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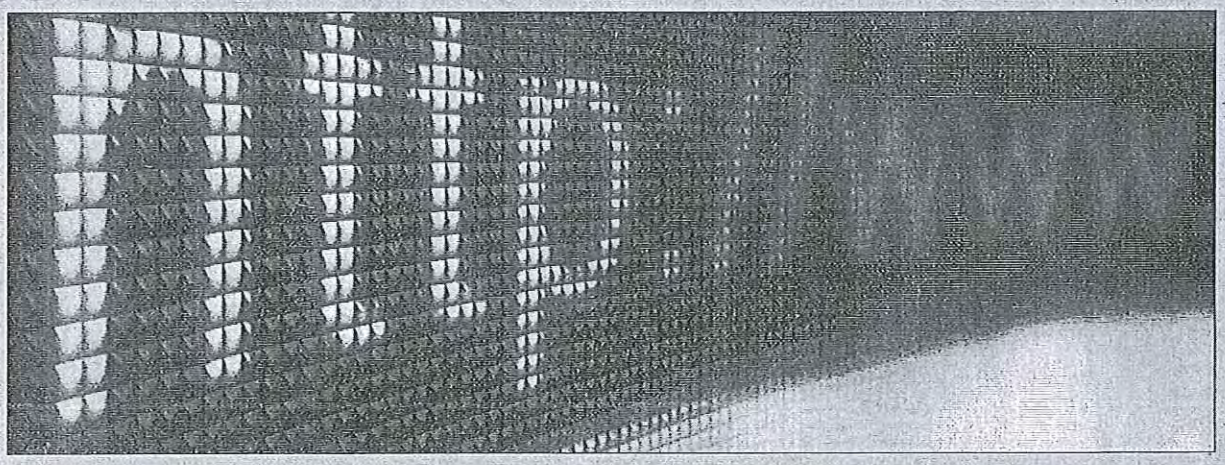
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Globalna ekonomija

CHAPTER ONE

Globalization



LEARNING OUTCOMES

This chapter will enable you to:

- Explain the nature of globalization
- Assess the pace and extent of globalization
- Analyse the factors driving and facilitating globalization
- Explain the importance of globalization for organizations and countries
- Analyse the factors inhibiting globalization

Case Study Globalization and Dell

The globalization process involves the establishment of economic, political, social, and technological links among countries. This case illustrates how one company, Dell, got involved in, and profited from, the process of globalization. It shows: how Dell took advantage of the freeing up of cross-border trade and investment to set up a global supply chain across five continents and to penetrate foreign markets; how it had to adjust its products to different country contexts and how its production methods have been influenced by foreign firms.

The Company

Dell, based in Texas, is the world's second largest manufacturer of personal computers and has grown very fast. In the ten years up to 2007, sales increased from US$5 billion to US$57 billion. Profits are around the £3 billion mark. The company sells over 100,000 computers every day, most of them direct to the final customer via the internet.

The Global Supply Chain

To manufacture its products, Dell coordinates a global production network that spans the five continents of North and South America, Europe, Asia, and Australasia. Dell assembles most of its machines in its own plants but outsources the supply of many components such as motherboards and CD/DVD drives to other companies and, as a result, is heavily reliant on foreign suppliers like Samsung of South Korea, Infineon of Germany, Foxconn in China, the Dutch firm Phillips, Nokia in Finland, and Sony of Japan. The whole production operation from the design to assembly stage can involve a dozen countries. The Dell Notebook illustrates the complex global nature of Dell's supply chain. The machine was designed by Dell engineers in Texas and Taiwan and assembled in Malaysia from parts made in China, the Philippines, Germany, Singapore, Costa Rica, Israel, India, Thailand, and Mexico.

Dell's production system aims to minimize the number of components held in stock. It does this by applying principles of lean manufacturing and just-in-time production first employed by Japanese manufacturers such as Toyota.



Source: www.dell.com

Selecting Locations

Dell's decisions about where to locate are driven by the desire to minimize costs and to extend the build-to-order, direct sales model around the world. Dell has taken advantage of the reduction and removal of barriers to trade and investment to locate in regions and sites that best meet its needs. Given the necessity to have production and support capabilities in the major markets, the company selects specific locations based on a combination of factors including the quality of labour and its cost—the company located in Ireland where labour cost were less than in most other members of the EU—now it is considering locating to one of the new EU member states in Eastern Europe, such as the Czech Republic, where workers are well-educated but much cheaper and less strongly unionized than in other EU countries; the quality of transport and telecommunications infrastructure—its sites in Tennessee are located close to major roads and to a Federal Express distribution centre—the availability, quality, and cost of telecommunications bandwidth are also factors, especially for call centres and data centres; access and proximity to markets—Malaysia is centrally located for markets in the Asia-Pacific region; government incentives—Ireland offered a low corporate tax rate, support in finding land, building facilities, and training employees and per capita →

→ grants for each employee; avoiding barriers such as tariffs that would make Dell's products uncompetitive—locating in Brazil and China not only gave good access to the South American and Chinese markets but also got around tariffs that would make Dell imported products too expensive.

As Dell moved beyond its home market in the USA, it had to adapt its business activities and organizational structure to the different markets in which it operates. While product development is largely centralized in the USA and the same base products are sold worldwide, Dell has to customize its products for different regional and country markets with appropriate power supplies, keyboards, software, and documentation.

Sources: Thomas Friedman (2005), *The World is Flat: Brief History of the Globalized World in the 21st Century*, London: Allen Lane; www.dell.com; *Thomson 1 Banker Analytics*

Introduction

How is it that a teenager in the UK can press a key on his computer and immediately bring chaos to Houston, the biggest US seaport? Why do bar owners in Southern Spain rub their hands with glee when another low cost airline is set up in the UK? Why is it that a plane crashing into a building in New York can cause hotels in London to drop their prices or a Belgian airline to go bankrupt? Why should an outbreak of peace in the Middle East be good news for European gas consumers, in the form of lower gas bills, but bad news for BP and Shell shareholders? Why should a fall in the value of the US dollar lead to higher unemployment in Germany, or the collapse of Communism cause a rise in unemployment among steel workers in South Wales? How is it that a decision by an obscure bureaucrat in Brussels causes the giant US multinational, General Electric to abandon its US$40 billion takeover of the electronics firm, Honeywell or that an industrial dispute in Belgium results in British workers getting more training?

These are all examples of globalization—a major theme of the book. They show that events in one corner of the globe can have a major impact on others, sometimes good, sometimes bad. Business operates in a world where globalization is going on at an accelerating rate. As globalization progresses, it confronts business with significant new threats and opportunities in the external environment to which it has to respond. So globalization is important for business, but what is it and why is it so important?

The Process of Globalization

Globalization involves the creation of linkages or interconnections between nations. It is usually understood as a process in which barriers (physical, political, economic, cultural) separating different regions of the world are reduced or removed, thereby stimulating exchanges in goods, services, money, and people. Removal of these barriers is called liberalization.

As these exchanges grow, nations, and the businesses involved, become increasingly integrated and interdependent. Globalization promotes mutual reliance between countries. Globalization can have many advantages for business such as new markets, a wider

choice of suppliers for goods and services, lower prices, cheaper locations for investment, and less costly labour. It can also carry dangers because dependence on foreign suppliers and markets leaves businesses vulnerable to events in foreign economies and markets outside their control.

Take the examples of Spain and Italy and their dependence on foreign countries for their energy supplies: they illustrate how important the interlinkages brought about by globalization can be, and what can happen when things go wrong. Since the 1980s, natural gas has become increasingly important in Spain as a source of energy. Spain itself produces an insignificant amount of oil and coal. As a result it depends on foreign suppliers for 99% of its natural gas requirements which is growing by 15% per annum. Three quarters of its gas supply comes from three African countries, Algeria, Nigeria, and Libya. These countries are potentially unstable both politically and economically. This leaves Spain's power stations and four million Spanish consumers very vulnerable to any instability with their African suppliers (see the International Atomic Energy Authority web site www.iaea.org; and Isbel).

Italy is dependent on cross-border supplies of electricity from Switzerland. In 2003 major sections of the Italian economy were brought to a standstill. What happened? A



Mini Case The Global Environment and Business

This case illustrates the importance of external factors for organizations. It shows how a company's performance can depend on a whole range of forces in the global environment. Factors such as the state of the global economy, events in foreign currency markets, changes in the price of oil, and the activities of foreign competitors can have important effects on competitiveness, sales, costs, and profits.

Evonik is a multinational company based in Germany. It has activities in the chemicals, energy, and real estate sectors, operates in more than 100 countries, and is one of the world's largest producers of specialist chemicals. It employs around 40,000 workers and has a turnover of just over €14 billion.

In 2007 the company reported that the global economy was growing, but more slowly than in the previous year. The strongest market growth was registered in China, India, and Russia, while growth in the USA, Japan and the Eurozone had faltered. The high oil price, the strength of the euro, and the weakness of the US dollar and the yen were having adverse effects on company earnings. The company had managed to pass on to customers some of the higher raw material costs in the form of higher prices but was facing aggressive price competition from rivals in low-wage countries. The global demand for energy was increasing but the company was apprehensive that growing concerns about global warming would lead to tougher regulations on carbon dioxide emissions which could make their power stations uncompetitive.

Sales rose by 2% compared with the previous year. However, the hike in raw material costs caused by the increased price of oil, combined with the weakness of the US dollar and competitive price pressures, left the profit margin unchanged.

Source: Evonik Annual Report 2007

Now go to the Evonik web site (www.evonik.com), find the latest annual report and read the section entitled 'Management Report'. Make a list of the external forces cited there and identify how they have affected the company's recent performance.

tree in the Swiss Alps, uprooted by a strong gust of wind, had fallen on to a power line causing massive economic disruption. It left 57 million people in Italy without electricity. The entire country, with the exception of the island of Sardinia, was affected. Transport ground to a halt with tens of thousands of people left stranded on trains. Planes were unable to take off and traffic lights ceased operating. Hospitals were forced to use emergency generators, telephones and televisions went dead, and cars were unable to get out of electronically controlled garages. Shops were reduced to accepting nothing but cash and giving hand-written receipts because their electronic tills were not working.

Globalization also poses a threat insofar as it removes protection from domestic producers by opening up their markets to foreign competitors. In 2005, under pressure from domestic textile producers, the authorities in both the EU and the USA imposed restrictions on imports of cheap textiles from China.

Nations may also find that globalization causes them to specialize in producing those goods and services in which they are relatively more efficient. While this could generate benefits from economies of scale in production, it could also create dependence on a smaller range of products, and leave their economies more vulnerable to external events.

Globalization is not Global (yet)

Globalization is something of a misnomer because most foreign trade and investment takes place within and between the three great economic blocs:

- Western Europe dominated by EU member states;
- NAFTA comprising the USA, Canada, and Mexico; and
- Japan.

They are called the triad. Other parts of the world tend to play only a minor role. The majority of world trade takes place either within each triad member or between the blocs. However, most of this trade is internal i.e. NAFTA is not heavily dependent on trade with either the EU or with Japan.

This situation is reflected in the strategies pursued by big multinational companies. These organizations focus their strategies on the bloc where they produce. More than 90% of cars produced in Europe are sold there and a similar situation exists in North America (more than 85%) and Japan (more than 93%). This is also the case for steel, heavy electrical equipment, speciality chemicals, energy, transportation, and services (Rugman 2002). This concentration of trade in their own bloc is largely due to the size of their markets. Globally, rich countries make up less than a fifth of the world population but consume more than four fifths of the goods produced (World Bank 2005).

The number of countries making up the triad has changed over time. For example, membership of the EU increased to 27 in 2007 with the entry of ten Eastern European countries, Cyprus, and Malta. The USA is also pushing hard for the incorporation of Latin American countries with its proposal to set up the Free Trade Area of the Americas (FTAA).

Although the triad still accounts for over 50% of world exports and imports, its predominance is under threat from China whose share of world trade in manufacturing has grown very rapidly. China has become the second largest trader after Germany and ahead of the USA (World Trade Organization 2007).

The triad is also dominant in investment, but even here its position is under challenge from emerging countries such as China and India. This aspect is dealt with in the next section.

The Indicators of Globalization

There are three main economic and financial indicators of globalization, these are:

- international trade in goods and services
- the transfer of money capital from one country to another
- the movement of people across national borders.

Of the three, international trade and foreign investment are the most important. Each of the three indicators will be examined in turn.

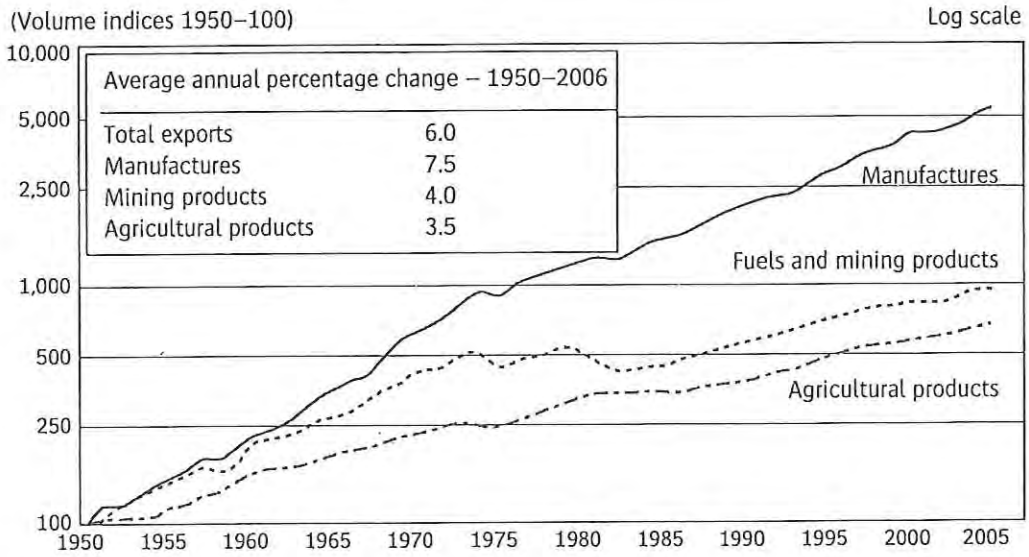
International Trade

International trade means that countries become more interconnected through the exchange of goods and services, that is, through imports and exports. Between 1950 and 2006, world trade grew 27-fold in volume terms, three times faster than world output growth (WTO 2007). We can conclude from this that importing and exporting is becoming an ever more crucial component of global and national economic activity.

As can be seen in Figure 1.1, merchandise trade grew very quickly in the second half of the 20th century, particularly in manufactures which increased tenfold between 1950 and 1975. While the rate of growth subsequently fell, it was still very rapid. In the 1990s, world exports grew on average by almost 7% per annum with services exports growing even faster than those of goods. In the six years up to 2006, trade in both goods and services grew by about 10% on an annual basis but then growth started to tail off, slowing to between 4 and 5% by 2008 (www.wto.org). Over the same period, developing countries increased their share of merchandise trade to around one quarter (World Trade Organization 2007).

Multinational companies (MNCs) are major traders and account for a large proportion of international trade, with significant proportions accounted for by trade between subsidiaries within the same company. So for example, Ford makes gearboxes in its factory in Bordeaux and exports them to its assembly plants in other European countries. Around one half of US manufactured exports and more than 60% of its imports flow within MNCs. International trade has increased more rapidly than global output which has been increasing by around 3% per annum.

Figure 1.1 International trade by product group



Source: WTO

Learning Task

Examine Figure 1.1.

1. Compare and contrast the rates of growth of world exports of manufactures in the period between 1950 and 1975 with the period up to 2006. Try to come up with some explanations for the different rates of growth.
2. Since the mid 1980s the growth of exports of fuels and mining materials has accelerated. What link could there be between this growth and the rapidly expanding Chinese and Indian economies?

Some economies are particularly dependent on international trade. According to the World Trade Organization (WTO), exports and imports together amount to more than two thirds of China's Gross Domestic Product (the total value of a country's output of goods and services), more than half for the UK, but only around one quarter for the USA (http://stat.wto.org). Furthermore, the UK depends on customers in only two countries, the USA and Germany, for almost a third of its exports of goods. Events in those economies are outside the control of UK business but could have a major impact on it. For example, a rapid and simultaneous expansion of both economies would be very good news for sales of British manufactures but a recession, on the other hand, would

mean a significant fall in turnover and profits. Dependence is also reflected in particular industries. For example, 65% of domestic demand for chemicals in the UK is satisfied by foreign suppliers. At the same time, the UK chemical industry is very dependent on foreign customers because their orders account for more than two thirds of sales (Annual Abstract of Statistics 2004).

Financial Flows

Foreign Indirect Investment

The second main driver is the transfer of money capital across borders.

This can take two forms. The first, Foreign Indirect Investment (FII, or Portfolio Investment), occurs where money is used to purchase financial assets in another country. These assets could comprise foreign stocks, bonds issued by governments or companies, or even currency. Thus, UK financial institutions such as HBOS and Barclays often purchase bonds or company shares quoted on foreign stock exchanges such as New York or Tokyo. Purchasers buy them for the financial return they generate. This activity has been increasing very rapidly—in the 1990s such trading was expanding at more than 20% per annum, helping to bring about an increased integration of financial markets. Growth faltered after the East Asian financial crisis of the late 1990s but picked up again in the new century. The interlinkages created by FII were demonstrated in 2006 when it was estimated that foreign financial institutions held more than 10% of the US$8 trillion in outstanding US residential mortgages in the form of mortgage-related securities. This left them vulnerable to the downturn in the US housing market which started in 2007 and led to a world-wide credit crunch (International Monetary Fund 2006) (see the section on financial crises in Chapter Nine and the end of chapter case study in Chapter Four).

Activity on the foreign exchange market is enormous. The average daily turnover worldwide in 2001 was US$1.4 trillion with most business taking place in the main financial centres of the triad: New York, London, and Tokyo. By 2007, turnover had more than doubled to US$3.2 trillion. Only a very small proportion of currency trading is associated with the financing of trade in goods and services—most goes on the buying and selling of financial assets (Bank of International Settlements 2007).

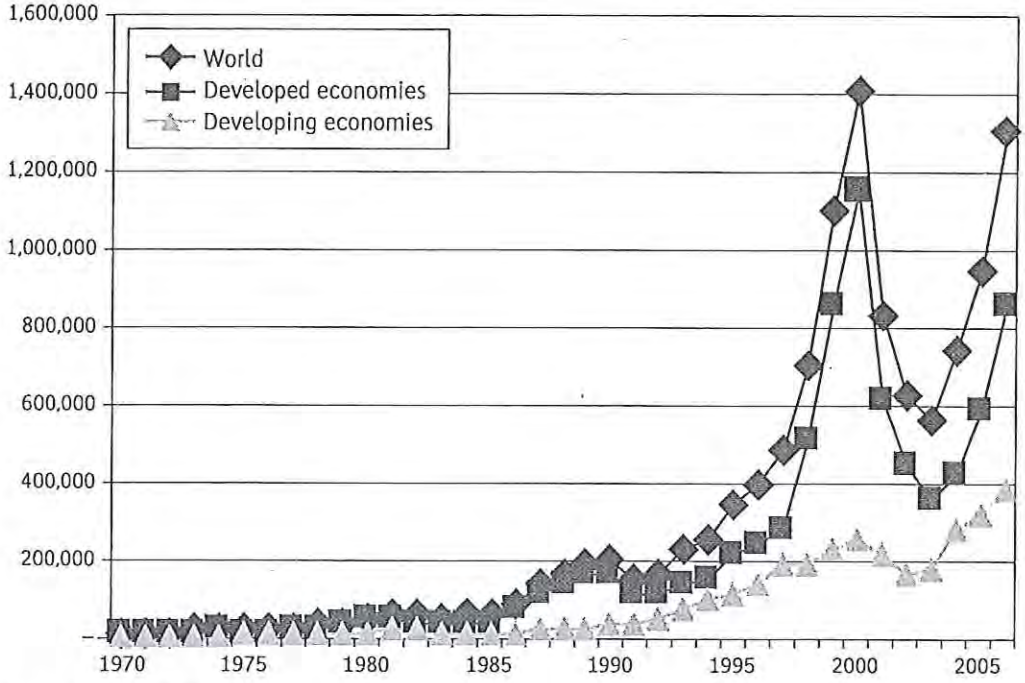
Foreign Direct Investment

The second form of capital movement is Foreign Direct Investment (FDI). FDI occurs when a firm establishes, acquires, or increases production facilities in a foreign country. MNCs are responsible for foreign direct investment and the massive increase that has occurred in FDI in the last 50 years.

The distinguishing feature between FII and FDI is that MNCs not only own the physical assets but also wish to exercise managerial control over them.

Countries can receive inflows of investment but they can also be sources of investment. The major recipients of FDI are the developed countries, mainly because of their large and affluent markets. In 2006, rich countries received around 60% of FDI inflows whilst

Figure 1.2 Inward FDI Flows US$m



Source: based on UNCTAD data

they accounted for the vast majority—between 80 and 90% of the outflows (UNCTAD 2007; World Bank 2008a; Figure 1.2).

FDI grew spectacularly in the 1990s but declined steeply after 2000 due to weak growth of the world economy. The decline was halted in 2003/04. By 2006 it was once again approaching the peak of US$1.4 trillion reached in 2000.

In 2006 rich countries received just over 60% of FDI inflows with the USA being the most favoured location, particularly for firms from Western Europe and Asia. Developing economies accounted for the remaining 40%—with China, Hong Kong, and Singapore being the largest recipients (UNCTAD 2007).

FDI thus largely involves MNCs in rich countries investing in production facilities in other rich countries. The developing countries and Eastern Europe, having smaller and less lucrative markets, play only a minor part. Where FDI does take place in poor countries it is often to exploit natural resources such as oil or other minerals, to take advantage of cheap labour or, sometimes, to penetrate a market. China is favoured by foreign multinationals because labour is cheap and there is great market potential. Firms like Volkswagen, Toyota, Caterpillar, and Tesco have invested there to take advantage of cheap resources or to exploit the market.

According to UNCTAD (2007) there are some 78,000 multinational companies, with around three quarters of a million foreign affiliates. While the vast majority are based in

Figure 1.3 The world's top 25 non-financial TNCs, ranked by foreign assets, 2005[a] (Millions of dollars and number of employees)

Ranking by:						Assets		Sales		Employment			No. of affiliates	
Foreign assets	TNI	II	Corporation	Home economy	Industry	Foreign	Total	Foreign	Total	Foreign	Total	TNI (Per cent)	Foreign	Total
1	70	42	General Electric	United States	Electrical & electronic equipment	412,692	673,342	59,815	149,702	155,000	316,000	50.1	1184	1527
2	8	94	Vodafone Group PLC	United Kingdom	Telecommunications	196,396	220,499	39,497	62,428	51,052	61,672	82.4	77	210
3	85	72	General Motors	United States	Motor vehicles	175,254	476,078	65,288	192,604	194,000	335,000	42.9	91	158
4	16	61	British Petroleum Company PLC	United Kingdom	Petroleum expl./ref./distr.	161,174	206,914	200,293	253,621	78,100	96,200	79.4	417	602
5	29	80	Royal Dutch/Shell Group	United Kingdom, Netherlands	Petroleum expl./ref./distr.	151,324	219,516	184,047	306,731	92,000	109,000	71.1	507	964
6	38	43	ExxonMobil	United States	Petroleum expl./ref./distr.	143,860	208,335	248,402	358,955	52,920	84,000	67.1	258	331
7	64	95	Toyota Motor Corporation	Japan	Motor vehicles	131,676	244,391	117,721	186,177	107,763	285,977	51.8	141	391
8	79	56	Ford Motor	United States	Motor vehicles	119,131	269,476	80,325	177,089	160,000[b]	300,000	47.6	201	285
9	27	55	Total	France	Petroleum expl./ref./distr.	108,098	125,717	132,960	178,300	64,126	112,877	72.5	401	567
10	94	36	Electricite de France	France	Electricity, gas and water	91,478	202,431	26,060	63,578	17,801	161,50	32.4	218	276
11	73	51	France Télécom	France	Telecommunications	87,186	129,514	25,634	61,071	82,034	203,008	49.9	175	243
12	51	54	Volkswagen	Germany	Motor vehicles	82,579	157,621	85,896	118,646	165,849	345,214	57.6	199	279
13	63	74	RWE Group	Germany	Electricity, gas and water	82,569	128,060	23,390	52,081	42,349	85,928	52.9	248	432
14	53	88	Chevron Corp.	United States	Petroleum expl./ref./distr.	81,225	125,633	99,970	193,641	32,000	59,000	56.8	106	234
15	77	73	E.ON	Germany	Electricity, gas and water	80,941	149,900	29,148	83,177	45,820	79,947	48.8	367	639
16	24	52	Suez	France	Electricity, gas and water	78,400	95,085	39,565	51,670	96,741	157,639	73.5	440	613
17	87	59	Deutsche Telekom AG	Germany	Telecommunications	78,378	151,461	31,659	74,230	75,820	243,695	41.8	266	382
18	40	47	Siemens AG	Germany	Electrical & electronic equipment	66,854	103,754	64,447	96,002	296,000	461,000	65.3	877	1177
19	12	70	Honda Motor Company Limited	Japan	Motor vehicles	66,682	89,923	69,791	87,686	126,122	144,785	80.3	141	243
20	11	17	Hutchison Whampoa	Hong Kong, China	Diversified	61,607	77,018	24,721	31,101	165,590	200,000	80.8	75	83
21	67	38	Procter & Gamble	United States	Diversified	60,251	135,695	38,760	68,222	69,835	138,000	50.6	269	345
22	47	37	Sanofi-Aventis	France	Pharmaceuticals	58,999	102,638	18,901	34,013	69,186	97,181	61.4	142	181
23	89	77	ConocoPhillips	United States	Petroleum expl./ref./distr.	55,906	106,999	48,568	179,442	15,931	35,591	41.4	68	125
24	60	32	BMW AG	Germany	Motor vehicles	55,308	88,316	44,404	58,105	25,924	105,798	54.5	142	175
25	49	96	Nissan Motor Company Limited	Japan	Motor vehicles	53,747	97,661	59,771	83,440	89,336	183,356	58.5	54	172

Source: UNCTAD, World Investment Report 2007

rich countries, there are an increasing number of MNCs to be found in poor economies, two examples are: Tata of India and Hong Kong's Hutchison Whampoa.

Big MNCs are the most important foreign direct investors. Figure 1.3 shows the 25 biggest global companies ranked by the value of their foreign assets. The list is dominated by companies based in the advanced economies. Seven are US companies, 14 are Western European (6 German, 5 French, 2 British and 1 Anglo/Dutch), and three are based in Japan. Many of the largest companies are extremely international in their operations. Oil companies like ExxonMobil, BP, Shell, and Total, and others such as Vodafone, and Procter and Gamble, all generate more than 50% of turnover from foreign sales. Wal-Mart, the world's biggest retailer has expanded its foreign activities very rapidly. In the late 1990s Wal-Mart's sales from its foreign subsidiaries grew six fold. By 2007, it was employing more than half a million workers in over 3,000 stores in 14 countries, and across four continents (www.walmartstores.com).

However, the reality is that only a few of the 500 MNCs that dominate international business have a genuinely global presence. Most focus primarily on sales within their part of the triad. So American MNCs focus their strategy on North America, European companies on Western Europe, and Japanese MNCs on Asia. Rugman (2002) has found that many MNCs find it difficult to maintain profitable foreign operations.

Greenfield and Brownfield Investment

MNC investment overseas can be broken down into greenfield and brownfield investment. Greenfield investment involves the establishment of completely new production facilities, such as Ford setting up its new car factory near St Petersburg in Russia. Brownfield investment entails the purchase of already existing production facilities—the acquisition of Asda, the British supermarket chain, by Wal-Mart, is an example of brownfield investment. MNCs have undertaken massive brownfield investment. In 2000 they were involved in around 11,000 cross-border mergers to a value of more than US$1.1 trillion, two to three times greater than the figures for 1995. However, after 2000 there was a significant drop in merger activity to around US$380 billion by 2004 (see Figure 1.4). Merger activity then started to pick up so that by 2006 the total had reached some US$880 billion. The main purchasers were rich country MNCs, but companies from China, India, and Russia also played a prominent role. Consumer goods, services including financial services, energy, and basic materials were all major areas of activity. The biggest acquisition was the US$32 billion takeover of Arcelor, the European steel firm, by Mittal, originally Indian but now based in the Netherlands (UNCTAD 2007).

Another example of cross-border flows of money are migrant remittances. Migrants often send money to their home countries and the total amount has grown over time. They totalled some US$318 billion in 2007 with India, China, and Mexico as the three largest recipients, each receiving more than US$20 billion. The USA was the biggest source, sending some US$42 billion in 2006 (www.worldbank.org). Remittances are a vital source of foreign currency for some poor countries—Albania, Morocco, Jordan, and El Salvador are countries whose remittances from abroad equate to 10% or more of their GDP (Ratha *et al.* 2008).

Mini Case Cross-Border Mergers & Acquisitions—A Minefield

This case looks at the issues confronted by firms going in for cross-border mergers.

As we can see from Figure 1.4 there have been huge waves of cross-border mergers and acquisitions (M&As) indicating their popularity with business as a way of gaining competitive advantage. Such mergers have become a fundamental tool of business strategy. However, a number of studies have shown that the majority of these M&As are not successful. For example, a 2006 survey of business in North America, Europe, and Asia by the consultancy firm, Accenture, found most firms had not achieved the expected cost and revenue gains from cross-border M&As.

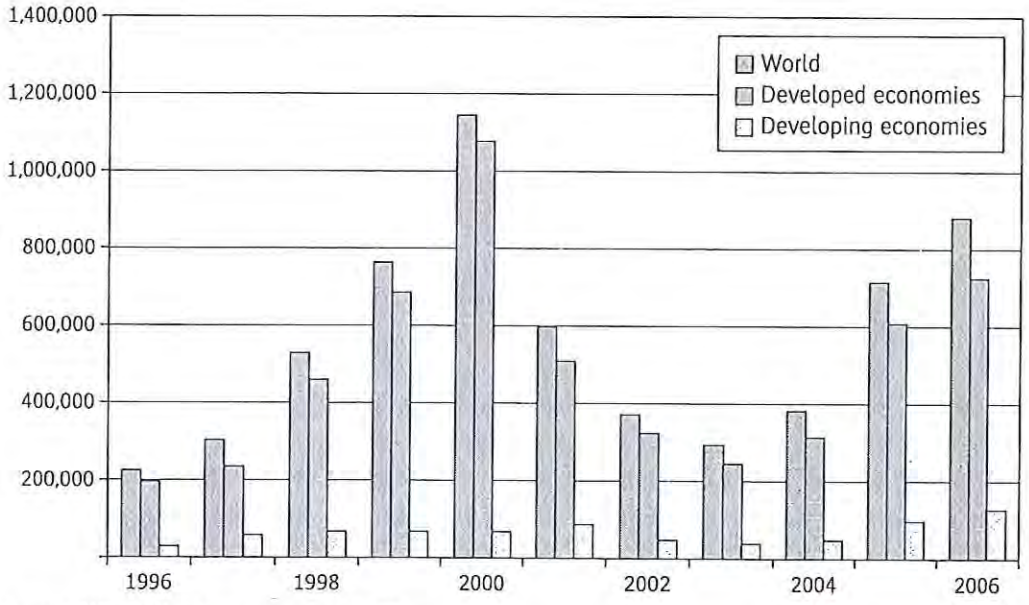
One notable example of the problems encountered in cross-border M&As was the acquisition of the American firm Columbia Pictures by Sony. Five years after paying a handsome premium for the company, Sony had to write down the value of its assets in Columbia by a massive US$3.2 billion. Many of the problems encountered by Sony reflect the issues to be confronted by firms involved in cross-border mergers. These include coming to terms with a very different business culture. Business is conducted very differently in Japan than in the USA. Such differences relate to the rules around corporate governance*, the power of shop floor workers, job security, differences in the legal and regulatory environment, and customer expectations. It is hardly surprising, says Finkelstein, that cross-border mergers are a potential minefield.

However, despite the evidence, cross-border M&As continue to be popular amongst businesses. The respondents in the Accenture survey, whilst recognizing the problems of integrating different cultures, still saw cross-border M&As as an essential part of their competitive strategy.

* corporate governance refers to the systems by which companies are directed and controlled particularly at the highest level of the organization.

Sources: Accenture, *Globalization and the Rise of Cross-Border Mergers and Acquisitions*; Sydney Finkelstein, *Cross Border Mergers and Acquisitions* available at www.tuck.dartmouth.edu

Figure 1.4 Cross-border M&As US$m



Source: UNCTAD, World Investment Report 2007

Migration

The globalization of markets has not been paralleled by the liberalization of labour flows. While globalization has led to the dismantling of barriers to trade in goods, services, and capital, barriers to cross-border labour movements are not falling as fast. Nevertheless, migration between developing and developed countries has continued. Flows of migrants are greatest to two triad members, North America and Europe—while Asia, Latin America, and Africa are major sources. The US population includes 38 million people born abroad (World Bank 2008b). That is the official figure, however the US authorities estimate that some 5 million people are living in the USA without permission, and the number is growing by more than quarter of a million each year.

According to the UN, the number of migrants (people currently residing for more than a year in a country other than where they were born) lies between 185 and 192 million—which is around 3% of the world's population. This meant that the migrant population had more than doubled in 25 years. Europe had most migrants with 56 million, Asia had 50 million, and Northern America 41 million. Almost one of every 10 persons living in the more developed regions is a migrant. In contrast, only one of every 70 persons in developing countries is a migrant. This increase in numbers has occurred despite the fact that during the last 30 years of the 20th century migration had become steadily more difficult—particularly for people in developing countries wanting to enter Europe. OECD (2007) figures show that migrants constitute a significant proportion of the population in some countries. In Australia, Canada, New Zealand, Luxembourg, and Switzerland the percentage is close to or exceeding 20%. The USA, along with certain European countries such as Austria, Germany, the Netherlands, and Sweden, has a percentage of immigrants at around 12%. It also found that the percentage exceeded 10% of the total population in Greece and Ireland, while it was about 10% in the UK. None of these compares with the Middle Eastern State of Qatar where more than three quarters of the population are migrants. Care needs to be taken regarding the accuracy of migration statistics because countries differ in their definition of 'migrant' and clandestine migrants are unlikely to be picked up by official statistics.

People move for a variety of economic, social, and political reasons. They may move voluntarily to find work, to earn higher wages, to study, or to reunite with their families. Widening inequalities in income and job opportunities increase the pressures to move. Movement may also be stimulated by employers in developed countries actively recruiting labour from abroad. The economic boom of the late 1950s and the 1960s caused countries like Germany, France, and the UK to run short of labour. Initially, they looked to other European countries that had been slower to industrialize—including Italy, Portugal, and Spain. In addition, some countries drew on their colonial ties. France turned to North Africa, and the UK to the Caribbean, and the Indian sub-continent. Germany, on the other hand, recruited short-term contract workers from countries adjacent to Western Europe, notably Yugoslavia and Turkey. Over this period net immigration for Western Europe reached around 10 million. European economies started to falter in the late 1960s and governments effectively closed the doors to migrants with the oil shock of 1973 when OPEC increased recessionary pressures by quadrupling the price of oil. At the

start of the new century, the attitudes of certain governments towards migration have changed, as shortages of skilled workers have emerged. For example, the USA, UK, and Germany are starting to look much more favourably on the entry of workers with high levels of education and skills in areas such as IT.

Migration may also be involuntary where people, often in large numbers, are forced to migrate by political instability and violations of human rights—as we have seen for example in Zimbabwe and the Balkans. Natural disasters, such as hurricanes, earthquakes, and floods can also force people to move. Global warming is expected to cause extensive flooding in coastal areas of South East Asia which will cause large waves of migration.

Large short term movements of people also occur as a result of executives going on foreign business trips, students involved in study abroad, and tourism. In 2004, France, the most popular tourist destination, received more than 79 million tourists, the USA around 51 million, and China 50 million. Some small countries are heavily dependent on tourism for their income. In the Caribbean countries of St Lucia, Antigua, and the Bahamas, tourism contributes more than 30% to their GDP (UNWTO 2007).



Learning Task Wal-Mart and the Movement of Labour

The American retail giant Wal-Mart has half a million employees worldwide manning some 3,000 stores which are visited by 138 million shoppers each week.

Not only does Wal-Mart go in for large amounts of FDI in its globalization activities, it also attracts labour across borders. It was reported that more than 300 illegal workers had been arrested at 61 Wal-Mart stores in the USA as part of an investigation into contract cleaning crews at the world's largest retailer. The investigation involved allegations that a contractor had recruited illegal immigrants, mainly from Eastern Europe.

Source: *The Observer*, 26 October 2003; *Financial Times*, 24 October 2003

1. What are the advantages to Wal-Mart of employing illegal migrants to clean its stores?
2. What dangers might Wal-Mart face by taking on such workers?

Globalization is All-Pervasive

Although globalization is often seen as an economic phenomenon involving trade and investment, it also has many other cultural and social dimensions. Held (1999) argues that globalization is all-pervasive. He defines globalization as:

> the widening, deepening and speeding up of worldwide interconnectedness in all aspects of contemporary social life, from the cultural to the criminal, the financial to the spiritual (p 2).

As Held observes, globalization is not confined to economic life but also influences many other areas of society. And he contends that each of these areas is becoming more deeply

affected by the phenomenon. Cultural life involving the attitudes, behaviour, and values that are characteristic of a society, can be influenced by the process. Globalization can influence culture through the transfer of knowledge, ideas, and beliefs across national borders.

Mass media, such as television and film, illustrate how culture has been influenced by globalization. American programmes such as *The Simpsons*, *Heroes* and *Friends* are watched worldwide. In Germany, in 2002, around one in four TV programmes was made in the USA while in Italy it was 15%. Similarly, US films like *The Matrix* and *Charlie's Angels* are widely shown around the world. In Mexico roughly four out of every five films shown are produced in US studios. The collapse of communism in Eastern Europe and the arrival of cable and satellite system opened up more markets to US media companies. However, commentators such as Tunstall (2008) see a challenge to the American TV and film industry from the growing capacity of China and India to become global media players, and the increasing competition from Latin America.



Learning Task

One of the authors, while on holiday in Spain, looked at the films showing in cinemas in Catalonia. This is what he found:

Country of Origin of Films on Show in Catalonia

Total on show:	59
Number made in:	
USA	28
Spain	10
Spain with other countries	3
Other countries	18

Source: *La Vanguardia*, 4 August 2003

Examine the table and answer the following questions:

1. What conclusions can be drawn regarding the cultural interconnectedness of Spain with other countries?
2. How do you explain the position of the USA?

Now look at the film listings for your town or local area and work out to what extent it is connected with foreign countries. You could, if you wish, carry out a similar exercise on television programmes to see how many are of foreign origin.

Diet is another area influenced by globalization. In France, the consumption of fast food such as hamburgers, and soft drinks like Coca Cola has increased and this is attributed by some commentators to the globalization of fast food chains like McDonalds

and Burger King. The movement of people can also have an impact on diet. In the second half of the 20th century, many migrants came to the UK from India and Pakistan. With over 8,000 Indian restaurants in the UK, now almost all British towns and cities have an 'Indian' and it is claimed that the favourite meal, when eating out, is curry.

Another obvious route for transfer of culture across borders is through education. Universities in the USA, Western Europe, and Australia have enthusiastically embarked on campaigns to recruit students from abroad. Some have also gone in for FDI by setting up education facilities in other countries or have established partnerships with foreign colleges. The EU, through its Erasmus and Socrates programmes, has created large numbers of students studying in other member states. In a further move to facilitate the movement of students and workers across borders, more than 40 European countries have initiated a programme of reform of their university systems. The idea is to standardize the structure of university studies with degrees taking from three to four years and the introduction of a common system of assessment, the European Credit and Transfer System.

Another conduit for such transfers is through the world of work. For example, the UK and the USA have been favoured locations for Japanese car companies, in other words, capital has been moved to these countries from Japan. The movement of capital across national borders brings with it different ways of working such as Just-in-Time where suppliers deliver raw materials and components immediately before they are needed in the manufacturing process, or quality circles where small groups of employees meet together to identify how production could be improved. Domestic firms have, in turn, been influenced by this, e.g. Nissan has persuaded suppliers to alter their production methods. And Nissan's rivals such as General Motors, Ford, and Chrysler, finding their market shares slipping because of their inability to compete with the Japanese, have responded to the threat by introducing some of their working methods. As a result, in the UK and USA, car industry working methods have become similar to those in Japan. Another example concerns McDonalds setting up in Moscow in partnership with the City Council. It had to devise a strategy for dealing with a Russian workforce that had a reputation for being surly and slovenly. McDonalds introduced expatriate managers and training programmes to show the Russian staff how things should be done. Moscow City Council officials could not believe that the employees in the fast food outlet were Russian because they were so friendly.

The globalization process can also be seen in sport, where football players like David Beckham and Cristiano Ronaldo cross borders to play abroad. There has also been a rush of foreign direct investment into the English premier football league. Chelsea is owned by a Russian businessman, while Liverpool and Manchester United were acquired by US tycoons. Manchester United is promoted and known worldwide—it is marketed as an international brand and there is a lucrative trade in Manchester United team kits and other products outside the UK (for an interesting analysis of how cricket became globalized see Kaufman 2005). Furthermore, many of the top teams in England are now managed by foreigners.

A further impact of globalization is on health. A new treatment for disease, discovered in one country, can be quickly transferred to others, helping to limit the spread of disease and improve the quality of health care. On the other hand, diseases may also spread more

quickly as people move across borders, e.g. the outbreak and spread of Severe Acute Respiratory Syndrome (SARS) in 2003.

SARS originated in Southern China. It then spread very quickly to other Asian countries, as well as Europe, North America, and Canada, which had over 300 cases. Illness can also be spread through trade. In 2004 it was found that poultry farmers in Vietnam and Thailand had contracted the virus associated with avian flu. The infection spread to other countries through cross-border trade in poultry and the movement of migratory birds.

With regard to crime: globalization, by removing barriers to movement, can make it easier for criminals to operate in other countries. Criminals can move more easily across borders, as can pornography, prostitution, and illegal substances such as drugs. Large amounts of cocaine are produced in Colombia and gangs there ensure that the drug finds its way to users in the USA. The Russian mafia is involved in trafficking women for the vice trade in Amsterdam. Communications technology facilitates the electronic movement across borders of money generated by these illegal activities into countries where the criminals can portray it as being derived from a legitimate source. Or they may move the money to countries where the laws regulating such money laundering activities are deficient.

Religion, or the spiritual dimension as Held calls it, is another area that is globalized. Major churches, for example the Catholic, Anglican, Muslim, and Jewish churches all operate multinationally and have been spreading their values over large parts of the world for the last 2,000 years. In the UK the established churches, such as the Church of England, are in decline in contrast to evangelical churches which have their roots in the USA and, ironically, have their roots in English Puritanism.

The Drivers of Globalization

In 1983 Theodore Levitt claimed:

> Gone are accustomed differences in national or regional preferences. Gone are the days when a company could sell last year's model—or lesser versions of advanced products —in the less developed world. Gone are the days when prices, margins and profits were generally higher than at home.

Although he was overstating the case he was making the point that technology, through communication, transport, and travel was driving the world towards convergence. In the business world the process of competition would drive firms to seek out these markets and force down prices by standardizing what was sold and how it was made in an effort to cut costs and to maintain profit. International competition is not a new business phenomenon, nor is FDI or international trade but, as we have seen in the first section, the process of globalization appears to be accelerating. The organization of trade is also different, with much of it taking place between and within large multinational organizations across borders which are increasingly irrelevant. It is supported by international organizations and agreements which did not exist a century ago.

The process is also embracing an increasing number of countries, as the free market ideology is accepted as the dominant economic philosophy. The countries of South East Asia, Latin America, India, Central and Eastern Europe, and even China have one by one bowed to the power of market forces.

The big MNCs have not been passive participants in this process. They are usually to be found at the forefront, pushing governments to open up their economies by removing barriers to trade and investment. Indeed, Rugman (2002) argues that their managers are the real drivers of globalization. MNCs encourage governments through pressure groups such as The European Round Table (ERT) which was set up by MNCs from 17 countries. It brings together leaders of around 45 of the biggest MNCs with a combined turnover of around US$1400 billion, employing about 4 million people worldwide. It was instrumental in promoting the idea of a single market for the EU and is very keen to integrate the former communist countries and the developing nations into a globalized system (see the ERT web site at www.ert.be). Similarly, the National Association of Manufacturers in the USA has pressed for markets to be opened up from Cape Horn, the southernmost tip in South America, to Alaska.

Competition then, is one of the dominant drivers in the process of globalization of the world economy. If your competitors are globalizing and capturing new growth opportunities, scale efficiencies, and gaining invaluable knowledge of global operations then you are likely to cease to exist or be forced into small domestic market niches unless you follow suit.

There are other drivers, although some might be more correctly labelled as 'facilitators'. In the next sections we look at the forces driving the globalization of business, the facilitating factors, and those forces which act as barriers, helping to keep business 'local'.

Political/Regulatory

Governments have taken steps to remove barriers to trade and the movement of finance through international organizations such as the General Agreement on Tariffs and Trade (GATT) and its successor organization the World Trade Organization (WTO) and they have also set up free trade areas, customs unions, or common markets.

- Free trade area—member states agree to remove tariffs and quotas on goods from other members of the area. Members have the freedom to set the level of tariff imposed on imports of goods from non-members of the area.
- Customs union— this is a free trade area but with the addition that members agree to levy a common tariff on imports of goods from non-members.
- Common market—this is a customs union but with the addition that member states agree to allow free movement of goods, services, capital, and labour.

There have been major reductions in the barriers to movement, particularly for goods and capital brought about by liberalization. These have been brought about multilaterally through negotiations in international institutions such as the General Agreement on Tariffs and Trade (GATT) and its successor organization, the WTO, or bilaterally between individual governments. Governments help bring about increased economic and political interlinkage by signing treaties setting up regional trade areas (RTAs) such as the

North Atlantic Free Trade Area (NAFTA) with the involvement of the USA, Canada, and Mexico where barriers to movement such as tariffs and quotas are abolished among the members. Other examples are, The Association of Southeast Asian Nations (ASEAN) incorporating 10 countries in South East Asia, and Mercosur comprising four countries in South America. The number of RTAs rose dramatically from about 30 in 1990 to 380 in 2007 (www.wto.org). The WTO expected that more than half of all trade would be conducted inside RTAs by 2005. While such bodies do promote integration among the members they often limit integration with non-members by maintaining barriers against imports from them.

Sometimes governments push integration further by agreeing to the establishment of customs unions which comprise a free trade area plus a common import tariff against non-members. Or they may set up a common market where there is complete freedom of movement for goods, services, capital, and people. One result of this removal of barriers to the movement of people in the EU is that someone in southern Spain could drive to Lapland without necessarily having to stop at a single border. Some members of the EU have taken the integration process even further by removing currency as a barrier by agreeing on the introduction of a common currency, the euro. Economic integration often then leads on to political integration. So EU member states are subject not only to EU laws but also to common policies in areas such as agriculture, the regions, and social policy.

Changes in political regimes have also helped reduce barriers, e.g. the collapse of communism in the late 1980s and early 1990s led to Eastern European countries becoming more interconnected economically, politically, and militarily particularly with Western Europe and the USA. Many of the former communist countries have joined NATO and the EU. China has opened up its economy to foreign investors and has joined the WTO.

Governments, particularly in poorer countries in Asia, Africa, and Latin America, anxious to promote economic development, facilitate the movement of capital into their countries by setting up export processing zones (epz) where MNCs can invest, produce, and trade under favourable conditions. China has 15 zones employing 40 million people. Kenya has 45 zones, while Honduras has 24. MNCs are usually given financial incentives to invest and often they are allowed to import goods and produce output free of tax. The International Labour Organization (Boyenge 2007) estimated that, in 2006, there were nearly 4,000 epz employing around 66 million people. There are also many free trade zones or freeports which are supposed to act as entrepots and be used for storage purposes.

Technological

Improvements in communications and reductions in transport costs have facilitated the movement of goods, services, capital, and people. Modern communications technology makes it easier for businesses to control far-flung empires. It further allows people to connect and interact over long distances, and with transport becoming easier and cheaper, goods and people are able to travel long distances quickly and at a relatively low cost. According to BA, the cost of flying has halved in 25 years and the cost of flying the Atlantic has fallen even faster, by half in 10 years (*The Observer*, 9 November 2003).

The internet and cheaper telephony not only make it easier for MNCs to control their foreign operations but also for migrants to maintain links with their countries of origin. Furthermore, it has been a major force in integrating the world's financial markets. A trader in a bank in New York can use the computer to monitor movements in share prices, interest rates, and currency rates in all the major financial markets and can respond by buying and selling almost simultaneously. Vast amounts of money can be transferred across borders at the press of a button.

In 1930, it cost more than a week's average wage in the UK for a three minute telephone call from London to New York. Now it costs a fraction of the average hourly wage and some commentators believe that technology and competition will halve the cost of calls almost every year over the first years of the 21st century. Demand for telecommunications has increased very rapidly. In the UK there were 45 lines per 100 inhabitants in 1990 but more than 58 a decade later, while in Latin America the number tripled. It took over a century to 1997 to reach one billion telephone subscribers but only another nine years to add a further three billion subscribers (Gray 2008).

The growth in demand for telecommunications services has recently been driven by the development of the cellular technology associated with mobile phones. Another factor, the internet, has revolutionized telecommunications. It has become a very cheap and reliable method of communicating text, data, and images and it is also being increasingly used for voice communication. The number of people in the world with internet access grew more than tenfold from less than 100 million in the mid 1990s to over 1 billion in 2006 with China having around 131 million users and India 68 million. However, although their numbers are huge, the proportion of people with internet access is lower in these countries compared with the rich countries of North America and North Western Europe (Computer Industry Almanac at www.c-i-a.com).

India is a good example of a country that has benefited from the impact of advances in communications technology. It has a ready supply of relatively cheap educated labour and has become an increasingly popular location for call centre jobs. This has come about as a result of the advances in communication technology which have significantly reduced the costs and improved the quality and reliability of telephony. The cost of a one minute phone call from India to the USA is just over 20 cents and around 15 cents to the UK. Consequently, there has been a movement of jobs from the UK and the USA to South East Asia. More than half of the world's top 500 companies outsource either IT or other business processes to India.

Technology can also have the effect of reducing movements of people. Improvements in the costs and quality of video links may mean that business executives do not need to attend meetings abroad. They can be virtual travellers interacting electronically through teleconferencing with fellow managers in other countries.

Economic

In many modern industries the scale of investment needed for research and development (R&D) and production facilities can mean that the size of a single domestic market is insufficient to support that industry. The production of electronic components requires high levels of investment in both R&D and the manufacturing process, and this drives

firms to go global. This is especially so when product life cycles are shortening, increasing the pressure to recover investment quickly. Competitive pressures on costs also push firms to reduce product lines and to expand globally to seek every possible saving from economies of scale in R&D, manufacturing, and marketing.

The desire to cut costs can be seen in the aluminium industry. Aluminium is a relatively expensive metal to produce as it takes a lot of electricity to turn ore into metal. This is why aluminium firms locate their smelters in locations with access to cheap energy. Other industries will seek out cheap sources of labour. In the footwear industry, which uses relatively simple technology and is therefore labour intensive, labour costs represent about 40% of total costs. Hourly wages in some countries are very low. For example, in manufacturing, those in China are just 3% of those in the USA. As a result manufacturing has been relocating to countries with low labour costs such as China and India (Bureau of Labour Statistics at www.bls.gov).

Firms may globalize because they have outgrown their domestic market and in any case, the pace of growth in mature, developed economies for many industries is relatively modest. To maintain a rate of growth required by capital markets will mean for most of the world's leading companies that they must seek opportunities beyond their domestic borders.

The case of Wal-Mart is a very good example of this. Up to 1991 Wal-Mart was a purely American based company. Then it embarked on a joint venture with another retailer, Cifra, in Mexico. In just 11 years it developed 1,170 (27% of the total) stores outside the USA. Some commentators argued that it needed to do this in order to survive, to meet capital market requirements and the expectations of its own employees whose wealth was tied to a share purchase plan, the value of which depended on the growth prospects of the company (Gupta and Govindarajan 2004).

The rapid improvements in technology and the consequent reduction in communication and transport costs have enabled people to experience other societies' lifestyles first hand or through the medium of TV and film or the internet. This has led to a convergence in tastes which MNCs have been quick to exploit by creating global brands such as Coca Cola, Levi, Sony, Nike, and McDonalds. This has been called the 'Californiazation' or 'McDonaldization' of society (Ohmae 1985; Ritzer 2004, respectively).

Global companies mean global customers. Global customers require basic supplies of input materials, global financial and accounting services, and global hotel chains to house travelling executives. Dealing with one supplier of a standard product or service has many advantages for the global buyer; lower purchase costs, a standard product of consistent quality, lower administration costs, and more opportunities for cooperation with suppliers.

For example, Japanese banks became more global following the globalization of Japanese car manufacturers (an important customer).

Barriers to Globalization

Despite the fast pace of globalization, it remains the case that goods, services, capital, and people move more easily within nations than across borders. Trade between regions within nations is generally much higher than trade across borders even when adjusted for

income and distance levels. This occurs even when trading restrictions appear to be low, for example, between Canada and the USA. This suggests that there remain important barriers to globalization. Rugman (2002) argues that government regulations and cultural differences divide the world into the three blocs of the triad.

Government Regulation

Legal and regulatory barriers can hinder the flow of goods and services and the movement of capital and people.

Tariffs and Subsidies

There remain numerous tariffs on imports of goods. Rich countries impose particularly high tariffs on goods coming from poor countries. As can be seen from Figure 1.2, the EU and the USA levy high tariffs on imports of agricultural products and textiles while tariffs imposed on goods from other rich countries are lower. On average the tariffs on poor countries' exports are four or five times higher. Such differences in tariffs help to explain why trade tends to take place within and between the rich countries of the triad.

It is not only rich countries who apply tariffs to imports. Poor countries impose tariffs as well and usually they are higher than rich country tariffs. India applies an average tariff of over 30% on imports of industrial products while the figure for Brazil is 14%.

Subsidies can take the form of financial grants or tax concessions and are often given to protect domestic firms from foreign competition. In the 27 individual member states of the EU, state assistance in 2006 amounted to about €50 billion, or just above 0.4% of EU GDP. Much of this assistance goes to firms operating in agriculture, fisheries, and transport but substantial amounts have also been given to firms in manufacturing and finance (EU Commission 2008).

Protectionist devices such as tariffs and subsidies are particularly prevalent in agriculture. They are often used by rich countries to protect their farmers. In 2004, OECD countries subsidised their farmers to the tune of US$380 billion. The USA, the EU, and Japan are amongst the biggest subsidisers. Taking the EU as an example, it protects its farmers in a variety of ways. It guarantees them high prices. It ensures that the guaranteed price is maintained by imposing tariffs on imports of agricultural produce. Surplus production, which would put downward pressure on prices, is either bought up by the EU authorities and put into storage, or is exported at a subsidised price. In the EU, each farmer receives around US$1,000 for each cow and a total of around US$133 billion a year is spent supporting farmers. American cotton farmers receive more in subsidies than the value of the cotton they produce (OECD).

These tariffs and subsidies make it difficult for poorer countries to sell their agricultural produce in rich country markets. However, subsidies can also be used to promote globalization. In export processing zones they are often used to attract foreign investors.

Governments in the rich countries usually give financial assistance to poor countries. Frequently, such aid is used to promote the interests of domestic firms. This is done

by requiring the recipients to buy goods and services produced by firms in the donor country irrespective of whether they give best value for money. The US Agency for International Development requires that recipient countries must purchase goods and services from US companies. While that integrates the recipient economies with that of the USA it does freeze out non-US companies.

Controls on Capital

Controls on capital can take the form of either controls on inflows or outflows of foreign direct and indirect investment.

Big steps have been made in liberalizing the movements of capital. However, some countries have been more amenable to this than others. Thus India and South Korea have been reluctant to remove restrictions on capital inflows, and Japan has one of the most closed financial systems of all the advanced countries. Sometimes countries impose capital controls in times of economic crises. For example, when the South East Asian economy went into crisis in the second half of the 1990s, Malaysia responded by introducing controls on movements of short-term capital out of the country. It may be that countries are also reluctant to accept inflows of foreign direct investment where it involves sectors they regard as strategically important such as the basic utilities of gas, electricity, and water that are essential to everyone. France, for example, has shown itself very reluctant to open up certain sectors such as energy to foreign control and the USA and the EU are not prepared to cede control of their airline companies to foreign organizations. US law prevents foreign firms from buying more than 24.9% of an American airline (the corresponding figure for the EU is 49%).

Public Procurement

Government departments, nationalized industries, public utilities in telecommunications, gas, and water often spend large amounts of public money purchasing goods and services. Public procurement in the EU equates to 16% of GDP or €1,500 billion, in countries such as Sweden and Greece it accounts for more than 4% of their GDP. In the UK the government spends around £18 billion annually on the purchase of goods and services. Consequently, governments are very important customers for firms, particularly those producing goods and services for the defence, health, and education sectors. When issuing contracts, governments will often favour domestic producers over their foreign rivals even when domestic firms are more expensive.

An unusual illustration of discriminatory public procurement occurred after the invasion of Iraq by the coalition forces in 2003. The USA declared its intention only to give contracts for the rebuilding of Iraq to US companies and to firms based in countries that had supported the war.

Border and Immigration Controls

Border controls affect trade in goods. They can require the filling in of export/import forms and customs officers stopping vehicles and checking goods at the frontier. This can take time, add to traders' transport costs and make goods less competitive in the foreign market.

Many barriers remain to the movement of people. These include stringent visa requirements, quotas, requiring employers to search for a national employee before employing a foreign one, and refusal by the authorities to accredit foreign educational and vocational qualifications.

Most countries in the triad have laws controlling the entry of foreigners. US immigration laws make it difficult for people to enter the USA to find work or to study and the policy got stricter after September 11, particularly for people from Muslim countries in the Middle East. The USA permits around 675,000 immigrants each year. The law is aimed at keeping down the entry of unskilled workers, and attracting skilled workers and professionals.

The EU and Japan both control immigration, although these controls are under review given concerns that low birth rates and the aging of the population will cause shortages of workers. Migrants are seen as one part of the answer to this because they tend to be young and have a higher fertility rate than the indigenous population.

Technological

Technical standards and regulations can be formidable barriers. There are thousands upon thousands of different technical specifications relating to goods and services which can effectively protect domestic markets from foreign competition and consequently restrict trade. The EU has tried to deal with this through its Single Market programme. It uses the principle of mutual recognition whereby countries accept products from other member states so long as they do not constitute a danger to the consumer. But some products such as electric plugs, light bulbs, and televisions do not lend themselves to this approach. Even if member states were to recognize each other's standards, the Continental two-prong plug could not be sold in the UK where the three-pin plug is the norm. Companies in the service sector can also be hampered by the myriad of technical standards and requirements. Financial institutions such as banks may find it difficult to use the internet to sell their services in foreign markets because countries may lay down different solvency requirements, or different levels of liquidity for financial institutions operating in their territory. Regarding rail transport, countries have different electrification and signalling systems making it difficult for foreign train companies to enter and compete with domestic rail firms.

Different national policies towards what are called intellectual property rights (IPRs) could constitute barriers as well. IPRs relate to ideas and knowledge that are an increasingly important part of trade. They can take a number of forms, for example, the invention of new products and production processes, brand names, logos as well as books and films. Firms who own these argue that they should have the legal right to prevent others from commercially exploiting them. However the extent of protection and enforcement of these rights vary widely around the world. Some countries such as China and Malaysia do not offer the firms creating the ideas and knowledge much protection against counterfeiting. By all accounts it is very easy in Malaysia to obtain counterfeit versions of western music CDs, DVDs of popular firms made in the USA, and designer goods branded with the names of Versace, Louis Vuitton, and Rolex. Firms owning these IPRs argue that the lack of protection stunts their trade and FDI in those countries.

Cultural and Geographical Distance

Culture

Cultural distance can constitute an important barrier. This can take the form of differences in language, religious beliefs, race, national and regional tastes, and social norms and values which regulate what is regarded as acceptable behaviour and attitudes—these differences can constitute major impediments to globalization. Culture can be an important influence on consumer behaviour, work culture, and business practices. Thus, McDonalds cannot sell Big Macs in India because to Hindus the cow is sacred, nor can it assume that staff in Eastern Europe will have the same attitudes to work as its workers in the USA. Moreover, business practices may vary widely between countries. In China, for example, business culture is based on personal connections, as opposed to the Anglo-Saxon approach which places more value on getting the contract rather than on developing relationships. This means that companies have to take important cultural differences into account and to decide how to respond.

A classic example of a company failing to grasp the importance of culture was News International when it tried to enter the Asian market through its purchase of StarTV. The plan was to transmit US, English-language film and television programmes to the 5% of the population that was wealthy, educated, and had English as a second language. The neglect of cultural differences was costly for the company because it ended up making big losses. It only became successful when it recognized the cultural differences and started to make locally produced programmes in languages from Hindi to Mandarin.

Some goods and services are more sensitive than others to cultural differences. Ghemawat (2001) did some research on the impact of culture and found that products such as meat, cereals, tobacco, and office machines had to be adapted to local cultures, whereas firms producing cameras, road vehicles, cork and wood, and electricity did not need to adapt their products—or were under less compulsion to do so.

Corruption

Another area where cultural distance can cause problems for firms, concerns the issue of corruption. In some countries, in Africa and the Middle East for example, it is the norm for firms to reward individuals who help it to get business. However, in other countries such behaviour would be seen as corrupt and as such, would be deemed illegal. The prospect of prosecution in their home countries might deter firms from trading with, and investing in, countries where such behaviour is the norm.

Transparency International surveys show the degree of corruption as perceived in different countries by business people, academics, and risk analysts. The ratings range between 10 (highly clean) and 0 (highly corrupt). Rich countries, although not free of corruption, tend to get high scores. The ranks of the most corrupt are dominated by poor countries such as Bangladesh, Nigeria, Haiti, and Azerbaijan.

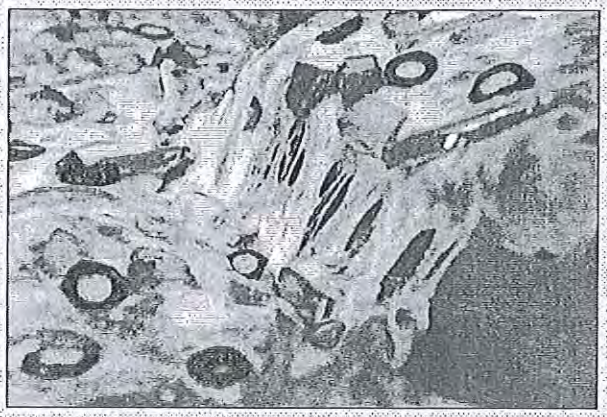
Firms generally find it much easier to operate in countries where the culture is similar to that of their home base. Cultural differences can be a significant barrier to globalization and ignoring them can be very costly (see Ghemawat 2001).

Mini Case Cultural Distance—Domino's Pizza

This case illustrates how companies wishing to profit from globalization have to take into account cultural differences in taste and eating habits.

The US firm Domino's Pizza is the world's second largest pizza chain with over 8,000 outlets in 55 countries across five continents. As it expanded around the world, the company found that it had to adapt both the product and the service to appeal to local consumers.

Icelanders prefer their pizza topped with fish while the French go for goat's cheese and lardons. In Taiwan, the favourite toppings are squid, crab, shrimp, and pineapple, whereas in Brazil pizza lovers go for mashed bananas and cinnamon. In Japan, mayonnaise, potato, maize, and bacon are the preferred options. Mexicans favour chorizo sausage and jalapeno peppers.



Source: www.dominos.co.uk

Domino's has found, simply by changing the toppings, that pizza is acceptable to consumers all round the world. But there can still be cultural complications. In India, the fact that Hindus cannot eat meat from cows meant Domino's had to replace pepperoni with a spicy chicken sausage. Most pizzas sold there are vegetarian. In Japan, where no word for pepperoni existed, they introduced it.

Domino's was able to export the idea of home delivery almost everywhere but not to China. In the capital, Beijing, Domino's had to fit tables in its restaurants. People in China, paying for a prepared meal, want to have somewhere to sit and eat it. Delivery can also be challenging in some markets. In Tokyo, where buildings are numbered not in sequence along streets but according to the date they were constructed, Domino's outlets each have a full-time employee whose job is to find locations on the map and tell drivers where to go.

Source: *Financial Times*, 26 November 2003; www.franchise-international.net; http://money.cnn.com

Learning Task

Some goods and services are more sensitive than others to cultural differences. Ghemawat did some research on the impact of culture and found the following:

More Sensitive Products	Less Sensitive Products
Meat	Cameras
Cereals	Road vehicles
Tobacco	Cork and wood
Office machines	Electricity

Discuss and advance explanations for Ghemawat's findings.

Geography

Geographical distance can also be a barrier. It has been shown that the more distance there is between countries, the less will be the trade between them (Ghemawat 2001). Geographical distance can make trade difficult particularly for firms producing goods that are low in value but high in bulk, such as cement or beer. The cost of transporting cement or beer over long distances would be prohibitive. Fragile or highly perishable products like glass and fruit may suffer similar problems. Firms can respond to the barrier posed by geographical distance in various ways. Brewers have responded either by taking over a foreign brewer or by granting a licence to firms in foreign markets to brew their beer. Thus barriers to one aspect of globalization, trade, result in globalization in another form, investment or licensing. Historically, geographical distance is likely to have declined in importance as transport has become cheaper and techniques for carrying fragile or perishable products more effective.

It would be unwise to assume that globalization is an unstoppable process and that barriers are continually being removed. Important barriers remain, and old barriers can be reintroduced. Early in the new century, for example, the US Government, under pressure from steel producers who were concerned about cheap imports, reintroduced tariffs of up to 30% on steel imports. This, in turn, provoked threats of retaliation, sometimes called tit-for-tat protectionism, from the EU, Japan, and several other countries, against US exports. In addition, new barriers can appear: where several companies are competing to develop a new product, the first to do so may establish its technical specifications as a standard for the new product which then acts as a barrier to trade.

The Benefits and Costs of Globalization for Business

Globalization can comprise major changes in the external environment of business. On the one hand, it creates opportunities for business, particularly for the big MNCs who are in the best position to take advantage. On the other hand, it can pose threats for business as well. We examine the benefits and costs in turn.

The Benefits for Business

The removal of barriers to trade or investment can open up markets to businesses that were previously excluded giving them the possibility of higher revenues and growth. The activities of car producers and tobacco firms in South East Asia illustrate this. As their traditional markets in North America and Western Europe have matured, General Motors, Ford, Volkswagen, Toyota, and others have all looked to the fast-expanding markets of South East Asia as a source of growth. China, with its rapidly growing car market, has been a particularly favoured location for car industry investment. Similarly, big tobacco firms such as Imperial Tobacco and Gallaher have formed partnerships with Chinese firms to produce and market their products to the 350 million smokers in China. Similarly, the fall of communism gave banks from the USA and Western Europe the opportunity to move

into the former Communist bloc countries and, in many countries such as the Czech Republic, Bulgaria, and Croatia, have ended up controlling a majority of banking assets.

Globalization may give business access to cheaper supplies of final products, components, raw materials, or to other factors of production such as labour which lowers their costs and makes them more competitive. It is hardly surprising that firms such as HSBC, Tesco, ebookers, and BT have been relocating activities to India where graduates can be employed for around 14% of the corresponding salaries in the USA or the UK. The relatively low cost of IT professionals has also resulted in the biggest computer firms establishing operations in India. Similarly, China is not seen by Western MNCs simply in terms of its market potential but also as a very cheap source of supply. B&Q, the large chain of DIY stores, not only has stores in China but also sources US$1 billion/£600 million worth of products from China for its outlets in Europe. And UK firms such as pottery producer, Waterford-Wedgwood, domestic appliance maker, Kenwood, and pram manufacturer, Silver Cross have relocated production to China where there is an abundant supply of labour whose wages are less than one tenth of those of corresponding British workers (*The Guardian*, 19 November 2003).

Barrier removal may also allow firms to obtain previously denied natural resources. For many years Saudi Arabia was unwilling to give foreign firms access to its energy deposits. The Saudi authorities had a change of heart and Shell has signed a deal allowing it to explore for gas. With the collapse of communism Western firms have been vying to get a stake in the vast natural resource deposits of former republics in the Soviet Union such as Kazakhstan and Azerbaijan.

The Costs for Business

When firms globalize it means that they are opening themselves up to an environment that is more complex and risky. They are confronted by new sets of factors in the form of different political regimes, laws and regulations, tax systems, competition policies, and cultures. In extreme cases, they may find that the host government seizes their investment or takes discriminatory action against them. For example, the Egyptian Government confiscated a hotel property, claiming that it was on holy ground. In Ecuador, the Government cancelled an American logging firm's concession and gave it to the nephew of the president.

Fraport, the international airport operator based in Frankfurt, had significant difficulties in the Philippines when it built an airport terminal in Manila. Fraport poured US$384 million into completing the terminal and had to write off US$345 million in debts incurred through the project. Fraport's problems arose when a new government came into power in the Philippines and promptly cancelled the contract without negotiation. According to the company, the government repeatedly broke its contractual obligations and ignored normal legal procedures. In the company's view the investment had been expropriated. Fraport admitted that it failed fully to understand how politics work and how Philippine people think.

Thus we can see that globalization not only generates benefits but also costs. It is likely to pose problems for inefficient firms previously protected by barriers from foreign competition. National airlines such as Lufthansa, or telecommunications companies like France Telecom found it difficult to face up to the more intense competition engendered

Mini Case Globalization and Football

This case shows the impact of globalization on the supply of scarce resources, in this case, talented footballers, to Brazilian football clubs.

Brazilian football fans have long lamented the loss of their football stars as their best players leave for big contracts abroad.

While Brazil's diplomats complain about unfair farm trade at the World Trade Organization, at home the country's sports fans complain about the impact of globalization on their favourite pastime—football.

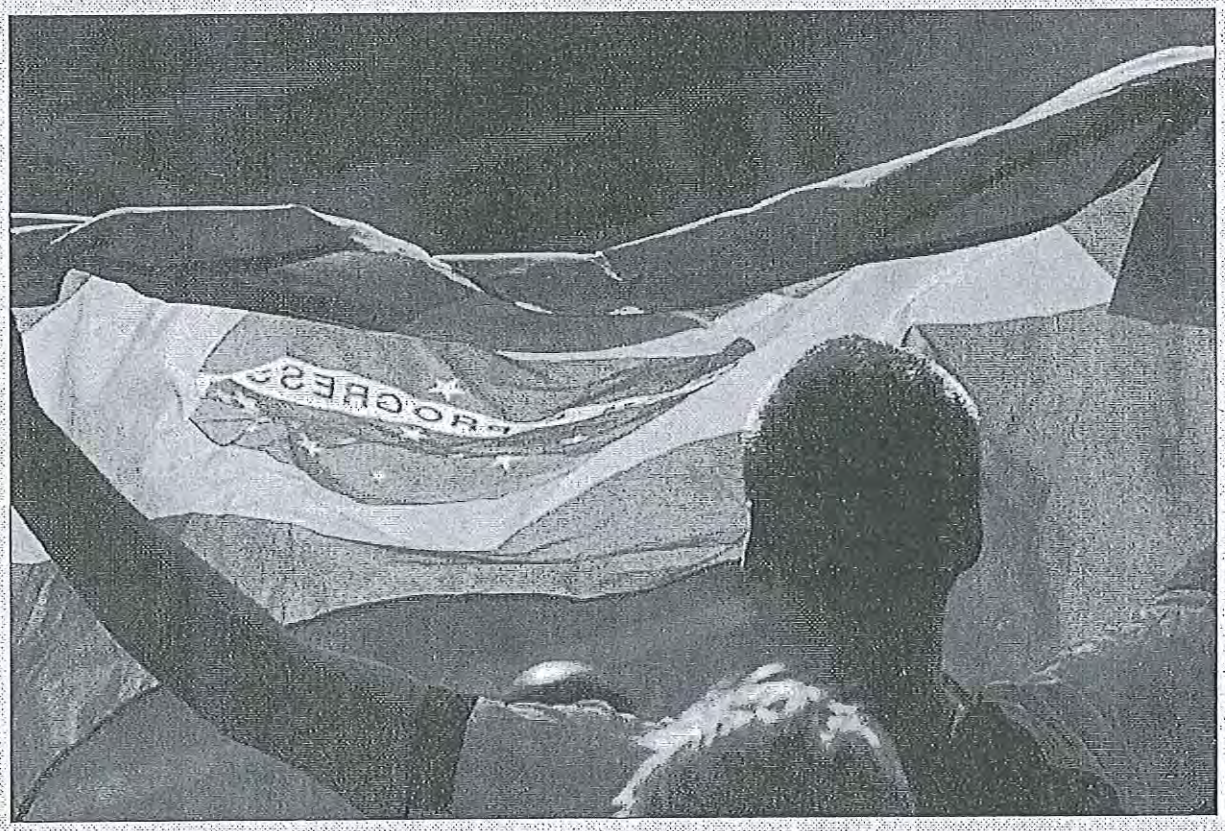
Arguably one of the largest sources of football talent in the world, Brazil itself has hardly any stars left. Fans and officials blame global capitalism. Brazil is a developing economy and is poor relative to its European counterparts. Its football clubs are in dire financial straits, so the best Brazilian players have been seeking greener grass in Europe.

The process is not new. Brazilian football icons went abroad long before Pele was lured to the New York Cosmos in the 1970s. However, the exodus reached new proportions in the 21st century. In 2004 alone, 850 players left the country for hard currency contracts making Brazil the world's biggest exporter of footballers. It is hardly surprising that the national team comprises many foreign-based players. Kaka plays for AC Milan, Gilberto Silva for Arsenal, and Robinho for Real Madrid (more recently, Manchester City). The attraction for foreign clubs is that Brazilian players cost less than local footballers of equivalent talent.

The trend is taking its toll on attendances at football matches in Brazil where an average match attracts fewer than 8,000 supporters compared with 35,000 in Britain's Premier League.

As the head of a Brazilian fan club put it, 'Brazil has the best football in the world but we are losing all our top players, we feel betrayed.'

Sources: *The Economist*, 20 January 2005; *Financial Times*, 15 September 2003



Source: www.istockphoto.com

by the liberalization of civil aviation and telecommunications in the EU. Often the endangered businesses will pressurize governments to leave the protective barriers in place or to reintroduce the barriers previously removed—the US steelmakers being a good example of the latter. It may also be a particular threat for the less competitive small and medium-sized enterprises. Removal of the barriers may allow the entry of new competitors from abroad or it may permit existing customers to switch their custom to foreign suppliers who are cheaper or who can offer better product quality. British apple growers have suffered in this way—the big supermarket chains in the UK have transferred a large proportion of their custom away from domestic suppliers to foreign apple growers in places like Chile, Australia, New Zealand, and South Africa. Weaker domestic firms may find that their access to factors of production is threatened (see mini case on Brazilian Football for an example of this).

Globalization can also cause problems insofar as it raises the dependence of plants and firms on foreign markets and suppliers. As a result of NAFTA, more than 3,000 plants (called maquiladoras) were set up along the Mexico/USA border employing some 1,300,000 workers, producing goods for the North American market. They accounted for half of Mexico's exports. The dependence of so much output and so many jobs on the USA left those plants vulnerable to events in the US economy. When US consumers stopped buying, as the recession hit in 2001, the maquiladoras also began shedding workers. The Mexican Government estimates that over 400,000 jobs disappeared in the process. In the Mexican border towns they now say that when the US economy catches cold, Mexico gets pneumonia (Rosen 2003).

Globalization raises another issue for firms trading in goods and services and investing in productive activities abroad. Such firms prefer to operate in an environment where the financial and macroeconomic systems are stable and predictable. However, there is evidence that the economies of developing economies, whose financial systems have integrated with the rest of the world, are more subject to greater instability than other developing countries (Prasad *et al.* 2003). So it seems that the increasing integration of financial markets allows enormous sums of money to be moved effortlessly across borders leaving financial markets more vulnerable to instability, and the world financial system more prone to violent fluctuations in exchange rates and interest rates. Such fluctuations can pose a major risk to business costs, revenues, and profits. This was seen in 1992 when sterling, after it was forced to leave the ERM, fell by over 40% against the Japanese yen. Another example occurred during the financial crisis in the late 1990s when vast sums of money were moved out of South East Asia causing the exchange rates of countries like Thailand and Indonesia to collapse (see end Case Study Chapter Nine).

CHAPTER SUMMARY

In this chapter we have explained the nature of globalization as a process through which barriers between nations are reduced. Nations thereby become increasingly interdependent, although we point out that most of this interdependence is between members of the triad, with the rest of the world playing a minor

role. The dominance of the triad is being challenged by the emergence of China, India, and Russia as world economic powers. Increased interdependence is indicated by increases in exchanges across borders of goods and services, financial capital, and people.

We also make the point that globalization is not just about economic exchanges but has a cultural and social dimension. The media, our diet, education, work practices, sport, health, crime, and religion all demonstrate the impact of globalization.

The main drivers of globalization are identified as competition, reduction in regulatory barriers, improvements in technology, saturated domestic markets, the desire to cut costs, and the growth of global customers. There still remain important barriers to the process including regulation, technology, and cultural and geographic distance.

Globalization presents both opportunities and threats to business. On the one hand it presents access to new and bigger markets and to different and cheaper sources of raw materials, components, and labour. On the other the environment is more complex and less stable.

It is this environment and the implications for business that this book will explore. In the next chapter we will look at the global economy and explain in more depth some of the topics discussed in this chapter.

REVIEW QUESTIONS

1. What is globalization?
2. How fast is globalization occurring?
3. Where is globalization mainly taking place? Why should that be the case?
4. Identify the main:
   - indicators of globalization
   - drivers of globalization
   - facilitators of globalization
5. What are the important barriers to globalization?
6. Outline the main advantages and disadvantages for business of globalization.

Case Study Globalization—Losers and Winners

The EU Sugar Regime

For almost 40 years the EU protected its sugar farmers from foreign competition. It did this by guaranteeing its farmers a price which was three times higher than the price on the world market. The price level was maintained by setting quotas and tariffs on sugar imports. Any surpluses produced were sold to markets outside the EU at the world price. Firms processing the sugar beet were also guaranteed a minimum price for sugar.

In addition, the regime gave preferential treatment to 18 former European colonies in Africa, the Caribbean, and the Pacific. They were allowed to export, each year to the EU, 1.3m tons of raw sugar at fixed prices.

Brazil, Thailand, and Australia complained to the WTO claiming that the regime broke the WTO rules by subsidising exports. The WTO investigated and found in favour of the complainants.

When the decision was announced shares in EU sugar refiners such as Tate & Lyle, and Associated British Foods, which →

→ owns British Sugar in the UK, and the Spanish company Ebro Puleva fell sharply.

Then the EU Commission announced its intention to reform fundamentally the sugar regime to bring it into line with global trade rules. The EU Commission proposed that guaranteed prices for growers and processors would be cut by up to 42% over a three-year period. Farmers and firms unable to make money from sugar production would be offered compensation to leave the industry.

The reform came under immediate attack from French and Irish farmers and left processors fearful for their livelihoods. Südzucker, the biggest sugar refiner in the EU, also criticized the proposed cuts in the guaranteed price. Ten countries, including Greece, Spain, Ireland, Hungary, and Italy, requested a slower and smaller price cut.

The Commission estimated that the reforms could force 7,500 beet farmers and 29,000 industrial workers out of the industry and around 40 processing plants could be closed. It said that sugar production was likely to be drastically reduced in Ireland, Greece, Italy, and Portugal and to fall significantly in Denmark, Finland, and Spain. In the more efficient producers such as the UK, France, and Germany production was unlikely to change.

The Africa, Caribbean, and Pacific group of countries said that the reduction in price would have a devastating effect upon their economies. In Guyana, for example, sugar production accounted for nearly one fifth of the whole economy and employed around 35,000 people.

On the other hand, the proposals were welcomed by countries such as Australia, Brazil, and Thailand and by producers of biscuits, cakes, chocolate, and confectionery.

Sources: http://europa.eu; www.bbc.co.uk; *Financial Times*, 29 April 2005; *The Guardian*, 1 July 2005

Questions

1. Explain how the sugar regime acted as a barrier to trade in sugar.
2. Give reasons why share prices of processing firms fell as a result of the WTO ruling.
3. Why is the EU proposing to reform the regime?
4. Explain why 10 EU countries asked for slower and smaller price cuts.
5. Why did countries like Brazil welcome the EU proposals?
6. Give reasons why sweet producers were happy with the reform proposals.



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FURTHER READING

For a discussion of the debates and controversies around globalization see:

- Held, D. and McGrew, A. (2007) *Globalization/Anti-Globalization: Beyond the Great Divide*, 2nd edn. Cambridge: Polity

For an examination of the various theories around globalization and how the world economy has been transformed by MNCs, states, and interest groups see:

- Dicken, P. (2007) *Mapping the Changing Contours of the World Economy*, 5th edn. London: Sage

The next book discusses the relationship between globalization and climate change, terrorism, energy supply, population, and business:

- Moynagh, M. and Worsley, R. (2008) *Going Global: Key Questions for the 21st Century*. London: A&C Black

The following article looks at the globalization of a particular sport, cricket:

- Kaufman, J. and Patterson, O. (2005) 'Cross-National Cultural Diffusion: The Global Spread of Cricket'. *American Sociological Review*, Vol 70, No 1, February

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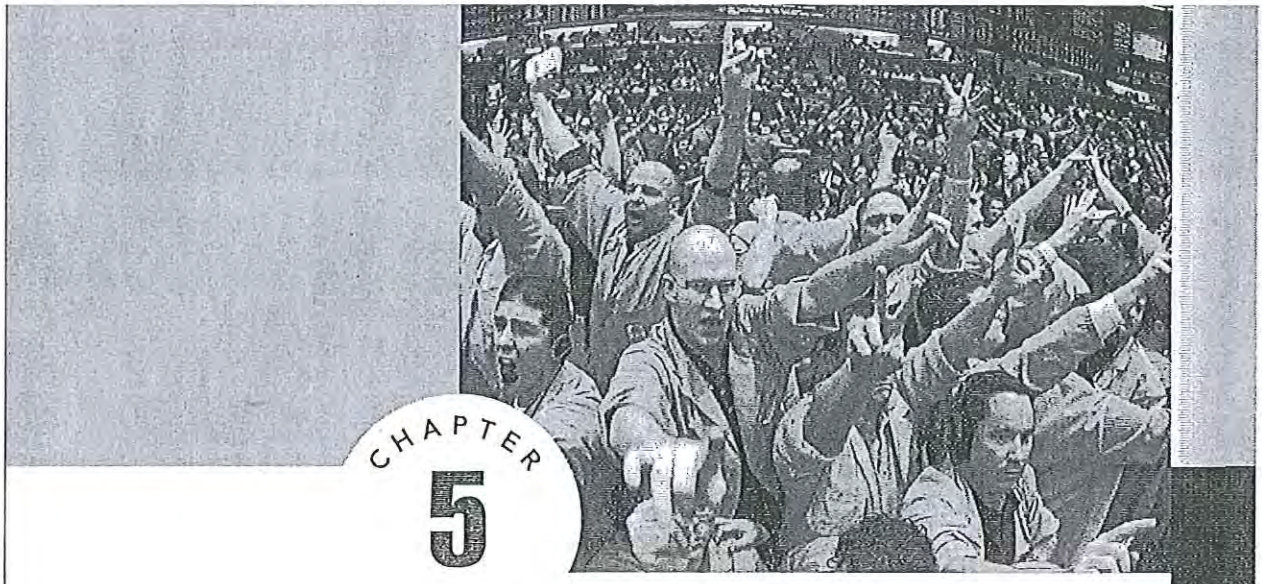
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CHAPTER 5

FINANCIAL MARKETS AND INSTITUTIONS

A Strong Financial System Is Necessary for a Growing and Prosperous Economy

Financial managers and investors don't operate in a vacuum—they make decisions within a large and complex financial environment. This environment includes financial markets and institutions, tax and regulatory policies, and the state of the economy. The environment both determines the available financial alternatives and affects the outcomes of various decisions. Thus, it is crucial that investors and financial managers have a good understanding of the environment in which they operate.

History shows that a strong financial system is a necessary ingredient for a growing and prosperous economy. Companies raising capital to finance capital expenditures as well as investors saving to accumulate funds for future use require well-functioning financial markets and institutions.

Over the past few decades, changing technology and improving communications have increased cross-border transactions and expanded the scope and efficiency of the global financial system. Companies routinely raise funds throughout the world to finance projects all around the globe. Likewise, with the click of a mouse an individual investor in Nebraska can deposit funds in a European bank or purchase a mutual fund that invests in Chinese securities.

It is important to recognize that at the most fundamental level well-functioning markets and institutions are based heavily on trust. An investor who deposits money in a bank, buys stock through an online brokerage account, or contacts her broker to buy a mutual fund places her money and trust in the hands of the financial institutions that provide her with advice and transaction services. Similarly, when businesses approach commercial or investment banks to raise capital, they are relying on these institutions to provide them with funds under the best possible terms, and with sound, objective advice.

While changing technology and globalization have made it possible for more and more types of financial transactions to take place, a series of scandals in recent years have rocked the financial industry and have led many to

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question whether some of our institutions are serving their own or their clients' interests.

Many of these questionable practices have come to light because of the efforts of a single man: the Attorney General of New York, Eliot Spitzer. In 2001, Spitzer exposed conflicts of interest within investment banking firms regarding dealings between their underwriters, who help companies issue new securities, and their analysts, who make recommendations to individual investors to purchase these securities. Allegations were made that to attract the business of firms planning to issue new securities, investment banks leaned on their analysts to write glowing, overly optimistic research reports on these firms. While such practices helped produce large underwriting fees for the investment banks, they compromised their ability to provide the objective, independent research on which their clients depended. A few years later, Spitzer turned his attention to the mutual fund industry, where he exposed unethical fee structures and trading practices of some of the leading funds. More recently, Spitzer has questioned whether some insurance brokers have compromised their clients' interests in order to steer business toward insurers, who provide the broker with rebates of different types.[1]

While some have criticized Spitzer for being overly zealous and politically ambitious, his efforts have appropriately brought to light many questionable practices. Hopefully, this spotlight will put pressure on the institutions to establish practices that will restore the public's trust and lead to a better financial system in the long run.

Putting Things In Perspective

In earlier chapters, we discussed financial statements and showed how financial managers and others analyze them to evaluate a firm's operations and financial position—past, current, and future. To make good decisions, financial managers must understand the environment and markets within which businesses operate. Therefore, in this chapter we describe the markets where capital is raised, securities are traded, and stock prices are established, as well as the institutions that operate in these markets. Because the overall objective of financial managers is to maximize shareholder value, we also take a closer look at how the stock market operates, and we discuss the concept of market efficiency.

[1] For example, some insurance companies allowed brokers to keep premiums for as much as a year before remitting them to the insurance companies. The brokers invested these premiums and earned interest on them, and this gave them an incentive to steer business to these companies rather than to insurance companies whose policies might be better for the brokers' clients.

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5.1 AN OVERVIEW OF THE CAPITAL ALLOCATION PROCESS

Businesses, individuals, and governments often need to raise capital. For example, suppose Carolina Power & Light (CP&L) forecasts an increase in the demand for electricity in North Carolina, and the company decides to build a new power plant. Because CP&L almost certainly will not have the $1 billion or so necessary to pay for the plant, the company will have to raise this capital in the financial markets. Or suppose Mr. Fong, the proprietor of a San Francisco hardware store, decides to expand into appliances. Where will he get the money to buy the initial inventory of TV sets, washers, and freezers? Similarly, if the Johnson family wants to buy a home that costs $200,000, but they have only $40,000 in savings, how can they raise the additional $160,000? And if the city of New York wants to borrow $200 million to finance a new sewer plant, or the federal government needs money to meet its needs, they too need access to the capital markets.

On the other hand, some individuals and firms have incomes that are greater than their current expenditures, so they have funds available to invest. For example, Carol Hawk has an income of $36,000, but her expenses are only $30,000, and as of December 31, 2004, Ford Motor Company had accumulated roughly $23.5 billion of cash and equivalents, which it has available for future investments.

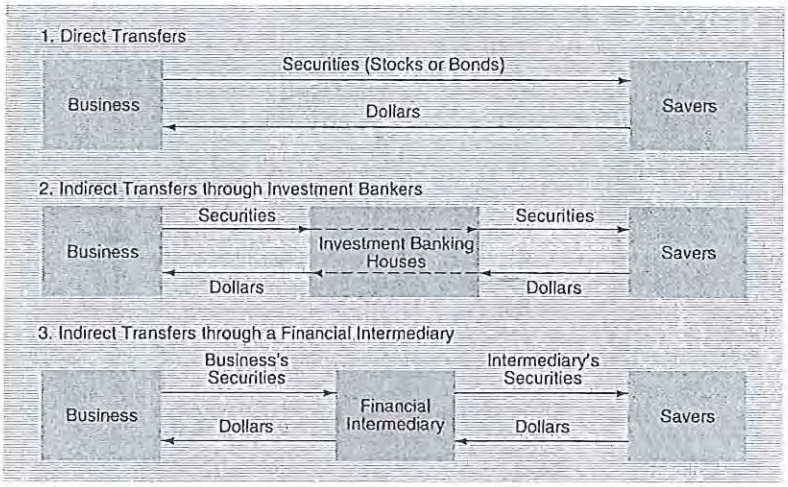
People and organizations with surplus funds are saving today in order to accumulate funds for future use. A household might save to pay for future expenses such as their children's education or their retirement, while a business might save to fund future investments. Those with surplus funds expect to earn a positive return on their investments. People and organizations who need money today borrow to fund their current expenditures. They understand that there is a cost to this capital, and this cost is essentially the return that the investors with surplus funds expect to earn on those funds.

In a well-functioning economy, capital will flow efficiently from those who supply capital to those who demand it. This transfer of capital can take place in the three different ways described in Figure 5-1:

1. *Direct transfers* of money and securities, as shown in the top section, occur when a business sells its stocks or bonds directly to savers, without going through any type of financial institution. The business delivers its securities to savers, who in turn give the firm the money it needs.
2. As shown in the middle section, transfers may also go through an *investment banking house* such as Merrill Lynch, which *underwrites* the issue. An underwriter serves as a middleman and facilitates the issuance of securities. The company sells its stocks or bonds to the investment bank, which in turn sells these same securities to savers. The businesses' securities and the savers' money merely "pass through" the investment banking house. However, the investment bank does buy and hold the securities for a period of time, so it is taking a risk—it may not be able to resell them to savers for as much as it paid. Because new securities are involved and the corporation receives the proceeds of the sale, this is called a primary market transaction.
3. Transfers can also be made through a *financial intermediary* such as a bank or mutual fund. Here the intermediary obtains funds from savers in exchange for its own securities. The intermediary uses this money to buy and hold businesses' securities. For example, a saver might deposit dollars in a bank, receiving from it a certificate of deposit, and then the bank might lend the money to a small business as a mortgage loan. Thus, intermediaries literally create new forms of capital—in this case, certificates of deposit, which are both safer and more liquid than mortgages and thus are better for most

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FIGURE 5-1 *Diagram of the Capital Formation Process*



savers to hold. The existence of intermediaries greatly increases the efficiency of money and capital markets.

Often the entity needing capital is a business, and specifically a corporation, but it is easy to visualize the demander of capital being a home purchaser, a small business, a government unit, and so on. For example, if your uncle lends you money to help fund a new business after you graduate, this would be a direct transfer of funds. Alternatively, if your family borrows money to purchase a home, you will probably raise the funds through a financial intermediary such as your local commercial bank or mortgage banker, which in turn may acquire its funds from a national institution, such as Fannie Mae.

In a global context, economic development is highly correlated with the level and efficiency of financial markets and institutions.[2] It is difficult, if not impossible, for an economy to reach its full potential if it doesn't have access to a well-functioning financial system. For this reason, policy makers often promote the globalization of financial markets.

In a well-developed economy like that of the United States, an extensive set of markets and institutions has evolved over time to facilitate the efficient allocation of capital. To raise capital efficiently, managers must understand how these markets and institutions work.



Identify three different ways capital is transferred between savers and borrowers.

Why do policy makers promote the globalization of financial markets?

[2] For a detailed review of the evidence linking financial development to economic growth, see Ross Levine, "Finance and Growth: Theory and Evidence," NBER Working Paper no. w10766, September 2004.

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5.2 FINANCIAL MARKETS

People and organizations wanting to borrow money are brought together with those having surplus funds in the *financial markets*. Note that "markets" is plural; there are a great many different financial markets in a developed economy such as ours. We briefly describe the different types of financial markets and some recent trends in these markets.

Types of Markets

Different financial markets serve different types of customers or different parts of the country. Financial markets also vary depending on the maturity of the securities being traded and the types of assets used to back the securities. For these reasons it is often useful to classify markets along the following dimensions:

1. *Physical asset versus financial asset markets.* *Physical asset markets* (also called "tangible" or "real" asset markets) are those for products such as wheat, autos, real estate, computers, and machinery. *Financial asset markets*, on the other hand, deal with stocks, bonds, notes, mortgages, and other *claims on real assets*, as well as with *derivative securities* whose values are *derived* from changes in the prices of other assets. A share of Ford stock is a "pure financial asset," while an option to buy Ford shares is a derivative security whose value depends on the price of Ford stock.
2. *Spot versus futures markets.* **Spot markets** are markets in which assets are bought or sold for "on-the-spot" delivery (literally, within a few days). **Futures markets** are markets in which participants agree today to buy or sell an asset at some future date. For example, a farmer may enter into a futures contract in which he agrees today to sell 5,000 bushels of soybeans six months from now at a price of $5 a bushel. On the other side, an international food producer looking to buy soybeans in the future may enter into a futures contract in which it agrees to buy soybeans six months from now.
3. *Money versus capital markets.* **Money markets** are the markets for short-term, highly liquid debt securities. The New York, London, and Tokyo money markets are among the world's largest. **Capital markets** are the markets for intermediate- or long-term debt and corporate stocks. The New York Stock Exchange, where the stocks of the largest U.S. corporations are traded, is a prime example of a capital market. There is no hard and fast rule on this, but when describing debt markets, "short term" generally means less than 1 year, "intermediate term" means 1 to 10 years, and "long term" means more than 10 years.
4. *Primary versus secondary markets.* **Primary markets** are the markets in which corporations raise new capital. If GE were to sell a new issue of common stock to raise capital, this would be a primary market transaction. The corporation selling the newly created stock receives the proceeds from the sale in a primary market transaction. **Secondary markets** are markets in which existing, already outstanding, securities are traded among investors. Thus, if Jane Doe decided to buy 1,000 shares of GE stock, the purchase would occur in the secondary market. The New York Stock Exchange is a secondary market because it deals in outstanding, as opposed to newly issued, stocks and bonds. Secondary markets also exist for mortgages, various other types of loans, and other financial assets. The corporation whose securities are being traded is not involved in a secondary market transaction and, thus, does not receive any funds from such a sale.

Spot Markets
The markets in which assets are bought or sold for "on-the-spot" delivery.

Futures Markets
The markets in which participants agree today to buy or sell an asset at some future date.

Money Markets
The financial markets in which funds are borrowed or loaned for short periods (less than one year).

Capital Markets
The financial markets for stocks and for intermediate- or long-term debt (one year or longer).

Primary Markets
Markets in which corporations raise capital by issuing new securities.

Secondary Markets
Markets in which securities and other financial assets are traded among investors after they have been issued by corporations.

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Private Markets
Markets in which transactions are worked out directly between two parties.

Public Markets
Markets in which standardized contracts are traded on organized exchanges.

5. *Private versus public markets.* Private markets, where transactions are negotiated directly between two parties, are differentiated from public markets, where standardized contracts are traded on organized exchanges. Bank loans and private debt placements with insurance companies are examples of private market transactions. Because these transactions are private, they may be structured in any manner that appeals to the two parties. By contrast, securities that are issued in public markets (for example, common stock and corporate bonds) are ultimately held by a large number of individuals. Public securities must have fairly standardized contractual features, both to appeal to a broad range of investors and also because public investors do not generally have the time and expertise to study unique, nonstandardized contracts. Their wide ownership also ensures that public securities are relatively liquid. Private market securities are, therefore, more tailor-made but less liquid, whereas publicly traded securities are more liquid but subject to greater standardization.

Other classifications could be made, but this breakdown is sufficient to show that there are many types of financial markets. Also, note that the distinctions among markets are often blurred and unimportant except as a general point of reference. For example, it makes little difference if a firm borrows for 11, 12, or 13 months, hence, whether we have a "money" or "capital" market transaction. You should be aware of the important differences among types of markets, but don't get hung up trying to distinguish them at the boundaries.

A healthy economy is dependent on efficient funds transfers from people who are net savers to firms and individuals who need capital. Without efficient transfers, the economy simply could not function: Carolina Power & Light could not raise capital, so Raleigh's citizens would have no electricity; the Johnson family would not have adequate housing; Carol Hawk would have no place to invest her savings; and so on. Obviously, the level of employment and productivity, hence our standard of living, would be much lower. Therefore, it is absolutely essential that our financial markets function efficiently—not only quickly, but also at a low cost.[3]

Table 5-1 (on pages 148–149) gives a listing of the most important instruments traded in the various financial markets. The instruments are arranged from top to bottom in ascending order of typical length of maturity. As we go through the book, we will look in more detail at many of the instruments listed in Table 5-1. For example, we will see that there are many varieties of corporate bonds, ranging from "plain vanilla" bonds to bonds that are convertible into common stocks to bonds whose interest payments vary depending on the inflation rate. Still, the table gives an idea of the characteristics and costs of the instruments traded in the major financial markets.

Recent Trends

Financial markets have experienced many changes during the last two decades. Technological advances in computers and telecommunications, along with the globalization of banking and commerce, have led to deregulation, and this has increased competition throughout the world. The result is a much more effi-

[3] As the countries of the former Soviet Union and other Eastern European nations move toward capitalism, just as much attention must be paid to the establishment of cost-efficient financial markets as to electrical power, transportation, communications, and other infrastructure systems. Economic efficiency is simply impossible without a good system for allocating capital within the economy.

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cient, internationally linked market, but one that is far more complex than existed a few years ago. While these developments have been largely positive, they have also created problems for policy makers. At one conference, Federal Reserve Board Chairman Alan Greenspan stated that modern financial markets "expose national economies to shocks from new and unexpected sources and with little if any lag." He went on to say that central banks must develop new ways to evaluate and limit risks to the financial system. Large amounts of capital move quickly around the world in response to changes in interest and exchange rates, and these movements can disrupt local institutions and economies.

Globalization has exposed the need for greater cooperation among regulators at the international level. Various committees are currently working to improve coordination, but the task is not easy. Factors that complicate coordination include (1) the differing structures among nations' banking and securities industries, (2) the trend in Europe toward financial services conglomerates, and (3) reluctance on the part of individual countries to give up control over their national monetary policies. Still, regulators are unanimous about the need to close the gaps in the supervision of worldwide markets.

Another important trend in recent years has been the increased use of **derivatives.** A derivative is any security whose value is *derived* from the price of some other "underlying" asset. An option to buy IBM stock is a derivative, as is a contract to buy Japanese yen six months from now. The value of the IBM option depends on the price of IBM's stock, and the value of the Japanese yen "future" depends on the exchange rate between yen and dollars. The market for derivatives has grown faster than any other market in recent years, providing corporations with new opportunities but also exposing them to new risks.

Derivative
Any financial asset whose value is derived from the value of some other "underlying" asset.

Derivatives can be used either to reduce risks or to speculate. Suppose an importer's costs rise and its net income falls when the dollar falls relative to the yen. That company could reduce its risk by purchasing derivatives whose values increase when the dollar declines. This is a *hedging operation*, and its purpose is to reduce risk exposure. Speculation, on the other hand, is done in the hope of high returns, but it raises risk exposure. For example, several years ago Procter & Gamble disclosed that it lost $150 million on derivative investments, and Orange County (California) went bankrupt as a result of its treasurer's speculation in derivatives.

The size and complexity of derivatives transactions concern regulators, academics, and members of Congress. Fed Chairman Greenspan noted that, in theory, derivatives should allow companies to manage risk better, but that it is not clear whether recent innovations have "increased or decreased the inherent stability of the financial system."



Distinguish between physical asset and financial asset markets.

What's the difference between spot and futures markets?

Distinguish between money and capital markets.

What's the difference between primary and secondary markets?

Differentiate between private and public markets.

Why are financial markets essential for a healthy economy and economic growth?

What is a derivative, and how is its value related to that of an "underlying asset"?

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TABLE 5-1 *Summary of Major Market Instruments, Market Participants, and Security Characteristics*

			SECURITY CHARACTERISTICS		
Instrument (1)	Market (2)	Major Participants (3)	Riskiness (4)	Original Maturity (5)	Interest Rate on 2/1/05[a] (6)
U.S. Treasury bills	Money	Sold by U.S. Treasury to finance federal expenditures	Default-free	91 days to 1 year	2.48%
Bankers' acceptances	Money	A firm's promise to pay, guaranteed by a bank	Low degree of risk if guaranteed by a strong bank	Up to 180 days	2.68
Dealer commercial paper	Money	Issued by financially secure firms to large investors	Low default risk	Up to 270 days	2.67
Negotiable certificates of deposit (CDs)	Money	Issued by major money-center commercial banks to large investors	Default risk depends on the strength of the issuing bank	Up to 1 year	2.70
Money market mutual funds	Money	Invest in Treasury bills, CDs, and commercial paper; held by individuals and businesses	Low degree of risk	No specific maturity (instant liquidity)	1.69
Eurodollar market time deposits	Money	Issued by banks outside U.S.	Default risk depends on the strength of the issuing bank	Up to 1 year	2.70
Consumer credit, including credit card debt	Money	Issued by banks/ credit unions/finance companies to individuals	Risk is variable	Variable	Variable, but goes up to 20% or more
U.S. Treasury notes and bonds	Capital	Issued by U.S. government	No default risk, but price will decline if interest rates rise	2 to 30 years	4.65

[a] The yields reported (except for corporate and municipal bonds) are from *The Wall Street Journal*. Money market rates assume a 3-month maturity. Corporate and municipal bond rates are for 30-year AAA-rated bonds; quotes are from *Federal Reserve Statistical Release*.

5.3 FINANCIAL INSTITUTIONS

Direct funds transfers are more common among individuals and small businesses, and in economies where financial markets and institutions are less developed. While businesses in more developed economies do occasionally rely on direct transfers, they generally find it more efficient to enlist the services of one or more financial institutions when it comes time to raise capital.

In the United States and other developed nations, a set of highly efficient financial intermediaries has evolved. Their original roles were generally quite specific, but many of them have diversified to the point where they serve

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TABLE 5-1 *(Continued)*

Instrument (1)	Market (2)	Major Participants (3)	SECURITY CHARACTERISTICS: Riskiness (4)	Original Maturity (5)	Interest Rate on 2/1/05[a] (6)
Mortgages	Capital	Borrowings from commercial banks and S&Ls by individuals and businesses	Risk is variable	Up to 30 years	5.20
State and local government bonds	Capital	Issued by state and local governments to individuals and institutional investors	Riskier than U.S. government securities, but exempt from most taxes	Up to 30 years	4.40
Corporate bonds	Capital	Issued by corporations to individuals and institutional investors	Riskier than U.S. government securities, but less risky than preferred and common stocks; varying degree of risk within bonds depending on strength of issuer	Up to 40 years[b]	5.22
Leases	Capital	Similar to debt in that firms can lease assets rather than borrow and then buy the assets	Risk similar to corporate bonds	Generally 3 to 20 years	Similar to bond yields
Preferred stocks	Capital	Issued by corporations to individuals and institutional investors	Riskier than corporate bonds, but less risky than common stock	Unlimited	6 to 8%
Common stocks[c]	Capital	Issued by corporations to individuals and institutional investors	Risky	Unlimited	NA

[b] Just recently, a few corporations have issued 100-year bonds; however, the majority have issued bonds with maturities less than 40 years.

[c] While common stocks do not pay interest, they are expected to provide a "return" in the form of dividends and capital gains. As you will see in Chapter 8, historical stock returns have averaged between 10 and 15 percent a year. Of course, if you buy a stock, your actual return may be considerably higher or lower than these historical averages.

many different markets. As a result, the differences between institutions have tended to become blurred. Still, there remains a degree of institutional identity, and therefore it is useful to describe the major categories of financial institutions here:

Investment Banking House
An organization that underwrites and distributes new investment securities and helps businesses obtain financing.

1. **Investment banking houses** such as Merrill Lynch, Morgan Stanley, Goldman Sachs, or Credit Suisse Group provide a number of services to both investors and companies planning to raise capital. Such organizations (a) help

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corporations design securities with features that are currently attractive to investors, (b) then buy these securities from the corporation, and (c) resell them to savers. Although the securities are sold twice, this process is really one primary market transaction, with the investment banker acting as a facilitator to help transfer capital from savers to businesses.

Commercial Bank
Traditional department store of finance serving a variety of savers and borrowers.

2. **Commercial banks**, such as Bank of America, Wells Fargo, Wachovia, and J. P. Morgan Chase, are the traditional "department stores of finance" because they serve a variety of savers and borrowers. Historically, commercial banks were the major institutions that handled checking accounts and through which the Federal Reserve System expanded or contracted the money supply. Today, however, several other institutions also provide checking services and significantly influence the money supply. Conversely, commercial banks are providing an ever-widening range of services, including stock brokerage services and insurance.

Financial Services Corporation
A firm that offers a wide range of financial services, including investment banking, brokerage operations, insurance, and commercial banking.

3. **Financial services corporations** are large conglomerates that combine many different financial institutions within a single corporation. Examples of financial services corporations, most of which started in one area but have now diversified to cover most of the financial spectrum, include Citigroup, American Express, Fidelity, and Prudential.
4. *Savings and loan associations (S&Ls)* traditionally served individual savers and residential and commercial mortgage borrowers, taking the funds of many small savers and then lending this money to home buyers and other types of borrowers. In the 1980s, the S&L industry experienced severe problems when (a) short-term interest rates paid on savings accounts rose well above the returns earned on the existing mortgages held by S&Ls and (b) commercial real estate suffered a severe slump, resulting in high mortgage default rates. Together, these events forced many S&Ls to merge with stronger institutions or close their doors.
5. *Mutual savings banks*, which are similar to S&Ls, operate primarily in the northeastern states, accepting savings primarily from individuals, and lending mainly on a long-term basis to home buyers and consumers.
6. *Credit unions* are cooperative associations whose members are supposed to have a common bond, such as being employees of the same firm. Members' savings are loaned only to other members, generally for auto purchases, home improvement loans, and home mortgages. Credit unions are often the cheapest source of funds available to individual borrowers.
7. *Pension funds* are retirement plans funded by corporations or government agencies for their workers and administered primarily by the trust departments of commercial banks or by life insurance companies. Pension funds invest primarily in bonds, stocks, mortgages, and real estate.
8. *Life insurance companies* take savings in the form of annual premiums; invest these funds in stocks, bonds, real estate, and mortgages; and finally make payments to the beneficiaries of the insured parties. In recent years, life insurance companies have also offered a variety of tax-deferred savings plans designed to provide benefits to the participants when they retire.

Mutual Funds
Organizations that pool investor funds to purchase financial instruments and thus reduce risks through diversification.

9. **Mutual funds** are corporations that accept money from savers and then use these funds to buy stocks, long-term bonds, or short-term debt instruments issued by businesses or government units. These organizations pool funds and thus reduce risks by diversification. They also achieve economies of scale in analyzing securities, managing portfolios, and buying and selling securities. Different funds are designed to meet the objectives of different types of savers. Hence, there are bond funds for those who desire safety, stock funds for savers who are willing to accept significant risks in the hope of higher returns, and still other funds that are used as interest-bearing

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checking accounts (**money market funds**). There are literally thousands of different mutual funds with dozens of different goals and purposes.

Money Market Funds
Mutual funds that invest in short-term, low-risk securities and allow investors to write checks against their accounts.

Mutual funds have grown more rapidly than most other institutions in recent years, in large part because of a change in the way corporations provide for employees' retirement. Before the 1980s, most corporations said, in effect, "Come work for us, and when you retire, we will give you a retirement income based on the salary you were earning during the last five years before you retired." The company was then responsible for setting aside funds each year to make sure it had the money available to pay the agreed-upon retirement benefits. That situation is changing rapidly. Today, new employees are likely to be told, "Come work for us, and we will give you some money each payday that you can invest for your future retirement. You can't get the money until you retire (without paying a huge tax penalty), but if you invest wisely, you can retire in comfort." Most workers recognize that they don't know enough to invest wisely, so they turn their retirement funds over to a mutual fund. Hence, mutual funds are growing rapidly. Excellent information on the objectives and past performances of the various funds are provided in publications such as *Value Line Investment Survey* and *Morningstar Mutual Funds*, which are available in most libraries and on the Internet.

10. *Hedge funds* are similar to mutual funds because they accept money from savers and use the funds to buy various securities, but there are some important differences. While mutual funds are registered and regulated by the Securities and Exchange Commission (SEC), hedge funds are largely unregulated. This difference in regulation stems from the fact that mutual funds typically target small investors, whereas hedge funds typically have large minimum investments (often exceeding $1 million) that are effectively marketed to institutions and individuals with high net worths. Different hedge fund managers follow different strategies. For example, a hedge fund manager who believes that the spreads between corporate and Treasury bond yields are too large might simultaneously buy a portfolio of corporate bonds and sell a portfolio of Treasury bonds. In this case, the portfolio is "hedged" against overall movements in interest rates, but it will do well if the spread between these securities narrows. Likewise, hedge fund managers may take advantage of perceived incorrect valuations in the stock market, that is, where a stock's market and intrinsic values differ.

Hedge funds generally charge large fees, often a fixed amount plus 15 to 20 percent of the fund's capital gains. The average hedge fund has done quite well in recent years. In a recent report, Citigroup estimates that the average hedge fund has produced an annual return of 11.9 percent since 1990. Over the same time period, the average annual returns of the overall stock market were 10.5 percent, and the returns on mutual funds were even lower, 9.2 percent. Given the stock market's relatively lackluster performance in recent years, an increasing number of investors have flocked to hedge funds. Between 1999 and 2004, the money managed by them more than quadrupled to roughly $800 billion. However, the same article in *BusinessWeek* that highlighted the strong growth and relative performance of these funds also suggested that their returns are showing signs of weakness and emphasized that they are certainly not without risk.[4]

Indeed, some hedge funds take on risks that are considerably higher than that of an average individual stock or mutual fund. Moreover, in recent years, some have also produced spectacular losses. For example, many

[4] See Anne Tergesen, "Time to Hedge on Hedge Funds? New Research Shows that Returns Are Sliding, and Some Don't Help You Diversify," *BusinessWeek*, September 13, 2004, p. 104.

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hedge fund investors suffered large losses in 1998 when the Russian economy collapsed. That same year, the Federal Reserve had to step in to help rescue Long Term Capital Management, a high-profile hedge fund whose managers included several well-respected practitioners as well as two Nobel Prize–winning professors who were experts in investment theory.[5]

As hedge funds have become more popular, many have begun to lower their minimum investment requirements. Perhaps not surprisingly, their rapid growth and shift toward smaller investors have also led to a call for more regulation.

With the notable exception of hedge funds, financial institutions have been heavily regulated to ensure the safety of these institutions and thus to protect investors. Historically, many of these regulations—which have included a prohibition on nationwide branch banking, restrictions on the types of assets the institutions could buy, ceilings on the interest rates they could pay, and limitations on the types of services they could provide—tended to impede the free flow of capital and thus hurt the efficiency of our capital markets. Recognizing this fact, policy makers took several steps during the 1980s and 1990s to deregulate financial services companies. For example, the barriers that restricted banks from expanding nationwide were eliminated. Likewise, regulations that once forced a strict separation of commercial and investment banking have been relaxed.

The result of the ongoing regulatory changes has been a blurring of the distinctions between the different types of institutions. Indeed, the trend in the United States today is toward huge financial services corporations, which own banks, S&Ls, investment banking houses, insurance companies, pension plan operations, and mutual funds, and which have branches across the country and around the world. For example, Citigroup combines one of the world's largest commercial banks (Citibank), a huge insurance company (Travelers), and a major investment bank (Smith Barney), along with numerous other subsidiaries that operate throughout the world. Citigroup's structure is similar to that of major institutions in Europe, Japan, and elsewhere around the globe.

Panel A of Table 5-2 lists the 10 largest U.S. bank and thrift holding companies, while Panel B shows the leading world banking companies. Among the world's 10 largest, only one (Citigroup) is based in the United States. While U.S. banks have grown dramatically as a result of recent mergers, they are still small by global standards. Panel C of the table lists the 10 leading underwriters in terms of dollar volume of new debt and equity issues. Six of the top underwriters are also major commercial banks or are part of bank holding companies, which confirms the continued blurring of distinctions among different types of financial institutions.



What is the difference between a pure commercial bank and a pure investment bank?

List the major types of financial institutions, and briefly describe the primary function of each.

What are some important differences between mutual and hedge funds? How are they similar?

[5] See Franklin Edwards, "Hedge Funds and the Collapse of Long Term Capital Management," *Journal of Economic Perspectives*, Vol. 13, no. 2 (Spring 1999), pp. 189–210, for a thoughtful review of the implications of Long Term Capital Management's collapse.

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TABLE 5-2 *10 Largest U.S. Bank and Thrift Holding Companies and World Banking Companies and Top 10 Leading Underwriters*

Panel A U.S. Bank and Thrift Holding Companies[a]	Panel B World Banking Companies[b]	Panel C Leading Global Underwriters[c]
Citigroup Inc.	Mizuho Financial Group (Tokyo)	Citigroup Inc.
Bank of America Corp.	Citigroup Inc. (New York)	Morgan Stanley
J. P. Morgan Chase & Co.	Allianz AG (Munich)	J. P. Morgan
Wells Fargo & Co.	UBS AG (Zurich)	Merrill Lynch
Wachovia Corp.	HSBC Holdings PLC (London)	Lehman Brothers
MetLife Inc.	Deutsche Bank AG (Frankfurt)	Credit Suisse First Boston
Bank One	Credit Agricole (Paris)	Deutsche Bank AG
Washington Mutual Inc.	BNP Paribas (Paris)	UBS AG
U.S. Bancorp	ING Group NV (Amsterdam)	Goldman Sachs
SunTrust Banks Inc.	Sumitomo Mitsui Financial Group (Tokyo)	Banc of America Securities

Notes:

[a] Ranked by total assets as of June 30, 2004. *Source:* "Top 150 Bank and Thrift Holding Companies with the Most Assets," *AmericanBanker.com*, October 19, 2004.

[b] Ranked by total assets as of December 31, 2003. *Source:* "World's Largest Banking Companies by Assets," *AmericanBanker.com*, November 12, 2004.

[c] Ranked by dollar amount raised through new issues (stocks and bonds) in 2004. For this ranking, the lead underwriter (manager) is given credit for the entire issue. *Source:* Adapted from *The Wall Street Journal*, January 3, 2005, p. R17.

5.4 THE STOCK MARKET

As noted earlier, secondary markets are those in which outstanding, previously issued securities are traded. By far the most active secondary market, and the most important one to financial managers, is the *stock market*, where the prices of firms' stocks are established. Because the primary goal of financial managers is to maximize their firms' stock prices, knowledge of the stock market is important to anyone involved in managing a business.

While the two leading stock markets today are the New York Stock Exchange and the Nasdaq stock market, stocks are actually traded using a variety of market procedures. However, there are just two basic types of stock markets: (1) *physical location exchanges*, which include the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and several regional stock exchanges, and (2) electronic dealer-based markets that include the Nasdaq stock market, the less formal over-the-counter market, and the recently developed electronic communications networks (ECNs). (See the box entitled, "The NYSE and Nasdaq Combine Forces with the Leading Online Trading Systems.") Because the physical location exchanges are easier to describe and understand, we consider them first.

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Citigroup Built to Compete in a Changing Environment

The financial environment has been undergoing tremendous changes, including breakthroughs in technology, increased globalization, and shifts in the regulatory environment. All of these factors have presented financial managers and investors with opportunities, but those opportunities are accompanied by substantial risks.

Consider the case of Citigroup Inc., which was created in 1998 when Citicorp and Travelers Group (which included the investment firm Salomon Smith Barney) merged. Citigroup today operates in more than 100 countries, has roughly 200 million customers and 275,000 employees, and holds more than $1.4 trillion (that's over a thousand billion!) worth of assets.

Citigroup resulted from three important trends:

1. A regulatory change made it possible for U.S. corporations to engage in commercial banking, investment banking, and insurance.
2. Increased globalization made it desirable for financial institutions to follow their clients and operate in many countries.
3. Changing technology led to increased economies of scale and scope, both of which increase the relative efficiency of huge, diversified companies such as Citigroup.

The same forces that are transforming the financial services industry have affected other industries. In particular, the growth of the Internet has provided many companies with increased opportunities, but it has also created additional competition and risk. For example, it has altered the way millions of consumers purchase airline tickets, hotel rooms, books, and automobiles. Consequently, financial managers must understand today's technological environment and be ready to change operations as the environment evolves.

The Physical Location Stock Exchanges

Physical Location Exchanges
Formal organizations having tangible physical locations that conduct auction markets in designated ("listed") securities.

The **physical location exchanges** are tangible physical entities. Each of the larger ones occupies its own building, has a limited number of members, and has an elected governing body—its board of governors. Members are said to have "seats" on the exchange, although everybody stands up. These seats, which are bought and sold, give the holder the right to trade on the exchange. There are currently 1,366 seats on the New York Stock Exchange (this number has remained constant since 1953). In early 2005, a seat on the NYSE sold for $1.0 million, which was considerably lower than the record high of $2.65 million. Seat prices are at multiyear lows due to low trading volume, declines in commissions earned, and recent scandals that have rocked the NYSE.

Most of the larger investment banking houses operate *brokerage departments*, and they own seats on the exchanges and designate one or more of their officers as members. The exchanges are open on all normal working days, with the members meeting in a large room equipped with telephones and other electronic equipment that enable each member to communicate with his or her firm's offices throughout the country.

Like other markets, security exchanges facilitate communication between buyers and sellers. For example, Merrill Lynch (the fourth largest brokerage firm) might receive an order in its Atlanta office from a customer who wants to buy shares of GE stock. Simultaneously, the Denver office of Morgan Stanley (the second largest brokerage firm) might receive an order from a customer wishing to sell shares of GE. Each broker communicates electronically with the firm's representative on the NYSE. Other brokers throughout the country are

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The NYSE and Nasdaq Combine Forces with the Leading Online Trading Systems

The forces that spurred consolidation in the financial services industry have also promoted online trading systems that bypass the traditional exchanges. These systems, which are known as electronic communications networks (ECNs), use electronic technology to bring buyers and sellers together. As of early 2005, the majority of these transactions were conducted by two firms: Instinet Group and Archipelago.

The rise of ECNs has accelerated the move toward 24-hour trading. Large clients who want to trade after other markets have closed may utilize an ECN, thus bypassing the NYSE and Nasdaq. The move toward faster, cheaper, and continuous trading obviously benefits investors, but it does present regulators, who try to ensure that all investors have access to a "level playing field," with a number of headaches.

Recognizing the new threat, the two leading exchanges have not been content to stand idly by. In April 2005, the NYSE announced plans to acquire Archipelago and to turn itself into a public company. If the deal goes through, the new company will be called NYSE Group Inc., and 70 percent of the combined company will be owned by those who currently hold seats on the NYSE. Archipelago shareholders will own the remaining 30 percent. Two days after this stunning announcement, Nasdaq announced its own plans to purchase Instinet.

These announced mergers confirm the growing importance of electronic trading and have led many to conclude that the floor traders who buy and sell stock on the NYSE may soon become a thing of the past as an increasing number of transactions take place electronically. Others contend that there will remain a role for these floor traders for at least the foreseeable future. In any event, what is clear is that the financial landscape of stock trading will continue to undergo dramatic changes in the upcoming years.

Sources: Katrina Brooker, "Online Investing: It's Not Just for Geeks Anymore," *Fortune*, December 21, 1998, pp. 89–98; "Fidelity, Schwab Part of Deal to Create Nasdaq Challenger," *The Milwaukee Journal Sentinel*, July 22, 1999, p. 1; Aaron Lucchetti, Susanne Craig, and Dennis K. Berman, "NYSE to Acquire Electronic Trader and Go Public," *The Wall Street Journal*, April 21, 2005, p. A1; and "Nasdaq Agrees to Buy Instinet for $1.88 Billion," www.wsj.com, *Wall Street Online*, April 22, 2005.

also communicating with their own exchange members. The exchange members with *sell orders* offer the shares for sale, and they are bid for by the members with *buy orders*. Thus, the exchanges operate as *auction markets*.[6]

[6] The NYSE is actually a modified auction market, wherein people (through their brokers) bid for stocks. Originally—about 200 years ago—brokers would literally shout, "I have 100 shares of Erie for sale; how much am I offered?" and then sell to the highest bidder. If a broker had a buy order, he or she would shout, "I want to buy 100 shares of Erie; who'll sell at the best price?" The same general situation still exists, although the exchanges now have members known as *specialists* who facilitate the trading process by keeping an inventory of shares of the stocks in which they specialize. If a buy order comes in at a time when no sell order arrives, the specialist will sell off some inventory. Similarly, if a sell order comes in, the specialist will buy and add to inventory. The specialist sets a *bid price* (the price the specialist will pay for the stock) and an *asked price* (the price at which shares will be sold out of inventory). The bid and asked prices are set at levels designed to keep the inventory in balance. If many buy orders start coming in because of favorable developments or sell orders come in because of unfavorable events, the specialist will raise or lower prices to keep supply and demand in balance. Bid prices are somewhat lower than asked prices, with the difference, or *spread*, representing the specialist's profit margin.

Special facilities are available to help institutional investors such as mutual or pension funds sell large blocks of stock without depressing their prices. In essence, brokerage houses that cater to institutional clients will purchase blocks (defined as 10,000 or more shares) and then resell the stock to other institutions or individuals. Also, when a firm has a major announcement that is likely to cause its stock price to change sharply, it will ask the exchanges to halt trading in its stock until the announcement has been made and digested by investors.

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The Over-the-Counter and the Nasdaq Stock Markets

Over-the-Counter (OTC) Market
A large collection of brokers and dealers, connected electronically by telephones and computers, that provides for trading in unlisted securities.

While the stocks of most large companies trade on the NYSE, a larger number of stocks trade off the exchange in what has traditionally been referred to as the **over-the-counter (OTC) market.** An explanation of the term "over-the-counter" will help clarify how this term arose. As noted earlier, the exchanges operate as auction markets—buy and sell orders come in more or less simultaneously, and exchange members match these orders. If a stock is traded infrequently, perhaps because the firm is new or small, few buy and sell orders come in, and matching them within a reasonable amount of time would be difficult. To avoid this problem, some brokerage firms maintain an inventory of such stocks and stand prepared to make a market for these stocks. These "dealers" buy when individual investors want to sell, and then sell part of their inventory when investors want to buy. At one time, the inventory of securities was kept in a safe, and the stocks, when bought and sold, were literally passed over the counter.

Dealer Market
Includes all facilities that are needed to conduct security transactions not conducted on the physical location exchanges.

Today, these markets are often referred to as **dealer markets.** A dealer market includes all facilities that are needed to conduct security transactions, but they are not made on the physical location exchanges. These facilities include (1) the relatively few *dealers* who hold inventories of these securities and who are said to "make a market" in these securities; (2) the thousands of brokers who act as *agents* in bringing the dealers together with investors; and (3) the computers, terminals, and electronic networks that provide a communication link between dealers and brokers. The dealers who make a market in a particular stock quote the price at which they will pay for the stock (the *bid price*) and the price at which they will sell shares (the *ask price*). Each dealer's prices, which are adjusted as supply and demand conditions change, can be read off computer screens all across the world. The *bid-ask spread*, which is the difference between bid and asked prices, represents the dealer's markup, or profit. The dealer's risk increases if the stock is more volatile, or if the stock trades infrequently. Generally, we would expect volatile, infrequently traded stocks to have wider spreads in order to compensate the dealers for assuming the risk of holding them in inventory.

Brokers and dealers who participate in the over-the-counter market are members of a self-regulatory body known as the *National Association of Securities Dealers (NASD)*, which licenses brokers and oversees trading practices. The computerized network used by the NASD is known as the NASD Automated Quotation System (Nasdaq).

Nasdaq started as just a quotation system, but it has grown to become an organized securities market with its own listing requirements. Over the past decade the competition between the NYSE and Nasdaq has become increasingly fierce. In an effort to become more competitive with the NYSE and with international markets, the Nasdaq and the AMEX merged in 1998 to form the Nasdaq-Amex Market Group. The merger turned out to be less than successful, and in early 2005 the AMEX members agreed to buy the exchange back from the NASD. Since most of the larger companies trade on the NYSE, the market capitalization of NYSE-traded stocks is much higher than for stocks traded on Nasdaq ($12.6 trillion compared with $3.7 trillion at year-end 2004). However, reported volume (number of shares traded) is often larger on Nasdaq, and more companies are listed on Nasdaq.[7]

Interestingly, many high-tech companies such as Microsoft and Intel have remained on Nasdaq even though they easily meet the listing requirements of the NYSE. At the same time, however, other high-tech companies such as Gateway, America Online, and Iomega have left Nasdaq for the NYSE. Despite these defec-

[7] One transaction on Nasdaq generally shows up as two separate trades (the buy and the sell). This "double counting" makes it difficult to compare the volume between stock markets.

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tions, Nasdaq's growth over the past decade has been impressive. In the years ahead, competition between Nasdaq and the NYSE will no doubt remain fierce.



What are the differences between the physical location exchanges and the Nasdaq stock market?

What is the bid-ask spread?

5.5 THE MARKET FOR COMMON STOCK

Some companies are so small that their common stocks are not actively traded; they are owned by only a few people, usually the companies' managers. These firms are said to be *privately owned*, or **closely held, corporations**, and their stock is called *closely held stock*. In contrast, the stocks of most larger companies are owned by thousands of investors, most of whom are not active in management. These companies are called **publicly owned corporations**, and their stock is called *publicly held stock*.

Closely Held Corporation
A corporation that is owned by a few individuals who are typically associated with the firm's management.

Publicly Owned Corporation
A corporation that is owned by a relatively large number of individuals who are not actively involved in its management.

A recent study found that institutional investors owned about 46 percent of all publicly held common stocks. Included are pension plans (26 percent), mutual funds (10 percent), foreign investors (6 percent), insurance companies (3 percent), and brokerage firms (1 percent). These institutions buy and sell relatively actively, however, so they account for about 75 percent of all transactions. Thus, institutional investors have a significant influence on the prices of individual stocks.

Types of Stock Market Transactions

We can classify stock market transactions into three distinct categories:

1. *Trading in the outstanding shares of established, publicly owned companies: the secondary market.* Allied Food Products, the company we analyzed in Chapters 3 and 4, has 50 million shares of stock outstanding. If the owner of 100 shares sells his or her stock, the trade is said to have occurred in the *secondary market*. Thus, the market for outstanding shares, or *used shares*, is the secondary market. The company receives no new money when sales occur in this market.
2. *Additional shares sold by established, publicly owned companies: the primary market.* If Allied decides to sell (or issue) an additional 1 million shares to raise new equity capital, this transaction is said to occur in the *primary market*.[8]
3. *Initial public offerings by privately held firms: the IPO market.* In the summer of 2004 Google sold shares to the public for the first time at $85 per share. By September 2005, the stock was selling for $303, so it had more than tripled. Several years ago, the Coors Brewing Company, which was owned by the Coors family at the time, decided to sell some stock to raise capital needed for a major expansion program.[9] These types of transactions are called

[8] Allied has 60 million shares authorized but only 50 million outstanding; thus, it has 10 million authorized but unissued shares. If it had no authorized but unissued shares, management could increase the authorized shares by obtaining stockholders' approval, which would generally be granted without any arguments.

[9] The stock Coors offered to the public was designated Class B, and it was nonvoting. The Coors family retained the founders' shares, called Class A stock, which carried full voting privileges. The company was large enough to obtain an NYSE listing, but at that time the Exchange had a requirement that listed common stocks must have full voting rights, which precluded Coors from obtaining an NYSE listing.

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Going Public
The act of selling stock to the public at large by a closely held corporation or its principal stockholders.

Initial Public Offering (IPO) Market
The market for stocks of companies that are in the process of going public.

going public—whenever stock in a closely held corporation is offered to the public for the first time, the company is said to be going public. The market for stock that is just being offered to the public is called the **initial public offering (IPO) market.**

IPOs have received a lot of attention in recent years, primarily because a number of "hot" issues have realized spectacular gains—often in the first few minutes of trading. Consider the 1999 IPO of Red Hat Inc., the open-source provider of software products and services. The company's underwriters set an offering price of $14 per share. However, because of intense demand for the issue, the stock's price rose more than 270 percent the first day of trading.

With the recent stock market decline, we have also seen a decline in the number of new IPOs. Table 5-3 lists the largest, the best performing, and the worst performing IPOs of 2004, and it shows how they performed from their offering dates through year-end 2004. As the table shows, not all IPOs are as well received as Red Hat's. Moreover, even if you are able to identify a "hot" issue, it is often difficult to purchase shares in the initial offering. These deals are generally *oversubscribed*, which means that the demand for shares at the offering price exceeds the number of shares issued. In such instances, investment bankers favor large institutional investors (who are their best customers), and small investors find it hard, if not impossible, to get in on the ground floor. They can buy the stock in the after-market, but evidence suggests that if you do not get in on the ground floor the average IPO underperforms the overall market over the long run.[10]

Indeed, the subsequent performance of Red Hat illustrates the risks that arise when investing in new issues. Figure 5-2 plots Red Hat's stock price from the time of its IPO in 1999 to early February 2005. After its dramatic first day run-up, Red Hat's stock closed just above $54 per share. Demand for the stock continued to surge, and the price reached a high of just over $300 in December 1999. Soon afterward, the company announced a two-for-one stock split. (Note that Figure 5-2 considers the stock split.) The split effectively cut the stock's price in half, but it doubled the number of shares held by each shareholder. After adjusting for the split, the stock's price stood at $132 per share in early January 2000. Soon thereafter, Red Hat's price tumbled—indeed, by mid-year 2001 its price was $3.50 per share, which was equivalent to $7.00 per share before the split. As Figure 5-2 shows, Red Hat's stock has slowly rebounded over the past few years, but its price still remains below its initial offering price of $14.

Amidst concerns about the allocation of IPO shares, Google Inc.'s highly publicized 2004 IPO attracted attention because of its size (Google raised $1.67 billion in stock) and the way it was conducted. Rather than having the offer price set by its investment bankers, Google conducted a Dutch auction in which individual investors directly placed bids for shares. In a *Dutch auction*, the actual transaction price is set at the highest price ("the clearing price") that causes all of the offered shares to be sold. Investors who set their bids at or above the clearing price receive all the shares they subscribed to at the offer price. While Google's IPO was in many ways precedent setting, it remains unclear whether other firms going public in the future will be able, or willing, to use the Dutch auction method to allocate shares in their IPOs.

It is important to recognize that firms can go public without raising any additional capital. For example, the Ford Motor Company was once owned

[10] See Jay R. Ritter, "The Long-Run Performance of Initial Public Offerings," *Journal of Finance*, Vol. 46, no. 1 (March 1991), pp. 3–27.

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TABLE 5-3 *Initial Public Offerings in 2004*

Issuer	Issue Date	U.S. Proceeds (Billions)	PERCENT CHANGE FROM OFFER: First Day Trading	PERCENT CHANGE FROM OFFER: Through 12/31/04
The Biggest IPOs				
Genworth Financial	05/24/04	$2.86	unch.	+38.5%
Assurant	02/04/04	2.02	+12.3%	+38.9
Google	08/18/04	1.92	+18.0	+126.8
Semiconductor Manufacturing Intl.	03/11/04	1.80	−11.3	−38.5
Freescale Semiconductor	07/16/04	1.69	+7.9	+37.1
China Netcom	11/10/04	1.31	+14.1	+22.6
LG Philips	07/15/04	1.06	−6.3	+19.9
Navteq	08/06/04	1.01	+15.0	+110.7
Dex Media	07/21/04	1.01	+2.6	+31.4
Dreamworks Animation	10/27/04	0.93	+38.4	+34.0

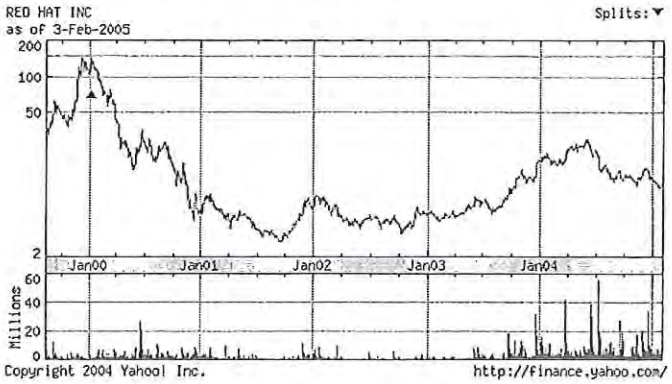
Issuer	Issue Date	Offer Price	U.S. Proceeds (Millions)	PERCENT CHANGE FROM OFFER: First Day Trading	PERCENT CHANGE FROM OFFER: Through 12/31/04
The Best Performers					
Shanda Interactive Ent	05/12/04	$11.00	$169.0	+8.8%	+286.4%
51Job	09/28/04	14.00	84.5	+51.1	+271.2
Marchex	03/30/04	6.50	26.0	+35.4	+223.1
Volterra Semiconductor	07/28/04	8.00	36.5	+3.1	+177.0
eCOST.com	08/27/04	5.80	20.1	+3.5	+175.0
Cogent	09/23/04	12.00	248.4	+49.8	+175.0
Jed Oil	04/05/04	5.50	10.5	+103.6	+165.5
Syneron Medical	08/05/04	12.00	60.0	−10.4	+155.0
Kinetic Concepts	02/23/04	30.00	621.0	+34.7	+154.3
Kanbay International	07/22/04	13.00	106.9	+16.9	+140.8

Issuer	Issue Date	Offer Price	U.S. Proceeds (Millions)	PERCENT CHANGE FROM OFFER: First Day Trading	PERCENT CHANGE FROM OFFER: Through 12/31/04
The Worst Performers					
Xcyte Therapies	03/16/04	$ 8.00	$ 33.6	−8.6%	−65.5%
Staktek Holdings	02/05/04	13.00	145.5	+14.5	−64.3
AlphaSmart	02/06/04	6.00	26.4	+2.0	−50.8
Corgentech	02/12/04	16.00	110.4	+20.3	−48.3
Corcept Therapeutics	04/14/04	12.00	54.0	+1.9	−47.9
Daystar Technologies	02/05/04	5.00	10.6	−1.0	−43.0
Infosonics	06/16/04	6.00	12.0	−2.5	−40.3
Linktone	03/03/04	14.00	86.0	+24.4	−40.0
Semiconductor Manufacturing International	03/11/04	17.50	1,803.0	−11.3	−38.5
Cherokee International	02/19/04	14.50	110.1	+13.8	−33.7

Source: "Initial Public Offerings of Stock Bounce Back in 2004," *The Wall Street Journal*, January 3, 2005, p. R10.

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FIGURE 5-2 *Red Hat Inc.'s Stock Price Performance from Its IPO to February 2005*



Source: finance.yahoo.com.

exclusively by the Ford family. When Henry Ford died, he left a substantial part of his stock to the Ford Foundation. When the Foundation later sold some of it to the general public, the Ford Motor Company went public, even though the company itself raised no capital in the transaction.



Differentiate between closely held and publicly owned corporations.

Differentiate between primary and secondary markets.

What is an IPO?

What is a Dutch auction? Why is it used?

5.6 STOCK MARKETS AND RETURNS

Anyone who has ever invested in the stock market knows that there can be, and generally are, large differences between *expected* and *realized* prices and returns. Figure 5-3 shows how total realized portfolio returns have varied from year to year. As logic would suggest (and as we demonstrate in Chapter 8), a stock's expected return as estimated by investors at the margin is always positive, for otherwise investors would not buy the stock. However, as Figure 5-3 shows, in some years actual returns are negative.

Stock Market Reporting

Up until a couple of years ago, the best source of stock quotations was the business section of a daily newspaper, such as *The Wall Street Journal*. One problem with newspapers, however, is that they report yesterday's prices. Now it is possible to obtain quotes all during the day from a wide variety of Internet

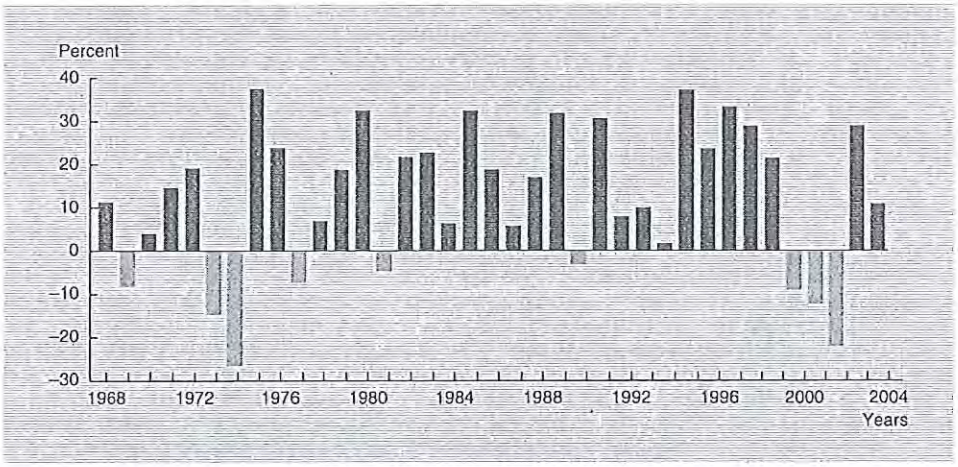
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sources.[11] One of the best is Yahoo!, and Figure 5-4 shows a detailed quote for GlaxoSmithKline PLC (GSK). As the heading shows, GlaxoSmithKline is traded on the New York Stock Exchange under the symbol GSK. (The NYSE is just one of many world markets on which the stock trades.) The first two rows of information show that GSK last traded at $45.55, and the stock traded thus far during the day from as low as $45.40 and as high as $45.65. (Note that the price is reported in decimals rather than fractions, reflecting a recent change in trading conventions.) The last trade was at 11:05 A.M. ET on February 4, 2005, and its price range during the past 52 weeks was from $38.80 to $47.59.

The next three lines show that GSK opened trading on February 4th at $45.42, that it closed on February 3rd at $44.65, and that its price rose by $0.90 (or a 2.02 percent increase) from the previous close to the current price. So far during the day, 401,700 shares had traded hands. GlaxoSmithKline's average daily trading volume (based on the past three months) was 1,349,318 shares, so trading was relatively light that day. The total value of all of GlaxoSmithKline's stock, called its market cap, was $130.09 billion.

The last three lines report other market information for GSK. If it were trading on Nasdaq rather than a listed exchange, the most recent bid and ask quotes from dealers would have been shown. However, because it trades on the NYSE, these data are not available. GSK's P/E ratio (price per share divided by the most recent 12 months' earnings) is 17.16, and its earnings per share for the most recent 12 months was $2.66. (Note that ttm stands for "trailing 12 months"—in other words, the most recent 12 months.) The mean of the analysts' one-year target price for GSK is $49.67. GSK's dividend is $1.46 per share, so the quarterly dividend is $0.365 per share, and the dividend yield, which is the annual dividend divided by the price, is 3.24 percent.

FIGURE 5-3 *S&P 500 Index, Total Returns: Dividend Yield + Capital Gain or Loss, 1968–2004*

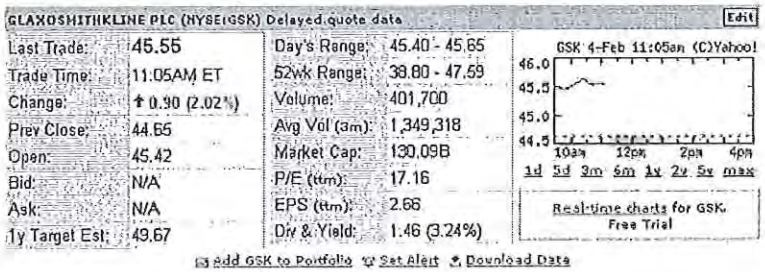


Source: Data taken from various issues of *The Wall Street Journal*, "Investment Scoreboard" section.

[11] Most free sources provide quotes that are delayed by 15 minutes. Real time quotes can be obtained for a fee.

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FIGURE 5-4 *Stock Quote for GlaxoSmithKline, February 4, 2005*



Source: finance.yahoo.com.

In Figure 5.4, the chart to the right plots the stock price during the day; however, the links below the chart allow you to pick different time intervals for plotting data. As you can see, Yahoo! provides a great deal of information in its detailed quote, and even more detail is available on the screen page below the basic quote information.

Stock Market Returns

In Chapters 8 and 9 we will discuss in detail how stock returns are calculated, the connection between stock market risk and returns, and the techniques that analysts use to value stocks. However, it is useful at this point for you to have a rough idea how stocks have performed in recent years. Figure 5-3 shows how the returns on large U.S. stocks have varied over the past years, and the box entitled "Measuring the Market" provides some information on the major U.S. stock market indices and their performances since the mid-1990s.

Since 1968 the market trend has been strongly up, but by no means does it go up every year. Indeed, as we can see from Figure 5-3, the overall market has been down in 9 of the 37 years, including the three consecutive years of 2000–2002. The stocks of individual companies have likewise gone up and down.[12] Of course, even in bad years some individual companies do well, so "the name of the game" in security analysis is to pick the winners. Financial managers attempt to put their companies into the winners' column, but they don't always succeed. In subsequent chapters, we will examine the decisions managers make to increase the odds of their firms performing well in the marketplace.



Would you expect a portfolio that consisted of the S&P 500 stocks to be more or less risky than a portfolio of Nasdaq stocks?

If we constructed a chart like Figure 5-3 for an average S&P 500 stock, do you think it would show more or less volatility? Explain.

[12] If we constructed a graph like Figure 5-3 for individual stocks rather than for the index, far greater variability would be shown. Also, if we constructed a graph like Figure 5-3 for bonds, it would have similar ups and downs, but the bars would be smaller, indicating that gains and losses on bonds are generally smaller than those on stocks. Above-average bond returns occur in years when interest rates decline, losses occur when interest rates rise sharply, but interest payments tend to stabilize bonds' total returns. We will discuss bonds in detail in Chapter 7.

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5.7 STOCK MARKET EFFICIENCY

Figure 1-1 (presented back in Chapter 1) suggests that a stock's price is affected by its intrinsic value, which is determined by the true level and riskiness of the cash flows it is likely to provide, and investors' perceptions about the stock's intrinsic value. In a well-functioning market, investors' perceptions should be closely related to the stock's intrinsic value, in which case the stock price would be a reasonably accurate reflection of its true value.

A body of theory called the **efficient markets hypothesis (EMH)** holds (1) that stocks are always in equilibrium and (2) that it is impossible for an investor to consistently "beat the market." Essentially, those who believe in the EMH note that there are 100,000 or so full-time, highly trained, professional analysts and traders operating in the market, while there are fewer than 3,000 major stocks. Therefore, if each analyst followed 30 stocks (which is about right, as analysts tend to specialize in the stocks in a specific industry), there would on average be 1,000 analysts following each stock. Further, these analysts work for organizations such as Goldman Sachs, Merrill Lynch, Citigroup, Prudential, and the like, which have billions of dollars that can be used to take advantage of bargains. In addition, as a result of SEC disclosure requirements and electronic information networks, as new information about a stock becomes available, these 1,000 analysts generally receive and evaluate it at about the same time. Therefore, the price of a stock will adjust almost immediately to any new development. That makes it very difficult for anyone to consistently pick stocks that will beat the market.

Efficient Markets Hypothesis (EMH) *The hypothesis that securities are typically in equilibrium—that they are fairly priced in the sense that the price reflects all publicly available information on each security.*

Levels of Market Efficiency

If markets are truly efficient, then stock prices will rapidly adjust to all relevant information as it becomes available. This raises an important question: What types of information are available to investors and, therefore, incorporated into stock prices? Financial theorists have discussed three forms, or levels, of market efficiency.

Weak-Form Efficiency

The *weak form* of the EMH states that all information contained in past stock price movements is fully reflected in current market prices. If this were true, then information about recent trends in stock prices would be of no use in selecting stocks—the fact that a stock has risen for the past three days, for example, would give us no useful clues as to what it will do today or tomorrow. People who believe that weak-form efficiency exists also believe that "tape watchers" and "chartists" are wasting their time.[13] For example, after studying the past history of the stock market, a chartist might "discover" the following pattern: If a stock falls three consecutive days, its price typically rises 10 percent the following day. The technician would then conclude that investors could make money by purchasing a stock whose price has fallen for three consecutive days.

But if this pattern truly existed, wouldn't other investors also discover it, and then why would anyone be willing to sell a stock after it had fallen three consecutive days if he or she knows the stock's price would likely increase by 10 percent the next day? In other words, if a stock were selling at $40 per share after falling three consecutive days, why would investors sell the stock at $40 if they expect it to rise to $44 per share the next day? Those who believe in weak-form efficiency argue that if the stock were really likely to rise to $44 per share

[13] Tape watchers are people who watch the NYSE tape, while chartists plot past patterns of stock price movements. Both are called "technicians," and both believe that they can tell if something is happening to the stock that will cause its price to move up or down in the near future.

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Measuring the Market

Stock indexes are designed to show the performance of the stock market. The problem is that there are many stock indexes, and it is difficult to determine which index best reflects market actions. Some are designed to represent the whole equity market, some to track the returns of certain industry sectors, and others to track the returns of small-cap, mid-cap, or large-cap stocks. We discuss below three of the leading indexes.

Dow Jones Industrial Average

Unveiled in 1896 by Charles H. Dow, the Dow Jones Industrial Average (DJIA) provided a benchmark for comparing individual stocks with the overall market, for ascertaining the trend in stock prices over time, and for comparing the market with other economic indicators. The industrial average began with just 10 stocks, was expanded in 1916 to 20 stocks, and then to 30 in 1928. Also in 1928, *The Wall Street Journal* editors began adjusting the index for stock splits, and making substitutions. Today, the DJIA still includes 30 companies. They represent almost a fifth of the market value of all U.S. stocks, and all are both leading companies in their industries and widely held by individual and institutional investors. Visit **http://www.dowjones.com** to get more information about the DJIA. You can find out how it is calculated, the current divisor, the companies that make up the DJIA, more history about the DJIA, and other interesting facts. In addition, there is a DJIA time line annotated with historical events.

S&P 500 Index

Created in 1926, the S&P 500 Index is widely regarded as the standard for measuring large-cap U.S. stock market performance. The stocks in the S&P 500 are selected by the Standard & Poor's Index Committee as being the leading companies in the leading industries, and for accurately reflecting the U.S. stock market. It is value weighted, so the largest companies (in terms of value) have the greatest influence. The S&P 500 Index is used for benchmarking by 97 percent of all U.S. money managers and pension plan sponsors, and approximately $700 billion is managed so as to obtain the same performance as this index (that is, in indexed funds).

Nasdaq Composite Index

The Nasdaq Composite Index measures the performance of all common stocks listed on the Nasdaq stock market. Currently, it includes more than 5,000 companies, and because many of the technology-sector companies are traded on the computer-based Nasdaq exchange, this index is generally regarded as an economic indicator of the high-tech industry. Microsoft, Intel, and Cisco Systems are the three largest Nasdaq companies, and they comprise a high percentage of the index's value-weighted market capitalization. For this reason, substantial movements in the same direction by these three companies can move the entire index.

tomorrow, its price would actually rise to somewhere near $44 per share immediately, thereby eliminating the trading opportunity. Consequently, weak-form efficiency implies that any information that comes from an examination of past stock prices cannot be used to make money by predicting future stock prices.

Semistrong-Form Efficiency

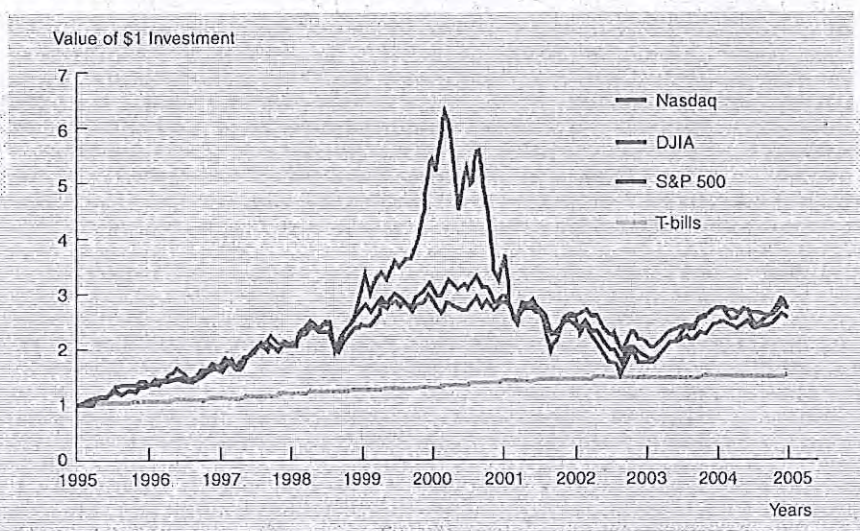
The *semistrong form* of the EMH states that current market prices reflect all *publicly available* information. Therefore, if semistrong-form efficiency exists, it would do no good to pore over annual reports or yesterday's *Wall Street Journal* looking at sales and earnings trends and various types of ratios based on historical data because market prices would have adjusted to any good or bad news contained in such

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Recent Performance

The accompanying figure plots the value that an investor would now have if he or she had invested $1.00 in each of the three indexes on January 1, 1995. The returns on the three indexes are compared with an investment strategy that only invests in T-bills. For the returns on T-bills, the one-year Treasury constant maturity rate is used. Over the past 10 years, each of these indexes performed quite well through 1999. However, for a couple years each index stumbled before beginning to rebound again in 2003. During the last 10 years the average annualized returns of these indexes ranged from 9.8 percent for the S&P 500 to 10.5 percent for the Nasdaq Composite Index. The Nasdaq experienced a huge bubble in 1999, reflecting overly optimistic valuations of technology companies. However, in 2000 the bubble burst and technology stock valuations spiraled downward, causing the Nasdaq Index to revert back to a level comparable to the S&P 500 and Dow Jones Industrial Average Index.

Growth of a $1 Investment Made on January 1, 1995



reports back when the news first came out over the Internet. With semistrong-form efficiency, investors should not expect to earn above-average returns except with good luck or information that is not publicly available.[14] However, insiders (for example, CEOs and CFOs) who have information that is not publicly available are able to earn above-average returns even under semistrong-form efficiency.

Another implication of semistrong-form efficiency is that whenever information is released to the public, stock prices will respond only if the information is different from what had been expected. If, for example, a company announces a

[14] Strictly speaking, these returns should be adjusted for risk. We discuss the relationship between risk and return in Chapter 8.

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30 percent increase in earnings, and if that increase is about what analysts had been expecting, the announcement should have little or no effect on the company's stock price. On the other hand, the stock price would probably fall if analysts had expected earnings to increase by 50 percent, but it probably would rise if they had expected a 10 percent increase.

Strong-Form Efficiency

The *strong form* of the EMH states that current market prices reflect all pertinent information, whether publicly available or privately held. If this form holds, even insiders would find it impossible to earn abnormally high returns in the stock market.[15]

Many empirical studies have been conducted to test for the three forms of market efficiency. Most of these studies suggest that the stock market is indeed highly efficient in the weak form, reasonably efficient in the semistrong form (at least for the larger and more widely followed stocks), but not true for the strong form because abnormally large profits are often earned by those with inside information.

Implications of Market Efficiency

If the EMH were correct, it would be a waste of time for most of us to seek bargains by analyzing stocks. That follows because, if stock prices already reflect all publicly available information and hence are fairly priced, we can "beat the market" only by luck or with inside information, making it difficult, if not impossible, for most investors to consistently outperform the market averages. To support this viewpoint, efficient market proponents often point out that even the professionals who manage mutual fund portfolios do not, on average, outperform the overall stock market as measured by an index like the S&P 500.[16] Indeed, the relatively poor performance of actively managed mutual funds helps explain the growing popularity of indexed funds, where administrative costs are relatively low. Rather than spending time and money trying to find undervalued stocks, index funds try instead to match overall market returns by buying the basket of stocks that makes up a particular index, such as the S&P 500.[17]

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[15] Over the years, several cases of illegal insider trading have made the news headlines. These cases involved employees of several major investment banking houses and even an employee of the SEC. In the most famous case, Ivan Boesky admitted to making $50 million by purchasing stocks of firms he knew were about to merge. He went to jail, and he had to pay a large fine, but he helped disprove the strong-form EMH. More recently, Martha Stewart was imprisoned after being convicted on obstruction of justice charges surrounding a federal investigation of insider trading of ImClone Systems Inc. shares.

[16] For a discussion of the recent performance of actively managed funds, see Jonathan Clements, "Resisting the Lure of Managed Funds," *The Wall Street Journal*, February 27, 2001, p. C1.

[17] We should also note that some Wall Street pros have consistently beaten the market over many years, which is inconsistent with the EMH. An interesting article in the April 3, 1995, issue of *Fortune* (Terence P. Paré, "Yes, You Can Beat the Market") argued strongly against the EMH. Paré suggested that each stock has a fundamental value, but when good or bad news about it is announced, most investors fail to interpret this news correctly. As a result, stocks are generally priced above or below their long-term values.

Think of Figure 1-1, which was illustrated in Chapter 1, with stock price on the vertical axis and years on the horizontal axis. A stock's fundamental value might be moving up steadily over time as it retains and reinvests earnings. However, its actual price might fluctuate about the intrinsic value line, overreacting to good or bad news and indicating departures from equilibrium. Successful value investors, according to Paré, use fundamental analysis to identify stocks' intrinsic values, and then they buy stocks that are undervalued and sell those that are overvalued.

Paré's argument implies that stocks are at times systematically out of equilibrium and that investors can act on this knowledge to beat the market. That position may turn out to be correct, but it may also be that the superior performance Paré noted simply demonstrates that some people are better at obtaining and interpreting information than others, or have been lucky in the past.

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It is important to understand that market efficiency does not imply that all stocks are always priced correctly. With hindsight, it is apparent that at any point in time the situation shown in Figure 1-1 back in Chapter 1 tends to hold true, with some stocks overvalued and others undervalued. However, as the efficient markets hypothesis implies, it is hard to identify ahead of time the stocks in each category. To beat the market, you must have above-average information, above-average analytical skills, or above-average luck.

Finally, it is important to understand that even if markets are efficient and all stocks are fairly priced, an investor should still be careful when selecting stocks for his or her portfolio. To earn the greatest expected return with the least amount of risk, the portfolio should be diversified, with a mix of stocks from various industries. We will discuss diversification in greater detail in Chapter 8.

Is the Stock Market Efficient?

During the past 25 years, many empirical studies have been conducted to test the validity of the three forms of market efficiency. Until 10 years ago, most of these studies suggested that the stock market was highly efficient in the weak form and reasonably efficient in the semistrong form, at least for the larger and more widely followed stocks. However, the evidence also suggested that the strong form EMH did not hold, because those who possessed inside information could and did (illegally) make abnormal profits.

More recently, the empirical support for the EMH has been somewhat diminished. As we indicate in the **behavioral finance** box, skeptics point to the recent stock market bubble and suggest that at the height of the boom the prices of the stocks of many companies, particularly in the technology sector, vastly exceeded their intrinsic values. These skeptics suggest that investors are not simply machines that rationally process all available information—rather, a variety of psychological and perhaps irrational factors also come into play. Indeed, researchers have begun to incorporate elements of cognitive psychology in an effort to better understand how individuals and entire markets respond to different circumstances.[18]

Behavioral Finance
Incorporates elements of cognitive psychology into finance in an effort to better understand how individuals and entire markets respond to different circumstances.

Keep in mind that the EMH does not assume that all investors are rational. Rather, it assumes that whenever stock prices deviate from their intrinsic values due to the availability of new information, investors will quickly take advantage of these mispricings by buying undervalued stocks and selling overvalued stocks. Thus, investors' actions work to drive prices to their equilibrium level. Critics of the EMH stress, however, that the stock market is inherently risky and that rational investors trading in an irrational market can lose a lot of money even if they are ultimately proven to be correct. For example, a "rational" investor in mid-1999 might have concluded that the Nasdaq was overvalued when it was trading at 3,000. If that investor had acted on that assumption, he or she would have lost a lot of money the following year when the Nasdaq soared to over 5,000 as "irrational exuberance" pushed the prices of already overvalued stocks to even higher levels. Ultimately, if our "rational investor" had the courage and patience to hold on, he or she would have been vindicated, because the Nasdaq subsequently fell to about 1,300.

[18] Three noteworthy sources for students interested in behavioral finance are Richard H. Thaler, Editor, *Advances in Behavioral Finance* (New York: Russell Sage Foundation, 1993); Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* (New York: Oxford University Press, 2000); and Nicholas Barberis and Richard Thaler, "A Survey of Behavioral Finance," Chapter 18, *Handbook of the Economics of Finance*, edited by George Constantinides, Milt Harris, and René Stulz, part of the *Handbooks in Economics Series* (New York: Elsevier/North-Holland, 2003). Students interested in learning more about the efficient markets hypothesis should consult Burton G. Malkiel, *A Random Walk Down Wall Street* (New York: W.W. Norton & Company, 1999).

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A Closer Look at Behavioral Finance Theory

The efficient markets hypothesis (EMH) remains one of the cornerstones of modern finance theory. It implies that, on average, assets trade at prices equal to their intrinsic values. As we note in the text, the logic behind the EMH is straightforward. If a stock's price is "too low," rational traders will quickly take advantage of this opportunity and will buy the stock. Their actions will quickly push prices back to their equilibrium level. Likewise, if prices are "too high," rational traders will sell the stock, pushing the price down to its equilibrium level. Proponents of the EMH argue that prices cannot be systematically wrong unless you believe that market participants are unable or unwilling to take advantage of profitable trading opportunities.

While the logic behind the EMH is compelling, many events in the real world seem to be inconsistent with the EMH. This has spurred a growing field that is called *behavioral finance theory*. Rather than assuming that investors are rational, behavioral finance theorists borrow insights from psychology to better understand how irrational behavior can be sustained over time. Pioneers in this field include psychologists Daniel Kahneman and Amos Tversky and Richard Thaler, who is a professor of finance at the University of Chicago. Their work has encouraged a growing number of scholars to work in this promising area of research.

Professor Thaler and his colleague, Nicholas Barberis, have summarized much of this research in a recent article, which is cited below. They argue that behavioral finance theory's criticism of the EMH rests on two important building blocks. First, it is often difficult or risky for traders to take advantage of mispriced assets. For example, even if you know that a stock's price is too low because investors have overreacted to recent bad news, a trader with limited capital may be reluctant to buy the stock for fear that the same forces that pushed the price down may work to keep it artificially low for a long period of time. On the other side, during the recent stock market bubble, many traders who believed (correctly!) that stock prices were too high lost a lot of money selling stocks in the early stages of the bubble because stock prices went even higher before they eventually collapsed.

While the first building block explains why mispricings may persist, the second tries to understand how mispricings can occur in the first place. This component is where the insights from psychology come into play. For example, Kahneman and Tversky suggested that individuals view potential losses and potential gains very differently. If you ask an average person whether he or she would rather have $500 with certainty or flip a fair coin and receive $1,000 if a head comes up and nothing if it comes out tails, most would prefer the certain $500, which suggests an aversion to risk. However, if you ask the same person whether he or she would rather pay $500 with certainty or flip a coin and pay $1,000 if it's heads and nothing if it's tails, most indicate that they would prefer to flip the coin. Other studies suggest that people's willingness to take a gamble depends on recent performance. Gamblers who are ahead tend to take on more risks, whereas those who are behind tend to become more conservative.

These experiments suggest that investors and managers behave differently in down markets than they do in up markets, which might explain why those who made money early in the stock market bubble continued to keep investing in these stocks, even as their prices went higher. Other evidence suggests that individuals tend to overestimate their true abilities. For example, a large majority (upward of 90 percent in some studies) of us believe that we have above-average driving ability or above-average ability to get along with others. Barberis and Thaler point out that:

> Overconfidence may in part stem from two other biases, self-attribution bias and hindsight bias. Self-attribution bias refers to people's tendency to ascribe any success they have in some activity to their own talents, while blaming failure on bad luck, rather than on their ineptitude. Doing this repeatedly will lead people to the pleasing but erroneous conclusion that they are very talented. For example, investors might become overconfident after several quarters of investing success [Gervais and Odean (2001)]. Hindsight bias is the tendency of people to believe, after an event has occurred, that they predicted it before it happened. If people think they predicted the past better than they actually did, they may also believe that they can predict the future better than they actually can.

Recent research by Ulrike Malmendier of the Stanford Graduate School of Business and Geoffrey Tate of the Wharton School suggests that overconfidence leads managers to overestimate their ability and the quality of their projects. This result may explain why so many corporate projects fail to live up to their stated expectations.

Sources: Nicholas Barberis and Richard Thaler, "A Survey of Behavioral Finance," Chapter 18, *Handbook of the Economics of Finance*, edited by George Constantinides, Milt Harris, and René Stulz, part of the *Handbooks in Economics Series* (New York: Elsevier/North-Holland, 2003); and Ulrike Malmendier and Geoffrey Tate, "CEO Overconfidence and Corporate Investment," Stanford Graduate School of Business Research Paper #1799, June 2004.

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The events of recent years, and the new ideas developed by researchers in behavioral finance, suggest that the stock market is not always efficient. Still, the logic behind the EMH is compelling, and most researchers believe that markets are generally efficient in the long run.



What is the efficient markets hypothesis (EMH)?

What are the differences among the three forms of the EMH: (1) weak form, (2) semistrong form, and (3) strong form?

What are the implications of the EMH for financial decisions?

What is behavioral finance? What do the new ideas in this area tell us about the stock market?

Tying It All Together

In this chapter we provided a brief overview of how capital is allocated and the financial markets, instruments, and institutions used in the allocation process. We discussed physical location exchanges and electronic markets for common stocks, stock price reporting, and stock indexes. We demonstrated that security prices are volatile—investors expect to make money, and over time they generally do, but losses can be large in any given year. Finally, we discussed the efficiency of the stock market and developments in behavioral finance. After reading this chapter, you should have a general understanding of the financial environment in which businesses and individuals operate, realize that actual returns are often different from expected returns, and be able to read stock market quotations from either business newspapers or various Internet sites. You should also recognize that the theory of financial markets is a "work in progress," and countless work remains to be done.

SELF-TEST QUESTIONS AND PROBLEMS

ST-1 Key terms Define each of the following terms:

a. Spot markets; futures markets
b. Money markets; capital markets
c. Primary markets; secondary markets
d. Private markets; public markets
e. Derivatives
f. Investment banking house; commercial banks; financial services corporations
g. Mutual funds; money market funds
h. Physical location exchanges; over-the-counter market (OTC); dealer market
i. Closely held corporation; publicly owned corporation
j. Going public; initial public offering (IPO) market
k. Efficient markets hypothesis (EMH)
l. Behavioral finance

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QUESTIONS

5-1 How does a cost-efficient capital market help to reduce the prices of goods and services?

5-2 Describe the different ways in which capital can be transferred from suppliers of capital to those who are demanding capital.

5-3 Is an initial public offering an example of a primary or a secondary market transaction?

5-4 Indicate whether the following instruments are examples of money market or capital market transactions.

a. U.S. Treasury bills
b. Long-term corporate bonds
c. Common stocks
d. Preferred stocks
e. Dealer commercial paper

5-5 What would happen to the U.S. standard of living if people lost faith in the safety of our financial institutions? Why?

5-6 What types of changes have financial markets experienced during the last two decades? Have they been perceived as positive or negative changes? Explain.

5-7 Differentiate between dealer markets and stock markets that have a physical location.

5-8 Identify and briefly compare the two leading stock exchanges in the United States today.

5-9 Describe the three different forms of market efficiency.

5-10 Investors expect a company to announce a 10 percent increase in earnings, but instead the company announces a 1 percent increase. If the market is semistrong-form efficient, which of the following would you expect to happen?

a. The stock's price increases slightly because the company had a slight increase in earnings.
b. The stock's price falls because the earnings increase was less than expected.
c. The stock's price stays the same because earnings announcements have no effect if the market is semistrong-form efficient.

5-11 Explain whether the following statements are true or false.

a. Derivative transactions are designed to increase risk and are used almost exclusively by speculators who are looking to capture high returns.
b. Hedge funds generally charge higher fees than mutual funds.
c. Hedge funds have traditionally been highly regulated.
d. The New York Stock Exchange is an example of a stock exchange that has a physical location.
e. A larger bid-ask spread means that the dealer will realize a lower profit.
f. The efficient market hypothesis assumes that all investors are rational.

Integrated Case

Smyth Barry & Company, Part I

5-1 **Financial markets and institutions** Assume that you recently graduated with a degree in finance and have just reported to work as an investment advisor at the brokerage firm of Smyth Barry & Co. Your first assignment is to explain the nature of the U.S. financial markets to Michelle Varga, a professional tennis player who has just come to the United States from Mexico. Varga is a highly ranked tennis player who expects to invest substantial amounts of money through Smyth Barry. She is also very bright, and, therefore, she would like to understand in general terms what will happen to her money. Your boss has developed the following set of questions that you must ask and answer to explain the U.S. financial system to Varga.

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a. Describe the three primary ways in which capital is transferred between savers and borrowers.
b. What is a market? Differentiate between the following types of markets: physical asset versus financial markets, spot versus futures markets, money versus capital markets, primary versus secondary markets, and public versus private markets.
c. Why are financial markets essential for a healthy economy and economic growth?
d. What are derivatives? How can derivatives be used to reduce risk? Can derivatives be used to increase risk?
e. Briefly describe each of the following financial institutions: commercial banks, investment banks, mutual funds, and hedge funds.
f. What are the two leading stock markets? Describe the two basic types of stock markets.
g. If Apple Computer decided to issue additional common stock, and Varga puchased 100 shares of this stock from Smyth Barry, the underwriter, would this transaction be a primary or a secondary market transaction? Would it make a difference if Varga purchased previously outstanding Apple stock in the dealer market? Explain.
h. What is an initial public offering (IPO)?
i. What is the efficient markets hypothesis (EMH), what are its three forms, and what are its implications?
j. After the consultation with Michelle she asked you a few final questions:
(1) While in the waiting room of your office, she overheard an analyst on a financial TV network say that a particular medical research company just received FDA approval for one of its products. On the basis of this "hot" information, Michelle wants to buy a lot of that company's stock. Assuming the stock market is semistrong-form efficient, what advice would you give her?
(2) She has read a number of newspaper articles about a huge IPO being carried out by a leading technology company. She wants to get as many shares in the IPO as possible, and would even be willing to buy the shares in the open market right after the issue. What advice do you have for her?



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CHAPTER 7

The Global Financial Crisis



The global financial crisis had widespread effects. Out of work like many, marketing executive Chuck Bridges wears a variation of the "will work for food" sign.

INTRODUCTION

Financial crises and accompanying economic recessions have occurred throughout history. Periodic crises appear to be part of financial systems of dominant or global powers. The United States is the epicenter of the current financial crisis. Enjoying a unipolar moment following the collapse of the Soviet Union and the failure of Communism, the United States was confident that economic liberalization and the proliferation of computer and communications technologies would contribute to ever-increasing global economic growth and prosperity. Globalization contributed to the extraordinary accumulation of wealth by a relatively few individuals and created greater inequality. In an effort to reduce inequality in the United States, the government implemented policies that engendered the financial crisis.

finance ■ The major catalyst in the growth of globalization and national power

As we discussed in Chapter 1, finance is usually the leading force in the growth of globalization. The rise of great powers is inextricably linked to access to investments and their ability to function as leading financial centers, as we saw in Chapter 2. Their decline is also closely linked to financial problems. Finance enables entrepreneurs to start various enterprises and to become competitors of established companies. It is also essential to innovation and scientific discoveries. Finance also facilitates risk sharing and provides insurance for risk takers. Countries that have large financial sectors tend to grow faster, their inhabitants are generally richer, and there are more opportunities. Financial globalization contributed to the unprecedented growth and prosperity around the world. China and India became significant economic powers, and the industrialized countries grew even richer.[1] Closely integrated into the financial system are banks and investment firms. When the financial system is in crisis, banks reduce lending, companies often face bankruptcy, and unemployment rises. Ultimately, as we saw in the financial crisis of 2008–2009, many banks fail.

The financial crisis triggered a global economic recession that resulted in more than $4.1 trillion in losses, unemployment rates that climbed to more than 10 percent in the United States and higher elsewhere, and increased poverty. Stock markets around the world crashed. American investors lost roughly 40 percent of the value of their savings. Housing prices plummeted from their record highs in 2006. Consumers reduced their spending, manufacturing declined, global trade diminished, and countries adopted protectionist measures, many turning their attention inward to focus on problems caused by the financial crisis. Given the central importance of finance to virtually all aspects of globalization, issues such as trade, the environment, crime, disease, inequality, migration, ethnic conflicts, human rights, and promoting democracy are affected. Furthermore, the financial crisis weakened some countries more than others, thereby engendering significant shifts of power among countries, especially between the United States and China. The European Union struggled over how much to shore up or bail out banks and nations using the euro currency. The financial, economic, social, and political fallout continue. Citizens took to the streets in a protest movement against financial

inequality that began in New York City as "Occupy Wall Street" and spread around the world. This chapter examines the causes of the financial crisis, its impact, and responses to it. It concludes with a case study of the decline of the Celtic Tiger (Ireland).

CAUSES OF THE GLOBAL FINANCIAL CRISIS

The causes of financial crises are as complex as many of the crises themselves and the human beings responsible for them. There have been at least sixty recorded crises since the early seventeenth century. Human beings seem to have always been obsessed with money, and greed drives them to obtain increasing amounts of it. And humans generally spend more than they have, thereby creating huge debts that undermine the stability of the financial system. As early as 33 A.D., Emperor Tiberius of Rome had to inject public funds into the financial system to prevent it from collapsing.[2] Euphoria and excessive optimism, which often accompany financial bubbles, are usually followed by fear and panic when crisis arrives. Generally, people claim to not know how the crisis happened or that they could not see it coming. The Asian Financial Crisis in 1997 was a precursor to the financial crisis of 2008–2009. It started in Indonesia and spread to Malaysia, South Korea, other parts of Asia, and the rest of the world. Once-prosperous economies were now in deep recession, with stock markets crashing and capital flowing out of the various countries at unprecedented rates. The Asian crisis was largely caused by "hasty and imprudent financial liberalization, almost always under foreign pressure, allowing free international flows of short-term capital without adequate attention to the potentially potent downside of such globalization."[3]

Asian Financial Crisis ■ Started in Indonesia, caused stock markets to crash, and reversed economic growth

But the Asian crisis was part of larger global developments, many of which were driven by the United States. The end of the Cold War left America standing as the world's sole superpower with unprecedented power and unlimited options, or so it seemed. Affected by hubris, and made overly confident by the exponential growth of computer and telecommunications technologies, the United States believed, in the words of Thomas Paine, that it could build a brand-new world characterized by unlimited success. However, terrorist attacks on September 11, 2001, fundamentally altered America's sense of security and plunged the country into a recession.

An integral component of the struggle against terrorism was the restoration of domestic and global confidence in America's economic system in general and its financial system in particular. President George W. Bush launched a war against terrorism. To accomplish this, the U.S. defense budget was rapidly increased, a department of Homeland Security was created, and two wars, one in Afghanistan and the other in Iraq, were launched. Furthermore, part of the new security strategy was a comprehensive globalization agenda, in which American companies operating in foreign countries would be free from restraints imposed by those countries.[4] This meant increasing government debt and encouraging consumers to spend even more to strengthen both the economy and national security. With easy access to capital created by economic globalization, consumers and the U.S.

government relied on other people's money. In addition to concentrating on fighting a perpetual war against nonstate actors, an atmosphere was created in which questioning was discouraged and taking excessive financial risks and getting rich quickly were lauded. From John C. Bogle's perspective, at the root of the problem was a societal change. America valued form over substance, prestige over virtue, money over achievement, charisma over character, and the ephemeral over the enduring.[5] While it is almost impossible to disentangle the causes of the global financial crisis, we will concentrate on those that are most often discussed. They include (1) deregulation of financial markets; (2) sophisticated financial innovations linked to rapid changes in computer technologies; (3) excessive executive compensation; (4) low interest rates; (5) subprime loans, especially for mortgages; and (6) speculation in general, with an emphasis on speculation in housing.

Deregulation of Financial Markets

Just as the current financial crisis has engendered demands for reforms, the Great Depression of the 1930s led to the implementation of financial regulations to stabilize the economy and to give American savers confidence in banks. Banks were widely perceived as boring but safe. Although interest rates were low, inflation was also low. Furthermore, deposits were protected by the Federal Deposit Insurance Corporation (FDIC). An outgrowth of the Great Depression, rising inflation, which also occurred following rapid and dramatic increases in oil prices in 1973–1974, contributed to the erosion of confidence in regulations designed during the Great Depression. Rising inflation in the United States prompted foreigners to lose confidence in the U.S. dollar as the leading currency and to seek security by purchasing gold. In response, President Richard Nixon unlinked the dollar from gold and adopted a regimen of floating interest rates. This created greater volatility in the financial system as well as increased opportunities to earn higher interest rates.[6]

FDIC ■ Insures individual bank deposits for up to $250,000

Significant societal changes and developments in technology combined to serve as a catalyst to propel deregulation. Although large banks and financial institutions initiated efforts to eliminate or modify regulations that restrained them, individuals were also more assertive in gaining control over their savings pension funds and investments in the stock market. Between 1974 and 1980, many regulations were removed. For example, in 1980, commercial banks and savings and loans institutions were permitted to determine their own interest rates on deposits and loans, thereby spurring greater competition. Many smaller banks were acquired by larger, more distant banks. The local bank was fast becoming an outdated institution.[7]

deregulation ■ Removed many government restrictions on financial institutions in the United States and other countries

Just as financial globalization drives economic globalization, the rapid growth of trade was now facilitating global financial liberalization. Globalization in general enabled American banks to argue that they were disadvantaged in competition with British, German, Japanese, and other foreign banks that were free of restrictions faced by American banks. Moreover, American banks adopted a global outlook that freed them from limiting their operations to the United States. Many were moving their activities offshore to places such as the Cayman Islands, Bermuda, and the Bahamas. President Ronald Reagan, elected on a platform of limiting the role of government, pressured other countries to open their financial

global financial liberalization ■ Opening banks around the world to competition

systems to American firms. Financial deregulation in the United States was now inseparable from the globalization of trade and financial services. However, impeding global competition in banking was the Glass-Steagall Act of 1933, which prohibited commercial banks from underwriting or marketing securities.[8] The rapid growth of capital flows across national borders and the increasing power of investment bankers eventually led to the demise of the Glass-Steagall Act in 1999.

Glass-Steagall Act of 1933 ■ Prohibited commercial banks from underwriting or marketing securities

The phenomenal proliferation of sophisticated computer technologies and an almost unquestioning faith in the wisdom of markets contributed to escalating demands for and acceptance of less regulation. In essence, federal agencies designed to regulate banking became less effective. There was a general loss of control at all levels, which led to exponential risk taking at many companies, largely hidden from public scrutiny. Violations of financial regulations went largely unpunished.[9] Simon Johnson argues that from the confluence of campaign finance, personal connections, and ideology flowed a river of deregulatory policies. These included:

1. Insistence on free movement of capital across borders
2. The repeal of Depression-era regulations separating commercial and investment banking
3. Decreased regulatory enforcement by the Securities and Exchange Commission
4. Allowing banks to measure their own riskiness
5. Failure to update regulations to keep up with the tremendous pace of financial innovations[10]

Financial Innovations

As the global financial crisis unfolded, it was obvious that many of those in the banking and investment communities did not fully comprehend how the financial system they created functioned, or the scope and severity of the crisis. The financial wizards, the best and the brightest from leading business schools, could not really explain what was happening on Wall Street and in global financial markets. Ironically, financial innovations, designed by brilliant computer experts to manage risk and make capital less expensive and more available, ultimately led to the global financial crisis. Financial innovations, with instantaneous global impacts due to technologies that made electronic transactions faster and less expensive, raced ahead of regulations. Complex financial products created in one financial center involved assets in another and were sold to investors in a third financial market. As we saw in Chapter 1, governments are increasingly challenged to operate effectively in a globalized world. Whereas governments are restrained by issues of sovereignty, global financial firms enjoy relatively greater flexibility. Furthermore, many different agencies in the United States have regulatory authority, a situation that creates confusion and ineffectiveness.[11] Among the numerous financial innovations that led to the global financial crisis were securitization and hedge funds.

financial innovations ■ Sophisticated financial engineering, an outgrowth of revolutions in computer and telecommunications technologies

Prior to the widespread use of securitization, banks, many of them local, provided loans to customers they often knew, and the banks were responsible for the risks involved in making loans. This meant that bankers gave loans only to

individuals and companies they believed could repay the loans. With securitization, risks inherent in granting loans were passed from the bank giving the loans to others who had no direct interest in the customers' ability to repay the loans. Subprime mortgages, student loans, car loans, and credit card debts were securitized. Securitization is a sophisticated process of financial engineering that allows global investment to be spread out and separated into multiple income streams to reduce risk.[12] It involves bundling loans into securities and selling them to investors. In 2009, an estimated $8.7 trillion of assets globally were funded by securitization.[13] This innovation made vast sums of money available to borrowers. For example, securitization increased the amount of money available to individuals purchasing homes. This led to unprecedented growth in house prices. It also resulted in high default rates and the housing crisis. As we will discuss, applicants for mortgages were not carefully examined and were encouraged to obtain subprime loans.

securitization ■ Financial engineering designed to reduce risk

Another financial innovation was credit derivatives, which were bets on the creditworthiness of a particular company, like insurance on a loan. There were two types of credit derivatives: credit default swaps and collateralized debt obligations.[14] Credit default swaps were widely used, especially by insurance companies such as the American International Group (AIG). Life insurance companies invested in credit default swaps as assets. Parties involved in a credit default swap agreed that one would pay the other if a particular borrower, a third party, could not repay its loans. Credit default swaps were used to transfer credit risks away from banks. A major problem with credit default swaps was the lack of transparency. They were also unregulated. Ultimately, credit default swaps created confusion and encouraged excessive risk taking. It was difficult to determine where the risk ended up. Designed to pass on risks, loans were packaged as securities. Collateralized debt obligations were linked to mortgage companies, which passed on the risk. Mortgages, instead of being held by banks and mortgage companies, were sold to investors shortly after the loans closed, and investors packaged them as securities.

derivatives ■ Bets on the creditworthiness of a particular company, like insurance on a loan

credit default swaps ■ Financial innovation used to transfer credit risks away from banks

collateralized debt obligations ■ Linked to mortgage companies

Similar to securitization, hedge funds grew rapidly, accounting for more than $1.3 trillion in assets globally before the financial crisis of 2008–2009. The name hedge funds implies investment funds with a particular sort of hedging strategy. Created by the Investment Company Act of 1940, hedge funds allowed wealthy investors to avoid many financial regulations, and hedge funds were early participants in financial globalization.[15] Essentially, hedge fund managers created portfolios reflecting an assessment of the performance of diverse global markets. As long as the number of participants was relatively small, hedge funds avoided great systemic risks. This changed with revolutions in computer technology that allowed split-second timing on huge volumes of trades. An integral component of the hedge fund strategy is a technique known as arbitrage. This involves simultaneously buying at a lower price in one market and selling at a higher price in another market to make a profit on the spread between the two prices.[16]

hedge funds ■ Enabled wealthy investors to avoid some financial regulations in global financial markets

arbitrage ■ Simultaneously buying at a lower price in one market and selling at a higher price in another market to make a profit

Executive Compensation

Excessive executive compensation is widely perceived as playing a pivotal role in creating the global financial crisis. Wall Street became a magnet for the brightest

Americans who wanted to make a large amount of money very quickly. Most companies rewarded short-term performance without much regard for market fundamentals and long-term earnings. Executives were given stock options, which they could manipulate to earn more money. The more an executive could drive up his or her company's stock price or its earnings per share, the more money he or she would get. Frank Partnoy argues that a mercenary culture developed among corporate executives. They merged with or acquired higher-growth companies and, in many cases, committed accounting fraud.[17] This fraud led to the bankruptcy of companies such as Enron, Global Crossing, and WorldCom. Many executives received long prison sentences.

Low Interest Rates

A fundamental cause of the global financial crisis was the easy availability of too much money globally. An oversupply of money created unprecedented levels of liquidity and historically low interest rates. As we mentioned earlier, the terrorist attacks on the United States on September 11, 2001, triggered a national embrace of increased government spending as well as consumer spending. To accomplish this, the U.S. Federal Reserve, led by Alan Greenspan, lowered interest rates to around 1 percent in late 2001. The European Central Bank and the Bank of Japan also reduced interest rates to record lows. The U.S. government encouraged Americans to purchase homes and to refinance or borrow against the value of homes they owned. As consumers and the government lived beyond their means, they were able to borrow from developing countries that were accumulating huge reserves from the phenomenal growth of global trade. Much of the surplus of money in the global system also came from declining investment in the Asian economies following the 1997 financial crisis. Rising oil prices in the Middle East, Russia, and elsewhere enabled many countries to earn more money than they could spend rationally. By the end of 2008, central banks in emerging economies held $5 trillion in reserves.[18]

Alan Greenspan ■ Chairman of the U.S. Federal Reserve who kept interest rates low

The money supply increased rapidly in China, India, Russia, and the Persian Gulf states. Whereas it was generally assumed that global monetary policies were set by central banks in the United States, Europe, and Japan, the reality was that three fifths of the world's money supply growth flowed from emerging economies.[19] Based on their experiences with financial problems, many developing countries decided to save for a rainy day, as it were. They believed that high oil prices or trade surpluses would not last forever. Many of these countries created sovereign wealth funds to recycle their financial surpluses.

sovereign wealth funds ■ Created by countries to save and recycle surplus revenues

Subprime Loans

Another major cause of the financial crisis was the availability of subprime loans, which were directly an outgrowth of easy credit. Subprime loans generally refer to credit given to individuals who fail to meet rigorous standards usually expected by lending institutions. These individuals could not really afford their loans because of inadequate income and poor credit histories. In most cases, borrowers were not required to have a down payment. With excess liquidity globally, interest rates remained low. People with weak financial histories are generally more vulnerable to

subprime loans ■ High-risk credit given to individuals who fail to meet rigorous standards

being charged higher interest rates. For example, poor people pay exorbitant rates for payday loans. A basic reality of finance is that yields on loans are inversely proportional to credit quality: the stronger the borrower, the lower the yield, and vice versa.[20] Driving the demand for subprime loans was the development of a culture of entitlement and a false egalitarianism that appealed to people's egos. Home ownership was pushed by the U.S. government as an inalienable right, despite borrowers' inability to repay loans. Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation), both U.S. government corporations, made more money available to lenders and borrowers by purchasing loans from the lenders and selling them to investors in the secondary markets. Huge amounts of money gravitated to subprime mortgages in the United States and Europe and, ultimately, to weak borrowers globally. Given the complex interdependence that characterizes financial globalization, problems emanating from subprime loans in the United States rapidly spread around the world. Governments were largely unaware of the risks associated with new forms of financing and were unable to prevent the global financial crisis.[21]

Fannie Mae and Freddie Mac ■ U.S. government corporations involved in real estate

As the unprecedented sums of money flowed into commercial and residential real estate, housing prices escalated. For thirty years before the housing boom, the average American house appreciated at an average of 1.4 percent a year. This low return of prime loans discouraged homeowners from viewing their houses as cash machines. Home equity lines of credit were not available until recently. Things changed dramatically after 2000. Appreciation rates climbed to 7.6 percent between 2000 and 2006, reaching 11 percent before the market crashed between 2006 and 2007. Real estate prices in California, Arizona, Nevada, Florida, and other areas grew even faster.

There was a wide variety of subprime mortgages. These included adjustable-rate mortgages, balloon mortgages, piggyback loans, and interest-only loans. An adjustable-rate mortgage is a long-term loan that does not have a fixed interest rate. The interest can be changed, with low rates at the beginning and high rates at the end. It is also possible, but highly unlikely, that rates could decline. Adjustable-rate mortgages were attractive to homebuyers who moved frequently. They were less expensive, or so it seemed, than fixed-rate mortgages, which offered more protection. A variation of the adjustable-rate mortgage is a balloon mortgage. Under this arrangement, lower payments are made on a loan for five to ten years, with a final installment, or balloon payment, that is significantly larger than earlier payments. Most borrowers could not afford to pay the balloon payment. The piggyback loan allows the homeowner to take out a second mortgage that is piggybacked onto the first mortgage. This is a high-risk loan because it clearly indicates that the borrower cannot afford the down payment to purchase real estate.[22] In an environment that encourages consumption over savings, easy credit fueled the housing crisis. Interest-only loans required borrowers to pay the interest on a loan without reducing the principal balance. This enabled weak borrowers to obtain larger loans.

adjustable-rate mortgage ■ A long-term loan that has varying interest rates

Speculation

A combination of low interest rates, unprecedented liquidity, and a belief that the Internet and various computer technologies virtually guaranteed unending and

ever-increasing prosperity facilitated the growth of speculative financial forces. Excessive risk taking replaced caution, which was often equated with a lack of optimism. Speculation, a deeply ingrained human characteristic, fosters the development of a herd mentality. As prices continued to rise, even the most cautious individuals get caught up in speculation. Ultimately, a speculative bubble is created. *Speculative bubbles generally go through four stages:*

speculation ■ Involves excessive risk taking, excessive optimism, and the development of a herd mentality

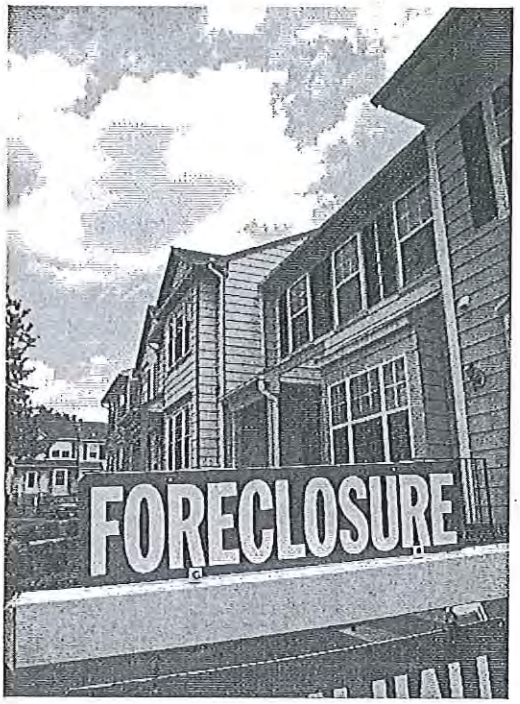
1. A new technology or invention changes people's expectations and those who are well informed try to profit from it.
2. Prices or profits continue to rise, which draws more people into the market.
3. The boom passes into euphoria and rational decision making is suspended.
4. The bust is almost inevitable. Prices and profits fall, companies and individuals go bankrupt, and the economy plunges into a recession.[23]

Many homeowners became speculators. In addition to low-interest loans and financial innovations in the housing market, political pressures to reduce taxes, including real estate taxes, contributed to the housing boom. Congress passed the Taxpayer Relief Act of 1997, which, among other things, exempted profits realized from the sale of a home if the home was owned and used as a principal residence for two of the last five years before it was sold. This new provision enabled homeowners to exclude up to $500,000 for couples and $250,000 for singles from capital gains tax. In many cases, removal of the capital gains tax encouraged home buyers to engage in a form of speculation known as flipping. The buyer would own the house for a short period with the sole intention of selling it very quickly for a higher price, thereby gaining a significant profit without much effort and by using very little of his or her own money as an investment. When the stock market crashed in 2000, real estate became more attractive to investors. Furthermore, the shock of the terrorist attacks on September 11, 2001, influenced more Americans to seek security in their homes. Consequently, they concentrated their investments in real estate. Because of the huge amounts of money that went into real estate globally and the preponderance of subprime loans and excessive risk taken in home mortgages, the housing crisis was at the epicenter of the global financial crisis.

Taxpayer Relief Act of 1997 ■ Exempted profits from taxes gained from selling one's home

THE IMPACT OF THE GLOBAL FINANCIAL CRISIS

As we mentioned earlier, the global financial crisis affected virtually all areas, including the process of globalization. Housing prices crashed; foreclosures became commonplace; unemployment reached 10 percent in the United States and higher levels in Europe and elsewhere; manufacturing declined sharply, especially in the automotive industry; students were faced with higher costs as colleges suffered financial losses; finding jobs after college became more challenging; and a global recession created widespread hardships. On the other hand, many developing countries that took a prudent approach to finance and saved money were not as badly damaged. In fact, countries that did not fully embrace financial liberalization were less affected than those that gave in to American pressure to fully engage in financial globalization. We also saw a global power shift, with the United States losing ground to China, India, Brazil, and other developing countries.



Housing was at the epicenter of the financial crisis. Falling house prices directly affect government revenues, including spending for education.

Foreclosures

Plunging real estate prices affected virtually all areas of the economy. People could no longer afford to purchase homes, which meant that homebuilders were forced to abandon construction projects. Think of all the products that are used in building and furnishing a home; all of the industries that produced these products generally experienced declining sales. Because houses became primary sources of wealth or perceptions of wealth, falling real estate prices made homeowners feel less economically secure. In a vicious circle, the economic recession, fueled by declining real estate markets, further eroded demand for real estate. But, mortgages must be repaid or the consequences can be severe. Despite decreasing home values, homeowners must continue to pay real estate taxes and spend money on maintenance. Many homes were bought at prices much higher than their actual worth just two or three years later. Rising levels of unemployment also pushed homeowners with strong credit into foreclosure. One in forty-five U.S. households, or 3 million, received a foreclosure filing, and banks repossessed 1 million homes in 2010. Housing prices continued to fall in 2011, the construction of new houses declined the most in twenty-seven years, and building permits dropped to their lowest level on record.[24]

The mortgage crisis inevitably spread to financial institutions, causing reputable Wall Street firms such as Lehman Brothers to collapse overnight. Because of Lehman's pivotal role in finance, its demise in September 2008 is generally

perceived as the most tangible evidence of the financial crisis on Wall Street. Iceland, which had a very successful banking system, saw its economy and currency collapse along with the banking system. Ireland, widely regarded as the Celtic Tiger for its rapid economic growth, experienced a deep recession. American consumers, the backbone of the United States and, to some extent, the global economy, had exhausted their resources and had a savings rate that was close to zero.

Decline in Manufacturing and Trade

Manufacturing, already in decline, fell dramatically. This especially was the case in the automotive industry, with General Motors and Chrysler declaring bankruptcy after closing many factories and dealerships, despite unprecedented financial support from the U.S. government. Industrial production was down by 12 percent in Europe, 11 percent in the United States, and 43 percent in Taiwan. Tightening credit and consumer fear ultimately created a downward spiral that significantly diminished global trade. Germany saw its exports drop by 20 percent. China's exports fell by more than 25 percent, and U.S. exports fell by almost 24 percent in 2008.[25] Both economies rebounded, with China surpassing Japan to become the world's second-largest economy and Germany experiencing the highest economic growth rate in Europe.

Global Power Shift

Another major impact of the global financial crisis is a global power shift. Although most countries were negatively affected by the financial crisis and global recession, some emerged stronger than others. Brazil, Russia, India, and China, also known as the BRIC countries, enhanced their power vis-à-vis the United States, Western Europe, and Japan. Within the EU, Germany emerged with the strongest financial and economic system and greater political and economic power. In sharp contrast to the policies adopted by the U.S. Federal Reserve under Chairman Alan Greenspan, the Reserve Bank of India, led by Yaga Venugobal Reddy, rejected many financial innovations and limited the participation of foreign investors in India's financial system. Instead of believing that markets are self-regulating, as many Americans do, the Indian government favored regulations and was quick to recognize financial bubbles. Reddy restricted bank lending to real estate developers, increased the amount of money banks had to set aside as reserves, and blocked the use of some derivatives. This conservative approach enabled India to largely avoid the global financial crisis.[26] Given America's role in pressuring the world to adopt a financial system that failed, BRIC countries perceive the financial crisis as a serious economic and political setback for the United States and free-market capitalism. All of these countries, sensing America's vulnerabilities, are becoming more politically and financially assertive. From their perspective, America is declining. It has escalating budget deficits, it is extremely dependent on foreign creditors such as China, and the dollar's status as the main global reserve currency has eroded. As we saw in Chapter 2, America's economic power following World War II enabled it to shape global financial institutions such as the International Monetary Fund (IMF) and the World Bank. However, the BRIC countries are now challenging America's leadership.[27] Economic power has shifted from the G-7 to the G-20, the group composed of countries with the largest economies, many of

BRIC countries ■ Brazil, Russia, India, and China; emerging global powers

Yaga Venugobal Reddy ■ Governor of the Reserve Bank of India; credited with helping India avoid the financial crisis

TABLE 7.1

Growth of Foreign Banks in the United States

Leading Banks (1999)	Share of Market (%)	Leading Banks (2009)	Share of Market (%)
1. Citi (U.S.)	13.9	J.P. Morgan (U.S.)	14.8
2. Merrill Lynch (U.S.)	13.7	Citi (U.S.)	14.7
3. Goldman Sachs (U.S.)	10.4	Bank of America Merrill Lynch (U.S.)	12.9
4. Morgan Stanley (U.S.)	10.4	Morgan Stanley (U.S.)	10.4
5. Lehman Brothers (U.S.)	8.2	Goldman Sachs (U.S.)	8.8
6. Chase Manhattan (U.S.)	7.3	Barclays Capital (British)	7.1
7. Credit Suisse First Boston (Swiss)	6.0	HSBC (British)	4.5
8. J.P. Morgan (U.S.)	6.2	Deutsche Bank (German)	4.2
9. Donaldson Lufkin Jenrette (U.S.)	4.9	Credit Suisse (Swiss)	4.1
10. Bear Stearns (U.S.)	4.6	RBS (Scotland)	3.7

Source: Graham Bowley, "Stalking a Weaker Wall Street," *New York Times*, 17 June 2009, B1.

them in the developing world. In 2011, when a new leader was being chosen for the IMF, countries with emerging economies called for the end of the tradition of European leadership of the IMF. Another indication of a power shift is the growing role of foreign banks in America's financial system, as indicated in Table 7.1.

GLOBAL RESPONSES TO THE FINANCIAL CRISIS

America's Response

Responses to the global financial crisis varied from country to country, with the strongest actions occurring in the United States. Being largely responsible for the crisis, the United States was not only the most severely affected but also the most shell shocked and anxious to find solutions. In a sharp reversal of its strong commitment to economic and financial liberalization and free-market capitalism, the United States has led efforts to nationalize its financial and some aspects of its manufacturing sectors to an unprecedented degree. There was general consensus among Republicans and Democrats that a massive financial and economic stimulus package, engineered primarily by Secretary of the Treasury Henry Paulson, was essential not just to rescue America's financial institutions but also to reassure Americans that their savings and investments were secure. A $787 billion stimulus package was passed by Congress. Because the financial crisis was reminiscent of the Great Depression, with its high levels of unemployment and massive withdrawals from banks, the U.S. government responded to avoid repeating the mistakes of the 1930s. Despite various protections

Henry Paulson ■ U.S. Secretary of the Treasury who initiated the stimulus package to rescue banks on Wall Street

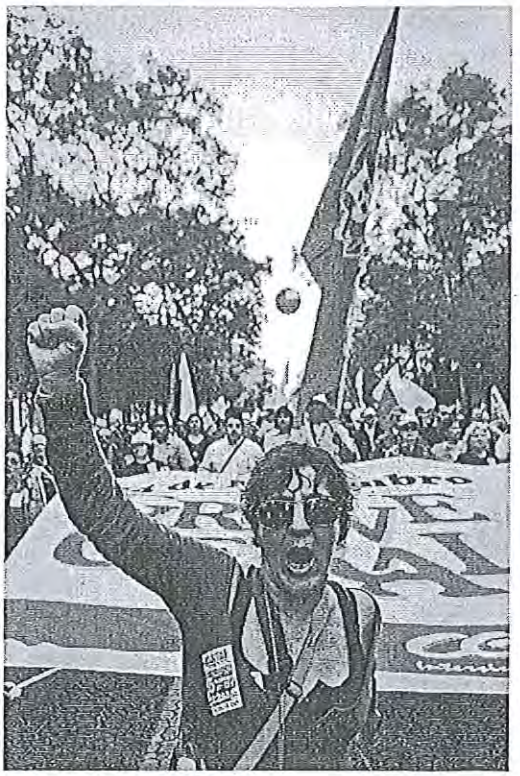
stimulus package ■ Money allocated by governments to financial institutions and selected industries to prevent their collapse and reinvigorate economic growth

implemented to insure the safety of deposits, such as the FDIC, Americans withdrew $150 billion from money market funds over a two-day period in September 2008, compared with average weekly outflows of roughly $5 billion. The huge amount of money poured into credit markets and banks was designed to restore confidence in financial institutions and to expand credit. Concerned about high unemployment rates and stagnant economic growth, the U.S. Federal Reserve enacted a type of monetary stimulus known as quantitative easing (QE). It bought $600 billion in long-term Treasury bonds to push down long-term interest rates.[28] That depreciated the value of the dollar, thereby making American exports less expensive and raising the cost of imports. That, in turn, fueled debates about currency wars. America also responded by electing Republicans in 2010 to replace Democrats who controlled the House of Representatives. A greater emphasis was placed on reducing budget deficits at both the national and state levels. Many public service employees lost their jobs, and public sector unions were severely weakened.

quantitative easing ■ A type of monetary stimulus used by the U.S. Federal Reserve. Long-term Treasury bonds are purchased to decrease interest rates.

European Responses

Although other countries also implemented stimulus packages, their concerns differed to a significant degree from those of the United States. Germany, for



Fallout from the financial crisis and economic recession is seen in Portugal, at a workers' protest against the government's new budget policies for trimming the country's budget deficit. Portugal asked the European Union for financial assistance to help solve its crisis.

example, resisted American pressure to adopt a more comprehensive, coordinated global stimulus package, partly because many Germans believe that the crisis was primarily an outgrowth of American financial policies and would have to be solved domestically. Germans worry about the possibility of hyperinflation, which the country experienced in the 1920s. Germans are also more frugal than Americans and are reluctant to impose huge deficits on future generations, especially in light of Germany's shrinking population. Europeans in general took a less-frantic approach to the financial crisis because in normal times their governments had created numerous safety nets. European governments provide national health insurance and generous pensions, and they have implemented programs to reduce unemployment and lost wages. Because they save a greater percentage of their income, at reduced levels, they have avoided losing their homes on such a massive scale as is the case in the United States. However, faced with mounting debts and a worsening financial crisis, many governments implemented austerity programs that cut government budget deficits and raised the minimum retirement age. These changes caused protests in France, Greece, Portugal, Britain, and elsewhere. Leaders of the "euro zone" countries, in which the single European currency is used, struggled to create an overall policy to deal with the region's growing debt crisis. Students in Britain protested the government's decision to increase college tuition and fees. Similar to the United States, the government that was in power in Britain during the financial crisis (Labor), lost its majority to a coalition of Conservatives and Liberal Democrats.

safety nets ■ The health insurance, pensions, and other programs that European governments provide citizens and that lessen losses in economic hard times

China's Response

China's response involved taking measures to strengthen its power vis-à-vis the United States. Unlike the United States, China regulates its financial institutions, has more than $2 trillion in reserves, and continues to have economic growth rates in excess of 7 percent, and the Chinese save more than 40 percent of their income. Despite rising unemployment and declining exports, China emerged from the financial crisis in a strong position and is taking advantage of new opportunities created by the crisis. China is using its $600 billion economic stimulus package to improve its infrastructure, to help its companies to become more competitive domestically and globally, and to enhance research and development. It is also gaining greater access to resources and augmenting its relations in Latin America, Africa, the Middle East, and elsewhere, even as the United States is preoccupied with its financial and economic crises as well as with fighting wars in Iraq and Afghanistan. China is also acquiring European and American companies in the automotive, textile, food, energy, machinery, electronics, and environmental protection sectors. One of the most visible acquisitions is the Hummer from General Motors.

Financial Regulations

In light of the general consensus among experts that deregulation and the lax enforcement of regulations in the financial sector contributed significantly to the global financial crisis, an immediate response to the crash was to try to

Ben S. Bernanke ■ Chairman of the U.S. Federal Reserve

Bank for International Settlements ■ Based in Basel, Switzerland; created to regulate banking and harmonize banking standards

strengthen and update regulations. The chairman of the U.S. Federal Reserve, Ben S. Bernanke, was particularly aware of the need for new regulations. As a professor at Princeton University, Bernanke focused his research on the Great Depression. The American government was now determined to avoid mistakes made during that financial and economic crisis. Efforts to enact international banking regulations began with the creation of the Bank for International Settlements, based in Basel, Switzerland. In 1988, the banking community signed the Basel Capital Accord, which attempted to harmonize banking standards, especially those requiring banks to set aside capital to cover the level of risk they faced. However, due to the dominant influence of bankers, the Bank for International Settlements was not very focused on regulations.[29] Since 1999, there has been a greater effort to develop a stronger regulatory framework, known as Basel 2. The accord gave credit-rating agencies an explicit role in determining how much capital is enough to cover certain risks. In 2010, an agreement known as *Basel 3* created new international rules for banks. They raised the amount capital lenders are required to have as a cushion against unexpected financial losses to 7 percent of their capital.[30] But, the failures of financial institutions in the United States, Europe, and elsewhere demonstrate that individual countries' unwillingness or inability to supervise their financial sectors was at the heart of the problem. Consequently, domestic regulatory reforms are likely to be more effective than global regulations. Financial innovations such as derivatives and executive compensation are the primary targets for greater supervision. However, the complex nature of the global financial system and strong reservations in the United States about the government's role in the economy will most likely diminish the effectiveness of regulations.

CASE STUDY | Ireland: The Decline of the Celtic Tiger

Ireland, the second-richest country in Europe before the global financial and economic crisis, now has one of Europe's weakest economies. What makes the Irish case different and of special interest is that after such a long history of hardship and poverty, Ireland was radically transformed into a highly successful country, becoming the Celtic Tiger in the 1990s, only to see prosperity decline precipitously by 2007. Massive public debt, due largely to the banking crisis, forced Ireland to turn to the European Union and the IMF for financial assistance. Unemployment rose to 14 percent and consumer spending and incomes fell. Ghost estates proliferated, homelessness increased, and younger Irish emigrated to the United States, Canada, Australia, and elsewhere to find employment.[31]

Ireland endured severe economic problems in the 1980s. Emigration, an integral part of the Irish experience for more than 150 years, rose sharply, draining the country of many talented individuals. High tax rates discouraged foreign investment, and high inflation and high interest rates made it difficult for the economy to recover. Ireland's entry into the EU and its adoption of the euro marked a major step toward Ireland's integration in the global economy. Ireland gained access to low interest rates, and the Anglo Irish Bank and other financial institutions borrowed heavily in the euro interbank market to finance property loans. Ireland's rapid economic growth was aided by policies implemented by the government led by Charles Haughey. Those included cuts in public spending to reduce the budget deficit, a three-year freeze on wages, and lowering inflation and interest rates. Ireland attracted many companies, especially high-tech industries like Intel,

(*continued*)

that wanted to gain entry in the EU before the removal of trade barriers among member countries in 1992. Ireland in many ways resembled South Korea, Taiwan, and other Asian Tigers. It offered a relatively low-wage workforce, highly educated individuals, low tax rates, and concessions to companies that invested. It also had the advantage of being an English-speaking country with a global diaspora. Ireland's economic prosperity was closely linked to America's. Many in the Irish diaspora, especially in the United States, returned to Ireland during the boom in the 1990s, bringing with them skills and capital. Ireland also became a magnet for immigrants from Eastern Europe and elsewhere, many of whom worked in the booming construction industry and in the service sector. Between 1993 and 2000, average GDP growth rates were around 10 percent, similar to rates in China and other Asian countries. Ireland became a Celtic Tiger during this period. But a financial bubble was also developing. Wages and prices rose faster than those in Ireland's trading partners, which diminished Ireland's competitiveness. Imports became less expensive and government deficits grew, as was the case in the United States. At the same time, the cost of living escalated. Ireland had become Europe's second-richest country overnight.

Ireland, like the United States, turned to investing in real estate following the dot-com bust. The general belief among many Irish was that real estate was a safe investment that would continue to appreciate. Low interest rates, the lack of stringent government regulations, and government corruption fueled a construction boom. Small down payments enabled financially vulnerable individuals to purchase homes. Buyers routinely secured loans worth more than 90 percent of the home's value, which pushed them into negative equity when property values declined. Speculation was common. People wanting to make money quickly invested in second homes and commercial property. The number of people employed in construction reached 272,000 in 2007, accounting for one eighth of the workforce. When employment in areas related to housing is considered, such as real estate agencies, mortgage brokers, and banks, the housing sector employed a fifth of Ireland's population. Housing problems were the main cause of the decline of the Celtic Tiger. Ireland experienced a precipitous drop in housing prices.[32]

In an effort to solve its economic problems, Ireland borrowed money, primarily to bail out banks. Germany, the leading EU economy and the biggest creditor, opposed lowering interest rates on Ireland's debt, favoring instead fiscal discipline. But austerity programs and high unemployment rates lessen the likelihood that consumers will be able to reinvigorate the economy. Ireland faces many difficult choices. The financial and budgetary crises will take time to be resolved. By keeping corporate taxes low, Ireland is likely to attract foreign investment as the global economy improves. Ireland's young and talented workforce will continue to be a major asset that will assist in the country's economic recovery.

SUMMARY AND REVIEW

The global financial crisis of 2008–2009 ushered in the most severe global recession since the Great Depression of the 1930s. Given the central role played by finances in globalization, the crisis has serious implications for virtually all global issues and for globalization itself. Although this chapter argued that financial crises seem to be an integral component of capitalism, human beings are ultimately responsible for creating them. Revolutions in computer and telecommunications technologies fostered the development of complex financial engineering that radically altered the global financial system. An emphasis on government deregulation, the growth of a culture that encouraged quick profits and excessive executive

compensation, and the availability of low interest rates played significant roles in creating the financial crisis. But a crisis presents both dangers and opportunities. While the United States has suffered severe setbacks, China has gained, thereby shifting global power. The financial crisis has significantly reduced global trade and caused unprecedented home foreclosures and high levels of unemployment. The global response has centered around regulating some of the financial innovations, paying greater attention to risk management, and monitoring executive compensation. Overall, the financial crisis has diminished support for financial liberalization and strengthened the role of governments around the world in economic affairs.

KEY TERMS

finance 139
Asian Financial Crisis 140
Federal Deposit Insurance Corporation (FDIC) 141
deregulation 141
global financial liberalization 141
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DISCUSSION QUESTIONS

1. Discuss how deregulation of financial markets and low interest rates contributed to creating the financial crisis.
2. Discuss the implications of the stimulus package for the United States. In light of the benefits derived from Europe's safety net, discuss the pros and cons of America's adoption of European policies, such as universal health care and job protection.
3. Discuss the role of subprime loans in real estate in the financial crisis and their broader social and economic implications.
4. In your view, has the financial crisis weakened the United States globally and strengthened China? Discuss.
5. Evaluate the global responses to the financial crisis. Give examples.

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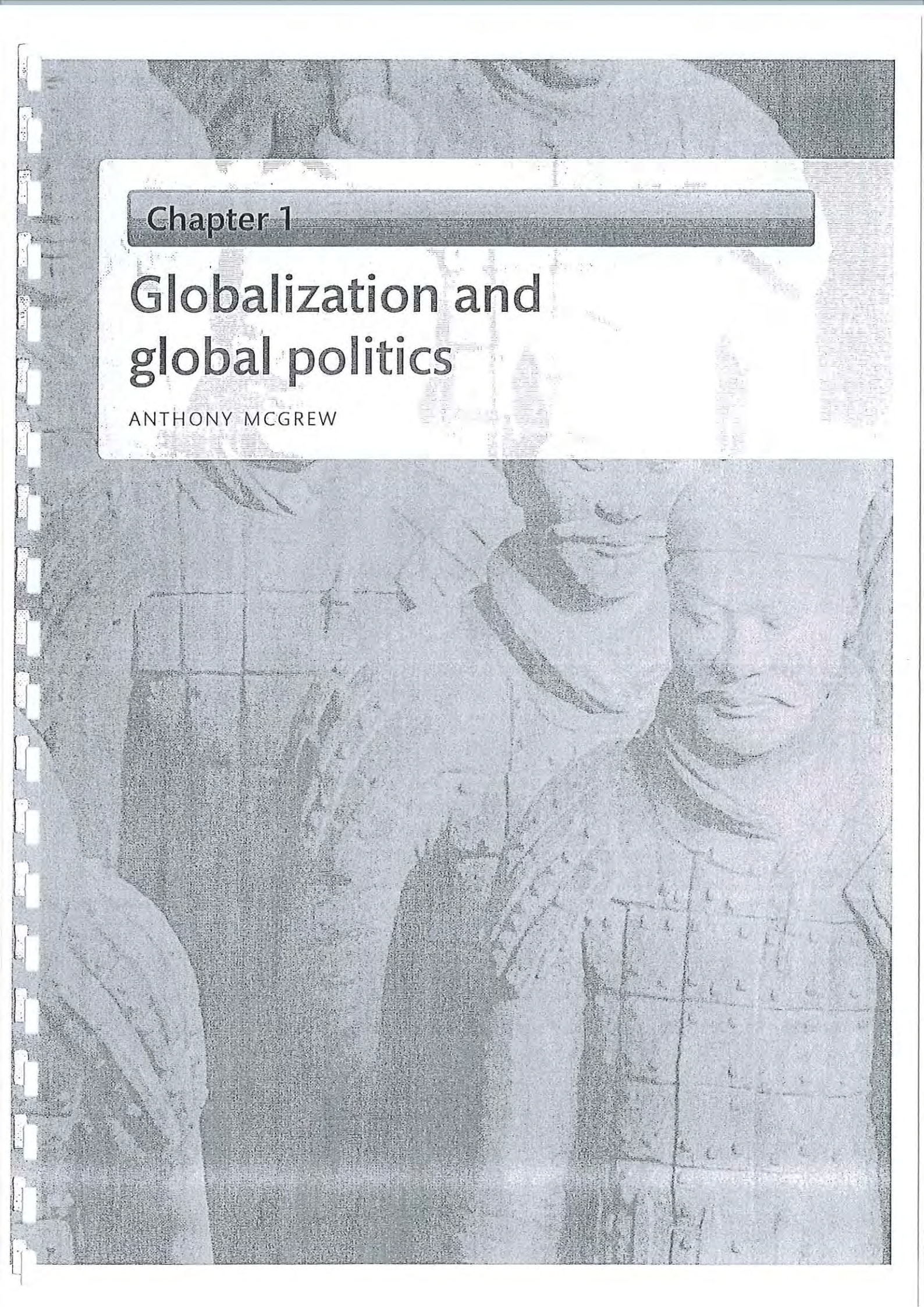
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Chapter 1

Globalization and global politics

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Reader's Guide

This chapter provides an account of globalization and its consequences for our understanding of world politics. Globalization is a long-term historical process that denotes the growing intensity of worldwide interconnectedness: in short, a 'shrinking world'. It is, however, a highly uneven process such that far from creating a more cooperative world it is also a significant source of global friction, instability, enmity, and conflict. Whilst it has important consequences for the power and autonomy of national governments, it by no means prefigures, as many have argued or desired, the demise of the nation-state or of geopolitics. Rather, globalization is associated with significant transformations in world politics, the most significant of which are the focus of this chapter. In particular the chapter concludes that a conceptual shift in our thinking is required to grasp fully the nature of these transformations. This conceptual shift involves embracing the idea of global politics: the politics of an embryonic global society in which domestic and world politics, even if conceptually distinct, are practically inseparable. It also requires rethinking many of the traditional organizing assumptions and institutions of modern political life—from sovereignty to democracy—since in a globalized world, power is no longer simply organized according to a national or territorial logic. This chapter has two key objectives: to elucidate and elaborate the concept of globalization; and to explore its consequences for our understanding of world politics.

Introduction

Globalization—simply the widening, deepening, and speeding up of worldwide interconnectedness—is a contentious issue in the study of world politics. Some—the hyperglobalists—argue that it is bringing about the demise of the sovereign **nation-state** as global forces undermine the ability of governments to control their own economies and societies (Ohmae 1995; Scholte 2000). By contrast, the sceptics reject the idea of globalization as so much 'globaloney.' They argue that states and geopolitics remain the principal agents and forces shaping **world order** (Krasner 1999; Gilpin 2001). This chapter takes a rather different approach—a transformationalist perspective—arguing that both the hyperglobalists and sceptics alike exaggerate their arguments, thereby producing misleading interpretations of contemporary world politics. This transformationalist perspective acknowledges that far from leading to the demise of the sovereign state, globalization is associated with the emergence of a conspicuously **global politics** in which the traditional distinction between domestic and international affairs is no longer very meaningful. Under these conditions, 'politics everywhere, it would seem, are related to politics everywhere else', such that the orthodox approaches to international relations—which are constructed upon this very distinction—provide at best only a partial insight into the forces shaping the contemporary world (Rosenau in Mansbach, Ferguson, and Lampert 1976: 22).

Since it is such a 'slippery' and overused concept, it is hardly surprising that globalization should engender such intense debate. Accordingly, this chapter begins by reviewing the concept of globalization before exploring its implications for the study of world politics. The chapter is organized into two main sections: the first will address several interrelated questions, namely: what is globalization? How is it best conceptualized and defined? How is it manifest today, most especially given the events of **9/11** and the 2008–9 global financial crisis? Is it really all that new? The second section will explore the ways in which globalization is producing a form of global politics that is highly skewed in favour of the most powerful to the exclusion of the majority of humankind.

Making sense of globalization

Over the last three decades the sheer scale and scope of global interconnectedness has become increasingly evident in every sphere, from the economic to the cultural.

Worldwide economic integration has intensified as the expansion of global commerce, finance, and production binds together the economic fortunes of **nations**, communities, and households across the world's major trading regions and beyond within an emerging global market economy. As the credit crunch of 2008 illustrates, the integration of the world economy is such that no national economy is able to insulate itself from the contagion effect of turmoil in the world's financial markets. Instability in one region, whether the collapse of the Argentinean economy in 2002 or the East Asian recession of 1997, very rapidly takes its toll on jobs, production, savings, and investment many thousands of miles away, while a collapse of confidence in US banks is felt everywhere from Birmingham to Bangkok.

Every day over $2 trillion flows across the world's foreign exchange markets. No government, even the most powerful, has the resources to resist sustained speculation against its currency and thereby the credibility of its economic policy (see Ch. 27). Furthermore, governments have to borrow significant sums in world bond markets. Their creditworthiness determines the availability and cost of such borrowing. In the aftermath of the 2008–9 financial crises, many governments, including the UK and USA, confront real reductions in public spending in order to protect their creditworthiness in world bond markets.

Transnational corporations now account for between 25 and 33 per cent of world output, 70 per cent of world trade, and 80 per cent of international investment, while overseas production by these firms considerably exceeds the level of world exports, making them key players in the global economy controlling the

location and distribution of economic and technological resources.

New modes and infrastructures of global communication have made it possible to organize and mobilize like-minded people across the globe in virtual real time, as expressed in coordinated worldwide protests in early 2003 against military intervention in Iraq and the 45,000 international **non-governmental organizations** (NGOs), from Greenpeace to the Climate Action Network, not to mention the activities of transnational criminal and terrorist networks, from drugs cartels to Al Qaeda.

With a global communications infrastructure has also come the transnational spread of ideas, cultures, and information, from Madonna to Muhammad, both among like-minded peoples and between different cultural groups—reinforcing simultaneous tendencies towards both an expanded sense of global solidarity among the like-minded and difference, if not outright hostility, between different cultures, nations, and ethnic groupings.

People—with their cultures—are also on the move in their tens of millions—whether legally or illegally—with global migration almost on a scale of the great nineteenth-century movements but transcending all continents, from south to north and east to west, while over 600 million tourists are on the move every year.

As globalization has proceeded, so has the recognition of transnational problems requiring global regulation, from climate change to the proliferation of weapons of mass destruction. Dealing with these transnational issues has led to an explosive growth of transnational and global forms of rule-making and regulation from **G20** summits in 2009 responding to the global financial crisis to the 2009 Copenhagen Climate Change Conference. This is evident in both the expanding jurisdiction of established **international organizations**, such as the **International Monetary Fund** or the International Civil Aviation Organization, and the literally thousands of informal networks of **cooperation** between parallel government agencies in different countries, from the Financial Action Task Force (which brings together government experts on money-laundering from different countries) and the Dublin Group (which brings together drug enforcement agencies from the European Union, the USA, and other countries).

With the recognition of global problems and global interconnectedness has come a growing awareness of

Box 1.1 Definitions of globalization

Globalization is variously defined in the literature as:

1 'The intensification of worldwide social relations which link distant localities in such a way that local happenings are shaped by events occurring many miles away and vice versa.'
(Giddens 1990: 21)

2 'The integration of the world-economy.'
(Gilpin 2001: 364)

3 'De-territorialization—or . . . the growth of supraterritorial relations between people.'
(Scholte 2000: 46)

4 'time-space compression'.
(Harvey 1989)

the multiple ways in which the security and prosperity of communities in different regions of the world are bound together. A single terrorist bombing in Bali has repercussions for public perceptions of security in Europe and the USA, while agricultural subsidies in the USA and the EU have significant consequences for the livelihoods of farmers in Africa, Latin America, and the Caribbean.

We inhabit a world in which the most distant events can rapidly, if not almost instantaneously, come to have very profound consequences for our individual and collective prosperity and perceptions of security. For those of a sceptical persuasion, however, this is neither far from a novel condition nor is it necessarily evidence of globalization if that term means something more than simply international **interdependence**, that is linkages between countries.

What, then, distinguishes the concept of globalization from notions of internationalization or interdependence? What, in other words, is globalization?

Key Points

Over the last three decades the sheer scale, scope, and acceleration of global interconnectedness has become increasingly evident in every sphere from the economic to the cultural. Sceptics do not regard this as evidence of globalization if that term means something more than simply international interdependence, i.e. linkages between countries. The key issue becomes what we understand by the term 'globalization'.

Conceptualizing globalization

Initially, it might be helpful to think of globalization as a process characterized by:

- a *stretching* of social, political, and economic activities across political frontiers so that events, decisions, and activities in one region of the world come to have significance for individuals and communities in distant regions of the globe. Civil wars and conflict in the world's poorest regions, for instance, increase the flow of asylum seekers and illegal migrants into the world's affluent countries;
- the intensification, or the growing *magnitude*, of interconnectedness, in almost every sphere of social existence from the economic to the ecological, from the activities of Microsoft to the spread of harmful microbes, such as the SARS virus, from the intensification of world trade to the spread of weapons of mass destruction;
- the *accelerating pace* of global interactions and processes as the evolution of worldwide systems of transport and communication increases the rapidity or velocity with which ideas, news, goods, information, capital, and technology move around the world. Routine telephone banking transactions in the UK are dealt with by call centres in India in real time, whilst at the outset of the recent financial crisis stock markets across the globe displayed a synchronized collapse within hours rather than in weeks as in the Great Crash of 1929;
- the growing *extensity*, *intensity*, and *velocity* of global interactions is associated with a deepening enmeshment of the local and global in so far as local events may come to have global consequences and global events can have serious local consequences, creating a growing collective awareness or consciousness of the world as a shared social space, that is globality or **globalism**. This is expressed, among other ways, in the worldwide diffusion of the very idea of globalization itself as it becomes incorporated into the world's many languages, from Mandarin to Gaelic.

As this brief description suggests, there is more to the concept of globalization than simply interconnectedness. It implies that the cumulative scale, scope, velocity, and depth of contemporary interconnectedness is dissolving the significance of the borders and boundaries that separate the world into its many constituent states or national economic and political spaces (Rosenau 1997). Rather than growing interdependence between discrete bounded national states, or internationalization, as the sceptics refer to it, the concept of globalization seeks to capture the dramatic shift that is under way in the organization of human affairs: from a world of discrete but interdependent national states to the world as a shared social space. The concept of globalization therefore carries with it the implication of an unfolding process of structural change in the scale of human social and economic organization. Rather than social, economic, and political activities being organized solely on a local or national scale today, they are also increasingly organized on a transnational or global scale. Globalization therefore denotes a significant shift in the scale of social organization, in every sphere from economics to security, transcending the world's major regions and continents.

Central to this structural change are contemporary informatics technologies and infrastructures of communication and transportation. These have greatly facilitated new forms and possibilities of virtual real-time worldwide organization and **coordination**, from the operations of multinational corporations to the worldwide mobilization and demonstrations of the anti-globalization movement. Although geography and distance still matter, it is nevertheless the case that globalization is synonymous with a process of **time-space compression**—literally a shrinking world—in which the sources of even very local developments, from unemployment to ethnic conflict, may be traced to distant conditions or decisions. In this respect globalization embodies a process of **deterritorialization**: as social, political, and economic activities are increasingly 'stretched' across the globe, they become in a significant sense no longer organized solely according to a strictly territorial logic. Terrorist and criminal networks, for instance, operate both locally and globally. National economic space, under conditions of globalization, is no longer coterminous with national territorial space since, for example, many of the UK's largest companies have their headquarters abroad and many domestic companies now outsource their production to China and East Asia, among other locations. This is not to argue that territory and borders are now irrelevant, but rather to acknowledge that under conditions of globalization their *relative significance*, as constraints upon social action and the exercise of power, is declining. In an era of instantaneous real-time global communication and organization, the distinction

Case Study 1 Global production and the iPod



Take just one component of the iPod nano, the central microchip provided by the US company PortalPlayer. The core technology of the chip is licensed from British firm ARM and is modified by PortalPlayer's programmers in California, Washington State, and Hyderabad. PortalPlayer then works with microchip design companies in California that send the finished design to a 'foundry' in Taiwan (China) that produces 'wafers' (thin metal disks) imprinted with thousands of chips. The capital costs of these foundries can be more than $2.5 million. These wafers are then cut up into individual disks and sent elsewhere in Taiwan (China), where each one is tested. The chips are then encased in plastic and readied for assembly by Silicon-Ware in Taiwan (China) and Amkor in the Republic of Korea. The finished microchip is then warehoused in Hong Kong (China) before being transported to mainland China where the iPod is assembled.

Working conditions and wages in China are low relative to Western standards and levels. Many workers live in dormitories and work long hours. It is suggested that overtime is compulsory. Nevertheless, wages are higher than the average of the region in which the assembly plants are located and allow for substantial transfers to rural areas and hence contribute to declining rural poverty. PortalPlayer was only established in 1999 but had revenues in excess of $225 million in 2005. PortalPlayer's chief executive officer has argued that the outsourcing to countries such as India and Taiwan (China) of 'non-critical aspects of your business' has been crucial to the development of the firm and its innovation: 'it allows you to become nimbler and spend R&D dollars on core strengths'.

Since 2003, soon after the iPod was launched, the share price of Apple, the company that produces and sells the iPod, has risen from just over $6 to over $60. Those who own shares in Apple have benefited from the globalization of the iPod.

Sources: C. Joseph, 'The iPod's Incredible Journey', Mail on Sunday, 15 July 2006; 'Meet the iPod's "Intel"', Business Trends, 32(4) (April), 2006; World Bank (2006), Global Economic Prospects 2007: Managing the Next Wave of Globalization (Washington, DC: World Bank): 11.

between the domestic and the international, inside and outside the state, breaks down. Territorial borders no longer demarcate the boundaries of national economic or political space.

A 'shrinking world' implies that sites of power and the subjects of power quite literally may be continents apart. As the world financial crisis of 2008 illustrates, the key sites and agencies of decision-making, whether in Washington, Beijing, New York, or London, quite literally are oceans apart from the local communities whose livelihoods are affected by their actions. In this respect globalization denotes the idea that power (whether economic, political, cultural, or military) is increasingly organized and exercised at a distance (or has the potential to be so). As such the concept of globalization denotes the relative denationalization of power in so far as, in an increasingly interconnected global system, power is organized and exercised on a transregional, transnational, or transcontinental basis while—see the discussion of political globalization—many other actors, from international organizations to criminal networks, exercise power within, across, and against states. States no longer have a monopoly of power resources, whether economic, coercive, or political.

To summarize: globalization is a process that involves a great deal more than simply growing connections or interdependence between states. It can be defined as:

> A historical process involving a fundamental shift or transformation in the spatial scale of human social organization that links distant communities and expands the reach of power relations across regions and continents.

Such a definition enables us to distinguish globalization from more spatially delimited processes such as **internationalization** and **regionalization**. Whereas internationalization refers to growing interdependence between states, the very idea of internationalization presumes that they remain discrete national units with clearly demarcated borders. By contrast, globalization refers to a process in which the very distinction between the domestic and the external breaks down. Distance and time are collapsed, so that events many thousands of miles away can come to have almost immediate local consequences while the impacts of even more localized developments may be diffused rapidly around the globe.

Box 1.2 Globalization at risk? The financial crisis of 2008

Whilst the causes of the financial crisis of 2008 remain hotly debated, there is a general consensus that both in terms of its scale and severity the crisis posed the greatest risk to the effective functioning of the entire world economy since the Great Depression of the 1930s. Without unprecedented internationally coordinated intervention by the governments of the world's major economies, confirmed at the 2009 G20 summits in London and Pittsburgh, the crisis could have degenerated into an economic catastrophe much worse than that of 1929. As the crisis unfolded throughout 2008 and 2009, it precipitated an unprecedented contraction in global economic transactions from international bank lending to foreign investment, trade in commodities and manufactures and transnational production. Whether this contraction prefigures a significant trend of economic deglobalization or is simply a temporary adjustment to the current global market downturn has yet to be established definitively. The 'great correction' of 2008 has put economic globalization at risk. Paradoxically, in doing so it has reinforced tendencies towards political globalization as governments seek to coordinate their economic strategies to prevent a slide into a global depression or towards protectionism. Moreover, for emerging powers, such as China, India, and Brazil, economic globalization remains essential to sustaining economic growth and national prosperity. Whilst economic globalization is at risk as a consequence of the 'great correction' of 2008, the outcome may be more of a moderation of its pace and intensity, by comparison with more recent historical trends, as opposed to a process of deglobalization, i.e. a reversal of such trends.

If globalization refers to transcontinental or transregional networks, flows, or interconnectedness, then regionalization can be conceived as the intensification of patterns of interconnectedness and integration among states that have common borders or are geographically proximate, as in the European Union (see Ch. 26). Accordingly, whereas flows of trade and finance between the world's three major economic blocs—North America, Asia Pacific, and Europe—constitute globalization, by contrast, such flows within these blocs are best described as regionalization.

Key Points

- Globalization denotes a tendency towards the growing extensity, intensity, velocity, and deepening impact of worldwide interconnectedness.
- Globalization is associated with a shift in the scale of social organization, the emergence of the world as a shared social space, the relative deterritorialization of social, economic, and political activity, and the relative denationalization of power.
- Globalization can be conceptualized as a fundamental shift or transformation in the spatial scale of human social organization that links distant communities and expands the reach of power relations across regions and continents.
- Globalization is to be distinguished from internationalization and regionalization.

Contemporary globalization

According to John Gray, the cataclysmic attacks on the United States on 11 September 2001 heralded a new epoch in world affairs, 'The era of globalization is over' (Naím 2002). In response to the perceived threat of globalized terrorism, governments sought to seal their borders. Moreover, in response to the global financial crisis many governments have become more interventionist, protecting key national industries from foreign and trade competition. As a consequence, the intensity of economic globalization (whether measured in terms of trade, financial, or investment flows) has undoubtedly diminished by comparison with its peak at the turn of this century. This has been seized upon by those of a sceptical persuasion (see Box 1.3) as confirmation of their argument (Hirst and Thompson 2003). Sceptics conclude that not only has globalization been highly exaggerated but also that it is a myth or 'conceptual folly' that conceals the reality of a world which is much less interdependent than it was in the nineteenth century, and one that remains dominated by geopolitics and Western capitalism (Hirst and Thompson 1999; Gilpin 2002; Rosenberg 2000, 2005). By contrast, for many of a more globalist persuasion, the very events of 9/11 and the financial crisis are indicative of just how globalized the world has become in the twenty-first century. What is at issue here, at least in part, are differing (theoretical and historical) interpretations of globalization.

One of the weaknesses of the sceptical argument is that it tends to conflate globalization solely with economic trends: it sometimes invokes a form of economic reductionism. As such it overlooks non-economic trends and tendencies or treats them as insignificant. However, contemporary globalization is not a singular process: it is manifest within all aspects of social life, from politics

Box 1.3 The sceptical view of globalization

Sceptical accounts of globalization tend to dismiss its significance for the study of world politics. They do so on the grounds that:

1 By comparison with the period 1870 to 1914, the world is much less globalized economically, politically, and culturally.

2 The contemporary world is marked by intensifying geopolitics, regionalization, and internationalization, rather than by globalization.

3 The vast bulk of international economic and political activity is concentrated within the group of OECD states.

4 By comparison with the heyday of European global empires, the majority of the world's population and countries in the South are now much less integrated into the global system.

5 Geopolitics, state power, nationalism, and territorial boundaries are of growing, not less, significance in world politics.

6 Globalization is at best a self-serving myth or conceptual folly (according to Rosenberg) that conceals the significance of Western capitalism and US hegemony in shaping contemporary world politics.

7 Responses to the financial crisis demonstrate the centrality of hegemonic and national power to the effective functioning of the world economy.

(Hirst and Thompson 1999, 2003; Hay 2000; Hoogvelt 2001; Gilpin 2002; Rosenberg 2005)

Box 1.4 Patterns of contemporary globalization

Globalization, to varying degrees, is evident in all the principal sectors of social interaction:

Economic: in the economic sphere, patterns of worldwide trade, finance, and production are creating global markets and, in the process, a single global capitalist economy—what Castells (2000) calls 'global informational capitalism'. Multinational corporations organize production and marketing on a global basis while the operation of global financial markets determines which countries get credit and upon what terms.

Military: in the military domain the global arms trade, the proliferation of weapons of mass destruction, the growth of transnational terrorism, the growing significance of transnational military corporations, and the discourse of global insecurity point to the existence of a global military order.

Legal: the expansion of transnational and international law from trade to human rights alongside the creation of new world legal institutions such as the International Criminal Court is indicative of an emerging global legal order.

Ecological: a shared ecology involves shared environmental problems, from global warming to species protection, alongside the creation of multilateral responses and regimes of global environmental governance.

Cultural: involves a complex mix of homogenization and increased heterogeneity given the global diffusion of popular culture, global media corporations, communications networks, etc., simultaneously with the reassertion of nationalism, ethnicity, and difference. But few cultures are hermetically sealed off from cultural interaction.

Social: shifting patterns of migration from South to North and East to West have turned migration into a major global issue as movements come close to the record levels of the great nineteenth-century movements of people.

to production, culture to crime, and economics to education. It is implicated directly and indirectly in many aspects of our daily lives, from the clothes we wear, the food we eat, the knowledge we accumulate, through to our individual and collective sense of security in an uncertain world. Evidence of globalization is all around us: universities are literally global institutions, from the recruitment of students to the dissemination of academic research. To understand contemporary globalization therefore requires a mapping of the distinctive patterns of worldwide interconnectedness in all the key sectors of social activity, from the economic and the political through to the military, the cultural, and the ecological.

As Box 1.4 illustrates, globalization is occurring, albeit with varying intensity and at a varying pace, in every domain of social activity. Of course it is more advanced in some domains than others. For instance, economic globalization is much more extensive and intensive than is cultural or military globalization. To this extent contemporary globalization is highly uneven. Making sense of it requires asking: the globalization of what? Contrary to the sceptics, it is crucial to appreciate that globalization is a complex *multidimensional process*: patterns of economic globalization and cultural globalization are neither identical nor reducible to one another. In this respect, drawing general conclusions about globalizing tendencies simply from one domain produces a somewhat partial and inaccurate interpretation. As noted, in the aftermath of 9/11 and the financial crisis of 2008 the slowdown in economic globalization was heralded by sceptics as evidence of the end of globalization. This interpretation ignores the accelerating pace of globalization in the military, technological, and cultural domains. Moreover, what is highly distinctive about contemporary globalization is the confluence of globalizing tendencies across all the key domains of social interaction. Significantly, these tendencies have proved remarkably robust in the face of global instability and military conflicts.

If patterns of contemporary globalization are uneven, they are also highly *asymmetrical*. It is a common misconception that globalization implies universality: that the 'global' in globalization implies that all regions or countries must be similarly enmeshed in worldwide processes. This is plainly not the case, for it very markedly involves differential patterns of enmeshment, giving it what Castells calls its 'variable geometry' (Castells 2000). The rich OECD countries are much more globalized than many of the poorest sub-Saharan African states. Globalization is not uniformly experienced across all regions, countries, or even communities since it is inevitably a highly differentiated process. Among OECD and sub-Saharan African states, elites are in the vanguard of globalization while the poorest in these countries find themselves largely excluded from its benefits. Globalization exhibits a distinctive geography of inclusion and exclusion, resulting in clear winners and losers not just between countries but within and across them. For the most affluent it may very well entail a shrinking world—jet travel, global television and the World Wide Web—but for the largest slice of humanity it tends to be associated with a profound sense of disempowerment. Inequality is deeply inscribed in the very processes of contemporary globalization such that it is more accurately described as **asymmetrical globalization**.

Given such asymmetries, it should not be surprising to learn that globalization does not prefigure the emergence of a harmonious global community or an ethic of global cooperation. On the contrary, as 9/11 tragically demonstrated, the more the world becomes a shared social space, the greater the sense of division, difference, and enmity it may create. Historically, violence has always been central to globalization, whether in the form of the 'New Imperialism' of the 1890s or the current 'war on global terror'. Beyond the OECD core globalization is frequently perceived as Western globalization, stoking fears of a new **imperialism** and significant countertendencies, from the protests of the anti-globalization movement to forms of economic or cultural protectionism as different ethnic or national communities seek to protect their indigenous culture and ways of life. Rather than a more cooperative world order, contemporary globalization, in many respects, has exacerbated existing tensions and conflicts, generating new divisions and insecurities, creating a potentially more unruly world. More recently it is associated with a historic power shift in world politics since it has been the critical factor in propelling China, India, and Brazil to the rank of major economic powers. This power transition is eroding several centuries of Western dominance of the global order. The emergence of the G20, as opposed to the **G8**, as the key global arena in which global responses to the 2008 financial crisis were coordinated, attests to the dramatic redistribution of economic power consequent upon the most recent phase of globalization.

By comparison with previous periods, contemporary globalization combines a remarkable confluence of dense patterns of global interconnectedness, alongside their unprecedented **institutionalization** through new global and regional infrastructures of control and communication, from the **World Trade Organization** (WTO) to transnational corporations. In nearly all domains contemporary patterns of globalization have not only surpassed those of earlier epochs, but also displayed unparalleled qualitative differences—that is in terms of how globalization is organized and managed. The existence of new real-time global communications infrastructures, in which the world literally is transformed into a single social space, distinguishes very clearly contemporary globalization from that of the past. In these respects it is best described as a thick form of globalization or globalism (Held, McGrew *et al.* 1999; Keohane and Nye 2003).

As such, thick globalization delineates the set of constraints and opportunities that confront governments, conditioning their freedom of action or autonomy, most especially in the economic realm. For instance, the unprecedented scale of global financial flows at over $2 trillion per day imposes a significant discipline on any government, even the most economically powerful, in

Box 1.5 The engines of globalization

Explanations of globalization tend to focus on three interrelated factors: technics (technological change and social organization); economics (markets and capitalism); and politics (power, interests, and institutions).

Technics is central to any account of globalization since it is a truism that without modern communications infrastructures, in particular, a global system or worldwide economy would not be possible.

Economics—crucial as technology is, so too is its specifically economic logic. Capitalism's insatiable requirement for new markets and profits leads inevitably to the globalization of economic activity.

Politics—shorthand here for ideas, interests, and power—constitutes the third logic of globalization. If technology provides the physical infrastructure of globalization, politics provides its normative infrastructure. Governments, such as those of the USA and the UK, have been critical actors in nurturing the process of globalization.

Box 1.6 The three waves of globalization

Globalization is not a novel phenomenon. Viewed as a secular historical process by which human civilizations have come to form a single world system, it has occurred in three distinct waves.

In the first wave, the age of discovery (1450–1850), globalization was decisively shaped by European expansion and conquest.

The second wave (1850–1945) evidenced a major expansion in the spread and entrenchment of European empires.

By comparison, contemporary globalization (1960 on) marks a new epoch in human affairs. Just as the Industrial Revolution and the expansion of the West in the nineteenth century defined a new age in world history, so today the microchip and the satellite are icons of a globalized world order. It is also associated with a shift in economic power from the West to the East with the rise of China and India.

the conduct of national economic policy. Thick globalization embodies a powerful systemic logic that constitutes the circumstances in which states operate and thereby the limits to state power. It therefore has significant consequences for how we understand world politics.

Key Points

- Economic globalization may be at risk as a result of the 2008 financial crisis, but the contemporary phase of globalization has proved more robust than the sceptics recognize.
- Contemporary globalization is a multidimensional, uneven, and asymmetrical process.
- Contemporary globalization is best described as a thick form of globalization or globalism.

A world transformed: globalization and distorted global politics

Consider a political map of the world: its most striking feature is the division of the entire earth's surface into almost 200 neatly defined territorial units, namely sovereign states. To a student of politics in the Middle Ages a map of the world dominated by borders and boundaries would make little sense. Historically, borders are a relatively recent invention, as is the idea that states are sovereign, self-governing, territorially delimited political communities or polities. Although today a convenient fiction, this presumption remains central to orthodox state-centric conceptions of world politics as the pursuit of power and interests between sovereign states. Globalization, however, calls this state-centric conception of world politics into question. Taking globalization seriously therefore requires a conceptual shift in the way we think about world politics.

The Westphalian Constitution of world order

The Peace Treaties of Westphalia and Osnabruck (1648) established the legal basis of modern statehood and by implication the fundamental rules or constitution of modern world politics. Although Pope Innocent referred to the Westphalian settlement at the time as 'null, reprobate and devoid of meaning for all time', in the course of the subsequent four centuries it has formed the normative structure or constitution of the modern world order. At the heart of the Westphalian settlement was agreement among Europe's rulers to recognize each other's right to rule their own territories free from outside interference. This was codified over time in the doctrine of sovereign statehood. But it was only in the twentieth century, as global empires collapsed, that sovereign statehood and with it national **self-determination** finally acquired the status of universal organizing principles of world order. Contrary to Pope Innocent's desires, the Westphalian Constitution by then had come to colonize the entire planet.

Constitutions are important because they establish the location of legitimate political authority within a

Box 1.7 The Westphalian Constitution of world politics

1. **Territoriality**: humankind is organized principally into exclusive territorial (political) communities with fixed borders.
2. **Sovereignty**: within its borders the state or government has an entitlement to supreme, unqualified, and exclusive political and legal authority.
3. **Autonomy**: the principle of self-determination or self-governance constitutes countries as autonomous containers of political, social, and economic activity in that fixed borders separate the domestic sphere from the world outside.

polity and the rules that inform the exercise and limits of political power. In codifying and legitimating the principle of sovereign statehood, the Westphalian Constitution gave birth to the modern states-system. It welded the idea of **territoriality** with the notion of legitimate sovereign rule. Westphalian sovereignty located supreme legal and political authority within territorially delimited states. Sovereignty involved the rightful entitlement to exclusive, unqualified, and supreme rule within a delimited territory. It was exclusive in so far as no ruler had the right to intervene in the sovereign affairs of other nations; unqualified in that within their territories rulers had complete authority over their subjects; and supreme in that there was no legal or political authority beyond the state. Of course for many, especially weak states, sovereignty—as the legitimate claim to rule—has not always translated into effective control within their territories. As Krasner recognizes, the Westphalian system has for many states been little more than a form of 'organized hypocrisy' (Krasner 1999). Nevertheless this never fundamentally compromised its influence upon the developmental trajectory of world politics. Although the UN Charter and the Universal Declaration of Human Rights modified aspects of the Westphalian Constitution, in qualifying aspects of **state sovereignty**, it remains the founding covenant of world politics. However, many argue that contemporary globalization presents a fundamental challenge to the Westphalian ideal of sovereign statehood and in so doing is transforming world order.

From (state-centric) geopolitics to (geocentric) global politics

As globalization has intensified over the last five decades, it has become increasingly difficult to maintain the popular fiction of the 'great divide': treating political life as having two quite separate spheres of action, the domestic and the international, which operate according to different logics with different rules, actors, and agendas. There is a growing recognition that, as former President Clinton described it:

> the once bright line between domestic and foreign policy is blurring. If I could do anything to change the speech patterns of those of us in public life, I would like almost to stop hearing people talk about foreign policy and domestic policy, and instead start discussing economic policy, security policy, environmental policy.
>
> *(Quoted in Cusimano 2000: 6)*

Box 1.8 The post-Westphalian order

Territoriality
Borders and territory still remain politically significant, not least for administrative purposes. Under conditions of globalization, however, a new geography of political organization and political power (from transgovernmental networks to regional and global bodies) is emerging that transcends territories and borders.

State sovereignty
The sovereign power and authority of national government—the entitlement of states to rule within their own territorial space—is being transformed but not necessarily eroded. Sovereignty today is increasingly understood as the shared exercise of public power and authority between national, regional, and global authorities.

State autonomy
In a more interdependent world, simply to achieve domestic objectives national governments are forced to engage in extensive multilateral collaboration and co-operation. But in becoming more embedded in systems of global and regional governance, states confront a real dilemma: in return for more effective public policy and meeting their citizens' demands, whether in relation to transnational terrorism, the drugs trade or the financial crisis, their capacity for self-governance—that is state autonomy—is compromised.

As the substantive issues of political life consistently ignore the artificial foreign/domestic divide, from the worldwide coordination of anti-globalization protests to national courts enforcing the rulings of the World Trade Organization, the Westphalian Constitution appears increasingly anachronistic. A post-Westphalian world order is emerging, and with it a distinctive form of **global politics**.

To talk of global politics is to recognize that politics itself is being globalized, with the consequence that there is much more to the study of world politics than conflict and cooperation between states, even if this remains crucial. In other words, globalization challenges the one-dimensionality of orthodox accounts of world politics that conceive it principally in state-centric terms of geopolitics and the struggle for power between states. By contrast, the concept of global politics focuses our attention upon the global structures and processes of rule-making, problem-solving, the maintenance of security and order in the world system (Brown 1992). It acknowledges the continuing centrality of states and geopolitics, but does not *a priori* privilege either in understanding and explaining contemporary world affairs. For under conditions of political globalization, states

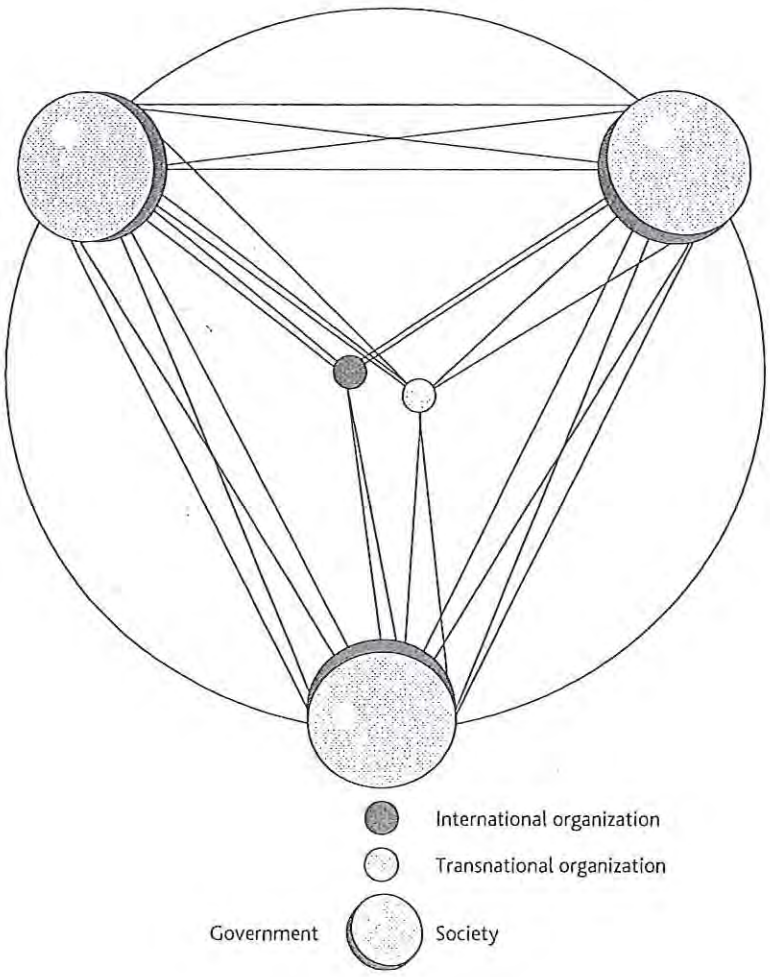
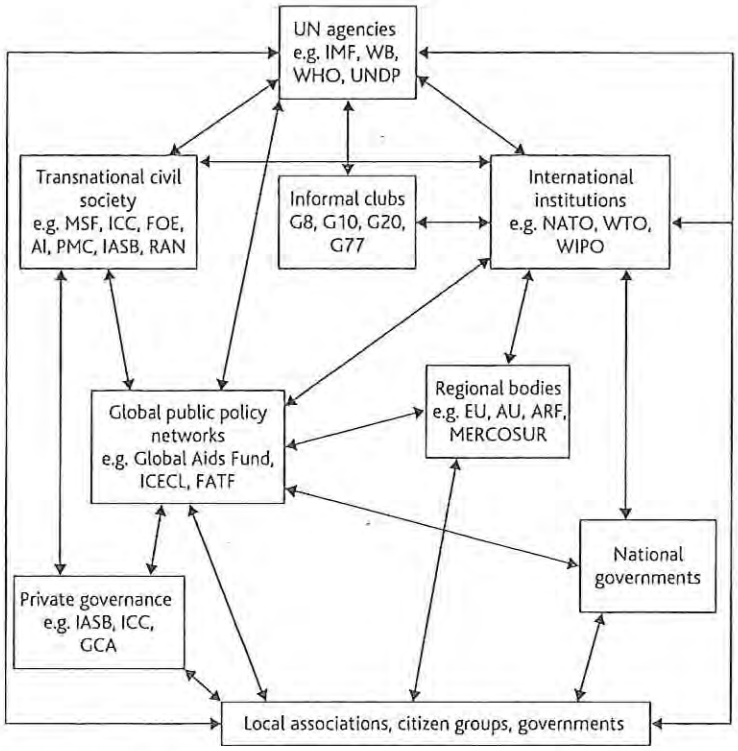


Figure 1.1 The World Wide Web

are increasingly embedded in thickening and overlapping worldwide webs of: multilateral institutions and multilateral politics from NATO and the World Bank to the G20; transnational associations and networks, from the International Chamber of Commerce to the World Muslim Congress; global policy networks of officials, corporate and non-governmental actors, dealing with global issues, such as the Global AIDS Fund and the Roll Back Malaria Initiative; and those formal and informal (transgovernmental) networks of government officials dealing with shared global problems, including the Basle Committee of central bankers and the Financial Action Task Force on money-laundering (Fig. 1.1).

Global politics directs our attention to the emergence of a fragile global polity within which 'interests are articulated and aggregated, decisions are made, values allocated and policies conducted through international or transnational political processes' (Ougaard 2004: 5). In other words, to how the global order is, or fails to be, governed.

Since the UN's creation in 1945, a vast nexus of global and regional institutions has developed, increasingly linked to a proliferation of non-governmental agencies and networks seeking to influence the governance of global affairs. While world government remains a fanciful idea, an evolving global governance complex exists—embracing states, international institutions, transnational networks and agencies (both public and private)—that functions, with variable effect, to promote, regulate, or intervene in the common affairs of humanity (Fig. 1.2). Over the last five decades, its scope and impact have expanded dramatically, with the result that its activities have become significantly politicized, as the G20 London Summit and recent Copenhagen Summit on Climate Change attest.



KEY:

AI	Amnesty International
ARF	ASEAN Regional Forum
AU	African Union
EU	European Union
FATF	Financial Action Task Force (on money-laundering)
FOE	Friends of the Earth
G8	Group of 8 (USA, Italy, UK, France, Germany, Russia, Canada, Japan & EU)
G10	Group of 10 (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, UK, USA).
G20	Brings together the major Western governments and the governments of the leading emerging economies, including Brazil, China, India and Russia
G77	Group of 77 developing countries
GCA	Global credit agencies, e.g. Moody's, Standard and Poor's
IASB	International Accounting Standards Board
ICC	International Chamber of Commerce
ICECL	International Convention on the Elimination of Child Labour
IMF	International Monetary Fund
MERCOSUR	Southern American Common Market
MSF	Médecins sans Frontierès
NATO	North Atlantic Treaty Organization
PMC	Private military companies, e.g. Sandline
RAN	Rainforest Action Network
UNDP	UN Development Programme
WB	World Bank
WHO	World Health Organization
WIPO	World Intellectual Property Rights Organization
WTO	World Trade Organization

Figure 1.2 The global governance complex

This evolving global governance complex comprises the multitude of formal and informal structures of political coordination among governments, intergovernmental and transnational agencies—public and private—designed to realize common purposes or collectively agreed goals through the making or implementing of global or transnational rules, and the regulation of transborder problems. A good illustration of this is the creation of international labour codes to protect vulnerable workers. The International Convention on the Elimination of Child Labour (ICECL), for instance, was the product of a complex politics involving public and private actors from trade unions, industrial associations, humanitarian groups, governments, legal experts, not forgetting officials and experts within the International Labour Organization (ILO).

Within this global governance complex, private or non-governmental agencies have become increasingly influential in the formulation and implementation of global public policy. The International Accounting Standards Board establishes global accounting rules, while the major credit-rating agencies, such as Moody's and Standard and Poor's, determine the credit status of governments and corporations around the globe. This is a form of private global governance in which private organizations regulate, often in the shadow of global

public authorities, aspects of global economic and social affairs. In those realms in which it has become highly significant, mainly the economic and the technological, this private global governance involves a relocation of authority from states and multilateral bodies to non-governmental organizations and private agencies.

Coextensive with the global governance complex is an embryonic **transnational civil society**. In recent decades a plethora of NGOs, transnational organizations (from the International Chamber of Commerce, international trade unions, and the Rainforest Network to the Catholic Church), advocacy networks (from the women's movement to Nazis on the net), and citizens' groups have come to play a significant role in mobilizing, organizing, and exercising political power across national boundaries. This has been facilitated by the speed and ease of modern global communications and a growing awareness of common interests between groups in different countries and regions of the world. At the 2006 Ministerial Meeting of the WTO in Hong Kong, the representatives of environmental, corporate, and other interested parties outnumbered the formal representatives of government. Of course, not all the members of transnational civil society are either civil or representative; some seek to further dubious, reactionary, or even criminal causes while many lack effective accountability. Furthermore, there are considerable inequalities between the agencies of transnational civil society in terms of resources, influence, and access to key centres of global decision-making. Multinational corporations, like Rupert Murdoch's News International, have much greater access to centres of power, and capacity to shape the global agenda, than does the Rainforest Action Network.

If global politics involves a diversity of actors and institutions, it is also marked by a diversity of political concerns. The agenda of global politics is anchored not just in traditional geopolitical concerns but also in a proliferation of economic, social, cultural, and ecological questions. Pollution, drugs, human rights, and terrorism are among an increasing number of transnational policy issues that, because of globalization, transcend territorial borders and existing political jurisdictions, and thereby require international cooperation for their effective

Case Study 2 Security and violence in global politics



Paradoxically, the same global infrastructures that make it possible to organize production on a worldwide basis can also be exploited to lethal effect. National security increasingly begins abroad, not at the border, since borders are as much carriers as barriers to transnational organized violence. This has become increasingly evident in relation to 'new wars'—complex irregular warfare in the global South. Inter-state war has been almost entirely supplanted by intra-state and trans-state conflict located in the global South, or on the perimeters of the West. These so-called 'new wars' are primarily located in weak states and rooted in identity politics, local conflicts, and rivalries. They involve complex irregular warfare between military, para-military, criminal, and private forces that rages through, but often around and across, state borders with little discrimination between civilians and combatants. The United Nations estimates, for instance, that thirty-five people die every hour across the globe as a consequence of irregular armed conflict. These 'new wars', whether in Bosnia, Darfur, or Venezuela, are curiously modern since they are sustained largely by the capacity of combatants to exploit global networks to provide finance, arms, *émigré* support, or aid, as well as to facilitate profiteering, racketeering, and shadow economies, such as the diamond or drugs trade, which pays for arms and influence. Despite their apparently localized quality, 'new wars' are in fact a manifestation of the contemporary globalization of organized violence. Disorder in one part of the world (as in Darfur in 2006, or in Kosovo and Somalia in the 1990s) combines with global media coverage and the speed of travel to feed insecurity, creating overlapping global security complexes. These complexes bind together the security of societies across the North–South divide. They also highlight a major disjuncture between the distribution of formal military power and the distribution of effective coercive power in the world today. Al Qaeda, the Triads, private military companies, drug cartels, narco-terrorism, and the illicit global arms trade are all examples of the growth of informal organized violence or post-international violence. They pose, as Keohane starkly notes, a profound challenge since 'States no longer have a monopoly on the means of mass destruction: more people died in the attacks on the World Trade Center and the Pentagon than in the Japanese attack on Pearl Harbor in 1941'.

(Keohane 2002: 284)

resolution. Politics today is marked by a proliferation of new types of 'boundary problem'. In the past, of course, nation-states principally resolved their differences over boundary matters by pursuing reasons of state backed by diplomatic initiatives and, ultimately, by coercive means. But this militaristic logic appears singularly inadequate and inappropriate to resolve the many complex issues, from economic regulation to resource depletion and environmental degradation to chemical weapons proliferation, which engender—at seemingly ever greater speeds—an intermeshing of 'national fortunes'.

This is not to argue that the sovereign state is in decline. The sovereign power and authority of national government—the entitlement of states to rule within their own territorial space—is being transformed but by no means eroded. Locked into systems of global and regional governance, states now assert their sovereignty less in the form of a legal claim to supreme power than as a bargaining tool, in the context of transnational systems of rule-making, with other agencies and social forces. Sovereignty is bartered, shared, and divided among the agencies of public power at different levels, from the local to the global. The Westphalian conception of sovereignty as an indivisible, territorially exclusive form of public power is being displaced by a new sovereignty regime, in which sovereignty is understood as the shared exercise of public power and authority. In this respect we are witnessing the emergence of a post-Westphalian world order.

Furthermore, far from globalization leading to 'the end of the state', it elicits a more activist state. This is because, in a world of global enmeshment, simply to achieve domestic objectives national governments are forced to engage in extensive multilateral **collaboration** and **cooperation**. But in becoming more embedded in frameworks of global and regional governance, states confront a real dilemma: in return for more effective public policy and meeting their citizens' demands, their capacity for self-governance—that is, **state autonomy**—is compromised. Today, a difficult trade-off is posed between effective governance and self-governance. In this respect, the Westphalian image of the monolithic, unitary state is being displaced by the image of the **disaggregated state** in which its constituent agencies increasingly interact with their counterparts abroad, international agencies, and NGOs in the management of common and global affairs (Slaughter 2004) (Fig. 1.3).

Global politics is a term that acknowledges that the scale of political life has altered fundamentally: politics understood as that set of activities concerned primarily with the achievement of order and justice is not confined within territorial boundaries. It questions the utility of the distinction between the domestic and the foreign, inside and outside the **territorial state**, the national and the international since decisions and actions taken in one region affect the welfare of communities in distant parts of the globe, with the result that domestic politics is internationalized and world politics

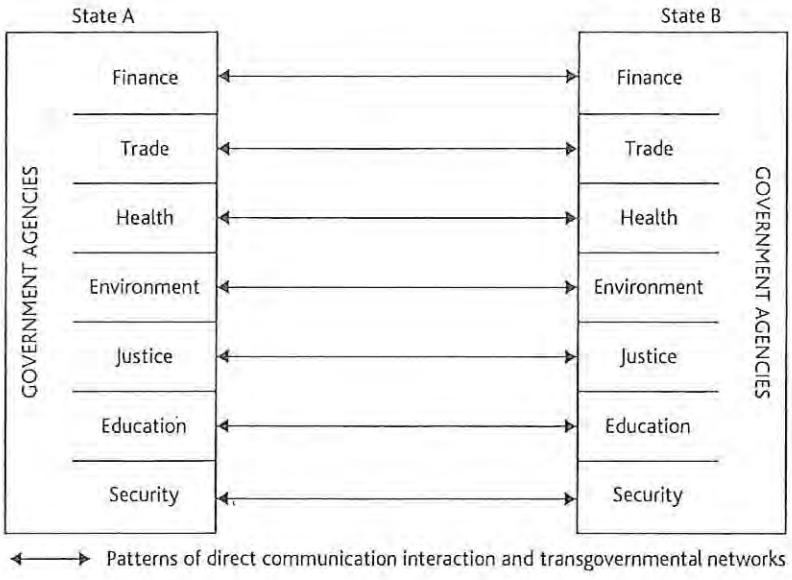


Figure 1.3 The disaggregated state

becomes domesticated. It acknowledges that power in the global system is not the sole preserve of states but is distributed (unevenly) among a diverse array of public and private actors and networks (from international agencies, through corporations to NGOs), with important consequences for who gets what, how, when, and where. It recognizes that political authority has been diffused not only upwards to supra-state bodies, such as the European Union, but also downwards to sub-state bodies, such as regional assemblies, and beyond the state to private agencies, such as the International Accounting Standards Board. It accepts that sovereignty remains a principal juridical attribute of states but concludes that it is increasingly divided and shared between local, national, regional, and global authorities. Finally, it affirms that, in an age of globalization, national polities no longer function as closed systems. On the contrary, it asserts that all politics—understood as the pursuit of order and justice—are played out in a global context.

However, as with globalization, inequality and exclusion are endemic features of contemporary global politics. There are many reasons for this, but three factors in particular are crucial: first, enormous inequalities of power between states; second, global governance is shaped by an unwritten constitution that tends to privilege the interests and agenda of global capitalism; third, the technocratic nature of much global decision-making, from health to security, tends to exclude many with a legitimate stake in the outcomes.

These three factors produce cumulative inequalities of power and exclusion—reflecting the inequalities of power between North and South—with the result that contemporary global politics is more accurately described as distorted global politics: 'distorted' in the sense that inevitably those states and groups with greater power resources and access to key sites of global decision-making tend to have the greatest control or influence over the agenda and outcomes of global politics. In short, global politics has few democratic qualities. This sits in tension with a world in which democracy is generally valued. Whether a more democratic or just global politics is imaginable and what it might look like is the concern of normative theorists and is the subject of later chapters in this volume (see Chs 12 and 32).

Key Points

- Globalization is transforming but not burying the Westphalian ideal of sovereign statehood. It is producing the disaggregated state.
- Globalization requires a conceptual shift in our thinking about world politics from a principally state-centric perspective to the perspective of geocentric or global politics—the politics of worldwide social relations.
- Global politics is more accurately described as distorted global politics because it is afflicted by significant power asymmetries.

Conclusion

This chapter has sought to elucidate the concept of globalization and identify its implications for the study of world politics. It has argued that globalization reconstructs the world as a shared social space. It does so, however, in a far from uniform manner: contemporary globalization is highly uneven—it varies in its intensity and extensity between different spheres of activity; it is highly asymmetrical; and it embodies a highly unequal geography of global inclusion and exclusion. In doing so it is as much a source of conflict and violence as of cooperation and harmony in world affairs.

In focusing upon the consequences of globalization for the study of international relations, this chapter has argued that it engenders a fundamental shift in the constitution of world politics. A post-Westphalian world order is in the making as sovereign statehood is transformed by the dynamics of globalization. A conceptual shift in our thinking is therefore required: from international (inter-state) politics to global politics—the politics of state and non-state actors within a shared global social space. Global politics is imbued with deep inequalities of power such that in its current configuration it is more accurately described as distorted global politics: a politics of domination, contestation, and competition between powerful states and transnational social forces.

Questions

1 Distinguish the concept of globalization from that of regionalization and internationalization.
2 What do you understand by the Westphalian Constitution of world order?
3 Why is global politics today more accurately described as distorted global politics?
4 Outline the principal causes of globalization.
5 Review the sceptical argument and critically evaluate it.
6 What are the principal characteristics of the post-Westphalian order?
7 Identify some of the key elements of political globalization.
8 What do you understand by the term 'global governance complex'?
9 Distinguish the concept of global politics from that of geopolitics and international (inter-state) politics.
10 Is the state being eclipsed by the forces of globalization and global governance?
11 Why is globalization associated with the rise of new powers such as China and India?

Further Reading

Castells, M. (2000), *The Rise of the Network Society* (Oxford: Blackwell). This is a now contemporary classic account of the political economy of globalization that is comprehensive in its analysis of the new global informational capitalism.

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James, H. (2009), *Creation and Destruction of Value* (Boston, MA: Harvard University Press). The first serious study from a renowned economic historian to explore the comparisons between the collapse of globalization and world order in the 1930s and the prospects for globalization in the aftermath of the 2008 global financial crisis.

Kennedy, P., et al. (2002), *Global Trends and Global Governance* (London: Pluto Press). A good introduction to how globalization is reshaping world politics and the nature of global governance.

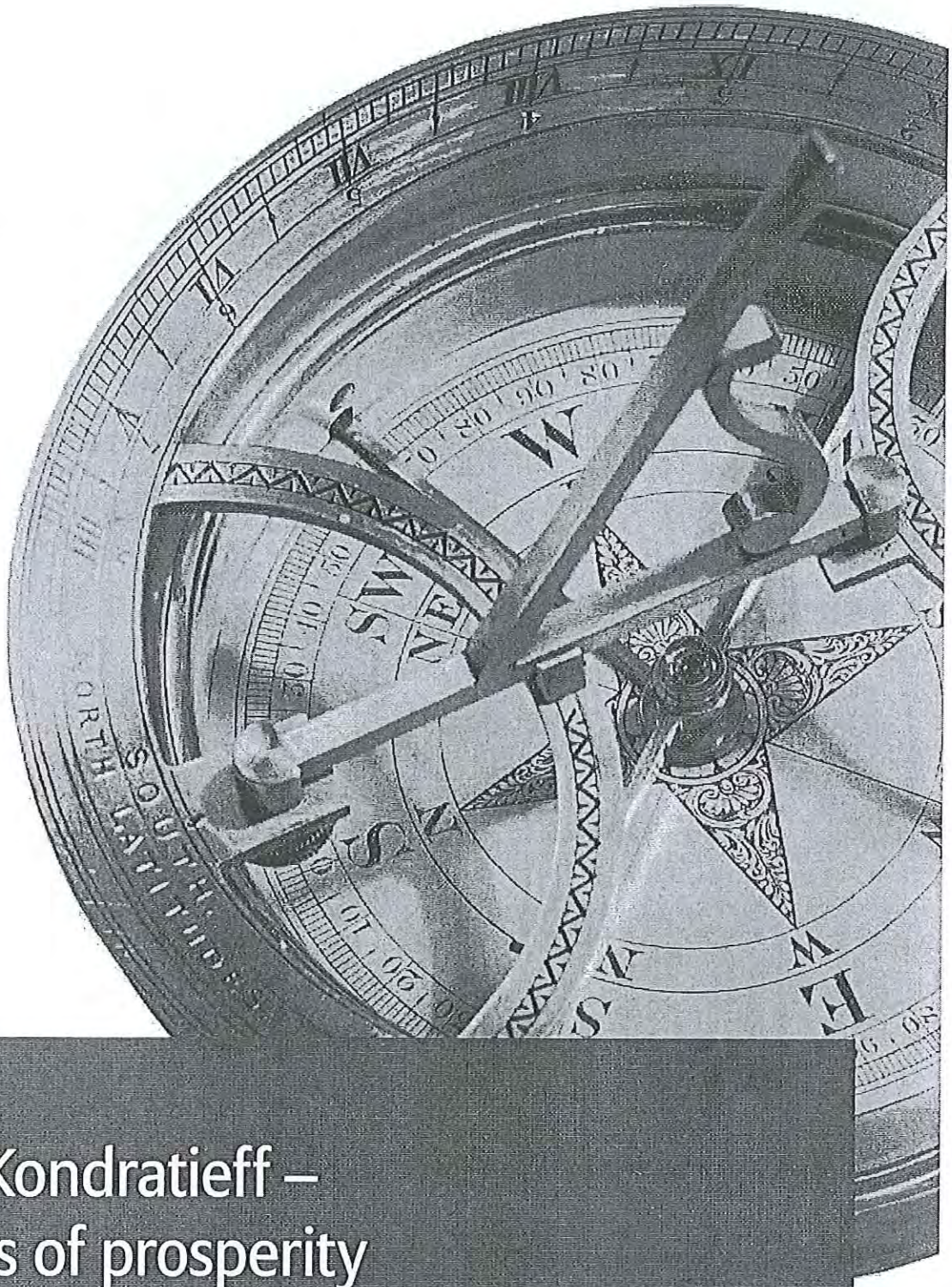
Rosenberg, J. (2005) 'Globalization Theory: A Post Mortem'. *International Politics* **42**(2): 2–74. A very influential essay that delivers a substantive Marxist critique of the transformationalist account of globalization.

Scholte, J. A. (2005), *Globalization—A Critical Introduction*, 2nd edn (Basingstoke: Palgrave Macmillan). An excellent introduction to the globalization debate from its causes to its consequences for the global political economy from within a critical political-economy perspective.

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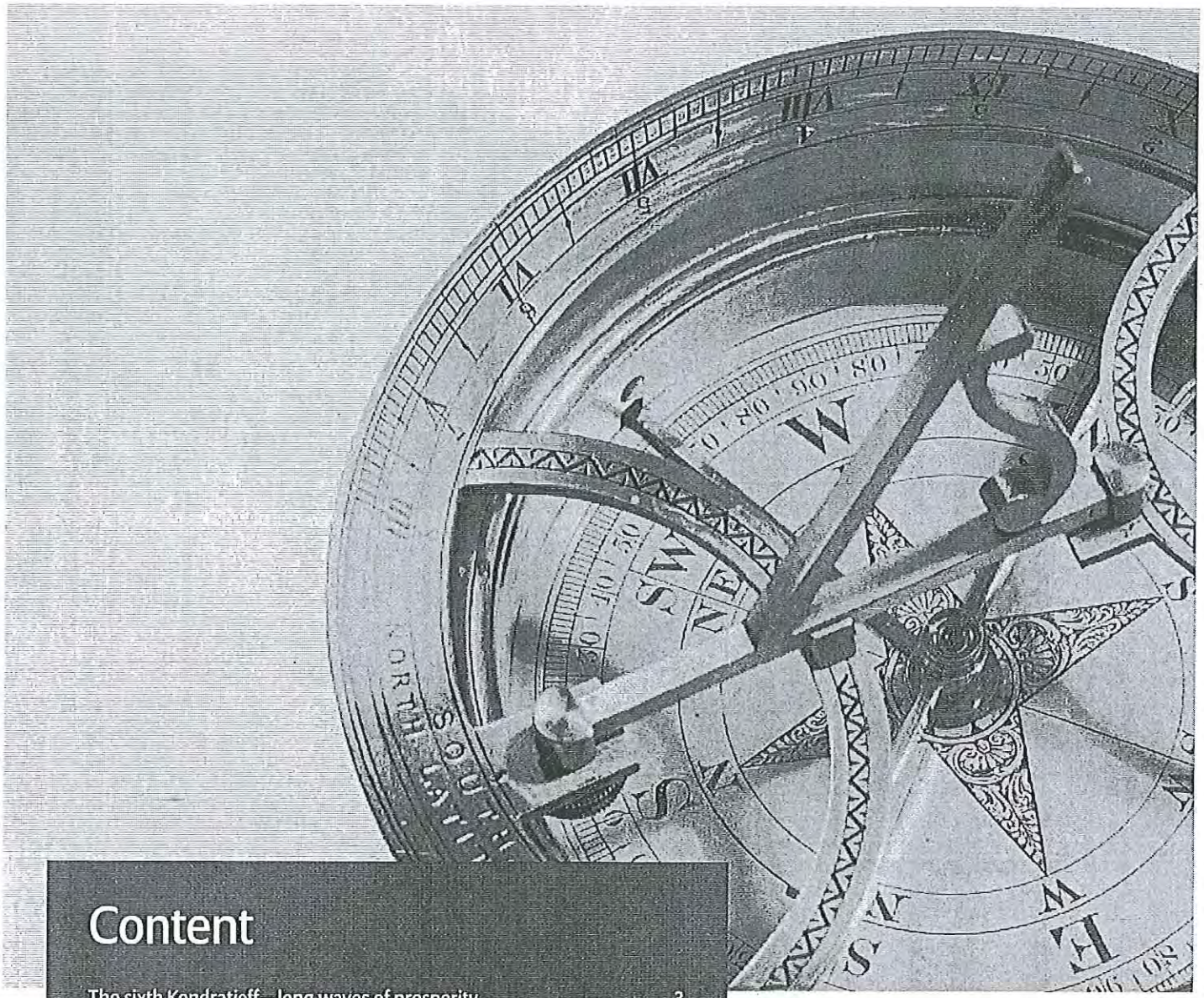


Analysis & Trends

The sixth Kondratieff – long waves of prosperity

January 2010

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Content

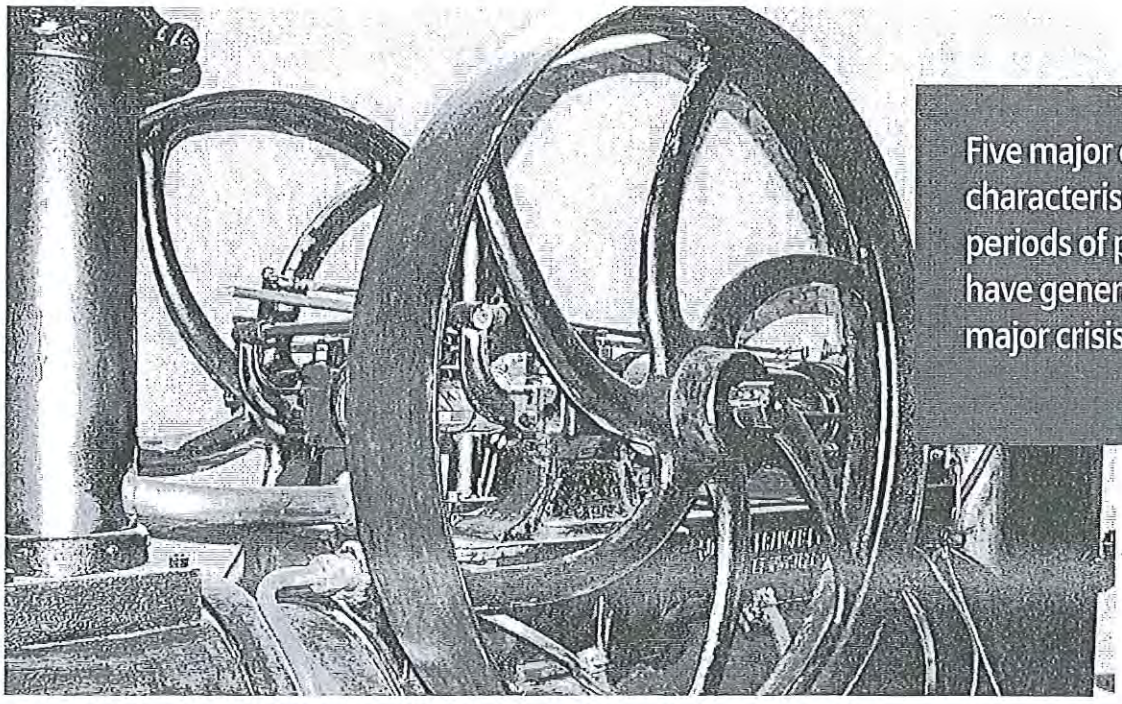
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The sixth Kondratieff – long waves of prosperity

From the invention of the steam engine to the internet, the last 200 years the economy has gone through five long (Kondratieff-)waves. Many investors are now asking whether the environment, biotechnology and health sectors serve as the economic engines of the future and put us back on a path of sustainable growth?

From the invention of the steam engine in the 18th century, the railway and the electrification of the 19th century, to the automobile and the development of the information society in the 20th century, the economy has gone through five long waves. Five major economic cycles, characterised by long periods of prosperity which have generally ended in a major crisis. Many investors are now wondering whether the current financial crisis could mark the beginning of a new cycle of prosperity. Will the environment, biotechnology and health sectors serve as the economic engines of the future and put us back on a path of sustainable growth?

Listening instead of reading: The study is also available as a three-part podcast under: www.allianzgi.de/capital-marketanalysis



Five major economic cycles, characterised by long periods of prosperity which have generally ended in a major crisis.

Summa Oeconomica

- The recent financial crisis could mark a period of upheaval and the beginning of the sixth Kondratieff cycle. Kondratieff lists four main characteristics of changes that lead to a new Kondratieff cycle. All seem to apply to the current financial and economic crisis:
  1. Potential for further exploitation of an old basic innovation is exhausted (cycle of around 40-60 years)
  2. High level of excess financial capital (versus physical capital)
  3. Period of severe recession (period of radical change)
  4. Social/institutional transformations

- In the search for the drivers of the 6th Kondratieff cycle, a distinction should be drawn between two sources:
  - Future megatrends, such as globalisation and demographics, that lead to shifts in demand and
  - Trends and innovations that change the supply structure in the economy, such as environmental technology, biotechnology and nanotechnology or holistic health.

- In the wake of ongoing globalisation and world population growth, the centre of gravity of the 21st century seems likely to shift increasingly to Asia.

- The path of the developed countries towards a knowledge economy seems already to have been mapped out so that they should play leading roles in the 6th Kondratieff cycle.

- While in the previous Kondratieff cycle the information age led to a tremendous increase in labour productivity, the key to a strong and sustainable economy in the next long cycle seems to lie in an increase in the productivity of resources and energy. Growth will probably continue to be generated from a new mix of economics, ecology and social commitment. A structural change in the economy that we called „Eco-Trends".

- The areas of nanotechnology and biotechnology are of interest in terms of increasing the productivity of resources and energy in the 6th Kondratieff cycle. Both of these segments could play major roles in the new structural cycle by using new materials (and/or properties of materials) and new processes to make many sectors more environmentally friendly through the use of fewer resources and less energy.

- In addition to the biotechnology sector, the healthcare sector could also be an important engine for economic growth in the 6th Kondratieff cycle. Health is now viewed less as a "condition" than as a resource and less as a cost factor than as a driver for economic growth and employment. As a result of this paradigm shift, the economic significance of the industry is expected to continue to grow.

Kondratieff cycles

A name one encounters again and again when investigating the emergence of long-term (structural) cycles is that of the economist Nikolai Kondratieff. He observed long-term economic fluctuations in cycles of 40 to 60 years (so-called Kondratieff waves). According to his theory, these cycles begin with technological innovations, which then become the cornerstones of a prolonged economic upturn. Provided, that is, that these so-called basic innovations permeate virtually all sectors of the economy and trigger new bursts of productivity throughout the entire economy. From the industrial revolution at the end of the 18th century until today, there have been five Kondratieff cycles:

Kondratieff cycles	1st Kondratieff	2nd Kondratieff	3rd Kondratieff	4th Kondratieff	5th Kondratieff
Period	1780–1830	1830–1880	1880–1930	1930–1970	1970 to today
Invention	Steam engine	Railway, steel	Electrification, chemicals	Automobiles, petrochemicals	Information technology, communications technology
Area of application	Clothing	Mass transportation	Mass production	Individual mobility	Information and communication

Source: L. A. Nefiodow, "Der Sechste Kondratieff" ["The Sixth Kondratieff"], 2006; Table: Allianz Global Investors Capital Market Analysis

These cycles marked times of enormous change, five long cycles in which technological networks transformed entire societies:

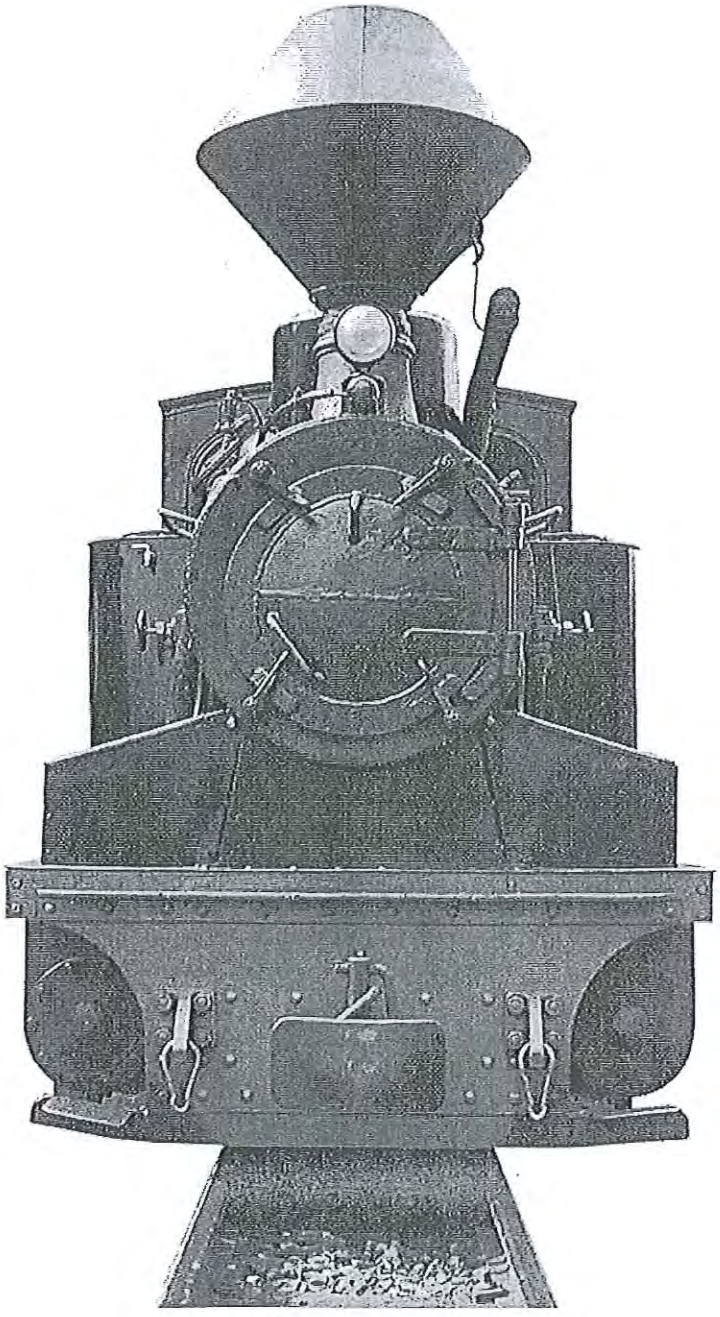
- Old industries were replaced by new ones,
- Corporate cultures and processes changed,
- New professions emerged,
- Extended periods of long-term economic growth resulted,
- Typically associated with rising equity markets.

In the most recent long-term cycle, the PC and the Internet have driven radical changes in many aspects of daily life and of work.

The financial markets, which have just brought about the end of a cycle through excessive speculation and inflated asset prices, will serve as the accelerator of the new upturn.

The financial crisis – the beginning of the sixth Kondratieff?

At the beginning of a new Kondratieff cycle, entrepreneurs usually require a considerable amount of capital to buy the steam engine, the (delivery) vehicle or the IT system. Higher interest rates are not an obstacle here, as entrepreneurs increase their earnings by implementing more productive systems. But after many years, the new technology networks begin to offer diminishing returns on investment. As a result, the demand for credit grows more slowly, and (real) interest



rates move toward zero in the end. This was the case in the Panic of 1837, the Long Depression of 1873, the Great Depression triggered in 1929 and the oil crises of 1974 and 1980. And it was also observed in the collapse of the TMT bubble and the recent financial crisis.

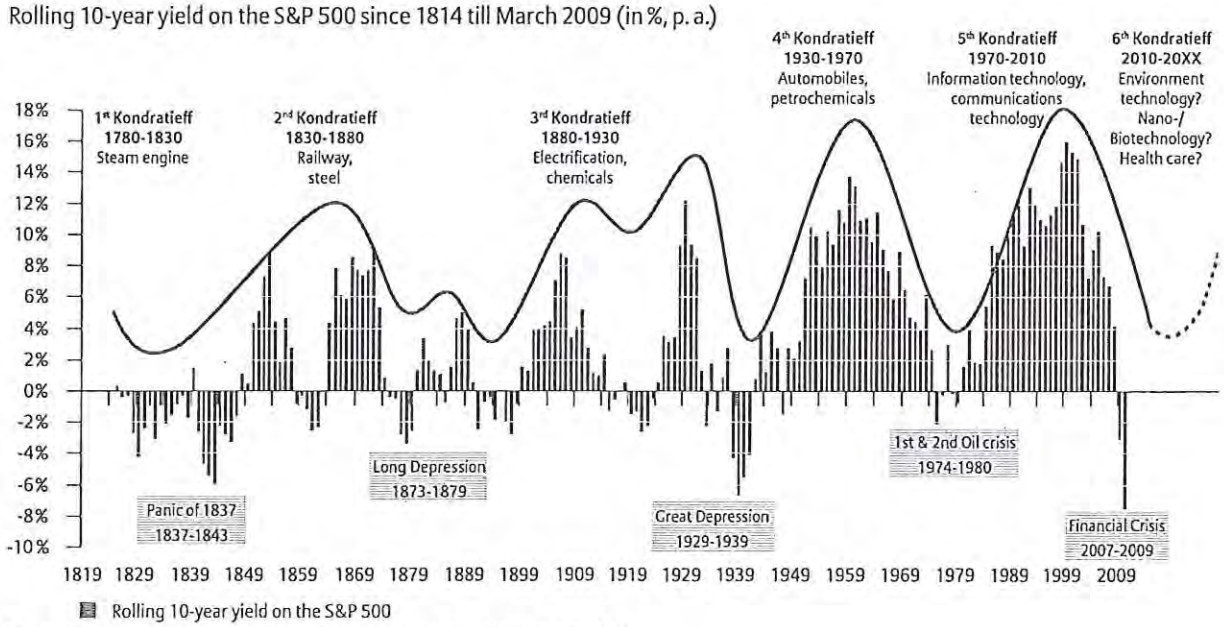
Kondratieff lists four main characteristics of changes that lead to a new Kondratieff cycle:

1. Potential for further exploitation of an old basic innovation is exhausted (cycle of around 40-60 years)
2. High level of excess financial capital (versus physical capital)
3. Period of severe recession (period of radical change)
4. Social/institutional transformations

Interestingly, a close examination shows that all four of the criteria marking the process of the reorientation of the economy seem to apply to the current financial and economic crisis:

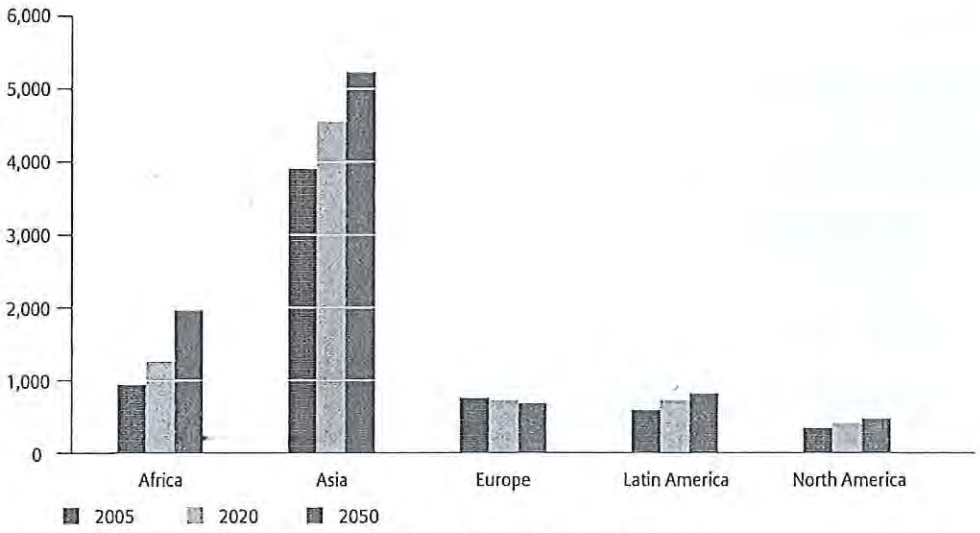
- The surge in productivity that had its origin in the invention of Konrad Zuse's „Z3" computer in 1941 appears to be slowly coming to an end. Work processes are not made much more productive by an even faster notebook computer. The Internet has already achieved considerable penetration.
- Similarly, until 2007, before the outbreak of the financial crisis, there was a substantial surplus of financial capital in the economy. The expansion of the credit (derivatives) economy put too much money into a small segment of the real economy. With the dominance of financial capital over the physical capital (sum of property, plant and equipment) investors sought returns in investment alternatives, which they primarily found in loans on U.S. real estate and in financial derivatives.
- The result was a financial crisis that became a global economic crisis, the likes of which had not been seen since 1930. The 9th of March 2009 was a historic day for investors – in a negative sense. On that day, U.S. share prices as measured by the S&P 500 not only hit their low point, but the 10-year performance of the U.S. equity index, with an average return of -8% p. a., also hit its lowest level in 200 years (see Figure 1).
- Work is now underway on the creation of a new global financial regulatory architecture that is intended to form the basis for a sustainable economic and financial system.

Figure 1: Kondratieff cycles – long waves of prosperity.
Rolling 10-year yield on the S&P 500 since 1814 till March 2009 (in %, p. a.)



Source: Datastream; Illustration: Allianz Global Investors Capital Market Analysis

Figure 2: Global trend: demography.
Population in millions of people



Source: UN, Population Division; Illustration: Allianz Global Investors Capital Market Analysis

The recent financial crisis could mark a period of upheaval as described by Kondratieff. The 6th Kondratieff cycle has probably already begun, but the main and supporting roles seem not yet to have been assigned.

What happens next? What trends could characterise the upcoming 6th Kondratieff cycle? And how will the foundations being laid today shape our life in the 21st century?

Journey into the future – the trends of tomorrow

In the search for the drivers of the 6th Kondratieff cycle, a distinction should be drawn between two sources:

1. Future megatrends, such as globalisation and demographics, that lead to shifts in demand and
2. Trends and innovations that change the supply structure in the economy, such as environmental technology, biotechnology and nanotechnology or holistic health.

These so-called megatrends and basic innovations must have the potential to influence economics, politics and society, and they must also be capable of boosting productivity in multiple economic sectors at the same time.

Globalisation and demographics: accelerators of change

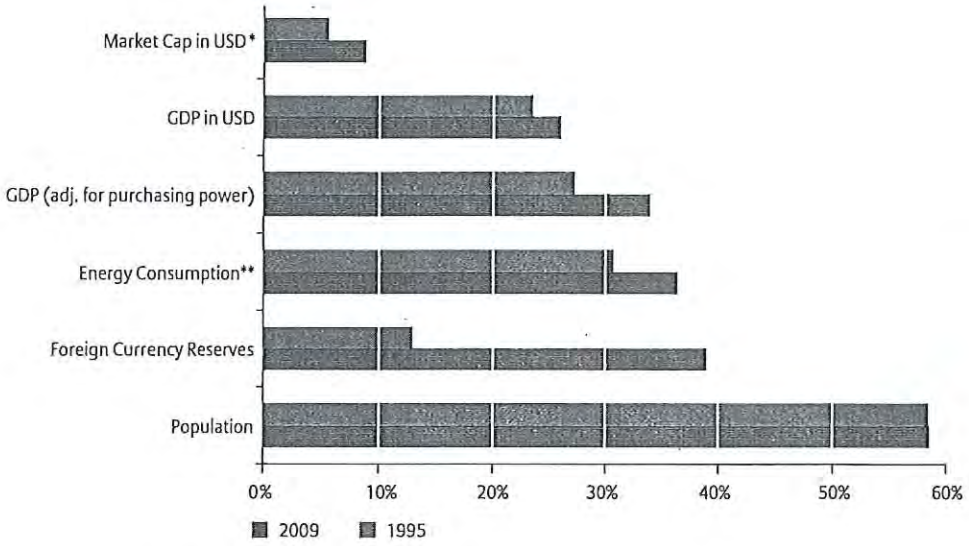
Two candidates for a major role in the next long economic cycle that are expected to result primarily in global shifts in demand have already been identified. Globalisation and demographic change. Both have been having a global impact for some time, but the full scope of their effect will not be seen for years or even decades.

The removal of technological barriers brought about by the Internet has pushed globalisation to an entirely new level. The Internet not only allows goods to be ordered at the press of a button from anywhere on Earth; it also makes the export of services possible. The volume of global trade has now quadrupled since 1987, despite the fact that global economic output (gross domestic product) has only doubled in the same period of time.

While the world is increasingly interconnected, there is also a growing demographic divide. By 2050, the world's population will have grown by about 40% to more than 9 billion people, but populations will shrink and age in half the

A more detailed analysis on the topic of „Demography: a global trend" is available at http://www.allianzgi.de/capitalmarketanalysis under the section Analysis & Trends

Figure 3: Asia's role in the world economy.
Global share of Asia (in %)

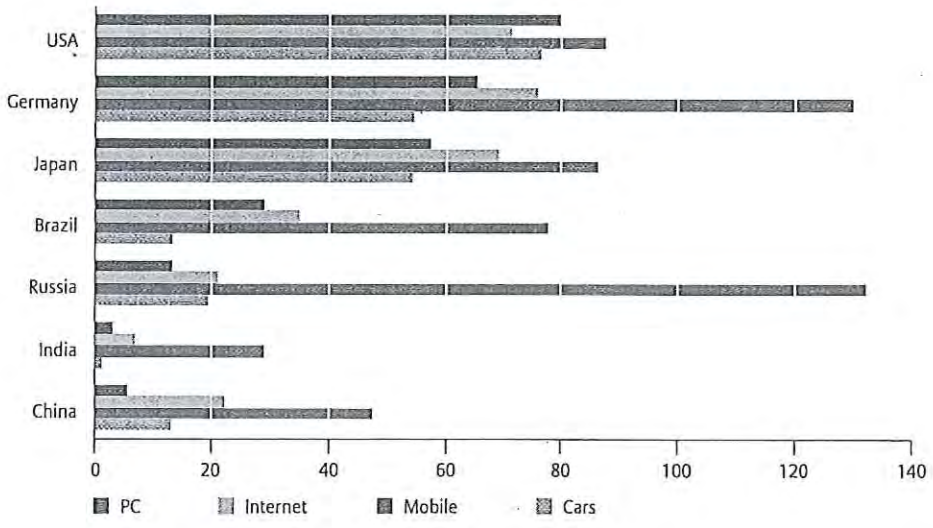


* without Japan; ** Year 2008
Source: MSCI, IWF,UN, BP, Illustration: Allianz Global Investors Capital Market Analysis

world - in developed regions such as Europe and Japan. And in the other half, mainly in emerging countries, the population will continue to grow and will remain relatively young (see Figure 2).

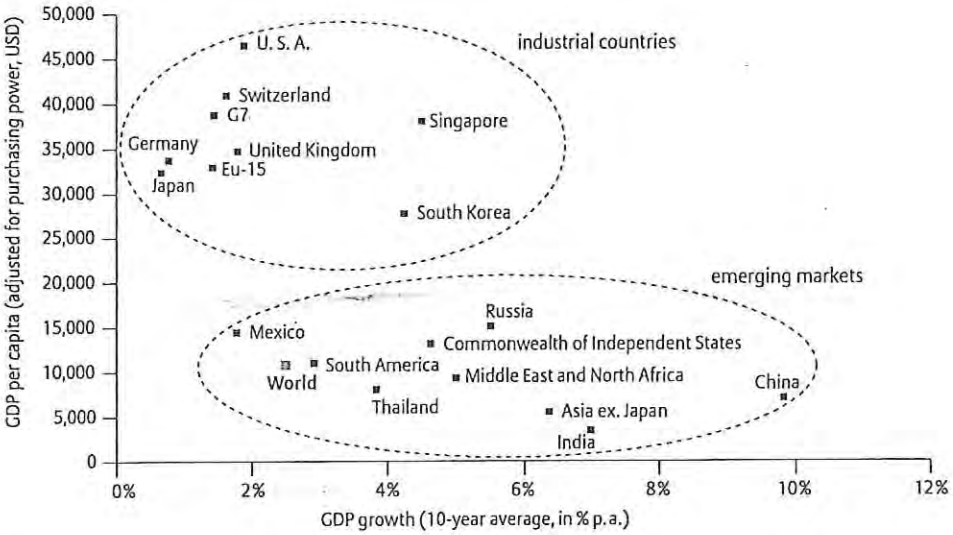
Two other long-term developments can be assumed on the basis of these two megatrends:

Figure 4: Emerging markets still have IT productivity reserves.
Owners/users per 100 inhabitants



Source: International Telecommunication Union, 2009; UN Statistical Yearbook, 2008;
Illustration: Allianz Global Investors Capital Market Analysis

Figure 5: Emerging countries continue to gain ground.
GDP per capita (adjusted for purchasing power, USD) vs. GDP growth (Average 1999 till 2009, in % p. a.)



Source: Datastream; Illustration: Allianz Global Investors Capital Market Analysis

Asia - the centre of gravity in the 21st century

In the wake of ongoing globalisation and world population growth, the centre of gravity of the 21st century seems likely to shift increasingly to Asia. With a population of almost 4 billion people, Asia not only represents around 60% of the world's population, but it holds nearly half of all foreign exchange reserves and now generates about 32% of global value creation, adjusted for purchasing power (see Figure 3). According to estimates by the Asian Development Bank, Asia will account for about 50% of global output by 2050 and China will likely have surpassed the U. S. and Europe in this area. Emerging markets in the middle of the 5th Kondratieff cycle still appear to be tapping into the productivity reserves of information technology. One indication of this is the fact that in China only 5 in 100 inhabitants own a PC and only 22 in 100 have Internet access, while the figures in India are just 3 and 7, respectively. In the U. S. and Germany, in contrast, the penetration rate for PCs stands at 80 and 69, respectively, per 100 inhabitants and 71 and 76, respectively, for Internet access (see Figure 4).

Growing prosperity – a study by the World Bank estimates that by 2030 China and India will make up about 44% of the global middle class – is expected to slowly close this gap. The World Bank assumes that low-income countries will grow twice as fast as high-income countries in the coming decades.

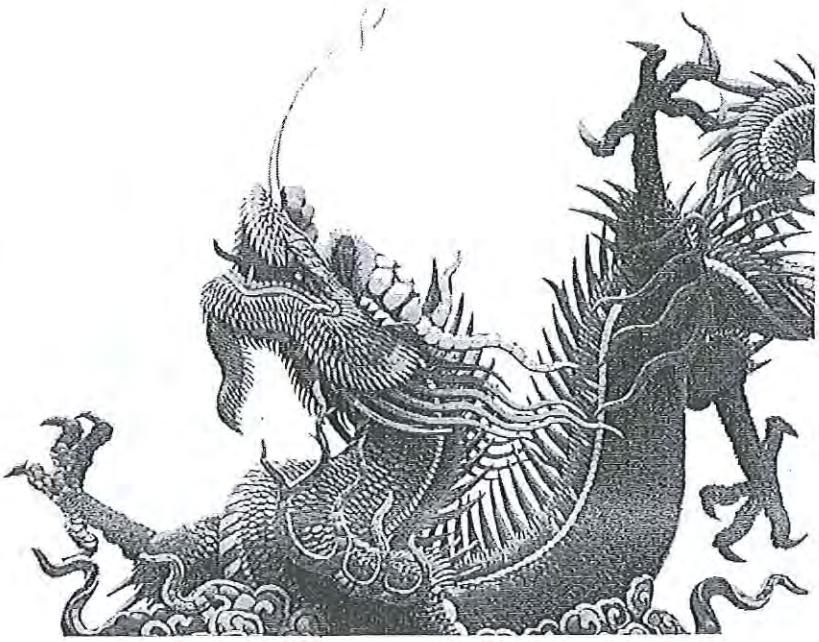
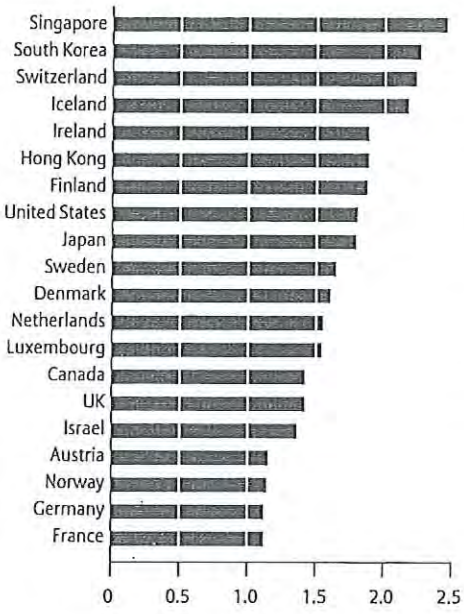


Figure 6: Developed countries still have a „pioneering advantage". Global Innovation Index (2009).



Source: Boston Consulting Group, Global Innovation Report 2009;
Illustration: Allianz Global Investors Capital Market Analysis

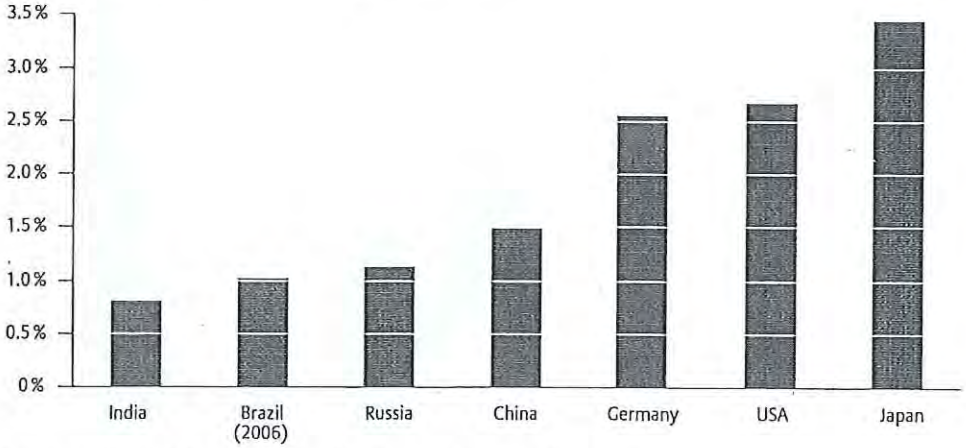
A more detailed analysis on the topic of „Asia on the move – gravitational centre of the 21st century?" is available at http://www.allianzgi.de/capitalmarketanalysis under the section Analysis & Trends

As a result, the demand for commodities in the emerging markets is not only increasing quantitatively because of their rising populations; there is also "qualitative" growth: consumption becomes more commodities-intensive as prosperity increases. At the same time, the supply is limited, meaning that commodities will become an increasingly scarce resource.

Developed countries: nucleus of the 6th Kondratieff cycle?

While the growth in prosperity in the emerging markets has not been very broad thus far, the developed countries seem to have progressed much further along the learning curve of the information age. As mentioned above, the penetration and use of PCs and the Internet is already extensive and the potential for the further exploitation of this basic innovation seems to have been largely exhausted. One indication of this is the fact that with higher per capita incomes, the productivity gains and growth rates in the established countries are significantly lower than in the emerging markets. This means that productivity – measured in terms of economic output per worker – in emerging countries has increased substantially. For example, China has seen output rise fourfold in this period and India has recorded a twofold increase. GDP growth for the group of emerging countries in the last 10 years (1999

Figure 7: Developed countries: research is emphasised. Expenditure on research and development as % of GDP



Source: UNESCO 2008; Illustration: Allianz Global Investors Capital Market Analysis

to 2009) reflects this trend: growth in these countries amounted to over 5% p. a. on average, while the economic output of developed countries grew relatively slowly, around 2% p. a. (see Figure 5).

Although the share of exports of the emerging countries in the field of high technology has grown significantly in recent years, the developed countries still have an important pioneering advantage in many areas. Two examples:

- The top 20 of the Global Innovation Index – an indicator produced by the Boston Consulting Group which measures the innovation strength of countries – contains only developed countries (see Figure 6).

- Developed countries are placing even greater emphasis on the area of research and development. For example, Japan, the U.S. and Germany spend the equivalent of about 2.5% of GDP on research and development, while emerging countries like China, Russia, Brazil and India invest no more than 1.5% of GDP in this area (see Figure7).

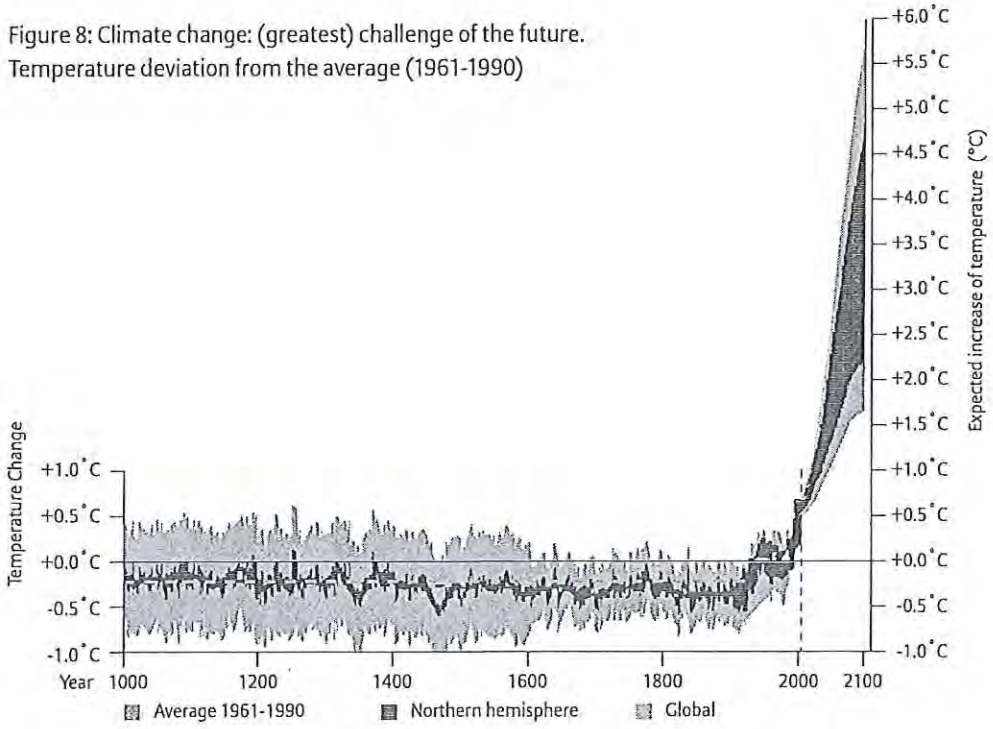
Because competitive pressure seems likely to increase rather than decrease with rising globalisation and demographic change, it seems likely that the 6th Kondratieff cycle will begin in the developed countries. For the established developed countries, there seems to be only one solution: to further expand the share of knowledge in the creation of value.

While the megatrends globalisation and demographics will boost demand primarily in emerging countries, particularly in Asia, during the transition from the 5th to the 6th Kondratieff cycle, the path of the developed countries towards a knowledge economy seems already to have been mapped out. Investors are now wondering which basic innovations and which sectors could serve as the drivers on the supply side and thus continue to play leading roles in the 6th Kondratieff cycle?

"Eco-Trends" – greening the economy

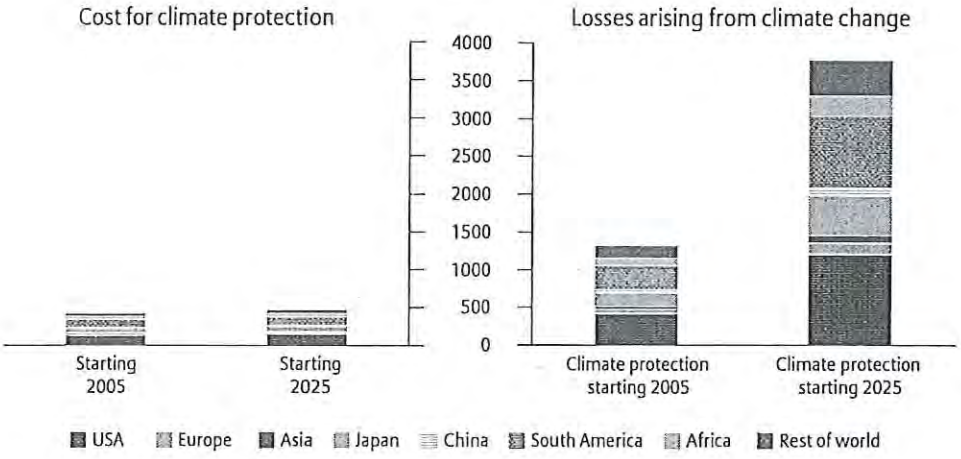
While in the previous Kondratieff cycle the information age led to a tremendous increase in labour productivity, the key to a

Figure 8: Climate change: (greatest) challenge of the future.
Temperature deviation from the average (1961-1990)



Source: IPCC/WG1, Climate Change 2001/2007, Illustration: Allianz Global Investors Capital Market Analysis

Figure 9: Ecology and economics are converging. Estimated cost of climate protection and damages caused by climate change (worldwide, in billions of U.S. dollars).



Source: Deutsches Institut für Wirtschaftsforschung (DIW); Illustration: Allianz Global Investors Capital Market Analysis

A brief analysis of the topic of „Eco-Trends" is available at http://www.allianzgi.de/capitalmarketanalysis under the section Analysis & Trends

strong and sustainable economy in the next long cycle seems to lie in an increase in the productivity of resources and energy. This is because under the new conditions imposed by globalisation, demographic change, climate change, scarce resources and greater awareness of the environment and of responsibility on the part of consumers, growth will probably continue to be generated from a new mix of economics, ecology and social commitment. A structural change in the economy that we called „Eco-Trends".

This makes the environmental market a hot candidate for a major role in the 6th Kondratieff cycle.

Climate – a scarce resource

Unlike just a few years ago, the debate about climate change no longer revolves around the questions of whether it exists at all and who culprits are. The facts are now well known:

- The years 2001 to 2007 were all among the 10 warmest years on record since 1880 (see Figure 8).
- Sea levels rose by 19.5 cm from 1870 to 2004.
- According to a 2008 study by the Global Carbon Project, CO_2 emissions grew four times faster from 2000 to 2007 than in the previous decade.
- Extreme weather events like hurricanes and floods have increased disproportionately in recent years.

Based on the assumptions of „RECIPE" (Report on Energy and Climate Policy in Europe), a joint study by the WWF together with the Allianz Group, without measures to protect the climate CO_2 emissions would increase to 2500 gigatonnes (Gt) by 2050 and

push global temperatures up by seven degrees over pre-industrial levels. The „Stern Review", which examined the economic cost of climate change, concluded that without further climate protection measures, climate change would reduce global economic output in 2050 by an estimated 5% to 20%. According to estimates by the German Institute for Economic Research (DIW), even if climate change measures were to be taken starting from 2025, the global damage caused by climate change would increase to around USD 3.8 trillion by 2050. If investments in climate change measures in the amount of just USD 500 billion were to be made today, the economic costs of global warming could be reduced to just USD 1.3 trillion (see Figure 9).

Preliminary conclusion: the environment is becoming an increasingly scarce resource. It now has a „price", i.e. the consumption of the environment is becoming a cost and scarcity factor. The trade in CO_2 emission rights is one piece of evidence that environmental costs are being increasingly internalised, i.e. polluters are being asked to pay their own way.

The environment gets a price tag

As the consequences of climate change may increasingly become a business risk, around 6,000 companies and 475 large institutional investors, with combined total assets of around USD 55 trillion, have now joined together in the Carbon Disclosure Project (CDP). They not only make use of uniform standards for the measurement of emissions and of climate change considerations in their analysis of securities, but also urge businesses to develop their own climate protection strategies and to reduce their emissions.

All these factors – the introduction of CO_2 emission rights, rising commodity prices and climate change as a business risk – contribute to putting a price tag on the consumption of the environment. The environment is increasingly becoming both a cost factor and a risk factor, resulting in the need to increase global value creation in the productivity of resources and energy and to practise sustainable management. At the same time, this trend also provides opportunities for growth.

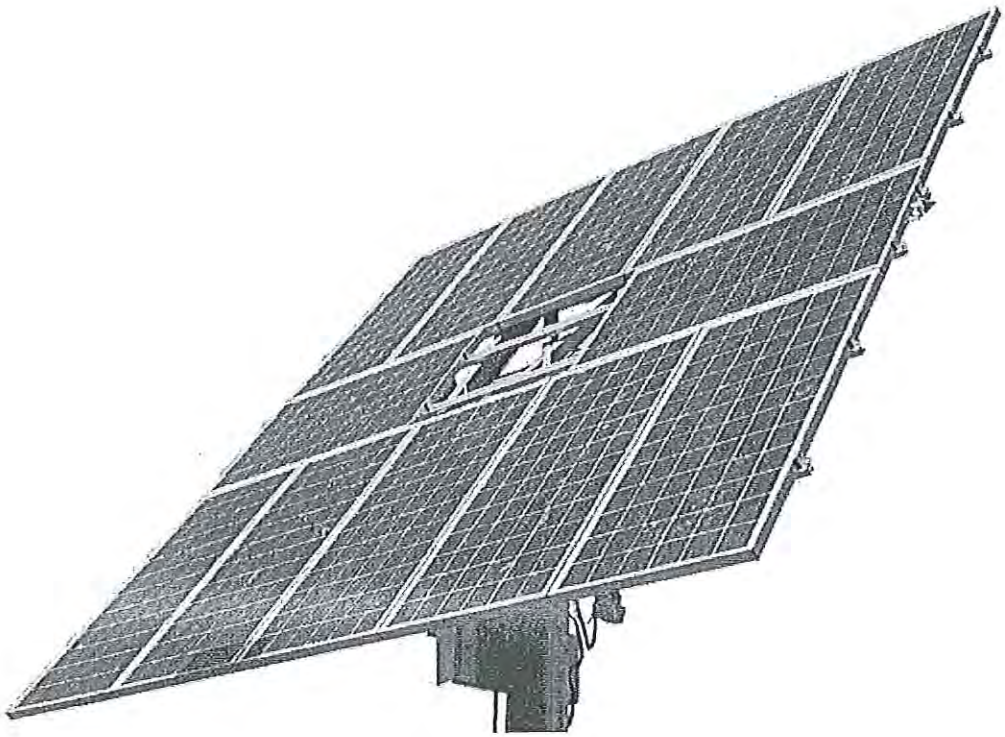
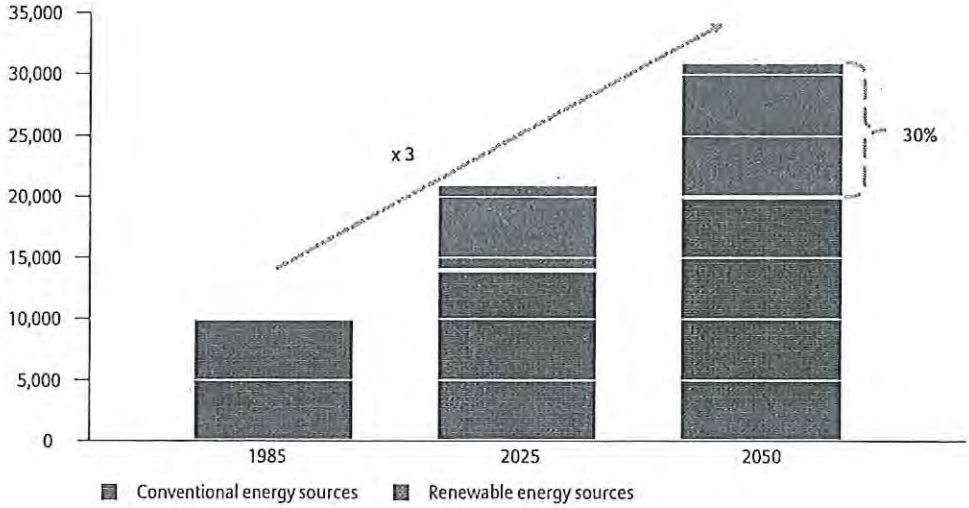


Figure 10: Sustainable energy consumption with renewable energy.
Expected development of electricity production from conventional and renewable energy sources by 2050



Source: World Energy Council; Illustration: Allianz Global Investors Capital Market Analysis

The global economic system has already taken environmental protection, resource conservation and corporate social responsibility on board in many areas – particularly in the industrialised countries. Consumption, primarily in the developed countries, now takes place under a completely different set of assumptions about ecological criteria and sustainability. For example, U. S. sales of hybrid cars rose approximately fourfold between 2004 and 2008, and over 80% of Britons recycle paper and glass. In emerging countries such as China, there were, for example, around 51,000 protests against environmental pollution in 2006. But even in other economic sectors, consuming with a clear conscience seems to be a growing engine for growth. The market for organic food is booming, as are „green" investments and fair-trade products.

Given all these developments, the 6th Kondratieff cycle now seems to have taken root. This makes it unsurprising that trend researchers view sectors that are crucial to sustainable development and human health as having particularly strong potential.

"Green tech" – a growth market

New forms of energy have become increasingly important. In particular, the share of renewable, CO_2-neutral energy sources on the global energy market is expected to continue to increase. The global demand for energy is rising in step with world population growth – where an increase of 40% by 2050 is expected – while conventional energy resources such as oil and gas are limited. The World Energy Council estimates that global electricity production will double by 2025 and triple by 2050. The global share of renewable energy sources is expected to rise from its current level of approximately 7% to about 30% by mid-century (see Figure 10). The World Energy Council estimates the market for renewable energy in 2010 at USD 635 billion. By 2020, it is expected to grow to USD 1.9 trillion.

High-tech industry is also expected to benefit significantly from the green transformation of the markets, because the demand for renewable energy, advanced environmental technologies, sustainable water management, recycling and more efficient propulsion technologies is rising. The

Smart Grid

Behind the smart grid are power grids that, in addition to conventional electric power transmission, allow the bidirectional flow of power and (electrical) data communications. The decentralised production of energy – primarily renewable energy – in a growing number of households and businesses is making the efficient management of the energy system increasingly important. More and more consumers are using solar, wind or geothermal power plants to become electricity producers themselves. The goal of this new technology is to make power generation, distribution and consumption on the energy market of the future as efficient as possible. The smart grid has three core components:

1. Smart metering: an intelligent electricity meter which allows the measurement of consumption and production via data transmission over the Internet. This makes it the cornerstone of the smart grid. Smart meters also allow variable prices to be charged for electricity, depending on the overall demand and network utilisation.
2. Grid intelligence: the name for the power grid infrastructure and the associated control equipment. This virtual power plant creates an efficient balance between production and consumption in the „energy web".
3. Utility IT: intelligent data management systems, which automatically control billing and the storage of customer data and parameters of power line networks.

The smart grid is also referred to as the "Internet of energy" or the "energy web". There are already some examples of the way it will be used in the future:

- The production of energy in the desert of North Africa or on a wind farm on the high seas requires intelligent power distribution networks that distribute electricity whose production is sometimes irregular directly to the source of consumption.
- If the North Sea winds are blowing at night, when consumption naturally decreases and electricity is generally cheaper, a wide variety of storage devices, including batteries for electric cars and trains, could be charged or thousands of washing machines could be activated.
- In summer, when hundreds of thousands of photovoltaic systems all across the country are feeding electricity into the grid at the same time, intelligent controls ensure that power plants can be shut down or their output reduced, as necessary.

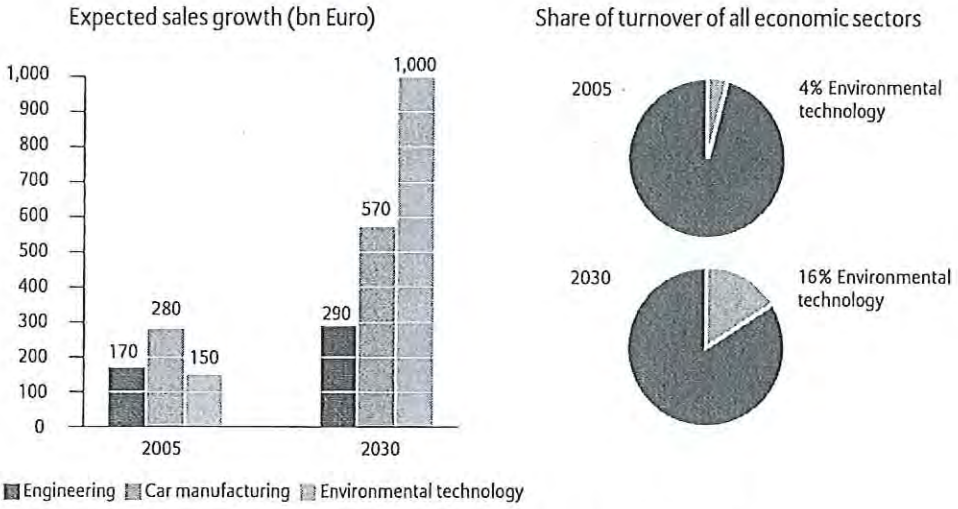
This makes the market potential of this new technology appear very promising. The European energy platform Smart Grids estimates that EUR 390 billion will have to be invested in Europe by 2030 to provide comprehensive smart grid coverage. EUR 300 billion of this amount will be put into the renewal and expansion of the electric power infrastructure, and EUR 90 billion into electricity transmission. Cisco Systems, one of the largest networking providers in the world, expects to record a turnover of USD 20 billion per year in the smart grid segment beginning in 2013 and assumes that the energy web will be 100 times bigger than the Internet.

Energy-efficient smart grids that reduce the consumption of resources thus represent an important technology in the ongoing greening of the economy.

Source: Smart Grids European Technology Platform, Siemens AG, Wikipedia

dovetailing of the 5th Kondratieff cycle with the 6th Kondratieff cycle, i.e. the connection of the area of information technology with the „green markets" is likely to continue to increase. For example, tremendous growth prospects are foreseen for the „Smart Grid", known as the „Internet of energy". The decentralised production of energy – primarily renewable energy – in a growing number of households and businesses is making the efficient management of the energy system increasingly important. Current measurement and management via the Internet, as well as virtual power plants, which create a balance between production and consumption in the „energy web", are likely to play a significant role in the future of the energy markets.

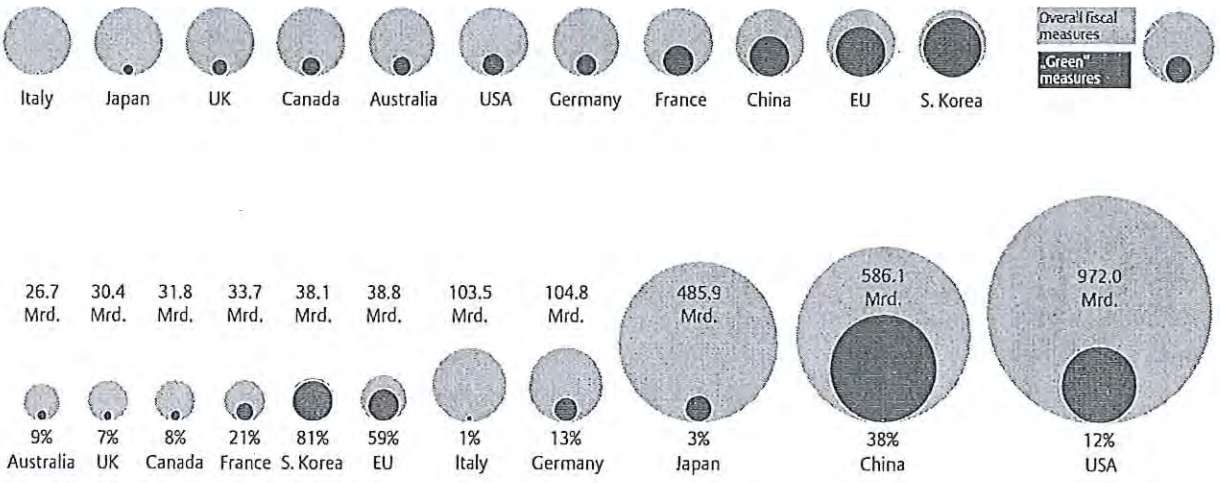
Figure 11: Green energy: an enormous and growing market.
Sales growth and share of turnover of all economic sectors in Germany



Source: BMU, 2006, Zukunftsinstitut; Illustration: Allianz Global Investors Capital Market Analysis

The „green-tech" markets will likely leave traditional industrial sectors far behind. For example, analyses by the DIW, Fraunhofer ISI and Roland Berger Strategy Consultants carried out on behalf of the Federal Environment Ministry show that by 2020 environmental technology will be of greater significance for the German economy than the automobile industry. The environmental technologies segment will quadruple to 16 percent of total German economic output by 2030, with sales expected to total EUR 1 trillion (see Figure 11).

Figure 12: „Green" fiscal packages.
Shares of fiscal measures for environmental protection



Source: Financial Times, RCM, Allianz Global Investors.

Box: Colour theory of biotechnology

Biotechnology is defined as the application of knowledge from biology and biochemistry in technical or technically useful fields. As biotechnology is a very broad term, a differentiation is made concerning the areas of application:	Red biotechnology:	medical/pharmaceutical
	Green biotechnology:	agriculture, plant biotechnology
	White biotechnology:	Biotech products/industrial processes
	Blue biotechnology:	products from the sea
	Grey biotechnology:	waste management
	Brown biotechnology:	engineering/environmental and biological technologies
	Yellow biotechnology:	production of foodstuffs and raw materials

Source: German Association of Biotechnology Industries (DIB)

Industrial policy goes green

Renewable energies are also much on the minds of policy makers, which is likely to give the field of environmental technology an additional boost. The European Union has set a target of receiving 20% of its energy supply from renewable sources by 2020. China is seeking to meet at least 15% of its energy needs through renewable energy by 2020. Moreover, the worldwide fiscal measures to support the economy, totalling more than USD 2 trillion, have a significant green orientation. The share of environmental protection measures contained in the fiscal stimulus packages is as high as 81% (South Korea). Following the change of government, the U.S. is also planning an extensive environmental programme. At least 12% of the stimulus package will go to climate-friendly projects, which represents a total investment of approximately USD 120 billion (see Figure 12).

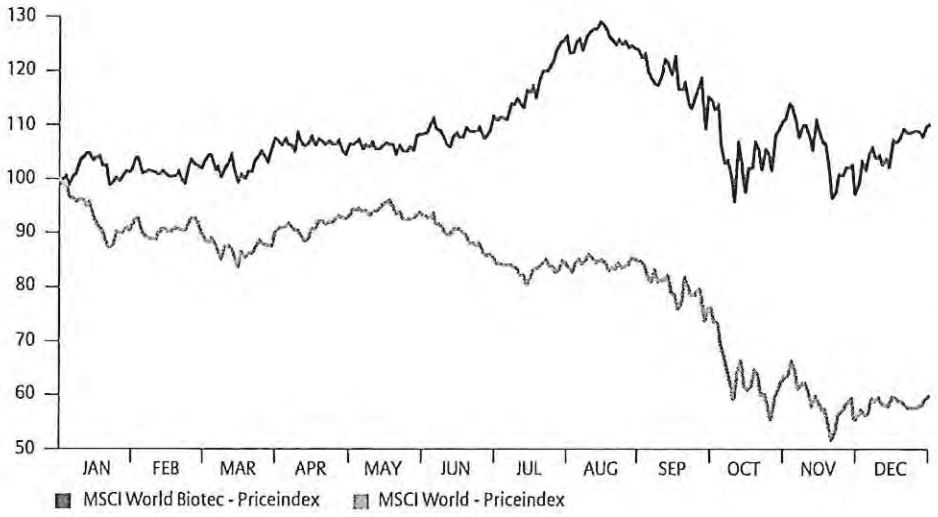
While the environmental protection aspect is, of course, key, forward-looking investors should think about how they can benefit from these long-term ecological and economic trends.

Megatrend: very small structures

The areas of nanotechnology and biotechnology are of interest in terms of increasing the productivity of resources and energy in the 6th Kondratieff cycle. Both of these segments could play major roles in the new structural cycle by using new materials (and/or properties of materials) and new processes to make many sectors more environmentally friendly through the use of fewer resources and less energy.

The contribution of nanotechnology and biotechnology to the economy is still small, but they are exactly what is needed to accelerate progress. As interdisciplinary technologies that find application in other areas, such as environmental, electrical and medical engineering, their significance is likely to continue to increase. There are already several applications in everyday life: for example, nanotechnology has resulted in stain-resistant textiles and paints as well as miniature drug depots for chronic illnesses and retractable flat-panel displays (OLED). Biotechnology has also become an integral part of our lives. The technology has, after all, been around for 5,000 years – when yeast was first used for fermentation in the production

Figure 16: Biotechnology – resilient during the financial crisis.
2008: performance of MSCI World vs. MSCI Biotechnology (1 January 2008 = 100)

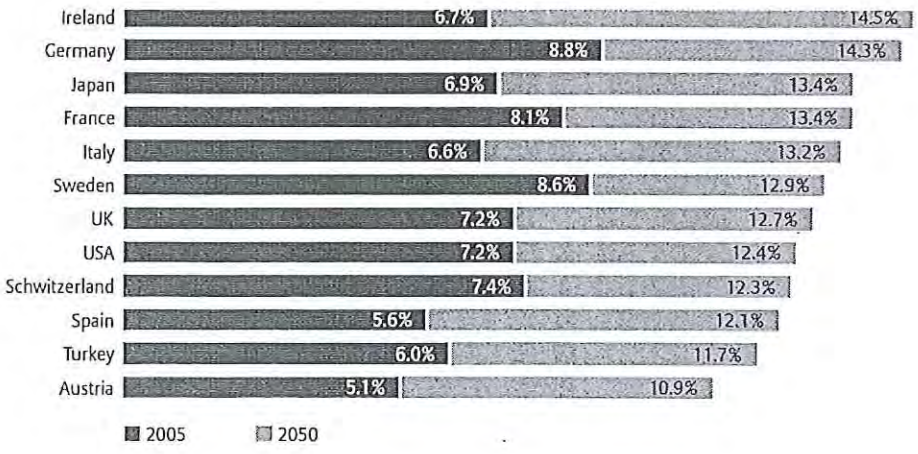


Source: Datastream, Illustration: Allianz Global Investors Capital Market Analysis

The rising profitability and demand in this sector is also reflected in share prices. Biotechnology stocks have recently proven themselves to be incredibly resilient in times of crisis. While stocks plummeted by about 40% worldwide in 2008 in the wake of the financial crisis, the industry index MSCI Biotechnology recorded a gain of around 10% (see Figure 16).

The area of very small structures, with the sectors of nanotechnology and biotechnology, is not yet capable of serving as a locomotive for the global economy. But in view of the high level of spending on research and development in this area, the major growth potential and the broad penetration of these interdisciplinary technologies, both of these fields may become megatrends and thus become drivers of the 6th Kondratieff.

Figure 17: Healthy ageing: spending in the healthcare sector rises.
Health care spending (as % of GDP)



Source: OECD, 2006; Illustration: Allianz Global Investors Capital Market Analysis

Megatrend: holistic health

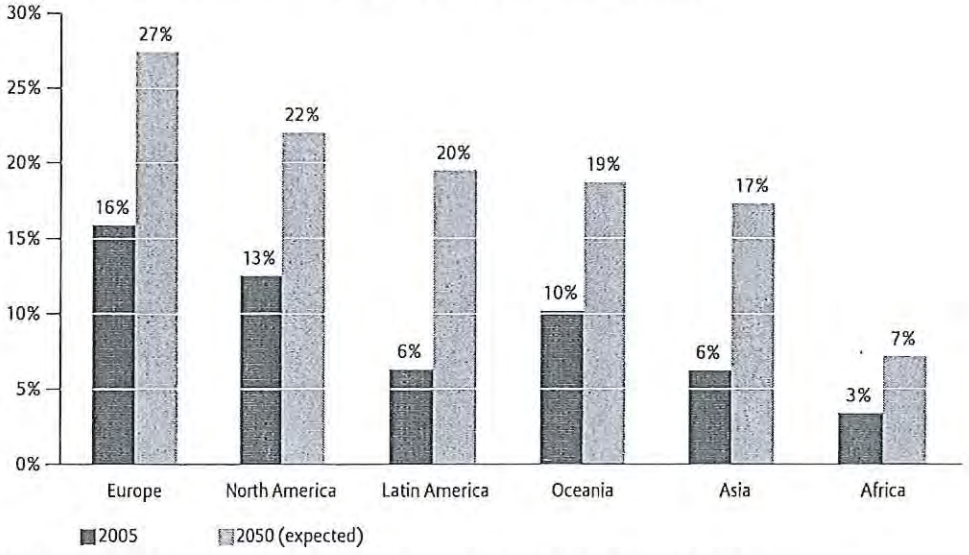
In addition to the biotechnology sector, the healthcare sector could also be an important engine for economic growth in the 6th Kondratieff cycle.



Health is now viewed less as a "condition" than as a resource and less as a cost factor than as a driver for economic growth and employment. As a result of this paradigm shift, the economic significance of the industry is expected to continue to grow.

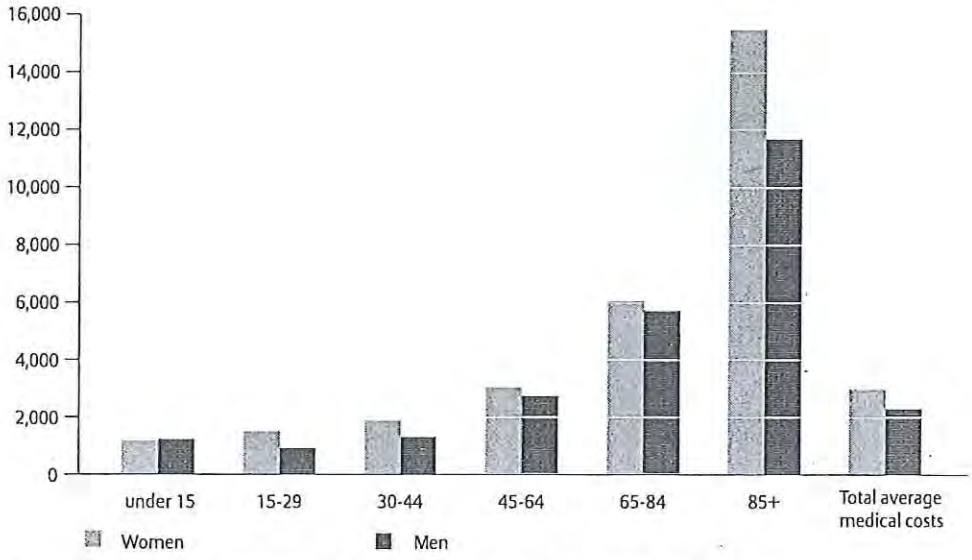
In 2005, spending on healthcare comprised between 5% and 10% of GDP in OECD countries. The OECD estimates that spending in this sector will rise disproportionately to GDP growth until 2050 and in some countries will account for up to 15% of economic output (see Figure 17). The sales of listed pharmaceutical companies alone totalled around USD 770 billion in 2008 (source: IMS Health). And new and expanding markets and product worlds are expected to develop around the concept of „holistic health", in the sense of physical, psychological, environmental and social health.

Figure 18: The healthcare market is benefiting from „double ageing". Percentage of population over 65 years of age by region (2005 and 2050)



Source: UN Population Report 2008, Illustration: Allianz Global Investors Capital Market Analysis

Figure 19: Living longer – with chronic diseases.
Medical costs per age group (in EUR p. a.)



Source: Gesundheitsberichterstattung des Bundes, „Gesundheit und Krankheit im Alter", 2009;
Illustration: Allianz Global Investors Capital Market Analysis

These are the main driving forces that are expected to further boost growth in the healthcare sector:

1. Global demographic change is likely to result in a changing and rising demand for health services.

   - First, the world population is expected to grow by more than 2.5 billion over the next 50 years, an increase of nearly 40%. The need for healthcare, however, will not only increase quantitatively as the global population rises; „qualitative" growth will also take place: the World Bank estimates that low-income countries will grow twice as fast as the high-income countries in the coming decades. The consumption of higher-quality health services increases together with prosperity. For example, the per capita consumption of health services in the United States was about USD 1,500 in 2008, while the figure was only about USD 200 in China and India.
   - At the same time, healthcare spending will also rise as a result of the increased longevity of the population in developed countries – it rises around 3 months every year – as well as the growing percentage of people over 65 years of age. For example, the proportion of the population over 65 in Europe is expected to rise from around 16% in 2005 to over 27% in 2050 (see Figure 18). This gives the concept of the „old continent" an entirely new meaning. But the ageing process on the other continents is also irreversible. In Asia, for example, the proportion of pensioners is expected to rise from its current level of about 6% to just over 17% in 2050. As a consequence, the demand for drugs and medical procedures is likely to grow. Chronic and acute diseases increase as people age, meaning that healthcare spending will grow disproportionately: a 45- to 64-year-old German consumes an average of around EUR 3,000 worth of health services in a year, while a 65- to

84-year-old consumes just under EUR 6,000 annually and the figure for those over 85 years of age is nearly EUR 12,000 (see Figure 19).

2. Progress in medical technology offers improved chances for healing and longer lives – even with chronic illnesses. New growth markets in the areas of diagnosis and therapy are being created through closer integration with other fledgling technology sectors such as biotechnology and nanotechnology. For example, it is already possible to place drugs directly in the bloodstream using nanorobots. And in the area of biotechnology, targeted vaccines and antibiotics can be produced through the use of enzymes. Another new market is improved diagnostics through the exchange of data on bodily functions over the Internet.

3. Particularly in the ageing affluent societies of the developed countries, a change in values can be seen as people move more towards self-managing their healthcare and more active physical fitness. In addition to the curing of diseases, the focus in the healthcare market is increasingly shifting to health maintenance. As a result, the healthcare market is likely to grow even more differentiated and develop from a regulated supply market to a demand market. New services and products are expected to be created in the areas of healthy foods (organic food, „functional food"), personal health, health counselling, prevention and wellness.

4. The health sector is becoming increasingly commodified. First, a trend is evident in which health services providers are modelling themselves more and more on private sector businesses. But it will not be just economic principles, such as efficiency, that will shape the medical value chain: those causing healthcare costs will also increasingly be required to make a contribution. There are already some examples of this latter trend, such as higher premiums for smokers and compensation payments from the tobacco industry. At the same time, the sector is becoming more and more liberalised. And finally, patients are turning into consumers, whose needs are at the forefront. For example, healthcare has become a major focus of marketing in the food and sporting goods industries



Conclusion

It is clear even now that existing technologies and materials will reach their technological limits. Whether megatrends on the demand side, such as globalisation and demographics, or megatrends on the supply side, such as environmental technology, the areas of very small structures or holistic health: all have the potential not only to trigger long-term productivity increases for the global economy, but also to influence society as a whole. New products and services are likely to open up new demand, which would initially be focussed in the developed countries.

Although the main and supporting roles in the 6th Kondratieff cycle have not yet been clearly assigned, the roots seem already to have taken hold. The TMT bubble and the recent financial crisis may mark the beginning of the 6th Kondratieff cycle. A cycle in which prosperity will probably come in long waves.

The period of upheaval following the financial crisis is not likely to come to an immediate end. However, long-term investors would be well advised to use the current crisis as an opportunity to get in early on the 6th Kondratieff wave.

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Box: Megatrends and their beneficiaries

Megatrend	Beneficiaries
Globalisation	Knowledge-intensive services with close proximity to corporations: - Logistics - IT services/ security - HR consulting and continuing education
Demographics	Healthcare and health maintenance services: - Pharmaceutical industry - Biotechnology - Care services/care facilities - Financial services for pension and health care
Eco-trends	Markets connected with the environment: - Renewable energy - Energy efficiency/ consulting - Water Treatment/ Desalination facilities - Recycling technologies
"Very small structures"	Companies from the sectors - Biotechnology - Nanotechnology
"Holistic health"	Products and services for „health maintenance" - Medical technology - Healthcare consulting - Wellness market - Organic products and functional food

Source: Allianz Economic Research "A look in the future", Allianz Global Investors Capital Market Analysis

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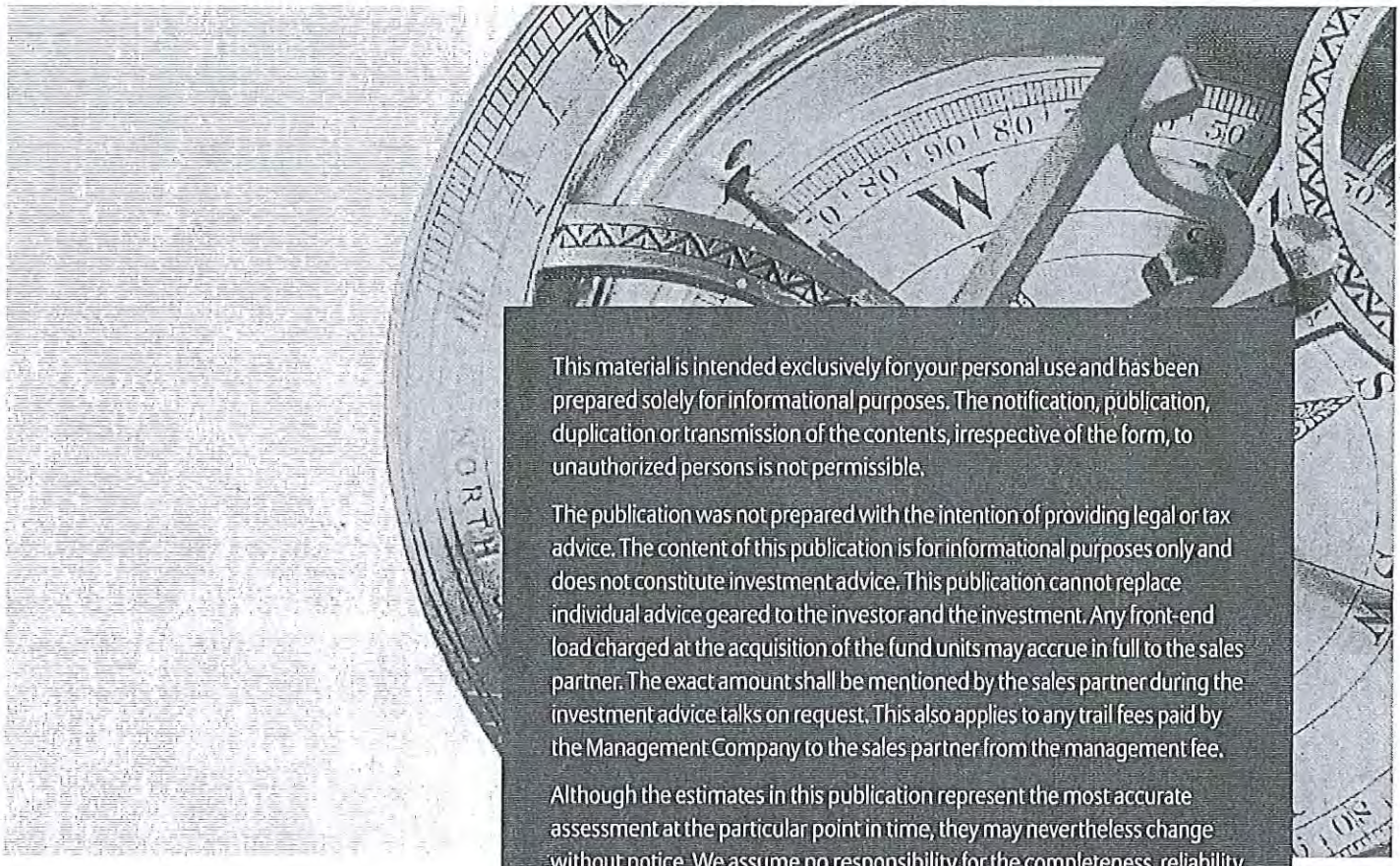
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