

# Economics of European Integration

## Lecture 11

### Globalisation and the EU; Recap

Stephen Kinsella

Dept. Economics, KBS  
University of Limerick.  
stephen.kinsella@ul.ie

November 24, 2009

## Part I

### Benefits of the EU for Ireland

## Today

- 1 Ireland and the EU
- 2 EU and Globalisation
- 3 Module Recap

## Benefits

- billions of euros of EU funding over 30+ years
- a single European market established between the EU members
- the break up of national monopolies and their privatisation
- deregulation of the marketplace across Europe
- the encouragement of free and fair competition between EU countries
- unrestricted trade between EU member countries using common rules
- a large and growing market of consumers as the EU enlarged and more countries joined
- low corporate taxes introduced within Ireland (12.5%)
- a (too) stable Irish political system
- a young educated English mother-tongue population
- high levels of Foreign Direct Investment flowing into Ireland

## Costs of the EU

- Sovereignty?
- Transactions costs remain high; price dispersion hasn't reduced since introduction of SEM.
- Fiscal/Monetary Policy discretion.
- SOE non-core economy very open to global downturns → potential for asymmetric shocks.
- Policy dice very unlikely to fall in our favour.

## Globalisation

### Definition (Globalisation)

The increase in connectedness and rates of exchange between factor markets. O'Rourke and Williamson [1999]

*"The surest way to do more to help the poor is to continue to open markets" (Agosin and Tussie, 1993, p. 9)*

- Washington Consensus: Liberalisation → growth

## Part II

## Globalisation and the EU

## Comparative Advantage

### Comparative Advantage

Nations specialise in sectors in which they have a comparative advantage. French→wine, Irish→bitterness, etc.

### Causal Story

open markets + financial liberalisation → ↑ trade → ↑ economic growth → ↑ technological change → improved allocation of natural resources from import substituting industries to export-oriented industries → ↓ unemployment → ↑ taxes → ↑ public services → ↑ stable economic growth, full(ish) employment.

### Policy Prescription

Deregulate financial markets and reduce/remove tariffs, quotas and other trade barriers, remove subsidies to 'infant' industries, allow in FDI and offer generous tax incentives to do so.

## Is it fair?

- CA is a 'sacred' tenet of modern economics.
- notion of comparative cost: nations should focus on producing stuff which is *comparatively* cheaper than other nations. Nations need to trade their exports for equivalent amounts of imports, or trade won't be balanced.
- serious theoretical issues here:
  - 1 nations don't trade. Firms do. Big contribution here by Melitz (2003).
  - 2 Terms of Trade must fall when nation runs a trade deficit **or: ToT must automatically eliminate trade imbalances over the medium term.** On average, over 10 years, ebbs and flows of comparative advantage should look random. They don't.
  - 3 trade balance must improve when terms of trade fall. (elasticities controversy)
  - 4 no overall job loss when these adjustments occur. ILO says UE has ranged from 3% to 25% over last 25 years in developed world.

## Helping infant industries grow

From Greenwald and Stiglitz [2006]

Assume two countries, developed  $D$  and less developed,  $L$ . These countries face the same production technologies, with only labour as the input for both produced goods, agriculture,  $A$  and industry,  $I$ . Call  $C_I^D(C_A^D)$  the cost of labour per unit of agricultural or industrial output in the developed country, and vice versa in the less developed country. Assume

$$C_I^D < C_I^L \quad \text{and} \quad C_A^D < C_A^L, \quad \text{but} \quad (1)$$

$$\frac{C_A^D}{C_I^D} < \frac{C_A^L}{C_I^L}. \quad (2)$$

## It is fair?

| Year | Rich: Poor GDP/Capita |
|------|-----------------------|
| 1820 | 3:1                   |
| 1913 | 11:1                  |
| 1950 | 35:1                  |
| 1973 | 44:1                  |
| 1992 | 72:1                  |

Table: Source: UNDP Human Development Report, various years.

## Helping infant industries grow

From Greenwald and Stiglitz [2006]

In equilibrium, the less developed nation will specialise in agricultural output while the rich country will produce both goods. Prices will be determined by a trade off between the cost of producing the industrial and the agricultural good, so

$$P_I^D = \frac{C_I^D}{C_A^D} \quad (3)$$

and wages in both countries will be given by

$$W^D = \frac{1}{C_A^D} \quad (4)$$

and

$$W^L = \frac{1}{C_A^L} \quad (5)$$

## Helping infant industries grow

From Greenwald and Stiglitz [2006]

Allowing free trade between these countries means that  $L$  will devote all their energies to specialising in agriculture. Consumption in  $L$  will therefore be determined by  $P_I^D$ . All gains to trade flow to  $L$  in this example.

Now adding a measure of technological progress by differentiating with respect to time yields:

$$\frac{-1}{C_I} \times \frac{\partial C_I}{\partial t} = \frac{-1}{C_A} \times \frac{\partial C_A}{\partial t}. \quad (6)$$

So:

$$-\frac{\partial}{\partial t} \left( \frac{C_I}{C_A} \right) = \frac{-C_I}{C_A} \left( \frac{1}{C_I} \times \frac{\partial C_I}{\partial t} - \frac{1}{C_A} \times \frac{\partial C_A}{\partial t} \right) \quad (7)$$

## Helping infant industries grow

From Greenwald and Stiglitz [2006]

Equation 7 says that increases in technological progress will spillover from the industrial sector to the agricultural one. Now let

$$g = \frac{-1}{C_I} \times \frac{C_I}{\partial t} = \frac{-1}{C_A} \times \frac{\partial C_A}{\partial t} = f \left( \frac{Q_I}{Q_I + Q_A} \right). \quad (8)$$

Here  $Q_A$  is the measure of output in the agriculture,  $Q_I$  is output in the industry. When  $Q_I^L = 0$ , industry stagnates in the less developed country.

## Helping infant industries grow

From Greenwald and Stiglitz [2006]

Now ban industrial exports from  $D$ . What will happen? First, there will be hardship, but at some point  $L$  will have to start producing its own industrial output to survive, thus  $P_I^L = \frac{C_I^L}{C_A^L}$ . If we wait long enough, eventually the benefits of this improvement will outweigh the short run costs. The country will become self sufficient because at some point

$$g^L = f \left( \frac{Q_I^L}{Q_I^L + Q_A^L} \right) > 0. \quad (9)$$

What's the point of the paper? Trade barriers might enhance rather than reduce welfare. What, in your opinion, is the major weakness of an argument like this?

## Part III

### Recap

## Learning Outcomes

- conversant with the historical literature on the development of the EU having written several thousand words on the subject;
- understand transaction-cost analysis, institutional analysis, optimal currency area theory and simple models of capital and labour market integration and be able to apply these theories to current practice following the problem sets given in class;
- conversant with the Solow model of economic growth, theory and practice of convergence, and able to assess the empirical reality of these claims;
- knowledgeable about EU social and environmental policy and their impact on the Irish economy.

## Exam

- 2.5 hours
- 10 Short qs, do all 10 (breadth)
- 3/4 long qa, do 3 (depth)

Recap tutorials this week, more questions, feel free to email [stephen.kinsella@ul.ie](mailto:stephen.kinsella@ul.ie) or [darragh.flannery@ul.ie](mailto:darragh.flannery@ul.ie).

## Outline

- 1 History, Structure, Institutions
- 2 OCA/EMU Theory
- 3 Size & Scale Effects, growth & development
- 4 Macroeconomics, economic inequality in the EU
- 5 Location effects, international trade, Ireland and the EU.

## References

- Bruce Greenwald and Joseph E. Stiglitz. Helping infant economies grow: Foundations of trade policies for developing countries. *American Economic Review*, 96(2):141–146, May 2006. URL <http://ideas.repec.org/a/aea/aecrev/v96y2006i2p141-146.html>.
- Kevin H. O'Rourke and Jeffrey G. Williamson. *Globalization and History: The Evolution of a Nineteenth-Century Atlantic Economy*. MIT Press, 1999.

