
EAGGF European Agricultural Guidance and Guarantee Fund
EC European Community
ECB European Central Bank
ECSC European Coal and Steel Community
EEA European Economic Area
EEA European Environment Agency
EEC European Economic Community
EFF Extended Fund Facility (IMF)
EIA Environmental impact assessment
EIB European Investment Bank
EMI European Monetary Institute
EMS European Monetary System
EMU European Monetary Union
EONIA Euro Overnight Index Average
EP European Parliament
<table>
<thead>
<tr>
<th>Symbol</th>
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<tbody>
<tr>
<td>ERDF</td>
<td>European Regional Development Fund</td>
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<td>ERM</td>
<td>Exchange Rate Mechanism</td>
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<td>ESCB</td>
<td>European System of Central Banks</td>
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<td>ESF</td>
<td>European Social Fund</td>
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<td>EU</td>
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<td>FDI</td>
<td>Foreign direct investment</td>
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<td>FIFG</td>
<td>Financial Instrument for Fisheries Guidance</td>
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<td>FSA</td>
<td>Financial Services Authority</td>
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<td>FTA</td>
<td>Free trade area</td>
</tr>
<tr>
<td>FTAA</td>
<td>Free Trade Area of the Americas</td>
</tr>
<tr>
<td>GATS</td>
<td>General Agreement on Trade in Services</td>
</tr>
<tr>
<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross domestic product</td>
</tr>
<tr>
<td>GEF</td>
<td>Global Environmental Facility</td>
</tr>
<tr>
<td>GRA</td>
<td>General Resources Account (IMF)</td>
</tr>
<tr>
<td>GHG</td>
<td>Greenhouse gas</td>
</tr>
<tr>
<td>GNP</td>
<td>Gross national product</td>
</tr>
<tr>
<td>HDI</td>
<td>Human Development Index</td>
</tr>
<tr>
<td>IBRD</td>
<td>International Bank for Reconstruction and Development</td>
</tr>
<tr>
<td>ICN</td>
<td>International Competition Network</td>
</tr>
<tr>
<td>ICT</td>
<td>Information and communication technology</td>
</tr>
<tr>
<td>IDA</td>
<td>International Development Association</td>
</tr>
<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
</tr>
<tr>
<td>ILO</td>
<td>International Labour Office</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IPR</td>
<td>Intellectual property rights</td>
</tr>
<tr>
<td>IRR</td>
<td>Internal rate of return</td>
</tr>
<tr>
<td>IT</td>
<td>Information technology</td>
</tr>
<tr>
<td>LDC</td>
<td>Less-developed country</td>
</tr>
<tr>
<td>MFA</td>
<td>Multifibre Agreement</td>
</tr>
<tr>
<td>MFN</td>
<td>Most favoured nation</td>
</tr>
<tr>
<td>MIGA</td>
<td>Multilateral Investment Guarantee Agency</td>
</tr>
<tr>
<td>MNC</td>
<td>Multinational corporation</td>
</tr>
<tr>
<td>NAFTA</td>
<td>North American Free Trade Area</td>
</tr>
<tr>
<td>NBFI</td>
<td>Non-bank financial intermediary</td>
</tr>
<tr>
<td>NCB</td>
<td>National Central Banks</td>
</tr>
<tr>
<td>NCM</td>
<td>New classical macroeconomics</td>
</tr>
<tr>
<td>NPV</td>
<td>Net present value</td>
</tr>
<tr>
<td>NTB</td>
<td>Non-tariff barrier</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
</tr>
<tr>
<td>OMA</td>
<td>Orderly market agreement</td>
</tr>
<tr>
<td>OMO</td>
<td>Open market operation</td>
</tr>
<tr>
<td>PPP</td>
<td>Purchasing power parity</td>
</tr>
<tr>
<td>Symbol</td>
<td>Description</td>
</tr>
<tr>
<td>--------</td>
<td>--------------------------------------------------</td>
</tr>
<tr>
<td>QMV</td>
<td>Qualified majority voting</td>
</tr>
<tr>
<td>QR</td>
<td>Quantitative restriction</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>Research and development</td>
</tr>
<tr>
<td>REH</td>
<td>Rational expectations hypothesis</td>
</tr>
<tr>
<td>SDR</td>
<td>Special Drawing Rights (IMF)</td>
</tr>
<tr>
<td>SEA</td>
<td>Single European Act</td>
</tr>
<tr>
<td>SEM</td>
<td>Single European Market</td>
</tr>
<tr>
<td>SGP</td>
<td>Stability and Growth Pact</td>
</tr>
<tr>
<td>SRF</td>
<td>Supplemental Reserve Facility (IMF)</td>
</tr>
<tr>
<td>SSA</td>
<td>Sub-Saharan Africa</td>
</tr>
<tr>
<td>SWF</td>
<td>Social welfare function</td>
</tr>
<tr>
<td>TARGET</td>
<td>Trans-European Automated Real-time Gross Settlement Express Transfer</td>
</tr>
<tr>
<td>TEU</td>
<td>Treaty on European Union</td>
</tr>
<tr>
<td>TFP</td>
<td>Total factor productivity</td>
</tr>
<tr>
<td>TIP</td>
<td>Tax-tied incomes policies/Tax-based incomes policies</td>
</tr>
<tr>
<td>TNC</td>
<td>Transnational corporation</td>
</tr>
<tr>
<td>TRIMs</td>
<td>Trade-Related Investment Measures</td>
</tr>
<tr>
<td>TRIPS</td>
<td>Trade-Related Aspects of Intellectual Property Rights</td>
</tr>
<tr>
<td>UN</td>
<td>United Nations</td>
</tr>
<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
</tr>
<tr>
<td>UNDP</td>
<td>United Nations Development Programme</td>
</tr>
<tr>
<td>UNEP</td>
<td>United Nations Environment Programme</td>
</tr>
<tr>
<td>VER</td>
<td>Voluntary export restraint</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organisation</td>
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</table>
Some forty years ago, there were rather simple and commonly accepted justifications for government intervention in the economy.

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

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

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

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

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

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

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

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

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

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

Part VI deals with the internationalisation of private institutions—i.e. the globalisation of markets and production, the challenges of globalisation for public policies and the quest for a new institutional setting.
This textbook is intended for students who have completed at least a full year’s study of both microeconomics and macroeconomics. No calculus is required, except for a very few passages. Some boxes are added to most chapters to deal with specific issues, often of a practical nature. Each chapter is completed by a summary. A detailed subject index makes the book a helpful resource for consultation by the educated public in general. A list of symbols, abbreviations and acronyms used in the text is provided at the beginning of the book.

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

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

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

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

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

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

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