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CHAPTER 1
Introduction

In the late 1990s, I met an anthropology student who had just returned from a year in Senegal. As soon as she learned that I was an international economist, she asked, "Can you tell me about the CFA franc devaluation? Why was it necessary? It has made life very difficult in Senegal." Some years later, I met a religion student who had just returned from a semester spent in Haiti working in a health clinic. As soon as he learned that I was an international economist, he asked, "Can you tell me about structural adjustment programs? I'm concerned about how they are being applied to Haiti." Subsequently, one of my children's school bus driver quizzed me about the Doha Round of multilateral trade negotiations, and a college professor wanted to know the exact distinction between trade and foreign direct investment.

These are not rare incidents. I have received such inquiries from all sorts of people. Increasingly, it seems, more and more of us need to know something about the world economy, religion students and bus drivers, as well as economics and business students. Why is this? Put simply, the world economy impacts us all in increasingly significant ways. It has become very difficult to take shelter in our respective majors and professions without being knowledgeable about the fundamentals of international economics. Increasingly, trade flows, exchange rates, and multinational enterprises matter to us all, even if we would prefer that they did not. The 2008 global financial crisis made this apparent in the most dramatic way, as did the 2016 Brexit vote in favor of the United Kingdom leaving the European Union.

As a consequence of these changes, students and professionals, but also citizens more broadly, have significant concerns about "globalization." Shortly before the failed Seattle Ministerial Meeting of the World Trade Organization (WTO) in December 1999, for example, I received a phone call from a former student. She was about to travel to Seattle to join in the protests against the WTO. She knew that I had spent a brief amount of time at the WTO, and before she set off, she wanted to raise her concerns with me about globalization and the impact it was having on rural economies in the United States. The Seattle Ministerial was a failure, in part due to the efforts of my former student and her fellow protesters. The same was true of many subsequent WTO Ministerial Meetings.

Since that time, an anti-globalization movement has increased in strength.[1] It has drawn attention to the distributional impacts of increased global integration but has also at times questioned the entire integration of the world economy in broad brush terms. Are the concerns of my former student and the anti-globalization movement well placed? Is globalization the evil that some contend it is? Or is it the unmitigated good that others contend it is? Most likely, the actualities of globalization are more nuanced than the good/evil dichotomy that is often invoked. For example, in an analysis of the effects of various globalization processes on the developing world, Goldin and Reinert (2012) stated that "The relationship between globalization and poverty is not well understood…. By examining both the processes through which globalization takes place and the effects that each of these processes has on global poverty alleviation, current discussions can be better informed" (p. 1).

Better informing students and professionals about globalization is an important component of this book, and exploring key aspects of globalization is one of the tasks we take up here. We will try to explore the world economy and globalization in as balanced a manner as possible. This will help us develop informed views and opinions, whatever they might be. Developing informed views and opinions, in turn, requires a serious study of international economics. This field of study is typically divided into two parts: international trade and international finance. Indeed, these two parts often constitute the only two courses in a standard "core-course" series. In this book, however, we are going to approach things a bit differently. Acknowledging the diverse interests of students and professionals, as well as the diverse aspects of the world economy, we are going to explore four different aspects or realms of the modern world economy. These are: international trade, international production, international finance, and international development. Let's briefly consider each of these in turn.

International Trade

Our first realm of of the world economy is **international trade**.[2] International trade refers to the exchange of *both* goods *and* services among the countries of the world. We typically picture international trade as only in *goods* such as steel, automobiles, wine, or bananas. However, this view is incomplete. It is important to acknowledge that a significant portion of world trade is composed of trade in *services*. For example, financial services, architectural services, and engineering services are all traded internationally. In fact, trade in services is about one fourth the magnitude of trade in goods.[3]

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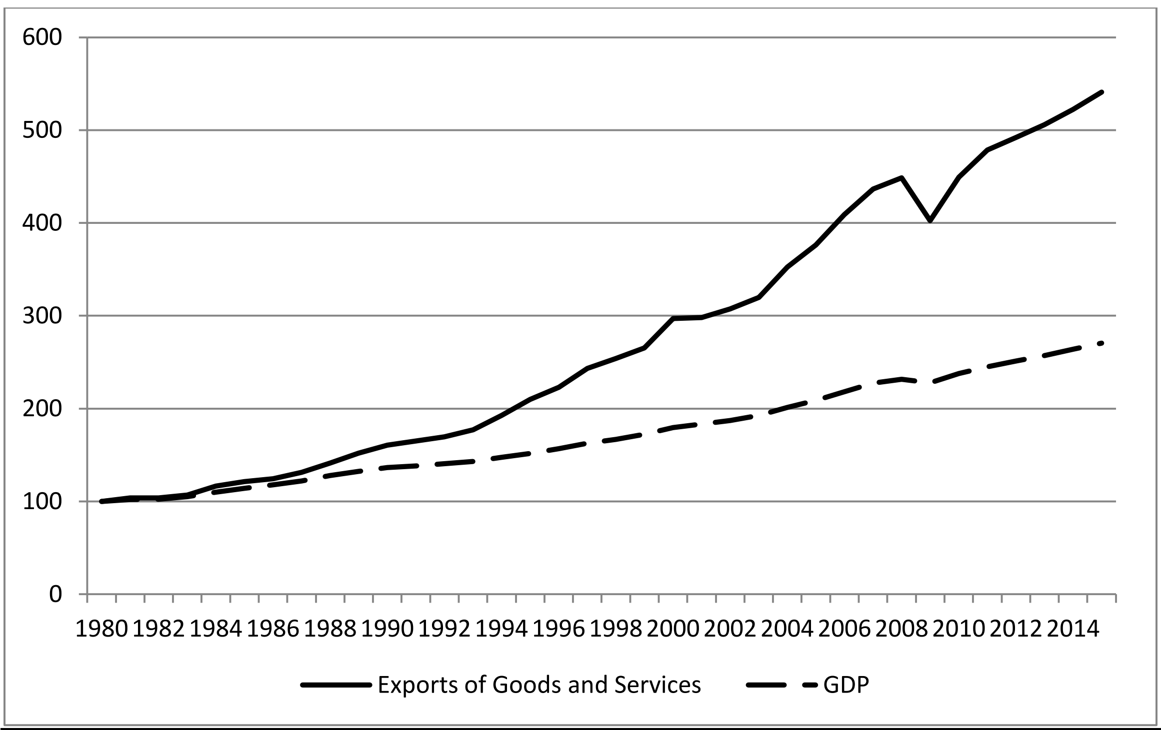
[1] See, for example, Ayres (2004) and *The Economist* (2016).

[2] Every time you encounter a term in **bold face** in this book, you can find its definition in the glossary.

[3] It is sometimes said that the word "goods" refers to things you can drop on your toe. Therefore, "services" refers to things you *cannot* drop on your toe! More formally, goods are tangible and storable, whereas services are intangible and non-storable. On trade in goods, see Reinert (2017) and on trade in services, see Francois and Hoekman (2010) and Chanda (2017). All three of these authors note that trade in goods and services are, to some degree, mutually reinforcing because manufacturing is becoming increasingly service intensive.

International trade in goods and services is playing an increasing role in the world economy. Consider the data presented in Figure 1.1. This figure plots two series of data for the years 1980 to 2015. The first series, represented by a dashed line, is inflation-adjusted, world **gross domestic product** (GDP), a measure of world output. It has been normalized so that the value in 1980 is 100, and the values for each subsequent year are measured relative to 1980. The second series, represented by a solid line, is inflation-adjusted, world exports.[4] This series has been normalized in the same way as the GDP series. As you can see in Figure 1.1, over the decades considered, trade activity increased faster than production activity in the world economy. This is one of the main features of globalization, namely the expansion of exchange of goods and services among the countries of the world. You can also see that trade decreased more quickly in 2009 than did production in response to the global recession of that year before more or less recovering its previous trajectory.

Figure 1.1: Gross Domestic Product and Exports in the World Economy, 1980 to 2015 (1980=100)



Source: World Bank, World Development Indicators and author calculations.

[4] Note that world imports track world exports very closely, so we can use the level of exports as a proxy for the overall level of world trade.

There are many reasons for the expansion of world trade illustrated in Figure 1.1. During the 1970s, a revolution began in global goods shipping using containers, with ships build to carry thousands of increasingly-standardized, 20-foot containers and ports being redesigned to handle these ships and containers efficiently. Advances in container shipping continue to this day. The largest container ships now carry over 15,000 containers, and there are ongoing experiments in new materials (e.g., carbon-fiber composites), new security scanning technology, and new means of embedding container transport histories.[5] Recent statistical evidence suggests that container transport did indeed have a significant, positive impact on increased globalization via trade flows.[6]

The container shipping revolution was followed by a revolution in information and communications technology (ICT) that greatly enhanced the ability of firms to coordinate both international trade logistics and, more generally, international production systems. Advances in ICT also greatly facilitated some types of services trade via electronic commerce. ICT subsequently enhanced the development of container shipping to such an extent that we can say, to paraphrase Levinson (2006, p. 267), the container, combined with the computer, opened the way to globalization. Further, an era of trade liberalization began with the lowering of tariff barriers both unilaterally and via regional and multilateral initiatives. All these factors helped to contribute to a world economy in which international trade relations grew increasingly important.

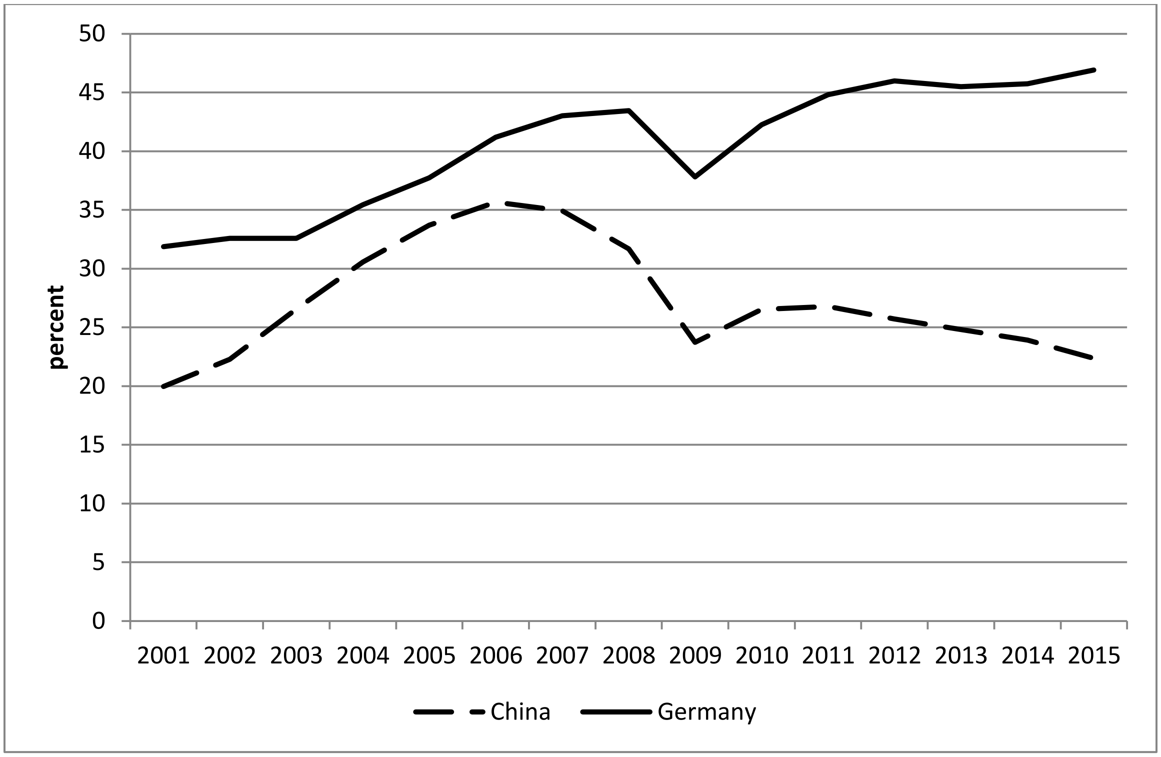
If we were to try to identify the most significant recent change in the global economy in the realm of trade, it would be the entry of China into the global trading economy as a result of its joining the WTO in 2001. China's substantial increase in exports, particularly manufactured exports, was an unprecedented event that had significant implications for what we will call the *political economy of trade* throughout much of the world.[7] Put more succinctly, China's exports have become a *political problem* in the United States and European Union. To gain some perspective, it is helpful to look at China's exports as a percent of GDP and compare this with another large exporter, Germany. We do this in Figure 1.2. We see here that China's exports as a percent of GDP are substantially lower than that of Germany and have been decreasing since 2006. Indeed, in 2015, China's exports as a percent of GDP were very nearly what they were in 2001, while Germany's increased steadily over the period of time considered in the figure.

You will begin to understand the major factors underlying international trade in Part I of this book. We will apply standard microeconomic thinking to analyzing both trade and trade policies. You will also be introduced to a set of key policy issues surrounding the management of international trade, including issues pertaining to the World Trade Organization and to **preferential trade agreements** such as the North American Free Trade Area (NAFTA) and the Association of Southeast Asian Nations (ASEAN). A full understanding of the factors underlying international trade, however,

[5] On some of these new container shipping technologies, see *The Economist* (2014).
[6] See *The Economist* (2013) and Bernhofen, El-Sahli and Kneller (2016).
[7] See, for example, *The Economist* (2016).

will also require an understanding of international production taken up in Part II of this book.

Figure 1.2: Exports as a Percent of GDP, China and Germany, 2001 to 2015



Source: World Bank, World Development Indicators.

International Production

A second important realm of the world economy is **international production**. Production patterns in the modern world economy can be relatively complex. For example, when my children were toddlers, one of their favorite books was *Bear's Busy Family*, published by the award-winning Barefoot Books. Featured in *Inc. Magazine* in 2006, Barefoot Books was founded in 1993 by Tessa Strickland and Nancy Traversy. It was initially run from their homes in the United Kingdom (where burgeoning inventory broke a table), but subsequently expanded with a flagship store in Cambridge, Massachusetts in the United States. In the case of *Bear's Busy Family*, the color separation was done in Italy, and the actual printing took place in Malaysia. So the book my children held with such interest in their hands was a result of a production process that took place in four countries. Production of products in multiple countries is what we mean by international production.

At the broadest level, international production can take place through two modes: contracts (international licensing and franchising) and **foreign direct investment** (FDI) undertaken by **multinational enterprises** (MNEs). Contracting is an arm's length relationship across national boundaries that can be described as a low-commitment-low-control option. In contrast, FDI involves firms based in one country owning at least 10 percent of a firm producing in another country and thereby exerting management influence. It can be described as a high-commitment-high-control option.[8] While both of these options are important in the modern world economy, MNEs are a particularly important set of players.[9] To get a sense of this, consider the following facts:[10]

- MNEs account for approximately one fourth of world GDP.
- The sales of foreign affiliates of MNEs now exceed the volume of world trade.
- MNEs are involved in approximately three fourths of all world trade.
- Approximately one third of world trade takes place *within* MNEs.
- MNEs account for approximately three fourths of worldwide civilian research and development.

A series of data on global FDI inflows from 1980 to 2015 is provided in Figure 1.3. The inflows are broken down among low-income, middle-income and high-income countries which receive or host the FDI. It is clear that the 1990s were characterized by a large surge of FDI inflows flows, mostly into high-income countries and partly reflecting an upturn in mergers and acquisitions activity. What is also clear, however, is that the middle income countries of the world are hosting a growing amount of FDI. FDI inflows into low-income countries are very low and stagnant, hardly even visible in the figure. These members of the global economic community are largely excluded from this important part of economic globalization. As a result of the financial crisis and global recession, total FDI flows decreased substantially in 2008 and 2009. They subsequently recovered to approximately US$ 2 trillion, a value that had been reached in the mid-2000s in the previous FDI upturn.

What has accounted for the long-term increase in FDI activity in middle and high income countries? Two relevant factors are those mentioned above in our discussion of international trade, namely improvements in transportation and ICT. Add to this an expansion of global mergers and acquisition activity, particularly in the services sector (finance, transport, communications). Indeed, services began to account for

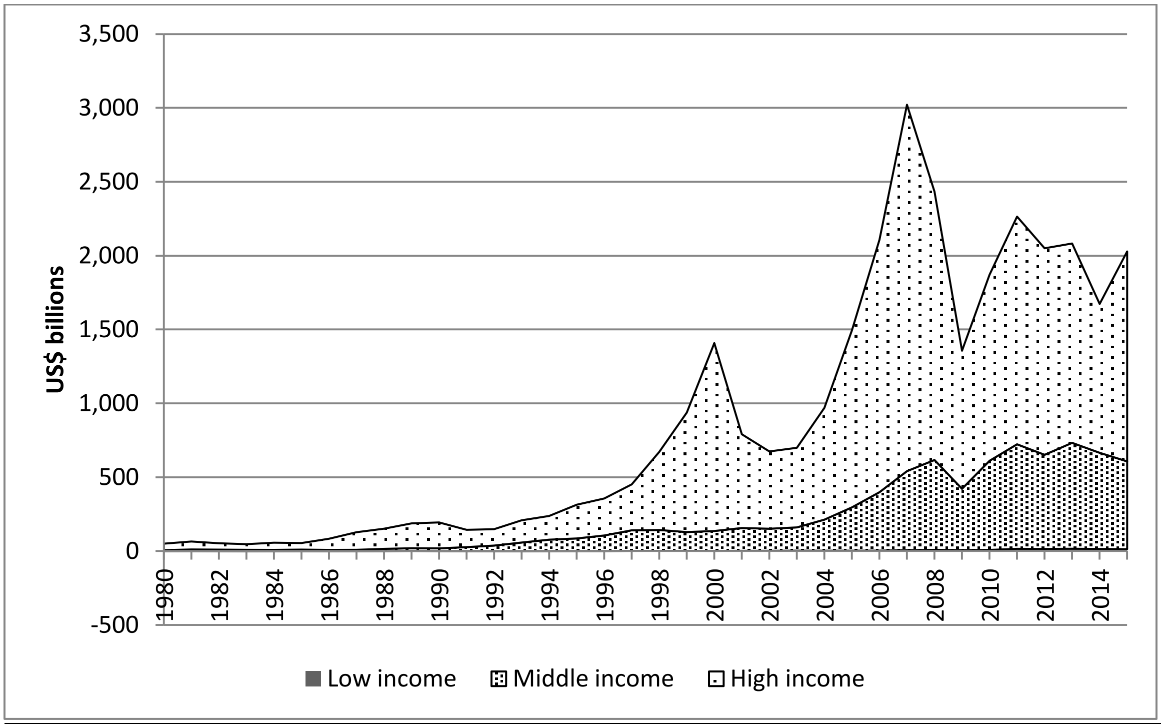
[8] The 10 percent ownership threshold for categorizing FDI is admittedly arbitrary, but it is a widely accepted standard in balance of payments accounting used by the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD).

[9] A formal definition of an MNE by Dunning and Lundan (2008) is: "A multinational or transnational enterprise is an enterprise that engages in foreign direct investment and owns or, in some way, controls value-added activities in more than one country" (p. 3).

[10] For further discussion of the role of MNEs, see chapter 2 of Dunning and Lundan (2008).

approximately half of FDI flows in the 1990s. Further, many countries in the developing world began to shift from a policy posture of antipathy toward FDI inflows to one of relative friendliness. This, for example, accompanied the well-known rise of FDI flows into China that helped spur its export expansion.

Figure 1.3: Nominal FDI Inflows to Low, Middle and High Income Countries, 1980 to 2015



Source: World Bank, World Development Indicators.

As the above facts and data indicate, the operation of MNEs is another main feature of globalization. In Part II of the book, you will gain an understanding of MNEs and their role in international production. This will include an appreciation of the relatively complex decisions facing global firms, the function of **global production networks** (GPNs), and the management issues that arise when firms are spread across international borders. You will also gain an appreciation of the role of **migration** in international production and as a feature of globalization.

International Finance

A third important realm of the world economy is **international finance**. Whereas international trade refers to the exchange of goods and services among the countries of the world, international finance refers to the exchange of **assets** among these countries.

Assets are financial objects characterized by a monetary value that can change over time. They make up the wealth portfolios of individuals, firms and governments. For example, individuals and firms around the world conduct international transactions in currencies, equities, government bonds, corporate bonds (commercial paper), and even real estate as part of their management of portfolios. The way in which the prices of these assets change in response to these international transactions impacts the countries of the world in important ways. Additionally, as we will see, these transactions can provide a source of savings to countries over and above the domestic savings of their households and firms.

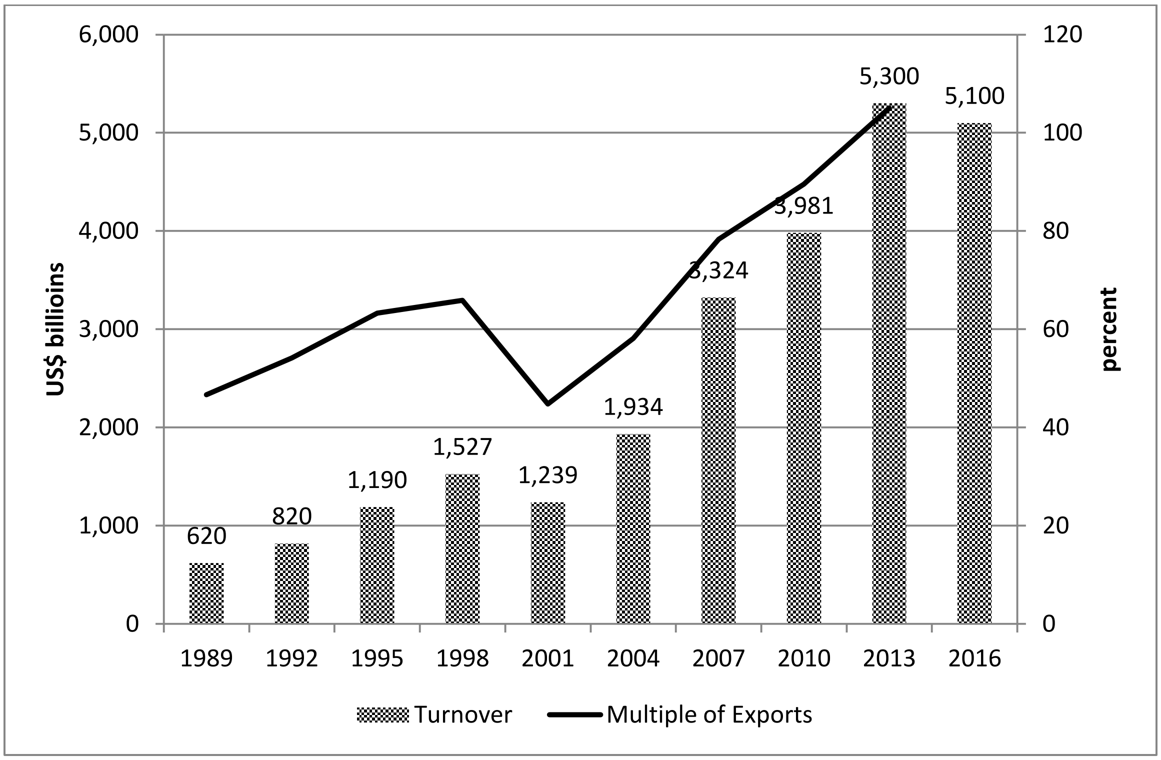
International finance plays an increasingly important role in the world economy. We can see this by considering foreign exchange transactions. Foreign exchange transactions are much larger than trade transactions. For example, Figure 1.4 plots two variables for 3-year intervals between 1989 and 2013. The first variable, plotted as the vertical bars in reference to the left hand scale (lhs), is daily foreign exchange turnover as measured by the Bank for International Settlements (BIS) in its triennial April surveys. Despite a downturn in 2001, the total foreign exchange turnover has increased substantially over time. Observers were amazed when it broke US$ 1 trillion in 1995, but in 2013 it reached over US$ 5 trillion! As of 2016, to some surprise, foreign exchange turnover declined a bit.

The second variable plots the annualized foreign exchange turnover (assuming constant turnover each day) as a multiple of total world exports in reference to the right hand scale (rhs) but only up to 2013. As you can see, foreign exchange turnover can be as high as 100 times the value of exports. This makes it strikingly clear that, on an annual basis, global transactions in foreign exchange dwarf global trade transactions. International finance matters.

Another important feature of international finance has emerged in recent years. A typical expectation in the field of international finance is that developing countries will naturally receive net inflows of capital and invest it at relatively high rates of return, with this capital being supplied by developed countries with relatively low rates of return. Since 2000, however, this pattern has been reversed. Due in large part to deficits in the United States (US citizens spending in excess of national savings), the developing world is now a significant exporter of financial capital rather than an importer. As of 2008, the capital exports of the developing world exceeded US$500 billion. This was and is a major new development in international finance.

Whether the foreign exchange transactions and capital flows of global finance are all for the best is a matter of current debate. Goldin and Reinert (2012, Chapter 4) struck a note of caution in their discussion of capital flows, noting that some types of global capital flows are volatile and potentially destabilizing. This is particularly the case for bond finance and commercial bank lending. Even the International Monetary Fund (IMF) has recently set a similarly cautious tone. A publication by its staff economists (Ostry, Loungani and Fuceri, 2016) also questioned the growth promoting effects of the bond finance and commercial bank lending. Since the IMF is the central institution of global finance, this is significant. *The Economist* (2016) summarized these concerns by stating that "there is plenty of evidence of the trouble that floods of short-term capital can cause" (p. 11). Mitigating this "trouble" is an ongoing challenge.

Figure 1.4: Daily Foreign Exchange Market Turnover and Annualized Multiple of Exports, 1989 to 2016 (billions of US dollars on lhs and multiple of exports on rhs).



Sources: Bank for International Settlements Triennial Central Bank Surveys and World Bank, World Development Indicators. Notes: The multiple of exports assumes a constant foreign exchange turnover each day of the year.

The importance of international finance, seen in Figure 1.4, became very evident in the latter part of the 1990s. During this time, investors quickly sold assets in Mexico, Thailand, Indonesia, the Philippines, Russia, and Brazil, causing **balance of payments** crises and financial crises. This was a process known as **capital flight**. Capital flight involves investors selling a country's assets and reallocating their portfolios into other countries' assets and is part of the "trouble" of global finance.

Beginning in mid-2008, the power of international finance again became evident in the form of a global crisis with roots in the United States housing market. Losses in housing mortgages were transmitted around the globe via a pyramid of financial instruments related to this sector. This was the result of banks taking loans that would traditionally remained on their books, repackaging them in the form of asset-based securities, and traded these securities internationally. This provided a mechanism for a crisis related to new financial products originating in one country to take on a global profile. As the *Financial Times* noted in 2008, "the global system has shifted from financing anything, however crazy, to refusing to finance anything, however sensible." This kind of volatility is, to say the least, not desirable.

The 2008 crisis did not just affect the United States. Its most severe effects were felt in Europe, first in the United Kingdom but then in Portugal, Italy, Ireland, Greece and Spain. The crises in Greece and Ireland were particularly acute, and the European Union has struggled to contain the damage to its political and economic integration. Watching the United States and the European Union succumb to financial instability has given many experts and policymakers pause.

As we can see, then, international finance is a realm of increasing importance in the modern world economy. You will enter into this realm in Part III of the book. You will learn about open-economy accounting, exchange rate determination, the international monetary system, and financial crises. Throughout Part III, the asset considerations that set international finance apart from international trade will be paramount.

International Development

The fourth and final realm of the world economy is **international development**. The processes of international trade, international production, and international finance reflect the many goals of their participants. From a public policy perspective, however, it is hoped that these three processes will contribute to improved levels of welfare and standards of living throughout the countries of the world. Two major issues are involved here. The first is how we conceptualize levels of welfare or standards of living. The second is how the processes of international trade, international production, and international finance support or undermine international development. To be truthful, neither of these issues has been fully settled, and policy debates on these matters are ongoing.[11]

One inclusive, although not uncontroversial, measure of differences in living standards is the **human development index** (HDI) measured by the United Nations Development Program. For our purposes here, suffice it to say that the HDI reflects per capita income (adjusted for cost of living), average life expectancy, and average levels of education. It is a relative measure in which countries are measured against each other. Data on the HDI and its component measures for the year 2014 are presented for a very small sample of countries in Table 1.1.

As we can see from Table 1.1, there is a *wide range* in measures of well-being among the countries of the world. GDP per capita ranges from approximately $1,400 in Ethiopia to over $50,000 in the United States, a factor of about 35 in this standard

[11] On this important issue, see Goldin and Reinert (2012).

measure of economic development.[12] Life expectancies range from 64 years in Ethiopia to 82 in South Korea (and even 84 in Japan). Low life expectancies often reflect high mortality among infants and children, 9 million of whom sadly perish each year. Average years of schooling range from 2.4 in the case of Ethiopia to nearly 13 in the case of the United States.

When combined into the single measure of the HDI, we again see a wide variance with a variation from approximately 0.44 to 0.92. However we view development (income, health or education) its level *varies widely* among the countries of the world from severe deprivation to relative opulence. Reducing this variance in development outcomes is one of the most important challenges faced by policymakers today. All evidence suggests that it is a challenge that will persist long into the future as well.

Table 1.1: Measures of Living Standards, 2014

Country	**PPP GDP Per Capita (2011 US$)**	**Life Expectancy (years)**	**Mean Years of Schooling (years)**	**Human Development Index (0 to 1) and Rank**
Ethiopia	1,431	64	2.4	0.442 / 174
India	5,392	68	5.4	0.609 / 130
China	12,599	76	7.5	0.727 / 90
Costa Rica	14,232	79	8.4	0.766 / 69
South Korea	33,640	82	11.9	0.879 / 17
United States	51,708	79	12.9	0.915 / 8

Source: World Bank, World Development Indicators and United Nations Development Program.

You will begin to understand how the activities of international trade, production, and finance affect international development in Part IV of the book. Here, we will consider alternative concepts of development, the way trade and other factors can contribute to economic growth, the process of hosting MNEs, and the role of the World Bank in developing countries. These intersections of our various realms of the world economy are critical for improving the well-being of (literally) billions of individuals worldwide.

[12] The GDP per capita measures are purchasing power parity measures, which adjust for differences in costs of living among countries (see Chapter 20). On GDP itself, see Coyle (2014).

Connecting the Realms of the World Economy

Each of our four realms of the world economy—trade, production, finance and development—offers a different view of larger globalization and development processes. Studying each realm offers some insights into the world economy, but these insights need to be supplemented by examining other realms as well. Too much specialization by focusing on one realm to the exclusion of others can be counterproductive.

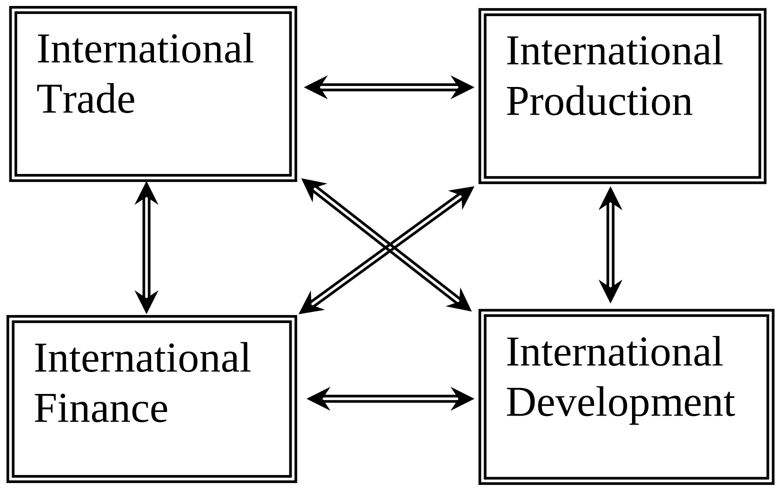
Let me give you an example. In 1991, I was working for the US International Trade Commission (USITC) in Washington, DC. At that time, most of my efforts were dedicated to analyzing the *trade* effects of the North American Free Trade Area (NAFTA). Based on the narrow trade view, I was excited about Mexico's prospects. One day, the USITC was receiving a delegation from Mexico, and I had an hour-long appointment with a Mexican economist accompanying the delegation. As it turned out, he was as worried about Mexico's prospects as I was excited. During our conversation, he said: "I am very worried about the future. All of the excitement over NAFTA is causing an inflow of portfolio investment. It is very short term, and it is financing a large trade deficit. It could turn around in a day! And then where will we be?"

As it turned out, this Mexican economist was right. The portfolio investment did turn around and caused a crisis in late 1994 and early 1995. My perspective on the Mexican economy was insufficient to allow me (and many other trade economists) to appreciate where Mexico was heading. The Mexican economist was more attuned to the realities of the Mexican economy because he was examining it through more than one viewpoint. He was paying attention to both trade and finance.

I want to suggest that you take the integrated view illustrated in Figure 1.5. Here, the four realms of our book are represented with four boxes. More importantly, there are six *connections* among the realms, represented by double-headed arrows. These are the connections among our four realms that we must keep in mind. NAFTA was an agreement for liberalizing trade and investment among the countries of North America, but its effects went beyond the trade and production realms to the realm of finance. The financial crises of the 1990s took place in the realm of international finance, but the effects were strongly transmitted to the realm of international development: standards of living fell. The same was true of the financial crisis of 2008. So as you proceed through the remainder of this book (and your career), it will be important for you to identify connections among our four areas of study.

While Figure 1.5 helps us to be cognizant of the connections among the four aspects of international economics that you will explore in this book, there are even additional realms that we must keep in mind that affect the way in which the world economy evolves over time. These are *technology*, *politics*, *culture* and the *environment*. At various points in the book, we will discuss how these factors play important roles. It is important to keep in mind that the boxes and arrows of Figure 1.5 should be thought of a being strongly influenced by technological, political, cultural, and environmental factors. The accompanying box takes up technology in the form of information and communications technology (ICT) mentioned above, but we also need to say a few words about politics, culture and the environment.

Figure 1.5: Interconnections among the Realms of the World Economy



ICT in the World Economy

As a dynamic, driving force for global economic change, technology is central. Indeed, a large part of the globalization process can be attributed to revolutions in information and communication technologies (ICT). As stated by Heshmati and Lee (2009), ICT "deals with the use of electronics, computers, and computer software to convert, store, protect, process, transmit and retrieve information" (p. 628). There is general consensus that ICT constitutes a technological innovation on the same order of magnitude as past innovations in steam power and electricity. It thereby constitutes a revolutionary change.

It is ICT that has allowed an employee of Philips, the Dutch consumer-electronics firm, to use the internet in order to adjust a television assembly line process in the Flextronics factory in Guadalajara Mexico. It is ICT that has allowed a fund manager in London to quickly buy or sell equities on the Johannesburg stock exchange. Most recently, ICT technologies in the area of "telepresence" have allowed teleconferencing to move into a new era in which it appears that participants half-a-world away are sitting across the table, greatly enhancing global coordination and reducing the need for international travel.

In the realm of international production, ICT has had a somewhat unusual impact of moving production in two opposing directions: towards greater global integration and towards selective disintegration of production systems. Communication and coordination costs of multinational production have long been a deterrent to FDI, requiring that MNEs possess offsetting advantages before engaging in successful foreign production. Advances in ICT have lowered these costs, contributing to increased integration of global production systems. Swissair, for example, has set up an accounting subsidiary in Mumbai India. Since close-of-business in Switzerland corresponds to morning in Mumbai, this accounting work is done on an overnight basis from the Swiss standpoint. This is an example of services being globalized but remaining *internal* to the firm.

At the same time, however, a second process has been at work. Improvements in ICT have resulted in firms *contracting out* on a global basis functions that they used to carry out in house, a process that has become known as "outsourcing." ICT has substantially reduced the transactions costs of outsourcing. For example, many US firms now contract their software development to Indian firms, notably to Tata Consultancy Services and Tata Unysys Ltd. Also, a number of hospitals in the United States now contract with Indian firms for medical transcription services, making use of satellite technology. These are example of services being globalized while being *external* to the firm.

Both of the above scenarios, FDI and outsourcing, have been made possible by advances in ICT that are causing a global reconfiguration of the way work is carried out. This is a process that has not yet reached its final destination but has already had revolutionary impacts on the world economy.

Sources: Dicken (2015), *The Economist* (2000, 2007), and Heshmati and Lee (2009)

In an ideal world, countries would interact with one another within the multilateral framework of international law, committed to dispute resolution procedures, conflict prevention, transparency, and respect for human rights. We do not live in this ideal world: country governments do not always respect international law, and armed, non-state actors exert their own influence across national boundaries. Consequently, *political events* of all magnitudes continually impact the world economy. Civil and international conflicts dramatically affect the supply sides of national economies, bias government expenditures towards armaments, and promote the role of militaries in national governments. These national governments themselves are of various degrees of strength and capability, from effective to outright failed. Political instability in struggling states affects all four realms of the world economy, but impinges on international development most strongly and negatively. Consequently, the best-intentioned developments in the world of international economic policy can come to naught in our less-than-ideal political world.[13]

[13] For one example of political considerations in the case of the Middle East, see *The Economist* (2015), which states that "the Middle East… is a valuable corrective to the Panglossian view of globalization" (p. 66).

Culture is as real as it is difficult to define, and we usually do not notice it until our own cultural norms have been seriously violated. James (2017) defined it as “a social domain that emphasises the practices, discourses, and material expressions, which, over time, express the continuities and discontinuities of social meaning of a life held-in-common” (p. __). It is popular to depict cultural clashes as inevitable and growing in strength in the form of a “clash of civilizations” and to further define this clash as one that is occurring between Islam and Christianity. Many of these claims do not stand up to close scrutiny. For example, Nobel Laureate Amartya Sen (2006) noted that India is considered to be central to the “Hindu world,” but has more Muslim citizens than most of the countries classified as part of the “Muslim world.” That said, it is nevertheless important to recognize that the extent to which cultural conflicts are managed (at the level of international politics or within a single MNE) matters a great deal to the evolution of the world economy. We should not discount culture’s importance.

The *environmental* issue as it relates to the world economy has developed along a number of tracks. There are global issues such as climate change, regional issues such as the environmental impacts of NAFTA, and local issues related to globalization such as toxic waste dumping. A common theme related to the politics of environmental issues is the importance of a multilateral approach to environmental problems and embodied in what is known as “multilateral environmental agreements” or MEAs.[14] MEAs include the Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES), the Montreal Protocol on Substances that Deplete the Ozone Layer (Montreal Protocol), the Convention on Biological Diversity (CBD), the Kyoto Protocol to the U.N. Framework Convention on Climate Change (Kyoto Protocol), and the Convention on Biological Diversity (CBD). The hope of many working in this realm is that MEAs will help the world economy avoid the dangers of serious and irreversible environmental harm.

It is important for us to appreciate the extent to which the political, cultural, environmental and economic can be deeply entwined. I once had the opportunity to talk at length with Dr. Owens Wiwa, the brother of Ken Saro-Wiwa, a member of the Ogani people of the Niger delta. Dr. Wiwa informed me of his brother’s campaign against the environmental damage resulting from oil exploration in the Niger delta for which he was eventually executed by the Nigerian government. One particular fact pressed upon me by Dr. Wiwa was that the gas flaring within the region takes place *horizontally* across the ground rather than vertically as is typical practice. Despite being a handy way to dry laundry, this has had severe environmental and health impacts. Today, one can view these gas flares on Google Images, and the Niger delta is in a near civil war. Global production of petroleum has gravely affected the politics, culture and environment of this particular region of the world economy. Other examples of the way political, cultural and environmental issues interact are common around the globe.[15]

[14] On MEAs, see Runge (2009).
[15] The struggle of the Wiwa family is described in Hunt (2006).

Analytical Elements

As we begin to examine the four realms of the world economy, we will utilize a number of *analytical elements* to improve our understanding of many complex processes. These are simultaneously actual elements at work in the real world economy and conceptual elements of the various models used by researchers to understand the world economy. We will rely on seven such analytical elements:

1. *Countries*. These are the states of the world economy, their national governments, serving as “home” to both firms and residents.
2. *Sectors*. These are categories of production defined largely in terms of final goods. An example is the automotive sector.
3. *Tasks*. On occasion, we are going to need to recognize that production in a particular sector involves a number of steps or separate tasks. Automobile production moves from a chassis to engine mounting to body mounting, for example.
4. *Firms*. Production in any sector of a country is undertaken by firms, either purely local or MNEs.
5. *Factors of production*. Production in any sector of a country undertaken by a firm makes use of various factors of production. Automobile production uses labor and physical capital.
6. *Currencies*. Most (not all) countries in the world economy have a separate currency in which transactions with other countries take place through foreign exchanges.
7. *Financial assets.* Both countries and firms issue various types of financial assets, denominated in a particular currency, which can be bought to be part of wealth management portfolios by other countries, other firms and residents of any country.

These are the seven analytical elements that we will draw upon in various combinations as we move the chapters of this book. At the beginning of each chapter, I will let you know what elements we are going to use.

Conclusion

It is becoming increasingly difficult for us to ignore the important realities of the world economy. Students and professionals of many types are finding that a basic understanding of international economics is necessary for them to operate successfully in the world. A thorough understanding of the world economy involves the study of four realms of international economics: international trade, international production, international finance, and international development. These are the four aspects of the world economy that we explore in this book.

International trade is increasing faster than global production. International production, meanwhile, is taking on more and more complex forms, involving both contractual arrangements and foreign direct investment. FDI is undertaken by multinational enterprises, and these organizations play a critical role in the world economy, one that cannot be ignored. However, as we have seen, viewing the world economy in its trade and production aspects is also incomplete. The realm of international finance is paramount, with foreign exchange transactions dwarfing trade transactions.

It is hoped that international trade, international production, and international finance will contribute positively to international development, improving welfare and living standards. Understanding how this occurs (or does not occur) provides an important fourth view of the world economy. This inquiry can be thought of as understanding the links between the processes of globalization and the processes of development.

These four aspects of the world economy—trade, production, finance, and development—must be seen as connected. Further, these four realms are strongly affected by the larger factors of technology, politics, culture, and the environment. The task of understanding how our four realms and the four larger factors evolve over time in a system of globalization is not, to say the least, an easy one. Indeed, it takes us far beyond the scope of this book. However, with persistence and some patience, you will begin to build an intellectual foundation for understanding this system in the remaining chapters.

Review Exercises

1. Why are you interested in international economics? What is motivating you? How are your interests, major, or profession affected by the world economy?

2. What are the four realms of the world economy? Define each of them carefully.

3. What is the difference between trade in goods and trade in services?

4. What is the difference between international trade and foreign direct investment?

5. What is the difference between international trade and international finance?

6. Identify one way in which the activities of international trade, finance, and production could *positively* contribute to international development. Identify one way in which these activities could *negatively* contribute to international development. How could you demonstrate that the activities have either a positive or negative impact on development?

Further Reading and Web Resources

Osterhammel and Petersson (2005) present a concise history of globalization accessible to a broad audience. Dicken (2015) and Dunning and Lundan (2008) look at foreign direct investment in recent decades, and Prahalad and Lieberthal (2008) provide a short, interesting assessment of FDI in developing countries. On international trade, see

Hoekman and Kostecki (2009). Eichengreen (2008) gives an excellent history of international finance, and the *Financial Times* (2008) takes a brief look at its recent failure. Goldin and Reinert (2012) and examine the relationship of a number of aspects of globalization to development and poverty alleviation. A review of globalization effects is also provided by *The Economist* (2016). Sen (2006) effectively addresses cultural issues in a global perspective, and Speth and Haas (2006) address global environmental issues. Szirmai (2015) provides a comprehensive consideration of economic and social development. Finally, Reinert et al. (2009) have edited a comprehensive encyclopedia of the world economy directly relevant to the four realms of the world economy examined here.

The Peterson Institute for International Economics in Washington, DC provides timely and readable analyses of many issues in international economics. Its website is www.piie.com. Two quality sources on international economic developments are *The Economist* and *The Financial Times*. Their websites are www.economist.com and www.ft.com. Important institutions of the world economy include the World Trade Organization (www.wto.org), the World Bank (www.worldbank.org) and the International Monetary Fund (www.imf.org).

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