



Is Social Europe Fit for Globalisation?

A study of the social impact of globalisation in the European Union

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ABSTRACT

Globalisation is one of the defining phenomena of today's economy, albeit one that is loosely defined and prone to exaggeration. For many, globalisation is an opportunity, affording scope on the supply side for increased specialisation, enhanced diffusion of technology, and a competitive spur to innovation and productivity growth. Yet for others, globalisation is perceived to be a threat to the values, institutions and policies that have underpinned post-war Europe's success and way of life, in short to *social Europe*. This study examines the social impact of globalisation for the EU economies and the policy challenges that arise. It starts by looking at the conceptual background, then provides an extensive empirical analysis of the different facets of globalisation and its social dimension, and moves on to discuss policy issues. The study's key message is that the EU as a whole will gain from globalisation, but that these gains will not be uniformly distributed across individuals, regions and countries. Nor will they accrue automatically, but will instead depend on successful adaptation and well-judged policy responses. In particular, the EU has to balance its efforts to boost competitiveness and to transform its economy by adopting and implementing policies that smooth the adjustment process and offer sufficient protection to those vulnerable to the changes and uncertainties that globalisation will bring.

CONTENTS

Executive Summary	i
Key messages	i
Definitions and overview of the study	ii
Main findings on globalisation and its consequences	iii
Policy issues	vii
Recommendations	ix

PART I. BACKGROUND, KEY CONCEPTS, FACTS AND FIGURES

1. Introduction	1
1.1 An interpretation of globalisation	1
1.1.1 <i>A multifaceted concept</i>	1
1.1.2 <i>Underlying drivers</i>	2
1.2 The policy context	3
1.3 Objectives of the study	5
1.4 Outline of this report	6
2. The Study of Globalisation: Insights from the Literature	8
2.1 What is globalisation?	9
2.1.1 <i>Trade</i>	10
2.1.2 <i>Finance</i>	11
2.1.3 <i>Post-industrial economy</i>	11
2.1.4 <i>Summary of the meaning of globalisation</i>	12
2.2 Drivers contributing to the process of globalisation.....	13
3. Evidence on the Degree of Openness	18
3.1 Empirical analysis of economic globalisation – Trade	21
3.1.1 <i>Outcome-based measures</i>	21
3.1.2 <i>Policy-based measures</i>	26
3.1.3 <i>Trade in services</i>	30
3.2 Integration of capital and money markets.....	34
3.2.1 <i>Consequences of the globalisation of capital markets</i>	36
3.2.2 <i>Domestic savings</i>	36
3.2.3 <i>Effect of the integration of capital markets on globalisation</i>	37
3.2.4 <i>Outcome-based measures</i>	38
3.3 Tax bases.....	45
3.4 Summary and conclusions on the degree of openness.....	47
4. Effects of Outsourcing on Labour Markets and Wages	49
4.1 The impact of outsourcing on labour markets.....	49
4.2 The effect of outsourcing on wages	50

PART II. THE SOCIAL DIMENSION OF GLOBALISATION

5. Conceptual Issues	57
5.1 Determinants of changes in inequality: Alternative explanations	57

5.1.1	<i>Trade liberalisation, growth and inequality</i>	58
5.1.2	<i>Regional productive factors as determinants of inequality changes</i>	61
5.1.3	<i>Competing theories, unexplained variance</i>	63
5.1.4	<i>Norms and institutions</i>	65
5.2	Globalisation and European social changes	66
5.2.1	<i>Unemployment</i>	67
5.2.2	<i>Pension reforms</i>	69
5.2.3	<i>Reforming tax systems</i>	70
5.2.4	<i>Poverty and the issue of the underclass</i>	71
5.2.5	<i>Investing in the future – Childcare and education</i>	71
5.2.6	<i>Reconceptualising the welfare state</i>	72
6.	Social Europe and Globalisation: A Race to the Bottom?	75
6.1	What kinds of reforms are taking place?	76
6.2	The use of social indicators: Methodological issues	80
6.3	Key trends	81
6.4	Poverty and inequality	88
6.5	Gender effects of globalisation in the labour market.....	93
6.6	Social policy and competitiveness	96
7.	Globalisation and Migration	102
7.1	Migration: The background	102
7.2	Perceptions of migrants and trends in policy reforms	111
8.	Deeper Analysis of Inequalities in the EU	115
8.1	Accounting for inequalities within the EU	115
8.2	Interregional differences within the EU: Macro data	120
8.3	Regional income inequalities and poverty in Europe: Microdata	122
8.4	Changes in openness and changes in inequalities in EU countries	125
PART III. POLICY ISSUES AND IMPLICATIONS		
9.	Understanding the Policy Issues	134
9.1	The costs and benefits	135
9.1.1	<i>The advantages of globalisation</i>	136
9.1.2	<i>Presumed threats and challenges</i>	137
9.2	Policy questions: What is at stake?	140
10.	Implications for the EU Social Agenda and the Social Policy Strategies of Member States	143
10.1	Strategic social choices	144
10.2	The dimensions of a policy response.....	147
10.2.1	<i>EU policies</i>	148
10.2.2	<i>Member state policies</i>	151
10.2.3	<i>Welfare state reforms – Fleshing out flexicurity</i>	153
10.2.4	<i>Labour market reforms</i>	154
10.2.5	<i>Product market liberalisation and competition policy</i>	157
10.3	Migration, welfare and globalisation	158
11.	Scenarios	163

11.1	Influences on future developments	164
11.2	Sources of variation	165
11.3	The most likely evolution	167
11.4	The risks and opportunities	170
12.	Overview, Policy Responses and Policy Processes	172
12.1	What is at issue?	173
12.1.1	<i>Opportunities and drawbacks</i>	173
12.1.2	<i>Growing inequality?</i>	174
12.2	Effects on public finances and the pressures on social protection systems	175
12.3	Policy responses	176
12.3.1	<i>Flexicurity and beyond in the reform of social protection</i>	177
12.3.2	<i>The primary role of enhancing human capital</i>	178
12.4	The policy process	179
12.5	Recommendations	180
	BIBLIOGRAPHY	184

LIST OF FIGURES

Figure 3.1	Development of openness to trade in the EU-14, EU-10 and EU-2 country groups (% calculated on merchandise trade and on GDP at current exchange rates and at PPP).....	24
Figure 3.2	Financial and telecommunication liberalisation indices (1996–99)	31
Figure 3.3	Portfolio investments (assets) in groups of EU member states (% of GDP, unweighted average)	38
Figure 3.4	Portfolio investments (liabilities) in groups of EU member states (% of GDP, unweighted average)	39
Figure 3.5	Inward FDI in groups of EU member countries (% of GDP, unweighted average).....	40
Figure 3.6	Outward FDI in groups of EU member countries (% of GDP, unweighted average).....	40
Figure 6.1	Trends in social protection outlays, 1990–2003 (% of GDP)	81
Figure 6.2	Public and private ‘social’ spending, 2001 (% of GDP)	83
Figure 6.3	Minimum wages compared with the EU highest (PPS index, Luxembourg=100)	85
Figure 6.4	Trends in the distribution of equivalised household income (OECD average, index)	91
Figure 6.5	At-risk-of-poverty rate for the EU-25, 2005	91
Figure 6.6	Gender pay gap, 1995–2004 (% difference in average hourly earnings, as a percentage of men’s earnings, ranked by 2001 gap)	95
Figure 6.7	Financing of social protection, 2003	96
Figure 7.1	Education levels of migrants and nationals in the EU-15, 2005	107
Figure 7.2	Unconditional correlation between perceptions of welfare abuse and the generosity of welfare systems	112
Figure 8.1	GDP per capita and income inequality in European countries	119
Figure 8.2	GDP per capita and relative income poverty in European countries	120
Figure 8.3	Part of the between-region Theil index in overall Theil	124
Figure 8.4	Globalisation index and inequality in Europe, around 2001	126
Figure 8.5	Globalisation index and relative poverty in Europe, around 2001	126
Figure 11.1	Growth of world output and trade	163
Figure 11.2	The unrelenting rise of globalisation	164
Figure 12.1	Schematic overview of the process of globalisation	183

EXECUTIVE SUMMARY

Key messages

1. There can be little doubt that globalisation is having, and will continue to have, a pervasive influence on 21st century economic and societal developments. International flows of goods, services and capital have all increased substantially relative to output, especially over the last two decades. Yet, much of the increase in exposure to international competition confronting EU member states is, in fact, the result of European economic integration.
2. An important aspect of globalisation is that the world's two most populous countries – China and India – have reintegrated into the world economy after decades of comparative isolation. Together with the reintegration of former communist countries in Europe, this has meant that the supply of labour available at the global level has greatly expanded, as has the number of global consumers and hence the size and diversity of the potential market for EU exporters.
3. Globalisation has to be seen in perspective, however. As a proportion of GDP, world trade reached a peak before the start of the First World War and it is only in the last decades that it has returned to these levels. As a proportion of the population, international migration is still less extensive than it was a hundred years ago.
4. A distinctive feature of the present wave of globalisation is the intensity of (mostly two-way) capital flows, including foreign direct investment (FDI). Although for most OECD countries FDI still accounts for a relatively small proportion of overall investment, it is a key source of capital and know-how for a number of developing countries and has been significant for some EU member states such as Ireland. Asian investment in the richer countries also deserves to be highlighted.
5. At a deeper level, globalisation can be attributed to underlying drivers of economic, political and social change. These include the long march towards market liberalisation that has characterised the period since the 1950s, the collapse of communism, demographic developments and technological change. Advances in information and communication technologies have had a very pronounced effect on the organisation of economic activity, as have the falling costs of transport, and technologies now flow across borders more readily and more rapidly. To illustrate the point, total freight costs for trade between developed countries are relatively trivial at 4% of the value of trade: two examples are that transport charges represent only 2% of the cost of a television shipped from Asia to Europe and 1.2% of the cost of a kilo of coffee. Similarly, at today's prices, a three-minute telephone call between New York and London would have cost \$293 in 1931, \$1 in 2001, and is now just a few cents – for a hugely better connection.
6. These trends have been associated with growing prosperity in aggregate, but it is evident that there are losers as well as winners. In particular, rapid advances in technology, coupled with adjustments in some global markets have exerted pressures on the returns to unskilled labour in Europe, with the falling relative wages of unskilled workers contributing to a widening of income inequalities.

Against this backdrop, there have been growing fears that the European social model, rightly seen as a defining feature of the EU and its member states, can no longer be sustained and that it will have to be reined back or even dismantled.

7. A clear conclusion of this report is, however, that these fears are largely unfounded and that there is no compelling evidence that globalisation is leading inexorably to a 'race to the bottom' in social policy or in the capacity of European society to maintain its commitments to solidarity and equality.
8. The contemporary economic environment nevertheless calls for more rapid adaptation to shifting economic currents and fresh thinking about the role of social policy in meeting the challenges of adjustment to new sources of competition – whether owing to technological change or to the different manifestations of globalisation. Social policy has several roles to play in responding to this challenge, notably in facilitating adjustment in labour markets. Education is at the heart of adaptation, but solidarity cannot be neglected.
9. Some of the directions for policy development, such as placing greater weight on flexibility in labour markets and making social protection systems more responsive, are already receiving considerable attention. Others, such as dealing with the consequences of an ageing population are recognised as key issues, but there is less evidence of coherence in policy responses. How to accommodate increased immigration has been less prominent on the policy agenda and has not always been viewed as the most urgent issue in many member states, although it is rapidly becoming so. Consequently, the development of new policy ideas can benefit from the exchange of experience and learning from those member states that have led the way in policy development and innovation.
10. We argue, furthermore, that within the debate on 'flexicurity', it is especially important to look beyond the labour market emphasis of much of the discourse to embrace those wider aspects of the concept that bear most on the economically inactive and the excluded, and not to lose sight of the solidarity function of social protection.

Definitions and overview of the study

11. This study is concerned with the social impact of globalisation in the EU context. Thus, it does not attempt to investigate the wider issues raised in work by, for example, the International Labour Organisation about the costs and benefits for richer and poorer nations and social groups, nor those for governance as raised by Joseph Stiglitz and others with respect to sharing out prosperity at the global level. Instead, the study concentrates on the implications for social policies at the EU and member state levels. The study takes as a given that globalisation has a positive overall economic effect, but also that it has distributive consequences that mean there will be losers as well as winners. It is also acknowledged that the benefits of globalisation do not necessarily accrue automatically to all member states, but need to be nurtured by appropriate policy choices.
12. Globalisation is not an easy concept to pin down, as it has many facets and encompasses a wide range of different processes associated with increased interconnectedness across national borders. A credible definition encompasses the following aspects: the growth in international flows of goods, services and capital;

an increased propensity towards international migration; the spread of technologies and of the multinational companies that play a major role in diffusing them; and the intensification of communication exemplified by the expansion of Internet use. Geographically more dispersed subcontracting, sourcing and division of labour in production processes are also associated with globalisation.

13. The study is in three main parts that draw upon the more detailed work produced by the research team responsible for the study. The first looks at the background, the facts and the figures about globalisation, with the objective of presenting a clear picture of what globalisation is and is not. In the second part, the focus is on the social dimension, including extensive documentation of EU social conditions, together with more specific work on migration (and the regulatory developments affecting it) and trends in inequality. The third part of the study then concentrates on the policy challenges, starting with a discussion of policy issues, what these imply for social policy and the social agenda in the EU, and continuing with a scenario exercise that speculates on the likely evolution of globalisation. A summary and recommendations complete the study.

Main findings on globalisation and its consequences

14. Many contributors to the literature have sought to develop and refine definitions of globalisation, in theoretical and empirical terms. Although the intensity of trade is often used as a proxy for the globalisation process, most authors dealing with the contemporary global economy argue that globalisation should be viewed as a multidimensional phenomenon. Capital and currency flows are just as important as trade in providing quantifiable indicators of globalisation. Certain structural factors, for example the rise of intra-industry trade and the growing salience of multinational enterprises, should be added to the picture.
15. The defining features of the current phase of globalisation include the fact that the global market has expanded to an unprecedented scale, along with the weakening of the traditional core-periphery effects. The volume of world trade quadrupled between 1980 and 2005, while output rose by 250%. In the past, the core provided manufactured goods to the periphery in exchange for raw materials. Today, by contrast, the emerging markets account for a large and growing share of world manufacturing capacity. Even more strikingly, the flow of capital has become bi-directional. While in the 19th century Britain exported financial capital to the periphery, the largest economy of today, the United States, runs a current account deficit substantially financed by emerging-economy nations.
16. In terms of addressing the behaviour of economies in the globalising world, traditional economic theories of trade based on comparative advantage struggle to explain actual developments in the world, particularly the rise of Asian economies, which have created rather than relied on existing, comparative advantages. China doubled its share of world trade in goods to 9% in the decade to 2005, not just by relying on cheap labour; still, the EU has maintained its share, unlike the US and Japan.
17. While globalisation is an uncontested worldwide phenomenon, the rise in the degree of openness to trade in goods and services of the EU member states has

been much less pronounced than frequently argued in the media and in public discourse. The pace of openness to trade has not shown a striking acceleration, with the exception of Germany, the Benelux countries and most of the recently acceded member states, where openness to trade in goods has increased. In the latter case, however, the increase is mainly an effect of elimination of trade barriers within the enlarged internal market.

18. Moreover, the current geographical fragmentation of production processes also has no precedent in history and in today's world countries progressively trade in tasks rather than products. It is also salient that capital markets are much more mature today than at any time during the previous expansions of trade and capital flows. Gross flows of capital are much larger than in the past and they take many more forms. In particular, the flows of FDI are much larger relative to output than at any time before.
19. During the last two decades, financial integration has been by far the most rapidly expanding field of globalisation. Both portfolio and direct investment have increased by a greater order of magnitude relative to GDP. For the 'old' EU member states, volume indicators of international financial integration show a tenfold increase in the 35 years between 1970 and 2004. The stock of external assets and liabilities for the EU as a whole as a proportion of GDP grew from 59% of GDP in 1970, to over 550% in 2004, with strong expansion after 1995. Because of more intense financial integration, the foreign influence on business has grown, including a substantial increase in control by foreign owners through majority-owned foreign affiliates. Although there has been a rise in both outward and inward FDI, there is no indication of an overall increase in foreign (non-EU) ownership of EU business.
20. There has been a considerable relocation of productive activities, in both goods and services. This has resulted in a rapid expansion in two-way trade flows between developed and developing economies. The EU has been among the winners, in particular in the field of business services, notwithstanding a substantial increase in the market share of India.
21. An analysis of the effect of the relocation of activities supports the thesis that the outsourcing of activities during the last 15 years has tended to lead to relative wage losses for unskilled workers and for branches employing a large share of unskilled workers. Yet, other studies reviewed underline sharply that rules and regulations concerning the functioning of the labour market and wage formation exert a strong impact on the degree of outsourcing. There are large disparities between countries with respect to skill levels, which have the arithmetic effect that those countries with low average levels of skills are the most vulnerable. The effects of global competition manifest themselves either in stagnating real wages or (in the case of rigidities with respect to wage formation) in rising unemployment.
22. The 'insourcing' of activities, that is, the expansion (notably of the export of business services and other high value-added service activities) in the world market for service industries have, as could be expected, mainly favoured the branches of activity relying on top-level, highly skilled human resources and has, unavoidably, contributed to the rise in the wedge between highly skilled and low-

- skilled labour. At the same time, there is an offsetting trend for certain professional activities to be outsourced to countries like India, with lower cost, but well-educated workers.
23. Despite these various forms of relocation of economic activity, there is little sign that tax yields in EU countries are coming under pressure. Among the old member states (EU-15) only Finland, Ireland and the Netherlands saw a substantial shrinkage of the relative size of their total tax revenues between the periods 1991–95 and 2001–05, comparable periods in the economic cycles. These developments seem to be the results of conscious structural reforms, however, rather than directly reflecting pressures from more mobile tax bases. Most of the EU-15 member states have either maintained the relative size of their tax revenues or even managed to increase them. In addition, several countries have chosen to alter their tax structures to change incentives for business, for reasons beyond just the threat of losing their tax base.
 24. Net migration into the EU has been on the increase, rising threefold between the mid-1990s and 2003 to reach some 2 million (although a sizeable share of this is regularisation of illegal immigrants, notably in Spain). The main migratory movement is still (and is likely to remain) immigration into the EU from neighbouring countries, Africa and, increasingly, South America (into Spain). The analysis undertaken within the framework of this study emphasises in particular that, judging from the increasing flow of remittances, links between the migrants and their families in the country of origin are probably more important than often assumed in the conceptual analysis. This conclusion would suggest that the share of migrants coming to work for a certain period in an EU country is increasing and that issues raised by this potential change of the pattern of migration should be studied carefully in addition to issue of social integration.
 25. There is convincing evidence that income inequalities have been increasing somewhat in many countries: Gini coefficients have risen over the two decades since the mid-1980s from levels of around 20 (indicating low inequality) in Sweden and Finland to closer to 25, and have grown from already fairly high levels in Italy and Greece. That being said, there is no (or only weak) evidence that this rise in income inequalities is attributable to globalisation. In fact, recent studies and additional examination of available data suggest that the rise in income inequalities is a phenomenon intimately associated with the emergence of the 'knowledge society', which has resulted in an increase in the return on human capital. At the same time, as indicated above, the knowledge society has brought about a widening of the gap between those with a high and those with only a basic endowment of knowledge and skills. It is also noteworthy that over the same period, there was a significant fall to around 30 in the Gini coefficients for Ireland and Spain, showing that the movement is not all one way.
 26. The inference to draw is that where there is rising inequality, it is attributable to either explicit political choices or inappropriate responses to the operation of more fundamental socio-economic drivers, such as, notably, the emergence of the knowledge society, increases in educational inequalities or the failure of systems of education to ensure equal opportunities to all. But this process has not followed the same pattern in all countries. In the endeavour to adapt their society and to

find new responses, certain countries have been more successful than others have in adjusting labour and product markets, and especially in actively investing in human capital, including at the lower end of the range of endowment.

27. Examination and assessment of the evidence on the development of the level and structure of social spending suggest that social policy in general has shown a high degree of resilience in the face of globalisation and the rise in inequalities. Social protection expenditure has broadly been stable as a proportion of GDP in the EU since the early 1990s at around 27-28%, contrary to the expectation that it would be squeezed in the interests of bolstering competitiveness. Indeed, its growth over the period 1992–2003 exceeded growth in GDP for the EU-15, with the implication that the European welfare state has become more, not less generous. Moreover, the evidence suggests that globalisation did not even affect the composition of social spending in OECD countries.
28. It is an open question whether an extensive social protection system should be seen as a necessary complement to a more competitive global market or an impediment to successful participation in globalisation. Both arguments are (often too glibly) advanced in crude terms that are at odds with the subtlety of the underlying logic. Some social protection systems, despite being costly in terms of outlays as a proportion of GDP, manifestly manage to strike a successful balance. Others are characterised by problems of inappropriate incentives or burgeoning costs (or both) that appear to be unsustainable.
29. Migration poses a test for the welfare state, not least because of popular perceptions that migrants take advantage of it and give little in return. There is a high risk in this context of setting in motion a vicious circle in which unskilled migration inflames public opinion, resulting in calls for unrealistic restrictions on migration, leading to more illegal and unskilled migration, further inflaming public opinion against migrants and forcing governments to adopt even stricter (and unenforceable) migration restrictions.
30. Overall, however, there is no evidence that migrants are abusing the (politically most sensitive) non-contributory parts of the welfare system, despite survey findings suggesting that 50% of EU citizens believe they do. Furthermore, migration can also contribute towards filling gaps that may emerge for demographic reasons in the capacity of EU member states to fund their social protection systems. This assertion implies that migrants are of working age and are supported sufficiently in the labour market to ensure that they have high enough employment rates. In this respect, migrants have to be seen not as competitors for jobs, undercutting indigenous workers, but as complements: the game is not zero-sum.
31. Globalisation is not – indeed by far – the only factor influencing the socio-economic and cultural fabric and it is often wrongly credited with, or blamed for, much that is happening in EU member states (and elsewhere). Longevity is increasing and the predictability of the life cycle in the sense of a stable career path is reduced for a large number of citizens. There are increasing returns on intellectual capital, that is, on investment in education and knowledge. At the same time, this emergence of the knowledge society entails an increase in

apparent income disparities and – at least in some socio-economic contexts – a change in the patterns and strength of the inclusive forces in society.

Policy issues

32. The core policy issue emanating from the different elements of globalisation is to enable the EU and individual member states to take advantage of the undoubted benefits without undue social costs that might arise from ‘winners’ being expected to compensate ‘losers’. In this regard, the default position is that globalisation is much more an opportunity for added growth than a social menace.
33. In response to the question, Is a social Europe fit for globalisation?, the answer of this report is an emphatic ‘yes’. But the benefits of globalisation cannot just be assumed to happen and, with an increased pace of change, it is inevitable that there will be losers as well as winners, with marked social consequences. The European social model is not doomed and the idea that only free market approaches are consistent with sustained prosperity is clearly wrong. Indeed, the success of the smaller open economies testifies to the scope for prospering, even with extensive and generous welfare states.
34. The principal benefits of globalisation arise from the scope it affords on the supply side for increased specialisation, enhanced diffusion of technology, and a competitive spur to innovation and productivity growth. Consumers gain from lower prices and wider choice, while an often-overlooked benefit on the demand side is that emerging markets offer rapidly growing sales opportunities for European companies.
35. It has also to be repeated that globalisation is not a zero-sum game. Nevertheless, in assessing the benefits of globalisation and the social impact, three issues need to be taken into account. First, the gains are not uniformly distributed across individuals, regions and countries. Second, the costs of globalisation are more likely to be concentrated in the short run, while the benefits will take longer to materialise. Third, the gains will not accrue automatically, but will depend instead on success in undertaking adequate competitive, regulatory and social reforms.
36. Critics of globalisation identify a broad range of actual or potential threats from unfettered globalisation. These encompass distributive impacts, such as adverse consequences for specific groups in society, issues of cultural hegemony, concerns about environmental damage and geopolitical disruption (especially now from terrorism). Threats also arise to the stability of public finances and from social tensions associated with migration.
37. Yet it is also important to stress offsetting effects. First, there is a boost to real incomes from the lower prices of imports. Second, the job losses resulting from international competitive effects are small in scale compared with normal ‘creative destruction’ in product and labour markets. In the same vein, the pressures on social protection budgets from demographic change are much more extensive. Third, the loss of low-value jobs may be less damaging than it sounds: if offshoring means retaining only high-value jobs, it could be seen as a logical answer to a declining labour force.

38. The policy issues surrounding globalisation can be grouped under three main headings. The first is equipping the economy to compete in the globalised age. Second, there are many demands on policy-makers to smooth adjustment. Third, there are issues of governance. One school of thought is that the EU simply has to become more like the US or other parts of the world. This standpoint can be summarised as ‘work harder, innovate more and expect less’. The Lisbon strategy is in many ways a response to globalisation, insofar as its primary aims are to reposition the EU in the global economy, but it is important to recall that the strategy also has as key goals creating employment and assuring social cohesion. As such, it is not about emulating the US model.
39. A central policy challenge is to achieve economic flexibility with better social protection in order to create an environment capable of making the best use of the opportunities offered by globalisation. In this context, social policy has a vital role to play, not least in endowing people with capabilities, with a premium on active policies that intervene early rather than passive, reactive policies.
40. Adjusting to globalisation implies policy developments that will, in turn, have social impacts and create uncertainties that need to be managed as social risks. Labour turnover can be expected to grow, putting a premium on the transferability and adaptability of skills, but also on suitable forms of flexibility in the workplace as well as for activating individuals. Active labour market policies are seen as part of the answer, but they are not a panacea and need to be complemented by other policies. Moreover, they are often costly and are prone to inappropriate incentives. An implication is that policy learning and experimentation are needed to find solutions that are effective, as well as attuned to conditions in the different member states.
41. There is an important time dimension to consider, because costs such as higher unemployment and increased income inequality tend to be concentrated in the short term, whereas benefits in the form of lower prices, higher productivity and income will only occur later. Similarly, many reforms will improve the benefits/costs ratio of globalisation in the long term, yet will have a short-term impact – often negative – on social cohesion, which makes them politically awkward to implement. Still, in this context it is important that whatever measures are envisaged to counter negative social repercussions, these should favour, not hamper, the adjustment to changing conditions. Nevertheless, leading commentators (such as Tony Atkinson) have stressed the vital role of social support in smoothing transitions. This stance supports the interpretation of social protection systems as productive factors.
42. It is important to recognise that in the globalised environment, migration is likely to be a permanent feature and thus migration policies have to take a long-term approach. Particular issues include whether to try to stem the increase in low-skilled migration in favour of skills tests or to impose some form of green card (as in the US) or points system to attract specific categories of immigrants.
43. In a long-term perspective, investments in human capital should be expected to deliver not only a higher rate of growth of income and output but also a higher degree of income equality and added labour market flexibility. This view is in line with, notably, the recent argumentation of Gøsta Esping-Andersen in favour of

shifting the emphasis in social and welfare policy towards giving higher priority to childcare and education of the younger generations.

44. To the extent that it is the lower skilled who are most vulnerable to the effects of globalisation, there are grounds for labour market policies aimed specifically at these groups. It has also to be recognised, however, that globalisation does not stand still. The most probable scenario for globalisation is that the main trends will broadly continue over the next 15 years. Therefore, it is reasonable to expect further increases in trade intensity, financial market integration and the spread of technology. Even if the growth of emerging markets slows, it will remain above that of the EU and of most member states, such that the share of global output of the likes of China and India will expand, an implication of which is that globalisation will – as the CIA puts it – acquire a more ‘Asian’ face.
45. A significant qualitative change in globalisation can nevertheless be expected, as companies rethink their value chains and seek to reduce costs by ‘unbundling’ tasks, rather than shifting the entire production of products. The much enhanced scope for coordination of production afforded by information and communications technology means that companies can more easily outsource or offshore segments of the production process that were kept in-house in the past. Such unbundling will make it more probable that groups of workers who have hitherto been insulated from globalisation will face new competition, but will equally give increased opportunities to the most qualified and adaptable workers in the EU.

Recommendations

46. A strong conclusion from this study is that many of the fears surrounding globalisation are greatly exaggerated and, even where justified, they tend to rest on an incomplete analysis of the process. Above all, there is no empirical support for the proposition that globalisation is leading to a race to the bottom in social policy. It follows that to view globalisation as an inexorable force is simply unwarranted. Countries can, and do, adjust and there is no great mystery about what is needed. This message has to be repeatedly articulated and ‘sold’ to citizens.
47. Globalisation reinforces tendencies to diminish ‘local solidarity’, to pit one welfare system against another and to expose the individual to a higher degree of unpredictability and risk. Yet these processes are not inevitable, especially if a coherent, EU-wide response is put in place. Much can be achieved by using the tools and methodology of the open method of coordination to enable member states to learn from one another and to improve their own policy performance, but it is also important for the social dimension of policy to be fully incorporated in wider policy processes, such as the Lisbon strategy for growth and jobs.
48. Responding to globalisation is only one rationale for ‘reinventing the welfare state’ and would miss a trick if it meant no more than ‘compensating’ those who suffer most from more intense international competition. Policy mechanisms and institutions have to be adapted to the changing economic environment, recognising that the ensuing social effects are not always directly attributable to globalisation, but result from the reactions of employment and wage formation.

49. The core of a social policy response is in the following main policy domains: education and training, immigration policy, labour market reforms and the reshaping of social protection. There is, in addition, an international governance dimension to consider, especially in the light of the EU's commitment to international obligations as part of its sustainable development strategy.
50. With regard to training and skills, these can and should be enhanced by due attention to the level of education of vulnerable target groups. It is especially important to extend adult training and learning beyond those who already have a high level of educational attainment.
51. In relation to migration, there is an evident need for new, more comprehensive policies to promote the social integration of different types of migrants into the economy and society of the host country. An active approach to the inclusion of immigrants should therefore be part of solidarity. In addition, national migration policies are bound to have externalities for other member states, so establishing common principles and approaches is a pressing matter.
52. The challenge facing welfare reform is not about defending or opposing levels of social expenditure or casting doubt on specific benefits or rules. Successful welfare states respond to new paradigms and associated risks not by cutting back, but by reconfiguring in ways consistent with values such as those espoused by the European social model. Our fond hope is that the discourse on globalisation can be altered to reflect this analysis.

PART I.

**BACKGROUND, KEY CONCEPTS,
FACTS AND FIGURES**

1. INTRODUCTION

Globalisation evokes strong passions among its supporters and detractors alike. It is also a highly salient political issue that lies behind many of the contemporary debates about policy reform. Often, too, it is perceptions of the threat from globalisation that are to the fore, even as consumers and workers enjoy its benefits. In particular, the viability of the European social model is seen as being at risk, despite much evidence to the contrary. For example, the May 2006 Eurobarometer survey on the Future of Europe (European Commission, 2006d) shows that a growing number of European citizens perceive globalisation as a threat to employment and social conditions. Asked about the increasing globalisation of the economy, 47% of interviewees considered that globalisation was primarily a threat to employment and companies in their country, compared with only 37% who saw it as a good opportunity for firms in their country. Moreover, the latter proportion had fallen by 19 percentage points since October 2003, when 56% of Europeans had viewed globalisation as “a good opportunity”. Only 11 of the (then) 25 member states in the May 2006 survey saw globalisation above all as an opportunity for national companies. Danish citizens (77%) and Swedish citizens (54%) were the most positive in their assessment of the consequences of globalisation. On the other hand, the vast majority of French citizens (72%), Greeks (also 72%) and Belgians (64%) seemed to be among the most worried about globalisation.

As a phenomenon of the late 20th and early 21st centuries, there can be little doubt that globalisation is something that resonates widely. Yet in some respects, it is hardly new: trade intensities as a proportion of national output were as high in 1910 as they are today and international migration was extensive. Nevertheless, the growth in research on different facets of globalisation has been extraordinary. Thus, a search of the library catalogue at the London School of Economics produced 1,761 ‘hits’, up from 1,521 in the 15 months since this study had been launched, on the terms *globalisation* or *globalization* in the titles of works it holds, most of them published in the last 20 years, and other data confirm this proliferation in interest. It is also apparent that the salience of globalisation is contested and approaches to coping with it provoke heated debate.

1.1 An interpretation of globalisation

1.1.1 A multifaceted concept

The term ‘globalisation’ is widely – if usually glibly – used, yet remains ill defined. It is one of those slippery terms that most people understand intuitively but, like the proverbial elephant, find it hard to define or give operational content. The website that accompanies the popular text by Held & McGrew (2003) observes that

globalization – the ‘big idea’ of the late twentieth century – lacks precise definition. More than this, it is in danger of becoming, if it has not already become, the cliché of our times. Nonetheless, the term globalization captures elements of a widespread perception that there is a broadening, deepening and speeding up of world-wide interconnectedness in all aspects of life, from the cultural to the

criminal, the financial to the environmental. At issue appears to be 'a global shift'; that is, a world being moulded, by economic and technological forces, into a shared economic and political arena.

From an economic perspective, Stiglitz (2003, p. 51) gives this definition of the phenomenon:

The idea of globalization is very simple. The decrease of communication costs, transportation costs, and artificial barriers to goods and factors of production has led to a closer integration of the economies of the world. Globalization implies mobility not only of goods and services but also of capital and knowledge – and to a lesser extent of people. Globalization entails not only the integration of markets, but also the emergence of a global civil society.

A number of facets of globalisation can be distinguished, most of which would be broadly accepted by critics and supporters alike. These include the growth in international flows of goods, services and capital; the increased propensity towards international migration; the spread of technologies and of the multinational companies that play a major role in diffusing them; and the intensification of communication exemplified by the spread of Internet use. Geographically more dispersed subcontracting, sourcing and division of labour in production processes – sometimes seen in more negative terms in the French expression *delocalisation* – are also associated with globalisation. For some of these variables, the relevant indicators may not have changed as much as is sometimes thought and, for variables such as trade flows, it may be that much of what is classed as globalisation is really attributable to forms of regional integration, such as the European Union or the North Atlantic Free Trade Association. Nevertheless, the rise of Chinese exports has dramatically undercut established suppliers and altered supply chains in developed and developing countries alike.

Equally, in areas such as financial markets, there has manifestly been a huge qualitative change insofar as there is instant transmission of information across the world that can trigger rapid flows. There is also a softer dimension to globalisation in the form of global values, global brands, global news and so on – as well as the inevitable backlashes against them. A corollary is that social models and policy approaches will inevitably have to be tempered by these trends. This provokes questions about whether the trends are leading towards an inevitable convergence or whether distinctive social models can be maintained.

1.1.2 Underlying drivers

Although globalisation is a phenomenon much in focus in the public debate and in research endeavours, it is not a *primary* driver of socio-economic developments. To the extent that globalisation exists as a measurable phenomenon, it is the *outcome* of the operation of, and interactions between, such basic drivers as the following:

- the expansion of trade and investment flows, arising partly from the functioning of markets and the organisational choices made by enterprises, and partly from policy choices regarding the liberalisation of trade;
- the integration of capital and money markets resulting in a vastly increased volume of such flows. The free circulation of capital outside government control has led to the transfer of the concept of power, traditionally invested in

governments, to private holders of capital. Capital flows – which were formerly directed towards banks and controlled by governments – are now held by individuals, institutions or private mutual funds and can circulate freely and instantaneously to projects that will yield the maximum profit. Electronic, computerised data transmission now gives them an unprecedented mobility on all the financial markets on the planet;

- demographic developments, notably in the EU context the substantial extent of population ageing underway, which will accelerate over the coming decades. At the same time, the youth populations of many neighbouring global regions, such as North Africa, have been expanding rapidly and these countries may struggle to provide sufficient opportunities for these populations;
- migration. A prominent phenomenon a century ago, but which has been much less in evidence in recent decades, migration is linked to the aforementioned demographic trends. Population movements, both within the EU and from the rest of the world to the EU, are increasing and posing new problems of social integration;
- innovation and R&D, and their impact on the pace of technological change as they affect not just products and processes, but also the options open to enterprises in the management of their activity;
- climate change, energy consumption and pollution; and
- the growing importance of human capital, knowledge and information.

A proper understanding of globalisation calls for an assessment of the respective impacts of these drivers. For example, a key problem facing governments today is how to attract new investment with a view to creating jobs and promoting sustained economic growth. To this end, nations vie with each other through variations in their interest rates or their rates of exchange, and through the competitiveness of their markets. The world has truly become capitalist, and the ever-increasing financial movements can reward savings and productivity, thus strengthening a country's economy. Conversely, foreign capital can abandon an economy or withdraw abruptly if an unfavourable fiscal policy drives it away.

1.2 The policy context

Globalisation poses challenges at all levels of government because of the many ways in which it alters the economic environment, the need for interventions to ensure that economies and support systems adjust and the demands on the state to adapt governance frameworks. From an economic theory standpoint, globalisation can boost growth and increase social welfare through a more efficient allocation of resources. The realisation of the implied social benefits relies on the fulfilment of several conditions, however, such as sufficient flexibility of the labour and product markets, the efficiency of the welfare state and, in the particular case of the EU, on the ability to shift the economic production frontier of the EU economies by a significant level of innovation. Yet, while benefits in the form of lower prices, higher productivity and income will only materialise in the medium term, social costs such as higher unemployment and income inequality are likely to be encountered in the short term. As stated in the Sapir

report to the European Commission, “[t]he key policy issue for Europe is how to enjoy the benefits of globalisation while continuing to mitigate its costs”.¹

The challenges of globalisation inevitably bear on the design and coordination of national labour market and social policies, as well as on the wider question of how the European social model should evolve. In this regard, the new policy framework agreed at the EU level for both economic and social policies needs to be taken into account. On one side of this framework is the partnership for growth and jobs (the relaunched Lisbon strategy), which brings together what were previously separate coordination mechanisms, the Broad Economic Policy Guidelines and the Employment Guidelines. Complementing this framework on the other side is a new approach to the ‘open’ coordination of social protection and social inclusion policies, agreed in 2006. Within this new ‘streamlined’ approach, the European Council adopted a Commission proposal, which states that

[the] overarching objectives of the OMC [open method of coordination] for social protection and social inclusion are to promote:

- social cohesion, equality between men and women and equal opportunities for all through adequate, accessible, financially sustainable, adaptable and efficient social protection systems and social inclusion policies;
- effective and mutual interaction between the Lisbon objectives of greater economic growth, more and better jobs and greater social cohesion, and with the EU’s Sustainable Development Strategy; and
- good governance, transparency and the involvement of stakeholders in the design, implementation and monitoring of policy.²

These aims suggest some of the contours of an EU response to globalisation. Of particular relevance in exploring the social impact of globalisation is the emphasis on the linkages between the economic and the social. These linkages are captured in the expressions ‘feeding-in’, meaning the reform of social protection and social inclusion policies to advance Lisbon objectives, and ‘feeding-out’, which refers to the effects of economic reforms in improving employment and other variables that help lead to greater social cohesion. Feeding-in can be seen as an extension of the notion of social protection as a productive factor, which underpins many recent initiatives to modernise social protection systems. In parallel, the concept of ‘active inclusion’, which is a central component of the EU’s social inclusion strategy, can be seen as a means of enhancing the EU labour force and thus as contributing to the competitiveness that the EU requires to confront globalisation.

That there is considerable policy development underway at present is undeniable, especially around the notion of ‘flexicurity’. In relation to the labour market, the European Commission’s (2006e) Green Paper on Modernising Labour Law to Meet the Challenges of the 21st Century invites public debate on how labour law can

¹ See *An Agenda for a Growing Europe: The Sapir Report*, by the High-Level Study Group organised by the President of the European Commission, and chaired by André Sapir, initially published in July 2003 (Sapir et al., 2004).

² See the Communication on Working Together, Working Better (European Commission, 2005d).

be rendered more flexible, so as to support the flexibility and adaptability of workers and enterprises alike. It highlights a concern about dual labour markets in which privileged 'insiders' prosper at the expense of 'outsiders'. An important issue raised is how labour law can underpin labour market transitions from one job (or status) to another, rather than protect the individual currently in a job. In this context, the paper invites ideas about how to promote lifelong learning and how to reinforce the inclusiveness of employment policies.

As part of the emerging architecture of economic and social governance in the EU, there is manifestly a strong political push towards defining a way forward for the European social model that embraces a mix of increased labour market flexibility, protection of the individual and wider social aims. Increasingly, this approach is being linked directly to the competitive challenges of globalisation and, within it, the flexicurity debate is crucial, as what the EU is trying to do is to achieve greater flexibility without unduly compromising the much-envied standards of protection that characterise the European social model. An important Communication published by the European Commission (2007b) puts forward an agreed characterisation of flexicurity, which is that it should comprise policies covering labour laws, active labour market measures, lifelong learning and social security reforms. Flexicurity covers both external flexicurity through the labour market and internal flexicurity within individual companies. As a paradigm, it has received the endorsement of the 2007 and 2008 spring European Councils.

1.3 Objectives of the study

The purpose of this study is to investigate the social impact of globalisation from a number of perspectives. The first aim is to develop an inventory of essential features and issues concerning the social impact of globalisation in the EU, to bring out differences in the social consequences for member states and to look for patterns of clustering across the enlarged Union. The assessment of the character and scale of the social impact seeks to highlight groups especially at risk of being disadvantaged by globalisation and to explore whether globalisation merely reinforces existing biases between winners and losers in Europe or whether it also creates new and different divisions. The assessment thus includes the following aspects:

- *The relocation of economic activities.* Under this heading, distributional effects and issues of inequality are considered. How polarised are the distributional outcomes? To what extent do job losses mainly occur in labour-intensive, low-skill processes located in vulnerable areas while job creation takes place in highly skilled sectors in the economic growth centres? How are life chances and living standards affected? What are the resulting patterns of social problems and social decline? Depending on whether they are among the winners or losers, what is the social impact on workers, their families and communities?
- *The relocation of people.* This aspect takes into account socio-cultural implications of global-scale immigration to and asylum-seeking in Europe, particularly
 - the extent to which political conflict and economic and social misery in faraway places have social and political repercussions in Europe;

- the sharing of the benefits and costs of immigration among the indigenous population; problems of exploitation of migrant workers and trafficking in people;
 - the social ramifications of insufficient economic, social and cultural integration; and
 - the implications of developments towards increasingly multicultural and multi-ethnic societies for social and political cohesion.
- *Opportunities and challenges for the European social model and social protection systems in particular.* Here the focus is first on social policy as a capacity factor: for anticipating and addressing social problems (e.g. sudden mass redundancies, social inequities calling for redistribution, the social exclusion repercussions from local concentrations of long-term unemployment and insufficiently integrated immigrants, etc.) in adequate ways by articulating the synergies between the different elements of the European social model. More specifically, these are active and preventative (employment and) social policies backed by social and civil dialogue. Second, this aspect looks at social policy as a cost factor: social protection (and labour and health & safety standards) as an element in non-wage labour costs. To what extent are EU social protection standards threatened by competition from countries for which a markedly lower level of social protection/labour standards constitutes a major part of their competitive advantage – and what are the social consequences?

The study does not attempt to investigate the wider issues raised in work by, notably, the International Labour Organisation about the costs and benefits for richer and poorer nations and for social groups, nor for governance as raised by Joseph Stiglitz and others with respect to sharing out prosperity at the global level. Instead, the study concentrates on the implications for social policies at the EU and member state levels. The study takes as a given that globalisation has a positive overall economic effect, but also that it has distributive consequences that mean that there will be losers as well as winners. It explores how member states differ in their ability to contain and address the negative social impact of globalisation while seizing the opportunities to benefit. The policy mixes and governance structures that are most effective are highlighted.

Finally, the study tries to assess how the abilities to seize opportunities and absorb the social impact can be improved and considers what can be done to improve Europe's scope for anticipating and handling the dilemmas posed by globalisation in the social field.

1.4 Outline of this report

This report is in three main parts that draw upon the more detailed work produced by the research team responsible for the overall study. This first part, which looks at the phenomenon of globalisation, comprises a synthesis of findings from the extensive literature on the subject and a presentation of relevant empirical material on trade and investment flows and on outsourcing. In the second part, the focus is on the social dimension of globalisation and the way in which it is evolving. A conceptual

discussion is complemented by an extended discussion of social conditions in the EU, together with more specific work on migration (including regulatory developments in the area) and on inequality. The third part of the study then concentrates on the policy issues, drawing out the implications for the social agenda in the EU and continuing with a scenario exercise that speculates on the likely evolution of globalisation. Concluding comments and recommendations complete the study.

2. THE STUDY OF GLOBALISATION: INSIGHTS FROM THE LITERATURE

The body of literature dealing with globalisation is vast and growing exponentially. Specialised databases and studies tell us something about the changing flows of goods and finance. Yet it is the conceptual issues relating to understanding these global changes that provide the most useful background for a study dealing with the impacts of globalisation. Therefore, much of the literature reviewed here not only deals with statistical issues, but also tries to answer some wider questions, most importantly: What is globalisation? How do standard economic and political theories help us to understand it? And what are the potential social impacts of globalisation-related changes?

The term 'globalisation' has caught the attention of the media and academics alike. The sense of profound change in the organisation of the world is often initiated by casual observation. In many shops, most of the products on display have been made or grown in faraway corners of the world. The apples in the shopping trolleys come from South Africa. The shrimps on the plate in the local restaurant were swimming a few days ago in the sea somewhere off the coast of Vietnam. This sense of change is accentuated by some striking statistics. The textile and clothing industry is the most globalised segment of manufacturing. Today, three-fifths of all clothing buttons used in the world are actually produced in one region of China,³ exemplifying the division of labour on a global scale. It is no wonder that globalisation has become such a popular term, nor that it has come to be used as shorthand for a wide range of economic challenges, seen as an opportunity for some and a threat for others.⁴

The body of literature dealing with globalisation is thus understandably vast. It comprises, first, specialised studies that statistically monitor developments in various economic activities. These indicators demonstrate that something profound is happening in the world and that it is something new. It is true that there was an earlier wave of globalisation associated with the 19th century industrial revolution that swept through Europe and extended to the US. At the end of the 19th century, the volume of

³ More specifically, they are produced in and around one town, Qiaotou (see "The tiger's teeth", *Guardian*, 25 May 2005).

⁴ Stanley Fischer (2003, p. 2, fn. 2) describes the rise of globalisation and anti-globalisation as follows:

During the 1970's the word 'globalisation' was never mentioned in the pages of *The New York Times*. In the 1980's the word cropped up less than once a week; in the first half of the 1990's, less than twice a week; and in the latter half of the decade, no more than three times a week. In 2000, there were 514 stories in the paper that made reference to 'globalisation'; there were 364 stories in 2001, and 393 references in 2002. Based on stories in *The New York Times*, the idea of being 'anti-globalisation' was not one that existed before about 1999. Turning from the newspaper to the Internet, 'globalisation' brings up 1.6 million links through the use of the Google search engine, and typing in 'anti-globalisation' brings up 80,000 links.

global trade relative to output was roughly the same as it is today. But today, the world is integrating in a novel way.

The Federal Reserve Board Chairman Ben Bernanke (2006) recently pointed out four defining features of the new developments. First, is the matter of their sheer volume: the global market has expanded to an unprecedented scale, with more countries than ever actively integrated in global markets. Second, is the observed weakening of the traditional core-periphery effects. In the past, the core provided manufactured goods to the periphery in exchange for raw materials. Today, however, the emerging markets account for a large and growing share of world manufacturing capacity and, as China's burgeoning demand for raw materials shows, a significant determinant of commodity prices. Even more strikingly, the flow of capital has become bi-directional. Whereas in the 19th century, Britain exported financial capital to the periphery, the largest economy of today, the US, runs a current account deficit substantially financed by emerging-economy nations. Third, the current geographical fragmentation of production processes has no precedent. Fourth, the capital markets are much more developed and sophisticated today than at any time during the past expansions of trade and capital flows. Gross flows of capital are much larger than in the past, and they take many more forms. In particular, the flows of foreign direct investment are much larger relative to output than at any time before.

Finance is arguably the area in which the world has been transformed into something very close to an idealised global market. With digitisation and the development of communication technologies, the transaction costs of moving money are practically zero. Today, a foreign-exchange dealer in a bank somewhere in Europe follows the movements of currencies in Asia just as closely as those in his or her own country, and interacts continually with counterparts across the globe. Momentous changes in the global organisation of finance and the deepening international division of labour raise questions about their societal implications.

International organisations have responded by organising large-scale research projects. The OECD came up with a programme on "Empowering People to Meet the Challenges of Globalisation". The International Labour Organisation established the World Commission on Globalisation, which gave its report in 2004. The World Bank published, for example, *Poverty in an Age of Globalisation* (2000) and more recently, *Managing the Next Wave of Globalization* (2006d).

Apart from statistical monitoring and impact studies, another layer of literature explores the characteristics of globalisation. This layer is the analytical literature that tries to categorise the phenomena entailed in the global socio-economic processes, looks for drivers of changes and interprets these social and economic processes in terms of larger frameworks of values, preferences and desirable outcomes. It is mostly this body of literature that has been reviewed as a background study for this report.

2.1 What is globalisation?

In 1962, Marshall McLuhan first brought out the term 'global' as something denoting a tectonic shift in social relations into the public domain in his book, *The Gutenberg Galaxy*. The term was more cultural in content than anything else. The concept of a 'global village' describes broadly changing patterns in human perceptions of time and space. Indeed, by now communication technologies and commercial developments

have created a certain global, common cultural code. Two people from different parts of the globe can easily discuss their favourite Hollywood movies, analyse the politics of some of those military conflicts that are heavily covered by news agencies or comment upon the contents of some globally disseminated lifestyle platform, as in the magazine *Cosmopolitan* for example.

Globalisation has progressively come to be referred to in connection with economic challenges, however. References are often negative, as when newspaper headlines describe anti-globalist protesters spoiling international gatherings or the anti-globalisation feelings that ran against the European Constitution (Giddens, 2005, p. 97). Globalisation in this sense denotes the processes of pressure on labour markets to become more flexible and wages to adjust to the rate dictated by the global market. Producers compete not just with other producers in the same country or region, but more and more with almost anyone across the globe, as new technology makes transportation much less of a cost and communication much easier.

2.1.1 Trade

The rise of globalisation is often used as shorthand for the growing prominence of trade in the global economy. In recent years, world trade integration outpaced other sources of growth (World Bank, 2006d, p. xiv). Between 1985 and 2002, trade integration more than tripled (Gunter & van der Hoeven, 2004, p. 3).

But the rise in the volume of trade is not the whole story. It is the composition of trade that tells us more about the nature of the current phase of globalisation. Analyses based on a high level of commodity disaggregation confirm that trade has risen as a consequence of the specialisation of exchanges within the same broad sectors (Gerstenberger, 1990; Storper, 1992, p. 63). Around two-thirds of trade volume today is intra-industry trade (Gunter & van der Hoeven, 2004, p. 10). This trade is largely driven by the activities of multinational enterprises (MNEs). As MNEs build global value chains, each heavily fragmented over a number of countries, global trade increasingly becomes trade in tasks, not entire products or services (Grossman & Rossi-Hansberg, 2006). Indeed, some authors point to the role of MNEs as a uniquely defining feature of globalisation (Strange, 1986). What is more, their role seems likely to grow in the future (Ostry, 1998, p. 86).

The most striking example of globalisation in manufacturing is the textiles, clothing and footwear industry. Here, Asia has plainly come to dominate the global market. It is estimated that Asian mills account for two-thirds of the world's spinning and weaving capacity (Asian Development Bank, 2006). At the same time, trade and production patterns are decisively shaped by distribution companies, which are based in Europe, North America and Japan (Hayashi, 2005).

Outsourcing is clearly one of the drivers of changing patterns of trade. The European Commission recently published a report on outsourcing (Havik & McMorrow, 2006), which showed that EU countries fare well in trade in intermediate goods, producing significant surpluses. Where the EU lags is in trade in information and communications technologies (ICT). Here, the report called the performance "exceptionally poor". Yet concerns arise over whether Europe's relatively good performance in intermediate outputs is simply owing to the fact that the capital stock in traditional industries is high, a product of long historical development. The risk is

that as other countries build up their capital stock – which is growing ever easier – Europe will lose its competitive edge. Another concern is that Europe is becoming more exposed to external price shocks as other countries come to play an important role on the margins of some markets, especially with respect to raw materials.

The rise of China has become a substantial new factor behind the globalisation story. In 2003, China's economy accounted for 55% of Asia's exports. As a percentage of the world economy, China accounted for 7.2% of imports and 16.5% of exports (Reisen, Grandes & Pinaud, 2005, p. 17) and its share keeps on rising. The country is progressively a price-setter in commodity markets (*ibid.*, p. 19). China is the second largest holder of US Treasury bills in the world (\$165 billion, 6.5% of total foreign holdings), which makes the cheap labour giant an extremely important player in US and world financial stability (*ibid.*, p. 20).

2.1.2 Finance

Some authors focus on financial markets as the key feature of the new economic order (Jessop, 2002, pp. 106–07) and indeed, the rise of various instruments of financial intermediation (if this can still be called 'intermediation') tells an even more dramatic story than the one presented by trade figures. "Between 1963 and 1995, the size of the total funds raised on international markets increased at an annual growth rate of 24.3% compared with 5.5% annual growth rate in world trade and 3.2% growth in global production" (Jessop, 2002, p. 106). These funds are seen, with growing frequency, as 'stateless money', which has a dynamic at odds with the immediate post-war financial regime (Leyshon & Tickell, 1994). Approximately \$1.5 trillion is exchanged daily on foreign exchange markets and only 5% of this amount is directly related to payments for traded goods or services (Jessop, 2002, p. 106). The deterritorialisation of money is being reinforced by the development of various derivative instruments.

The Asian crisis of 1997 and the Russian crisis of 1998, as well as the spectacular rise (and sometimes fall) of new financial actors (hedge funds), remind us of a peculiar dynamic of world financial architecture, whereby contagion can spread at a rapid pace from one part of the world to another. Indeed, the nature of such crises is noted by some as a particular characteristic of the present phase of globalisation. Some authors highlight the growing incidence of crises and their pattern – ever more frequently originating in the emerging markets (Pauly, 2005, pp. 183–84).

2.1.3 Post-industrial economy

Dealing with new structures of risks would not be complete without taking into consideration the whole conceptual framework that overlaps the theme of globalisation, namely the shift from an industrial to a post-industrial mode of economic growth. In short, an industrial economy is one centred on large-scale manufacturing operations, based on assembly-line or semi-assembly-line work processes. These concentrate a 'massified' workforce, often employed in lifetime jobs, and derive their profit advantage from economies of scale.

As economies become more developed, the technical content of products becomes more easily variable, while growing disposable incomes allow people to make more and more lifestyle choices. 'Flexibility' becomes the key word. On the one hand, products can be quickly modified and innovations can be introduced as production

and the dissemination of knowledge pick up pace with computer and communications technologies. On the other hand, technical and marketing variations also become easier as the market for manufacturing products becomes more global owing to decreases in transportation costs. The ratio of costs based on heavy hardware decreases – again as a result of the emergence of a global competitive market and the widespread standardisation of basic technologies. At the same time, the returns to quick adaptation and innovation increase. ‘Economies of scope’ and ‘economies of networks’ become the main sources of profit advantage in the post-industrial component of modern economies. All the while, the service sector grows bigger, generating new tensions and tough policy choices arising from the changes in relative costs in the service and manufacturing sectors (the ‘Baumol’ or ‘cost-disease’ effect). Yet it also has to be recognised that the boundary between certain forms of manufacturing and services is becoming more blurred and that for some services the scope for rapid productivity increases is considerable.

2.1.4 Summary of the meaning of globalisation

Thus, globalisation is a multifaceted concept. At the basic level, it refers to changing volumes of trade and investment flows. At the next level of analysis, it refers to a changing quality of these flows. Trade is progressively more intra-firm trade as well as trade in intermediate goods. It is driven by the expansion of MNEs, which have become the typical actor in globalisation processes.

The term ‘globalisation’ implies new developmental processes emanating from post-industrial organisation, which may then clash in their inherent logic. Bob Jessop speaks of the conflict between the concept of knowledge as intellectual commons and knowledge as intellectual property, and more broadly of the conflict between implications prioritising the information economy and those stressing the need for an information society (Jessop, 2002, p. 110). These conflicts are in line with contradictions sketched out already by Bell (1973) between the economising and sociologising logics of the post-industrial society.

The various dimensions of globalisation can be described as follows (Jessop, 2002, p. 115):

- 1) the internationalisation of national economic spaces through growing penetration (inward flows) and extraversion (outward flows);
- 2) the formation of regional economic blocs;
- 3) the growth of more ‘local internationalisation’ and ‘virtual regions’ through the development of economic ties between local and regional authorities in different national economies;
- 4) the extension and deepening of multinationalisation through MNEs, transnational banks and international producer-service firms;
- 5) the widening and deepening of international regimes covering economic and economically relevant issues; and
- 6) the emergence of globalisation proper through the introduction of global norms and standards, the adoption of global benchmarking and the development of globally integrated markets, in which ‘deracinated’ firms with no evident national base operate.

This list indicates that globalisation is far from producing a homogenised economic space. Rather, it involves a reordering of differences and complementarities in various geographical spaces as well as the global one, and this constant reordering is the basis for creating dynamic competitive advantages (ibid., p. 117).

Depending on which facet of changes sweeping the world they want to stress, different authors come up with different definitions of globalisation (Box 2.1).

Box 2.1 Globalisation – Some definitions

Globalisation is the...

- “integration into the world economy” and increased interdependence “through trade, investment, finance, regional integration, technology, and demographic factors” (Richardson, 1997, p. 50).
- “growing integration of economies and societies around the world as a result of flows of goods and services, capital, people, and ideas” (Dollar, 2001, p. 2).
- external opening and an increased role of markets internally (Robinson, 2001, “Preface”).
- process in which “trade grows more rapidly than production” (Storper, 1992, p. 66).
- “closer integration of the countries and peoples of the world which has been brought about by the enormous reductions of costs of transportation and communication, and the breaking down of artificial barriers to the flows of goods, services, capital, knowledge, and (to a lesser extent) of people across borders” (Stiglitz, 2002, p. 9).
- “reorganisation of production into global production systems, notably global value chains and export processing zones” (Carr & Che, 2004, p. 1).
- “gradual integration of economies and societies driven by new technologies, new economic relationships and the national and international policies of a wide range of actors, including governments, international organisations, business, labour and civil society” (Gunter & van der Hoeven, 2004, p. v).

Despite the prevalence of the economic dimension in the dominant public discourse on globalisation, which revolves around various indicators, it is probably worthwhile to keep in mind that the social reality cannot be simply compressed into a range of numbers. The Bureau of European Policy Advisers has recently published a consultation paper (Liddle & Lerais, 2007) that takes a wide view of the social realities and changes stemming from globalisation. This study is a response to the European Commission’s (2006a) Communication on a Citizens’ Agenda in which the Commission proposed a ‘social reality check’ ahead of preparing an agenda to promote access and solidarity in the EU.

2.2 Drivers contributing to the process of globalisation

The **drivers** of globalisation are in part determined by policy factors and in part by technological developments or underlying trends:

- The liberalisation of trade is largely a result of the various waves of lowering of trade barriers within the General Agreement on Tariffs and Trade and its successor the World Trade Organisation, but also of free trade agreements such as the European Free Trade Area and the North American Free Trade Area and a number of bilateral trade agreements across the world.

- In addition to the worldwide liberalisation of trade flows, the successive EU enlargements and the resulting integration have contributed significantly to the boosting of intra-EU trade flows and brought changes in the trade with non-EU countries.
- In recent decades, the rise in trade flows has accelerated through a remarkable reduction of transport costs and technological innovation, notably with the emergence of container handling and movements along with the associated increase in the role of container ships travelling around the world.
- Transport costs have fallen consistently, despite rising oil prices, while cross-border telecommunication costs among the major trading nations have become effectively negligible. Anne Krueger cites evidence that a three-minute telephone call between New York and London would have cost \$293 in 1931, \$1 in 2001, and is now just a few cents for a better connection.⁵ Similarly, key facts cited by the International Shipping Federation shows that between 1980 and 1999, a period when the *annual* increase in the value of world trade was 12%, the costs of shipping rose by just 7% over the whole period.
- Total freight costs for trade between developed countries account for less than 4% of the value of trade, with the implication that it is now other factors (such as regulatory restrictions, tariffs and so on) that limit trade, rather than transport costs. Indeed, transport costs make up only 2% of the cost of a television⁶ shipped from Asia to Europe and 1.2% of the cost of a kilo of coffee. Despite the fall in direct transport costs, Anderson & van Wincoop (2004) show that the costs of trading can still be considerable, especially for developing countries. The reasons lie in the costs of border formalities, information and other policy variables that affect distribution and margins at each stage in the chain from the producer to the consumer. They note that for these reasons, barriers to trade remain substantial.
- The rise in world trade has also been favoured by the liberalisation of capital movements, financial markets and payments. All of these developments have represented an imperative complement to the intensification of trade, but they have mainly been implemented within the OECD, by the International Monetary Fund, through EU enlargements or modifications in national policies.
- But again, the process of globalisation would probably not have taken place without the emergence of the Internet, ICT in general and the resulting huge reduction in the costs and increase in the speed of communication across the world.

⁵ See the lecture by A. Krueger given at the Kiel Institute symposium in honour of Herbert Giersch (Krueger, 2006).

⁶ See the website of the Roundtable of International Shipping Associations (<http://www.marisec.org/shippingfacts/worldtrade/costs.php>).

- Rules and regulations concerning immigration and frontier control should also be taken into account as a potential driver of globalisation. Pertinent issues in this field, such as growing demands for political asylum or flows of refugees, are of major importance.
- The genuine internationalisation of many (if not most) multinational companies on the one hand, and the nature of international governance, either absent or in certain areas brought about by intergovernmental cooperation (notably within the OECD) on the other, has contributed to the creation of a world market that is largely unregulated or subject to only partial enforcements of competition rules, for example in transatlantic trade.
- Yet the process of globalisation has also been (and will in the future probably be) even more influenced by the speed of innovation and R&D, the progress of education and of intellectual capital and intangibles, the transfer of technology and the nature of the societal model in different countries. These important aspects only feature tangentially in the present report.

The role and interplay of these and other main drivers have thus contributed to the **process of globalisation**, more specifically,

- huge changes in the size and direction of trade flows, with the share of merchandise trade in world GDP in real terms doubling since 1975 and quadrupling since 1950, but with trade in services only growing by half as much. Services are now starting to catch up, however;
- the outsourcing of production, initially of goods with a high content of low-skilled labour input, but increasingly also of services with a substantial content of highly skilled labour input, including ICT services and certain categories of R&D. According to a recent study by Statistics Canada, 20% of Canadian jobs were exposed to outsourcing, although the study found no indication that industries relatively more exposed to outsourcing had slower growth of employment than less-exposed industries (Morissette & Johnson, 2007). Work by the McKinsey Global Institute has even found that for the US, outsourcing leads to net job creation (Farrell, 2007);
- a certain relocation of people, mainly nationally and associated with the restructuring of production units, yet also to some extent internationally as a complement to the outsourcing and insourcing of production;
- vast changes in the size and patterns of capital movements, both in the field of portfolio investments and in foreign direct investments. The stock of external assets and liabilities for the EU as a whole as a proportion of GDP rose from 59% of GDP in 1970, to over 550% in 2004, with a particularly strong expansion after 1995; and
- the potential influence of the relocation of production on sources of government revenue, creating a need for reordering priorities and reforming taxation.

In view of the very size of the changes in the flows of goods, services and capital movements, and of the ongoing outsourcing and insourcing, the process of globalisation must be expected to have **social consequences**:

- The industrial restructuring in favour of highly skilled branches can be expected to lead not only to a weakening of employment of low-skilled labour but also to

changes in regional employment patterns. A strengthening of employment in regions and branches with a high proportion of highly skilled labour can be anticipated, offset by a negative effect on wages or employment (or both) in low-skilled jobs and branches.

- Since the effects are not symmetrical, nor do they influence the various levels of skill in the same direction or proportions, the process of globalisation may give rise to a tendency for income inequalities. Meanwhile, in countries with a low degree of labour market flexibility, the segmentation of the labour market risks is being accentuated.

Still, the social effects of globalisation are not, as underlined elsewhere in this report, felt in the same way or to the same extent in all EU member states. Depending on the flexibility of the economy, the level of education of the working population, labour market rigidities and the functioning of the system of social protection, globalisation may appear as an opportunity or a danger. Based on the interaction between the economy, the social protection system and the mechanisms of social solidarity, the following effects can be observed:

- In some member states, globalisation is primarily an opportunity to accelerate the process of adaptation to a knowledge society and the growth of productivity, while in others it tends to aggravate existing segmentations and rigidities.
- Globalisation is absorbed with relatively little change in the overall income distribution in some EU countries, even if added segmentation leads to increased disparities of income between 'insiders' and 'outsiders'. But globalisation may be a cause of a general shift in the functional income distribution in favour of capital income.
- Owing to the system of governance and the efficiency of tax collection in some member states, combined with the resilience of their economies, globalisation does not lead to a loss of tax revenue, but to a strengthening of public finance. Yet in other member states with high taxation of labour and rigidities in the system of public revenue, globalisation leads to added pressure on public budgets through a vicious circle of increasing rates of taxation and social security contributions, adding to the direct effects of globalisation on employment.
- In member states with highly adaptable product and labour markets and, especially those with social protection schemes favouring employment and rapid adjustment, the social protection schemes may contribute to accelerating the participation of the economy in the process of globalisation, suggesting that there may be a positive feedback from social protection schemes to the process of globalisation.

The policy recommendations in chapter 12 of this report argue that there is no empirical evidence of a 'race to the bottom', implying that globalisation is not an inexorable force. Even so, it is recognised that globalisation reinforces tendencies to pit one welfare system against another and to expose individuals to a higher degree of unpredictability and risks. Hence, responding to globalisation requires adapting policies and institutions to a changing economic environment, as discussed in section 12.5.

To the extent that the policy response adopts an active stance, favouring adaptation and maintaining high levels of social justice and solidarity, it can be expected to induce a positive feedback. These not only relate to the social consequences, but also to the very nature of the process of globalisation and the capacity of the EU to exert influence on the international governance of key aspects of this process.

3. EVIDENCE ON THE DEGREE OF OPENNESS

The investigation of globalisation as a new phenomenon that emerged at the end of the 20th century is often puzzling to scholars. One of the reasons is that some substantive aspects of internationalisation, such as massive cross-border trade, foreign direct investment and migration, are not novelties in the history of world economy. Scholars are divided as to whether the most recent wave of internationalisation has demonstrated the scale of quantitative or qualitative change that would justify considering it a paradigm shift (see the overview in Bordo, Eichengreen & Irwin, 1999). Another difficulty is, as discussed in chapter 2, that public perceptions and discourse on globalisation comprise extremely diverse developments starting from various cross-border economic activities through the progress in technology and communication to social and cultural transformations, the interaction of values, etc. An exact and balanced analysis and evaluation of such diverse phenomena summarised under the buzzword 'globalisation' is therefore almost impossible.

The heated debates about the causes and effects of globalisation are, however, with us, as is the enthusiasm for, or fear of, those who are convinced of the virtues or the vices of this process. To enhance the analysis of globalisation in the European context, in this overview we focus on 'economic globalisation': a basic, historically and theoretically circumscribed side of globalisation relative to the other aspects of the process. We concentrate on *openness* since it is intimately related to economic globalisation and it helps to *measure* the extent of the internationalisation process across countries and time.

This chapter adopts the simple formulation of Brahmhatt (1998, p. 1) that economic globalisation (or economic integration) is "the increasing freedom and ability of individuals and firms to undertake voluntary economic transactions with residents of other countries, a process entailing a growing contestability of national markets by foreign suppliers".

Drivers of the process have been both *policy-related* (such as the gradual reduction of official or private obstacles to exchange) and *business- or technology-related* (such as the reduction of transaction costs of exchange owing to inventions and technological developments in transport, information technology, communication, etc.). Some analysts attribute the recent wave of globalisation mostly or even solely to the developments in technology (Williamson, 1998; Giddens, 1999). Others, such as Sachs & Warner (1995), focus more on the role of public policy (trade liberalisation, the fall of communism and economic reforms) or even claim that one of the features distinguishing the current wave of globalisation from the earlier one is that current progress in openness relies less on technological developments and more on the abolition of government-erected obstacles to trade and capital flows (Bhagwati, 2004). Finally, some theorists accept both the role of technological developments and public policy, and complement these with further factors. Mussa (2000), for instance, considers the *tastes* of individuals and societies that prefer taking advantage of the opportunities of declining costs of transportation and communication as an equally important driver of globalisation as policy and technology.

Measures of economic openness try to gauge that part of economic integration that can be quantified, and thus analyse the progress (and in some periods, the regression) of globalisation. These measures are also useful because they make it possible to analyse the relationship of openness (or globalisation) with other processes, such as economic growth, inequality or financial volatility.

As the definition of globalisation above reveals, the degree of economic integration or openness is usually related to countries that are defined by their unique geographical location, political system, jurisdiction, language, social history and so forth, or to the residents of these countries. The ease of, or freedom to, conduct transactions across borders refers to various aspects of business:

- a) the cross-border trade of goods and services;
- b) the ability to carry out financial transactions (portfolio investments as well as lending and borrowing);
- c) the establishment, operation and control of business in another country through foreign direct investment;
- d) the offer of labour services by residents of another country (labour migration); and
- e) the exchange of information, conventions, perceptions and expectations necessary for the smooth and safe conduct of market exchanges.

Based on the current structure of the EU, this chapter centres on past and recent patterns of progress in openness. Both time-related and cross-country comparisons are undertaken, with the aim of establishing which European economies are most open to the rest of the world and which have benefited most from the technological developments of transport and communication of recent decades, as reflected in their openness. How much was economic globalisation enhanced in Europe by the collapse of the communist system and the ensuing broadening of economic freedom? Have the former centrally planned economies caught up with the 'old' EU member states in opening up or are they still following the tracks of their more developed partners? Are there characteristic differences in these patterns when observing trade, portfolio or foreign direct investment (FDI) flows, the exposure to foreign ownership and control, and the exposure to tax competition? In the analysis, we focus on the 15 old EU member states, the 10 new member states that joined the Union in 2004 and the two new countries (Bulgaria and Romania). For cross-country comparisons, we use these 27 countries. The chapter has only a few comparisons with other developed and less developed economies, partly because of brevity considerations and partly because the selection of comparator countries always involves some arbitrariness and would necessitate detailed qualifications in the subsequent analyses of data. In some analyses, however, we also have a look at the development of the 'BRIC' countries (Brazil, Russia, India and China), whose opening up and joining the world market in the past two decades are considered a major part of the current wave of globalisation.

Openness measures provide support to the comparative analysis of openness across countries and time periods. These are either *outcome-based* (showing the actual realisation of openness) or *policy-based* (reflecting the possibility for easy exchange provided by policy instruments). Outcome-based measures are usually associated with *de facto* liberalisation, while policy-based measures (also called 'rule-based' or

'restriction-based' measures) are associated with *de jure* liberalisation. A number of analysts use both kinds of measures, particularly because the exclusive observation of either measure may be misleading.⁷ In this chapter, both outcome- and policy-based measures are used where possible.

Some scholars have found that simple, outcome-based measures can be misleading because they tend to reflect, inter alia, idiosyncratic attributes of countries or transitory developments in certain periods. Thus, indices that are more sophisticated have been proposed for comparative analysis of the level of openness. For instance, since the most common outcome-based index, the trade/GDP ratio, may be influenced by the special geographical location or the size of a given country, it has been suggested that instead of the actual measured level of openness, one should correct actual openness with the country's potential openness (based on the potential trade), which is usually assessed with the help of the so-called 'gravity' model of trade. Others, such as O'Rourke & Williamson (2000), find that the growth in the trade/GDP ratio could reflect growth in import demand or in export supply induced by population growth, the colonisation of empty lands, capital accumulation or technological change - each different from the main drivers of globalisation (the reduction in transaction costs and in the protection provided by policy measures). Consequently, they propose the analysis of the progress in commodity price convergence, which would be "irrefutable evidence that globalisation is taking place" (ibid., p. 4).

For the characterisation of various fields of openness, it is common to use either single measure indicators or multiple measures, or synthesised multiple measures. Most outcome-based measures take values on a continuous scale (usually with no maximum value), while policy-based measures are bound to be qualitative and therefore discrete. The popular synthesised measure of openness of Sachs & Warner (1995), for instance, is binary, i.e. it simply shows whether a country can be considered open or closed at a point in time.

While measures of openness to trade and finance are more or less generally accepted,⁸ the openness or liberalisation of services is much more complicated to

⁷ Prasad et al. (2003) give examples of economies that show a high degree of policy-based openness, but achieve little openness in outcomes (remote countries in the case of trade flows and some African countries with respect to financial flows). They also highlight countries that were *de jure* closed to financial flows, but *de facto* suffered severe capital outflows (some Latin American countries involved in capital flight episodes of the 1970s and 1980s). In this chapter, examples demonstrating the different qualities of the policy-based and outcome-based openness indicators are given.

⁸ Although in the various investigations, as many as two dozen alternative indices are used.

gauge. Here, a combination of policy-based measures usually represents the move to a more or less open – or in other words, to a more or less liberal – regime.⁹

In the next sections of this chapter, we analyse various fields in which economic integration is taking place with the help of policy-based and outcome-based indices of openness. Trade in goods and services, financial flows in the form of debt instruments, portfolio and direct investments are discussed, as well as the expansion of foreign control and the effects of the increasing international mobility of the tax bases. The chapter ends with a summary and conclusions. It should be noted that throughout this chapter a grouping of EU-14 is used to denote the ‘old’ EU: this aggregate excludes Luxembourg for which it is often difficult to obtain comparable and reliable data. EU-10 refers to the countries that acceded to the EU in 2004 and EU-2 represents the newest member states, Bulgaria and Romania.

3.1 Empirical analysis of economic globalisation – Trade

3.1.1 Outcome-based measures

The most common indicator of the evolution of openness is the trade/GDP ratio. The advantages of easy availability of the underlying data and the simple calculation of this index outweigh its conceptual problems.¹⁰ Economic historians have been able to reconstruct the (likely) size of trade and GDP in a number of countries for the past, which shows the acceleration of the opening-up process in the economies around the world since the last decades of the 19th century. Although the evolution has not been without reversals, in the most recent decades and in most of the countries of the world, the extent of openness has reached levels never before experienced (Table 3.1).

Table 3.2 shows the result of the calculations for the evolution of this real openness in the old and new EU member states for five-year periods in the past 30 years as well as in the BRIC countries.¹¹ Contrary to expectations, the data do not reveal either spectacular or unbroken growth in openness in the individual countries and in the three groups of countries. Nevertheless, we can state that in the EU-14 group the increase of openness since 1981–85 has been sizeable, although the latest level does not seem to be historically high. The country groups EU-10 and EU-2 have also shown considerable growth in their openness since the early 1990s, albeit with large variations

⁹ In the analysis of the *impact of openness* on other phenomena, such as economic growth, employment rates, inequality or financial volatility, a general methodological consideration in choosing the appropriate measure of openness is that it must be exogenous to the phenomena on which openness is supposed to have an impact. Since in this report we analyse openness in itself and not in terms of its impact on other phenomena, we may neglect this – usually difficult – methodological problem.

¹⁰ In addition to the problems associated with actual versus potential trade (discussed above), there are also the problems of inconsistency between trade (which is a gross concept) and GDP (a net concept), with the drawback being that the index has no maximum value. A further consideration is the services bias (analysed below).

¹¹ Owing to scarce and distorted data, Luxembourg has been left out of most of our calculations.

across the countries.¹² At the end of the period covered in Table 3.2, the most open economies of the old EU member states are those of Belgium, the Netherlands and Ireland; among the new member states the economies of Malta, Estonia and Slovenia are most open.

Table 3.1 Ratio of merchandise exports to GDP, 1870–1998 (in 1990 prices, %)

	1870	1913	1929	1950	1973	1998
<i>Europe</i>						
France	4.9	7.8	8.6	7.6	15.2	28.7
Germany	9.5	16.1	12.8	6.2	23.8	38.9
Netherlands	17.4	17.3	17.2	12.2	40.7	61.2
UK	12.2	17.5	13.3	11.3	14.0	25.0
Spain	3.8	8.1	5.0	3.0	5.0	23.5
<i>The Americas</i>						
US	2.5	3.7	3.6	3.0	4.9	10.1
Mexico	3.9	9.1	12.5	3.0	1.9	10.7
Brazil	12.2	9.8	6.9	3.9	2.5	5.4
<i>Asia</i>						
China	0.7	1.7	1.8	2.6	1.5	4.9
India	2.6	4.6	3.7	2.9	2.0	2.4
Japan	0.2	2.4	3.5	2.2	7.7	13.4
<i>World</i>	4.6	7.9	9.0	5.5	10.5	17.2

Source: Maddison (2003).

By comparison with the data in Table 3.2, neither the level nor the speed of opening-up in the BRIC countries look as dramatic as the daily news would suggest. Among the four countries, China above all has shown a tendency to increase its trade compared to its GDP: in the most recent years, the index of openness (trade as a share of GDP) for China has increased by 1% each year. This progress is not staggering, however, even if we take into account the size of the Chinese economy. It is not a matter of indifference whether it is a mouse that opens its mouth or a dragon. China is large, but not (yet) that large that this steady opening-up itself should have far-reaching consequences for the EU: in 2004, China's GDP (calculated at international exchange rates) amounted to that of France.

¹² Data for the former communist economies for the period before 1990 should be considered with caution because of valuation problems and limitations in the reliability of official data at that time.

Table 3.2 Openness to trade in old and new EU member states since 1976 (% , countries in descending order of the values in the period 2001–03)

$((\text{merchandise exports} + \text{merchandise imports}) / 2) / \text{GDP at PPP}$

	1976–80	1981–85	1986–90	1991–95	1996–2000	2001–03
Belgium	-	45.7	58.1	66.8	72.3	78.5
Netherlands	53.2	38.2	44.0	49.1	53.3	52.1
Ireland	45.2	36.8	47.4	53.3	58.4	49.8
Malta	47.3	33.1	40.4	46.9	39.8	37.3
Austria	24.5	19.2	27.2	30.3	32.6	34.9
Sweden	37.9	28.6	35.3	35.5	39.1	33.8
Denmark	29.7	23.1	29.7	34.3	33.6	33.2
Estonia	-	-	-	19.8	30.3	32.6
Slovenia	-	-	-	31.8	31.3	30.7
Finland	28.5	23.3	27.3	28.0	32.5	30.1
Hungary	16.1	12.1	10.8	13.4	21.0	26.6
Germany	-	20.2	25.1	24.8	25.3	26.1
Czech Rep.	-	-	-	16.1	20.1	26.0
Slovak Rep.	-	-	-	16.3	19.7	24.8
France	20.2	15.7	19.4	21.5	23.0	21.7
UK	18.9	16.5	19.0	20.3	22.3	20.6
Lithuania	-	-	-	12.2	15.8	18.9
Portugal	10.6	9.8	15.4	18.7	19.6	18.4
Cyprus	31.8	25.1	23.0	23.8	21.4	17.7
Spain	8.8	8.3	11.7	14.7	16.7	17.2
Italy	14.7	12.3	15.2	16.3	17.3	17.1
Latvia	-	-	-	10.5	14.5	15.3
Bulgaria	-	36.4	28.6	9.4	10.9	13.1
Poland	-	-	-	7.9	10.5	12.3
Romania	-	-	-	5.6	7.9	11.3
Greece	10.1	8.3	10.0	12.4	12.7	11.0
EU-14	25.2	21.9	27.5	30.4	32.8	31.7
EU-10	-	-	-	19.9	22.5	24.2
EU-2	-	-	-	7.5	9.4	12.2

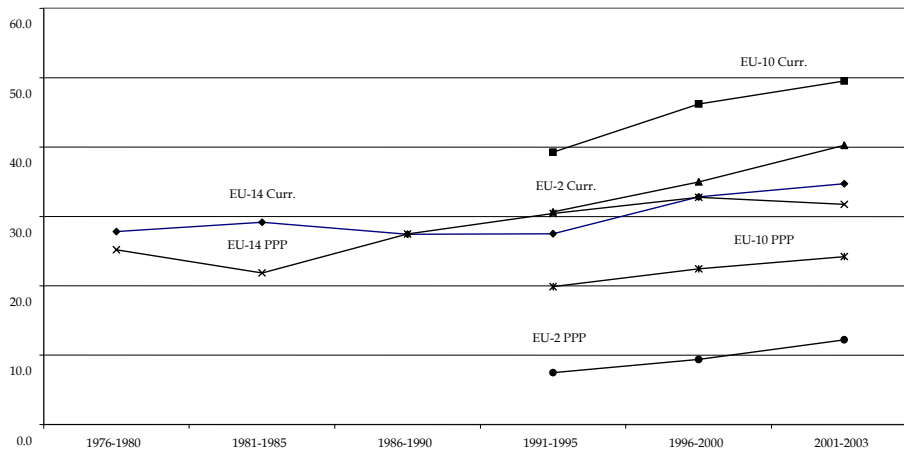
Notes: The group averages are unweighted averages. Owing to scarce and distorted data, Luxembourg has been left out of the EU-14 calculations.

Source: Own calculations based on data from World Bank (WDI) (2005c).

When comparing the positions of the three country groups to each other, we find that the less developed groups (EU-10 and EU-2) that have re-established the principal institutions of a market economy and carried out a policy of opening-up only more recently (i.e. starting with the early 1990s) are still much less open than the developed members of the EU-14. This relative position of the less and more developed countries is critically influenced by the prices used to value the GDP in the denominator of the openness indicator. As Figure 3.1 shows, the ranking of the country groups (and, naturally, of the countries themselves) radically changes if we use the current exchange

rates instead of the PPPs: with the index calculated at current exchange rates the EU-10 group becomes, on average, the most open group followed by the EU-2 and the EU-14.

Figure 3.1 Development of openness to trade in the EU-14, EU-10 and EU-2 country groups (% , calculated on merchandise trade and on GDP at current exchange rates and at PPP)



Source: Own calculations based on data from World Bank (WDI) (2005c).

If we use the broader category in the numerator of the index, i.e. goods and services instead of merchandise goods, we find that with the new numerator the relative position of the countries changes only minimally (Table 3.3). A notable exception is Cyprus, which, being one of the EU member states most dependent on trade in services, has a much more prominent rank in Table 3.3 than in Table 3.2.

Table 3.3 Openness to trade in old and new EU member states since 1976 (% , countries in descending order of the values in the period 2001–03)

((exp. of goods and services+imp. of good and services)/ 2) / GDP at PPP

	1976–80	1981–85	1986–90	1991–95	1996–2000	2001–03
Belgium	67.8	49.5	65.5	74.9	74.8	74.0
Ireland	51.3	41.7	54.8	64.4	76.3	72.3
Netherlands	58.8	46.0	53.0	58.7	58.6	53.3
Malta	66.3	47.6	58.4	64.4	54.9	50.3
Austria	33.8	27.0	38.2	43.6	45.3	47.0
Sweden	45.6	34.9	43.7	44.4	49.7	45.0
Denmark	36.6	28.9	37.3	43.4	43.0	44.8
Cyprus	41.8	35.8	39.2	42.0	39.2	-
Slovenia	-	-	-	37.3	37.0	36.1
Estonia	-	-	-	29.9	33.9	35.1
Finland	32.7	26.8	32.3	34.4	37.7	34.4
Germany	24.1	19.1	25.4	29.8	30.4	31.4
Hungary	16.1	11.9	11.1	15.4	25.5	31.3

Table 3.3 Continued

Czech Rep.	-	-	-	20.6	25.1	30.2
Slovak Rep.	-	-	-	21.3	23.9	28.9
UK	23.6	20.5	23.5	25.8	29.3	28.3
France	23.9	18.6	22.8	25.0	26.0	24.4
Spain	11.6	11.0	15.3	19.0	22.1	23.0
Lithuania	-	-	-	17.5	18.8	22.1
Portugal	13.8	12.4	19.1	24.0	24.4	21.6
Italy	17.1	14.2	18.1	20.5	21.8	21.5
Latvia	-	-	-	22.1	20.7	20.6
Greece	14.0	12.4	14.3	16.6	18.5	17.0
Bulgaria	-	20.6	20.2	10.6	13.3	16.7
Poland	-	-	-	9.1	13.0	15.2
Romania	-	-	-	6.8	9.1	12.5
EU-14	32.5	25.9	33.1	37.5	39.9	38.4
EU-10	-	-	-	28.0	29.2	30.0
EU-2	-	-	-	8.7	11.2	14.6

Notes: The group averages are unweighted averages. Owing to scarce and distorted data, Luxembourg has been left out of the calculations.

Source: Own calculations based on data from World Bank (WDI) (2005c).

At first sight, it is surprising that in the ranking according to the utilisation of trade potential, the new member countries show up only in 13th place (the Czech Republic) and below. The most convincing explanation is that the exercise considers the long period of 1991–2003. Table 3.4 also indicates that there are substantial differences among the countries according to the three rankings of openness. On the one hand, there are countries that are considered very open according to the traditional openness index (calculated using PPP), but at the same time performing much below their potential according to the gravity model (Estonia, Malta and Slovenia). On the other hand, there are others that, when gauged by the traditional indicator, do not look very open but when measured against their potential trade, belong to the very open economies (Italy, Spain and the UK).¹³ The last column indicates those countries for which openness levels seem to be robust: they are the most open or least open by a consensus of all three indicators. Again, with due consideration for the long period covered in this calculation, it is no surprise that in the ‘consensus ranking’ all the economies that are most open are old EU member states, while all but one of the least open ones are new member states. Were there similar calculations for potential trade available for the most recent years, some small new EU member states would probably also show up in the most open economies by consensus of the three openness indices.

¹³ Since the first three countries belong to the smallest economies and the second group to the largest economies of the 26 EU member states shown in Table 3.4, it seems that these small economies showed relatively less openness and these large ones relatively more compared with countries of a similar size in the 61-country sample used in the model of Bussière, Fidrmuc & Schnatz (2005).

Table 3.4 Ranking of the countries in terms of openness to trade according to three openness indicators, 1991–2003

	Trade/GDP at current exchange rates	Trade/GDP at PPP rates	Utilisation of trade potential	Consensus level of openness
Germany	20	11	1	M
Netherlands	6	3	2	M
Italy	25	19	3	-
Belgium	2	1	4	M
UK	22	14	5	-
France	23	13	6	-
Sweden	14	5	7	M
Spain	24	21	8	-
Denmark	16	6	9	M
Finland	17	10	10	-
Ireland	5	2	11	M
Austria	13	7	12	M
Czech Rep.	7	16	13	-
Hungary	9	17	14	-
Portugal	19	18	15	-
Poland	21	25	16	L
Greece	26	23	17	L
Bulgaria	11	24	18	L
Slovenia	8	8	19	-
Rumania	15	26	20	L
Slovak Rep.	4	15	21	-
Cyprus	18	12	22	-
Estonia	1	9	23	-
Malta	3	4	24	-
Lithuania	10	20	25	L
Latvia	12	22	26	L

M: Most open economies – based on the three rankings; L: Least open economies – based on the three rankings

Notes: The ranking according to the utilisation of trade potential comes from the results of the gravity model calculation, which assesses a country's trade potential based on its GDP, distance to its trade partners as well as cultural, historical and political factors affecting trade.

Sources: Own calculations based on data from World Bank (WDI) (2005c) and Bussière, Fidrmuc & Schnatz (2005).

3.1.2 Policy-based measures

Another approach to measuring openness is based on the extent of policy-related obstacles to trade. This approach filters out most of the geographical determination of a country's openness. Here, mainly (but not exclusively) those policy instruments of trade are taken into account that a country itself applies to ease or hamper trade transactions with the rest of the world. An often-used measure of openness belonging to this category is that developed by Sachs & Warner (1995). This binary indicator of

policy-based openness classifies a country as closed if at least one of five specific characteristics of a closed economy prevails in the country.¹⁴ According to this indicator, the cut-off dates for switching from a closed economy to an open one for an enduring period¹⁵ were different for the various EU member states. Ignoring temporary openness episodes, the first wave of opening-up happened at the end of the 1950s: France, Germany, Greece, Italy, Luxembourg and the Netherlands became open in 1959, while the transition in Austria, Belgium, Cyprus, Denmark, Finland, Portugal, Spain, Sweden and the UK occurred in 1960. Ireland followed suit in 1966. The next wave was stirred by the collapse of central planning and the start of economic transition in Central and Eastern Europe: Hungary and Poland started the process in 1990, followed by Bulgaria, the Czech and Slovak Republics (still as Czechoslovakia), Slovenia (1991), Estonia and Romania (1992), and finally Latvia and Lithuania (1993).¹⁶

Other, more sophisticated measures for the obstacles to trade are the IMF's Trade Restrictiveness Index (IMF-TRI),¹⁷ and the World Bank's series of indices: the Trade Restrictiveness Index (TRI), the Overall Trade Restrictiveness Index (OTRI) and the Market Access Overall Trade Restrictiveness Index (MA-OTRI). In the following discussion, we analyse the results of the calculation of the World Bank's trade restrictiveness indices based on Kee, Nicita & Olarreaga (2006).¹⁸ The World Bank indices are based on the theoretical approach developed in a series of papers by James Anderson and Peter Neary, starting with their seminal article, Anderson & Neary (1992). All the three indicators attempt to summarise the effects of both tariff and non-tariff barriers reflected in their combined impact on the affected economy. The TRI answers the question of what is the equivalent uniform tariff in a country that would keep *real income* (or welfare) constant. The OTRI answers the question of what is the equivalent uniform tariff in a country that would keep its *imports* at their observed levels. Finally, the MA-OTRI answers the question of what is the equivalent uniform tariff faced by exporters of a given country in the rest of the world that would keep its *exports* at their observed levels.

In their most recent exercise, the experts of the World Bank collected and processed data for 91 countries, mostly for the years 2003–04 (tariffs and trade) and for the late 1990s (non-tariff barriers) – see Kee, Nicita & Olarreaga (2006). The 15 old EU member states were considered a single economy and only their extra-EU trade was taken into account. The new member states (not all of them present in the sample) were handled as separate entities (in practice, what they really were in the period before 2004). Table 3.5 points to some interesting insights that can be drawn from the trade

¹⁴ These characteristics are 1) non-tariff barriers covering 40% or more of trade; 2) average tariff rates of 40% or more; 3) a black market exchange rate that has been depreciated by 20% or more relative to the official exchange rate for a considerable period of time; 4) a socialist system in place; and 5) a state monopoly on major exports (Sachs & Warner, 1995, pp. 22–23).

¹⁵ More specifically, this relates to the date of switching from a closed economy to an open one up to 1994, i.e. the time of writing the study by the authors.

¹⁶ Malta was not rated by the source because of insufficient data on trade policies.

¹⁷ See IMF (2005).

¹⁸ See also the *Global Monitoring Report 2006* published by the World Bank (2006c).

restrictiveness indices. The table contains the ranking of the group of EU-15 and the new member states according to the different trade restrictiveness indices. For each category, there are three indices: a composite index, one calculated for manufacturing products and one for agricultural products.

The first striking result is that the EU-15 is far from being a champion of non-restrictive trade practices with respect to its trade partners. This result is reflected in the EU's positions in the TRI and OTRI rankings. A second interesting finding is that in the relevant period, most of the new member countries were less restrictive vis-à-vis their partners than the EU-15 was vis-à-vis its partners. This is, however, an illusion that can be dispelled with the appropriate interpretation. In the period in question, the basically obstacle-free trade between the new member states and the EU-15 amounted to about 60-70% of the total trade of the new member states, but only about 5-15% of the total trade of the EU-15. This difference is more than sufficient to explain why the new member states may look more open than the old ones, but if we recall that intra-EU trade, which amounts to about 60% of the total trade of the EU-15, is not taken into account in the TRI and OTRI indices, the whole puzzle is solved. With this interpretation in mind, we can assume that in a future edition of TRI and OTRI indices the new member countries (by that time counted as members of the EU) will slip back in the ranking of the countries in terms of openness based on trade restrictiveness. Although we do not have trade restriction indices for all the 27 countries, it is clear that the ranking in Table 3.5 does not match those in Tables 3.2 and 3.3. For instance, Slovenia, a very open economy according to Tables 3.2 and 3.3 (i.e. using outcome-based measures) turns out to be the least open among the Central and Eastern European EU countries in Table 3.5 (i.e. using policy-based measures).

So far, we have presented several measures of openness. Below we continue to do this with the understanding that each index approaches the problem of globalisation from a different angle and can be used to analyse different issues. To show the diverse qualities of the openness indices, here we draw attention to how differently these indices handle the issue of the 'doubling of the global labour force', a recently and sharply formulated line of development of the globalisation process. In his short pamphlet, Richard Freeman states that the fundamental reality of globalisation is that in the past 15 years, the global labour force has doubled.¹⁹

Workers in China, India and the former Soviet bloc were around and active before the mid-1980s, but only since then have they gradually joined the global workforce pool - effectively doubling the size of the world's connected workforce compared with this pool without them. Transformation, market liberalisation reforms and opening-up in China, India and the former communist countries (as well as progress in the liberal world trading system) have led these countries to join the world's actively and freely trading community. The implications are and will be substantial: more intense global competition, pressure on labour markets around the world, job migration, etc., although offset by more consumer demand.

¹⁹ See Freeman (2005a and 2005b) and Pisani-Ferry (2005).

Table 3.5 Trade restrictiveness indices: Ranking of current EU member states among 91 countries

	TR			OTR			MA-OTR		
	Real income-related			Import-related			Export-related		
	All	Manuf.	Agric.	All	Manuf.	Agric.	All	Manuf.	Agric.
EU-15 (extra-EU trade)	60	57	67	38	34	58	27	33	42
Czech Rep.	5	10	3	3	7	1	11	29	68
Estonia	8	14	4	6	11	3	51	73	50
Hungary	32	46	35	19	28	28	25	36	64
Latvia	41	35	48	27	22	48	54	56	33
Lithuania	14	21	22	8	12	18	72	81	52
Poland	22	31	39	21	26	37	41	53	31
Romania	50	58	53	64	62	64	30	59	22
Slovenia	46	49	70	36	36	70	35	70	86
<i>Memo items</i>									
No. 1	Hong Kong	Hong Kong	Kyrgyzstan	Hong Kong	Hong Kong	Czech Rep.	Gabon	Gabon	Gabon
No. 91	Egypt	Sudan	Egypt	Sudan	Sudan	Tunisia	Nicaragua	Trinidad & Tobago	Thailand*
China's position	52	64	40	39	46	34	5	10	16

* Last in the ranking (in fact no. 88, owing to the lack of data for some countries)

Source: Calculations based on data in Kee, Nicita & Olarreaga (2006).

How does this epochal development in globalisation show up in the openness indicators of the EU-27 analysed so far? From among the indices focusing on policies, the Sachs–Warner index shows a qualitative change for the new member states in the past 15 years, but no change for the 15 old member states. While we do not have a time series for the restriction-based indices of the TRI, OTRI and MA-OTRI, the impression is that the doubling of the global workforce is reflected only to a minor extent in the TRI and OTRI. (Notable exceptions are the Czech Republic, Estonia and Lithuania, which have achieved quite prominent places in these rankings.) The results for the MA-OTRI index (which is to some extent a mirror index of the OTRI) show that China and to a degree Russia have already reached favourable positions among the 91 countries in the ease of access to export markets. In contrast, India can still be found among those countries that have the most difficult access to external markets.

In principle, *outcome-based indicators* (such as trade/GDP) should reflect the effect of the doubling of the global labour force more strongly than policy-based measures. The detected change, however, has so far not been as dramatic as the formulation by Richard Freeman suggests. This result tempts the analyst to contemplate whether the traditional indices of openness are the right tools to reflect appropriately and in a timely manner the most recent developments in the globalisation process.

3.1.3 Trade in services

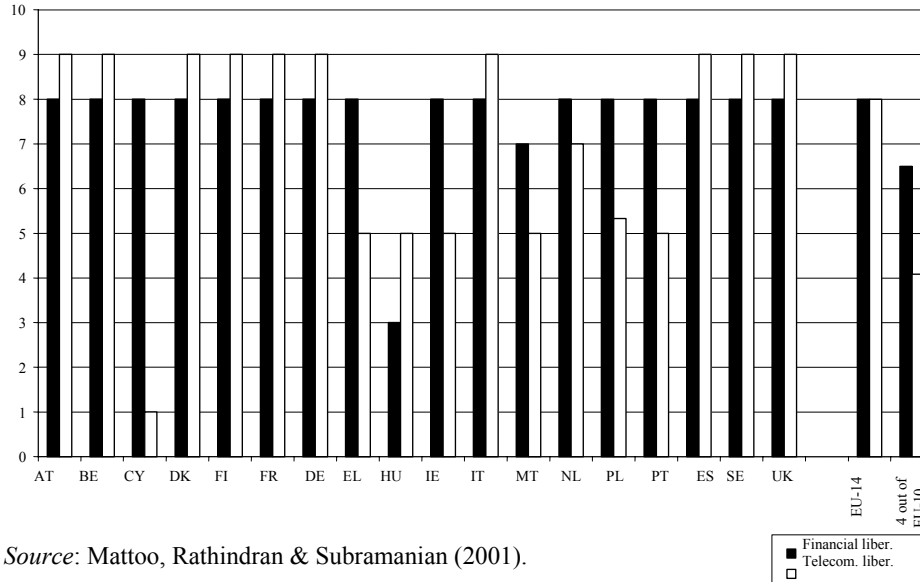
In the literature and public discourse on globalisation, there is a common perception that the liberalisation of services and the expansion of trade in services have made a considerable contribution to the present wave of globalisation. Owing to policies that are more liberal, the global scene of service provision has been reshaped in the past two decades by financial innovations, the development of telecommunication and information technologies, advances in the trade in services as well as the international outsourcing of services.

Services are a diverse package of activities. There are two characteristics distinguishing them from goods with respect to production and trade, with most services having either or both of these. First, because of the simultaneity of production and consumption, trade proper is impossible, and the provision of services by non-residents to residents requires that the factors of production (capital and labour) move to the location of the consumer. Second, barriers to entry are usually maintained not only against foreign suppliers, but also against emerging domestic producers (Mattoo, Rathindran & Subramanian, 2001; UNCTAD, 2004). The implications of these two characteristics are that in many lines of services, FDI (and to a lesser extent, labour migration) on the one hand has to be a prerequisite to and the major mode of penetration of foreign business in domestic services markets. On the other hand, this penetration has to be preceded by the liberalisation of domestic services markets for indigenous business.

The implication of these features for measuring the openness of services markets is that it is necessary to focus on policy-based measures as well as on the evolution of services-related FDI. Because of the diversity of services, different lines of services usually require different indicators of openness. For instance, Eschenbach & François (2002), in their investigation covering 130 countries, use three indicators to characterise the openness of the financial sector in these countries, two of which are policy-related

and one of which is outcome-based.²⁰ Mattoo, Rathindran & Subramanian (2001) devised even more complex openness indices for two lines of services, the telecommunications sector and the financial services sector. These indicators are based on the degree of competition, the extent of foreign ownership and the nature of regulation in the sector in the given country. The values of these indicators for the EU member states are replicated in Figure 3.2.

Figure 3.2 Financial and telecommunication liberalisation indices (1996–99)



Source: Mattoo, Rathindran & Subramanian (2001).

As the data indicate, in the second half of the 1990s, the old member states of the EU achieved the maximum level of openness in financial services (which, in the classification of the authors, takes the value of 8) and a level quite close to the maximum in telecommunication services (8, while the maximum level is 9). The four new member states in the sample show a reasonable lag behind the old member states in the process of liberalisation.

Table 3.6 gives evidence that in recent years, by utilising the opportunity of increasing openness, service activities have really become an attractive field for foreign investors. Although at the beginning of the 1990s, in the EU member states about half of inward direct investment flows targeted service activities, 10 years later these already made up three-quarters of total FDI inflows. While in this group of countries, the outflow of services-related FDI has not evolved as rapidly as FDI inflows, the reorientation of direct investments from industry (mainly manufacturing) towards services is a clear tendency. Data for the new member states are not complete, but it

²⁰ These indicators are 1) the estimates of the tariff equivalents for financial services trade, based on GATS (General Agreement of Trade and Services) commitments within the World Trade Organisation; 2) the Heritage Foundation's Bank Freedom Index; and 3) the share of the banking sector accounted for by foreign banks.

seems that these economies are going through the same stages of refocusing FDI flows towards services as the old EU member states did.

Table 3.6 Share of services in total FDI (%)

	Flows				Stock	
	Inward		Outward		Inward	Outward
	Average 1990-94	Average 2000-02	Average 1990-94	Average 2000-02	2001	2001
Austria	-	84.0	40.7	65.7	73.9	-
Belgium	-	-	-	-	-	-
Bulgaria	-	74.1	-	129.0	-	41.4
Cyprus	-	-	-	-	-	-
Czech Rep.	42.8	82.0	-	93.9	60.5	82.0
Denmark	46.6	87.1	49.6	75.2	89.2	78.4
Estonia	41.8	82.0	22.2	87.6	78.2	87.5
Finland	31.9	89.5	24.1	28.9	56.6	27.0
France	69.5	70.8	57.9	81.4	80.2	75.9
Germany	191.4	107.2	46.2	49.5	66.4	68.7
Greece	-	-	-	-	-	-
Hungary	-	62.8	-	30.2	53.3	76.3
Ireland	3.4	50.7	-	26.4	-	-
Italy	61.6	57.0	68.7	43.0	57.0	56.3
Latvia	-	-	-	-	77.2	-
Lithuania	-	85.0	-	-	69.7*	-
Malta	-	-	-	-	-	-
Netherlands	57.8	67.7	53.3	63.7	65.0	58.1
Poland	-	77.3	-	25.9	54.8	86.2
Portugal	45.4	65.6	67.8	58.9	47.9	-
Romania	-	-	-	-	-	-
Slovak Rep.	-	-	-	-	45.8*	60.4
Slovenia	-	-	-	-	52.1	43.7
Spain	40.9	85.5	84.0	88.4	-	-
Sweden	32.1	43.7	43.4	58.8	30.3	39.2
UK	50.4	77.5	46.6	50.5	61.0	62.5
Countries from EU-14	57.4	73.9	52.9	57.5	62.8	58.3
Countries from EU-10	42.3	77.8	22.2	59.4	61.5	72.7
Countries from EU-2	-	74.1	-	129.0	-	41.4

* Data from 2000

Notes: Owing to scarce and distorted data, Luxembourg has been left out of the calculations. Since FDI flows can be both positive and negative (irrespective of whether they are inward or outward), substantial non-service-related negative flows may cause the share of service-related FDI flows to exceed 100%.

Source: UNCTAD (2004).

As regards trade in services, the data presented in Table 3.7 demonstrate that growing openness to services trade (or an expansion in the relative weight of trade in services) is apparent, but its scale is not stunning, and unbroken growth has not been a general characteristic of all the EU member states in the past 10-15 years.

Table 3.7 *Openness to services trade in old and new EU member states since 1976*
(%, countries in descending order of the values in the period 2001–03)
(*(exp. of services + imp. of services)/2*) / GDP at PPP

	1976–80	1981–85	1986–90	1991–95	1996–2000	2001–03
Ireland	6.8	5.2	8.5	11.3	19.8	26.0
Cyprus	12.9	13.1	17.2	20.4	22.5	22.5
Belgium	11.5	8.7	12.7	16.4	15.5	16.7
Denmark	8.5	6.9	9.2	11.1	12.1	15.9
Austria	9.2	8.0	11.4	14.5	14.7	15.4
Malta	21.2	14.9	19.0	18.5	15.4	14.0
Netherlands	11.1	8.5	10.2	12.9	12.4	12.5
Sweden	8.7	6.7	8.7	9.6	10.1	10.9
Estonia	–	–	–	4.4	9.0	9.1
Greece	3.3	2.7	3.3	4.7	6.4	7.8
UK	5.5	4.5	5.0	5.8	7.3	7.8
Spain	2.9	2.7	3.9	4.7	5.3	5.9
Germany	4.5	3.7	4.6	5.3	5.5	5.8
Slovenia	–	–	–	6.2	5.9	5.7
Finland	5.3	4.6	5.8	7.1	6.4	5.6
France	6.1	4.8	5.7	6.6	5.4	5.0
Hungary	–	0.8	1.5	3.5	4.4	4.8
Latvia	–	–	–	3.1	5.7	4.8
Portugal	2.7	2.3	3.4	4.8	4.8	4.6
Czech Rep.	–	–	–	4.4	4.9	4.3
Italy	3.0	2.5	3.6	4.7	4.6	4.2
Slovak Rep.	–	–	–	4.5	3.7	3.9
Bulgaria	–	2.7	1.8	2.3	3.4	4.1
Lithuania	–	–	–	1.6	3.2	3.4
Poland	–	–	–	2.1	2.4	2.4
Romania	–	–	–	0.9	1.3	1.7
EU-14	6.4	5.1	6.9	8.5	9.3	10.3
EU-10	–	–	–	6.9	7.7	7.5
EU-2	–	–	–	1.6	2.3	2.9

Notes: The group averages are unweighted averages. Owing to scarce and distorted data, Luxembourg has been left out of the EU-14 calculations.

Source: Own calculations based on data from World Bank (WDI) (2005c).

Undoubtedly, some economies have traditionally been committed to trade in services because of their specialisation in trading in specific service lines. These countries, such as Cyprus, Malta, Belgium, Austria and the Netherlands, persistently show a high degree of openness. Others have achieved remarkable progress recently, particularly Ireland, but also Denmark, Estonia, Cyprus and Greece. The expansion in the full sample, however, is not staggering. An interesting characteristic emerges (not shown in the table) whereby countries that vigorously expand their export of services also tend to do this in their import of services. Since services are very diverse activities, in some lines of tradable services a real breakthrough has manifestly occurred in recent years, which could go on in the future. Aggregate data, however, do not bring out these developments. This could also be the case for India, the BRIC country for which specific evidence suggests that the cross-border export of services showed spectacular expansion in recent years. Data in Table 3.7 and the underlying export data show that on an aggregate level, service exports from India are still very limited, at less than 1% of GDP.

3.2 Integration of capital and money markets

As noted in a UN training paper, capital markets are in the process of rapid evolution (United Nations, 2001). Capital flows – which were formerly directed towards banks and controlled by governments – are now held by individuals, institutions or private mutual funds and can circulate freely and instantaneously to projects that will yield the maximum profit. Electronic computerised data transmission now gives them an unprecedented mobility on all the financial markets on the planet. Moreover, the volume of such flows has grown – tripling or increasing tenfold in the past few years – mainly as a result of the success of mutual funds, whose assets often exceed those of many governments.

In the past, rivalries between nations were resolved by means of armed conflicts in which empires or ideologies clashed. Nowadays, the wars being waged seem ever more removed from the principal events taking place on the economic and financial front. During the cold war, the superpowers provided assistance in the form of official financial flows or subsidies to centralised economic systems and developing countries whose survival they ensured. Today, these flows and subsidies are considerably reduced or they have even disappeared in some cases. They have given way to the laws of the market place, which govern growth, development, employment and decline.

Today, too, the main problem facing governments is how to attract new investment with a view to creating jobs and promoting sustained economic growth. Governments compete for capital. To this end, nations vie with each other through variations in their interest rates or their rates of exchange, and through the competitiveness of their markets. The world has become capitalist and the ever-increasing financial movements can reward savings and productivity and thus strengthen a country's economy. Conversely, foreign capital can also abandon an economy or withdraw abruptly if an unfavourable fiscal policy drives it away. Speculators may attack a weak currency to weaken it still further. Capital movements may penalise unproductive expenditure and thus help to destroy a country's economy.

Governments and heads of enterprises therefore strive to attract this capital by offering favourable conditions and to utilise capital more productively than their rivals do.

With the end of the cold war, official subsidies and other financial flows dried up in countries such as the Democratic People's Republic of Korea, Myanmar and Cuba, while investors preferred to steer their capital towards countries where the climate was more favourable to them, such as the Republic of Korea, the Taiwan province of China and other emerging countries. Capital has thus become more mobile and more difficult to stabilise and control.

During the 1990s, over 50 developing countries established functioning capital markets. These countries need capital in order to launch their new market economies. In Asia and Latin America, economies are in a state of full expansion; they need to build up infrastructure and find capital to sustain their economic growth. After a period of recession, Europe and Japan also need capital to finance their expansion, create jobs, make good their budget deficits and privatise their state enterprises.

In the face of this increased demand for capital, the competition has become increasingly fierce. In order to attract these financial flows and pay a return on them without over-burdening the costs of production, some countries have had to resort to reducing wages or extending working hours. Moreover, the mounting budget deficits of the US have triggered an additional demand for capital. Prior to the slowdown triggered by the sub-prime crisis in late 2007, the effect of these demands for capital was evident in rising interest rates in Europe despite moderate inflationary pressures. Loans are becoming progressively more expensive and risk breaking the recent cycle of recovery. The countries with economies in transition are also seeking capital. The dearth of capital led to the fall of the Soviet empire, which had been unable either to create sufficient capital or to utilise it effectively.

All these countries are feverishly engaged in establishing a complete capital market infrastructure. The first countries to achieve this will have the benefit of direct and preferential access to international investors. In this context, many countries are also making ever-greater use of derivative markets, including futures markets and options, which will allow improved coverage of risks related to stocks and shares, bonds and exchange rates.

The free circulation of capital outside government control has led to the transfer of the concept of power, traditionally invested in governments, to private holders of capital. This development explains the inability of central banks to curb the speculations that have recently attacked the value of the yen, the dollar and the European currencies. Governments have thus experienced erosion in their ability to control their budgets and their capital. Their fiscal resources appear to be reduced in relation to private capital, no longer enabling them to make the necessary investments. The same applies to the international financial institutions, the World Bank and the International Monetary Fund, which are financed by governments.

In contrast, multinational financiers, managers of private funds and directors of companies or banks have tended to become more powerful. Governments urge them to steer their clients' investments towards their countries: the emergence of private capital as a leading actor on the international scene marks a great turning point in the evolution of world financial management.

After the Second World War, it was generally believed that governments were responsible for the allocation of resources. Today, it is the markets that have taken over this role, thus confirming the decline in state control or 'New Deal' trends. Moreover, until the early 1980s, governments sought to regulate the international monetary system and capital movements for fear of losing their natural capital and control over domestic economic policy. Those countries that have attempted to impose severe restrictions on capital movements have generally had to recognise the fluidity of the financial markets, which have moved towards more welcoming political centres, thus creating an offshore industry that still exists. As a result, governments have been compelled to reduce the barriers to capital movements and, in particular, to reduce the amount of tax deducted at source on foreign investments. From the standpoint of governments responsible for controlling emerging markets, the question of the taxation of capital flows is extremely important. Such taxes can be useful if they are used to build a market infrastructure. Too high a rate of taxation, however, would drive investors away.

3.2.1 Consequences of the globalisation of capital markets

Beneficial economic consequences. The globalisation of capital has beneficial characteristics in many respects. In order to attract the capital necessary for their development, national economies must become or remain open to foreign investment and must adopt responsible fiscal and monetary policies.

The majority of governments have made economic stability one of their highest priorities. Thus, the lowering of customs barriers has introduced competition into previously protected markets. If governments impose excessive regulations or too high a rate of taxation, if public expenditure is too high in relation to revenue and if the central banks destroy too many liquid assets, foreign capital will not be attracted or it will be withdrawn if it is already there. International mutual funds have become a strategic weapon in the arsenal of democracies.

Adverse consequences. The play of market forces may also have adverse consequences. Indeed, the decision-makers and controllers of capital turn away from states that have serious budget deficits or budgets burdened by considerable social expenditure. Deficits and the absence of economic and financial reforms may dissuade the investment of capital in the countries in question. The gap between rich and poor may therefore widen in the face of the exigencies of this social Darwinism and the rigid rules of capitalist disciplines.

Lastly, it is believed that if governments reduce taxes on capital movements, create offshore markets and establish a stable and convertible currency, private capital will flow in.

3.2.2 Domestic savings

Domestic savings are the alternative solution to trying to attract foreign capital. Yet savings have decreased in recent years, since prosperity has placed more consumer goods on the market. Traditionally, national savings supplied the economy with investments that ensured growth and employment. These days, governments have difficulty in keeping these reduced savings within the country. For example, the US is the largest exporter of capital in the world, despite a considerable budget deficit, which

the use of domestic savings would help to clear or reduce; the US deficit, however, is financed mainly by foreign capital. In several countries, governments have established mandatory savings plans. Since the restructuring of pension systems, states have encouraged the development of private pensions, which have increased the rate of savings and which are mostly invested in the stock market.

3.2.3 Effect of the integration of capital markets on globalisation

The globalisation of capital markets and the growth of trade will help create new surpluses, which could meet the world demand for capital. Still, these financial resources, in search of attractive returns, will be invested in countries that achieve a fundamental balance in their public finances and introduce economic and financial measures to reduce budget deficits and current payments, rationalise and privatise public enterprises, develop private savings and the capital market, and liberalise trade.

During the past decade, a growing number of developing countries, emerging countries and economies in transition have introduced the reforms necessary for the restoration of financial equilibrium. Even so, the need to attract external financial flows that could contribute to the creation of jobs and the growth of their economies requires, especially in the context of the globalisation of capital markets, a greater effort in favour of national capital markets. The development of such markets, combined with national capacity-building and the establishment of institutions connected to the international financial centres, would help enhance the effectiveness of financial mediation in the allocation of resources, to channel external flows and to increase and diversify the volume of medium- and long-term financial resources necessary for the economic development of these countries. Finally, these flows, both internal and external, cannot fail to constitute a source for the mobilisation of additional resources through appropriate taxation.

In the past quarter century, governments of industrial and subsequently less developed countries have carried out widespread capital account liberalisation, which has led to the intensification of international financial integration. Appropriately measuring the pace of this progress in openness is perhaps even more important than measuring openness in trade, for two reasons. First, the beneficial nature of financial globalisation is more controversial than the gains achieved as a consequence of unfettered trade. Second, gauging the scope and scale of regulations on a great number of short- and long-term financial instruments and FDI is even more difficult than the extent of tariff and non-tariff barriers to exports and imports.²¹

Owing to the complexity of these regulations, we do not deal with the policy-based measures of financial globalisation here, but focus only on indices that reflect the progress in actual financial openness. This does not mean that the pace and the strategy of the process of financial integration, managed by the governments mostly through adjustments in the relevant regulations, are unimportant. On the contrary, particularly since the financial crises that started in East Asia in 1997, the fine-tuning of financial liberalisation has become a major issue. Experience shows that successful

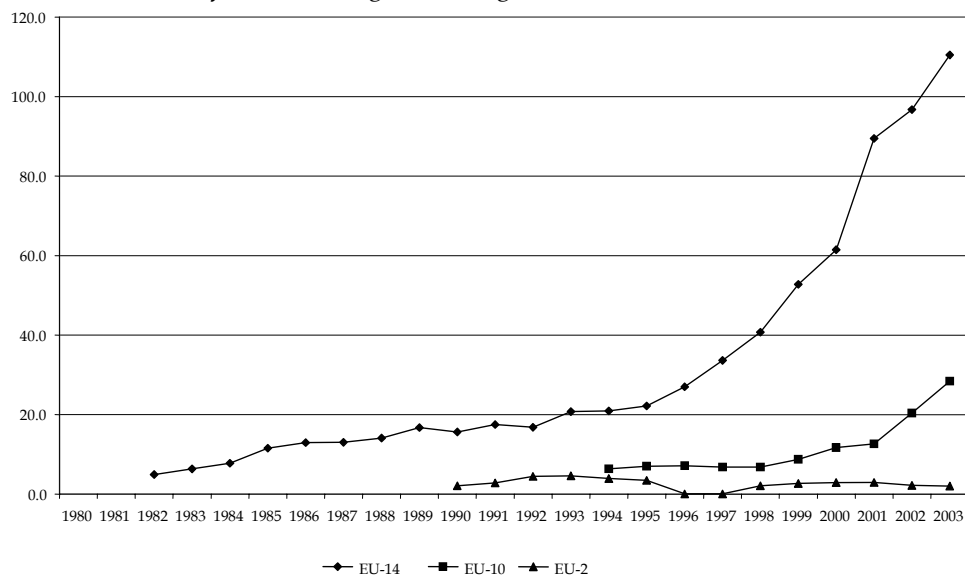
²¹ See Chapter IV in IMF (2001), Edison et al. (2002), Prasad et al. (2003), Lane & Milesi-Ferretti (2006) and Gács, Holzmann & Wyzan (1999).

management of financial liberalisation needs, among other things, careful preparation, sound macroeconomic fundamentals, prudent fiscal policies, financial regulations and supervision, and the possible containment of short-term debts, notably those denominated in foreign currencies (see Prasad et al., 2003).

3.2.4 Outcome-based measures

Recently, various attempts have been made to assess the scale of capital mobility (and compare it across countries and time) either through calculating actual, specific capital inflows and outflows as a percentage of GDP, or by calculating composite indices of the main financial flows, also as a percentage of GDP. We have made similar calculations for the EU member countries and their groupings. Figures 3.3 to 3.6 show the results for the development of stocks of different categories of portfolio investments and FDI for the relevant groups of EU member states.

Figure 3.3 Portfolio investments (assets) in groups of EU member states
(% of GDP, unweighted average)

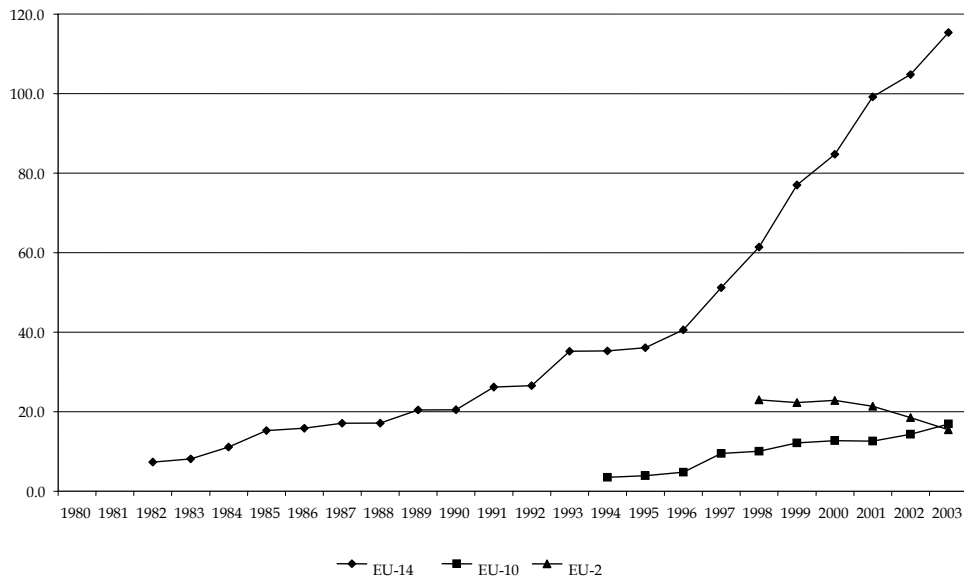


Source: Own calculations based on the IMF International Statistics database.

The figures give evidence of the especially dynamic expansion of capital flows in this part of the world in the past decade. The main drivers of the expansion have been liberalisation and the development of domestic and international capital markets, large-scale privatisation programmes, demographic changes, such as an increasingly ageing population, and the rise in importance of institutional investors in the developed countries.

Figures 3.3 and 3.4 show that the new EU member states (notably the former communist countries) have simply been unable to catch up with the scale of openness to portfolio investments that the old EU member states have achieved despite major institutional transformations and their strong efforts to adopt liberalisation measures in domestic financial markets. The transition countries have been latecomers in establishing solid and open financial markets, and the hectic transformation period of the 1990s had not been attractive to portfolio flows either. Accordingly, it is no surprise that in terms of the accumulated portfolio of liability stocks, they hold the same position now as the old EU member states did 15 years ago.

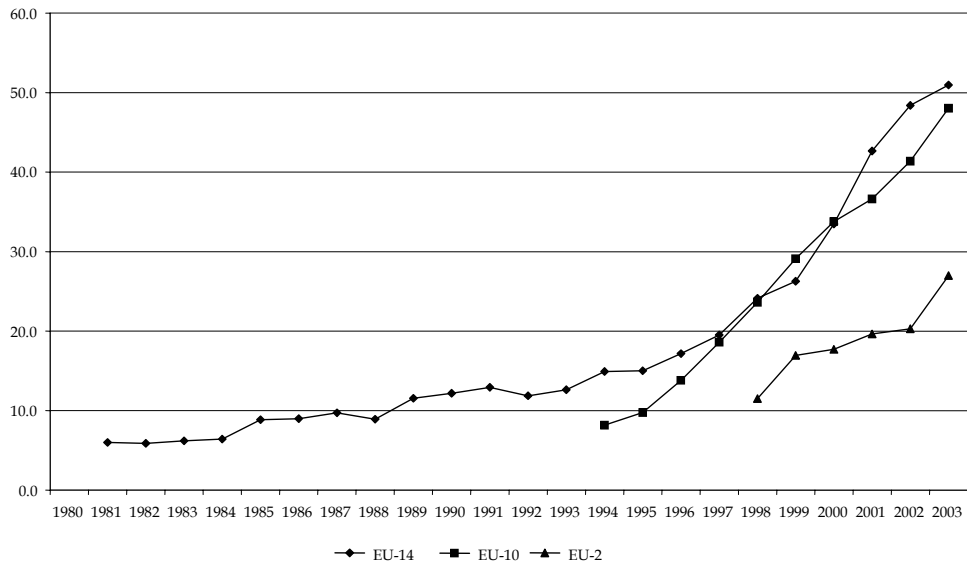
Figure 3.4 Portfolio investments (liabilities) in groups of EU member states (% of GDP, unweighted average)



Source: Own calculations based on the IMF International Financial Statistics database.

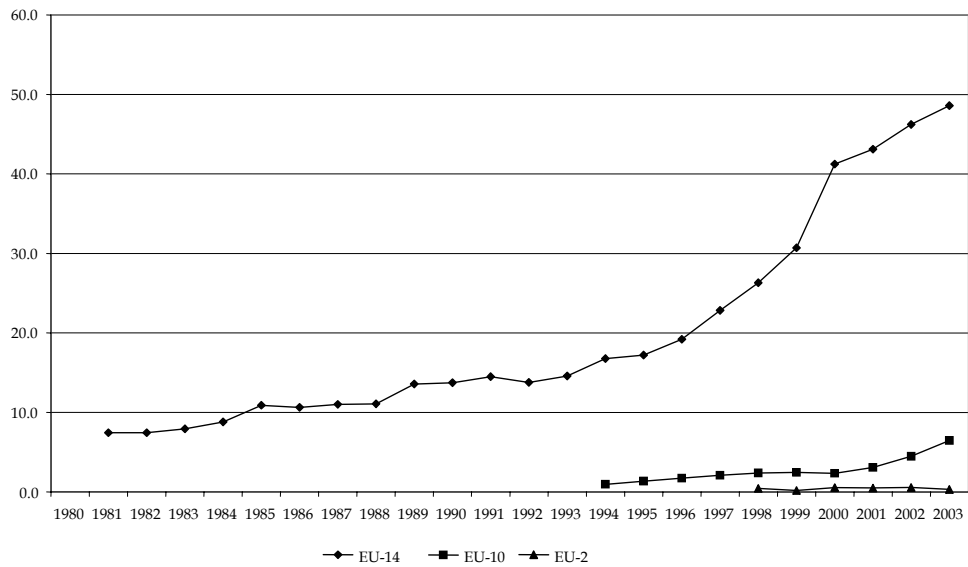
Figures 3.5 and 3.6 indicate, however, that the picture for FDI inflows is completely different. As a result of the unique opportunities afforded by large-scale privatisation and the expected high returns in their markets, in the past decade the 10 (now) new member states experienced massive inflows of FDI, and consequently, by 2003 they showed a similar level of integration in inward investments as the more mature members of the EU. The EU-2 countries, by contrast, seem to lag behind the other two groups by four to five years. Yet in terms of outward FDI, the EU-10 and EU-2 member states have a much lower relative stock than the old member countries. This is no surprise given their low level of development and relative scarcity of indigenous capital.

Figure 3.5 Inward FDI in groups of EU member countries (% of GDP, unweighted average)



Source: Own calculations based on the IMF International Financial Statistics database.

Figure 3.6 Outward FDI in groups of EU member countries (% of GDP, unweighted average)



Source: Own calculations based on the IMF International Financial Statistics database.

Indicators that are more complex, representing the position of individual countries in global financial integration, can be calculated from the data of the IMF's External Wealth of Nations database.²² This useful source of information has been developed by Lane & Milesi-Ferretti,²³ who took the IMF's concept of 'International Investment Position'²⁴ as a starting point. The database covers portfolio investments (both equity securities and debt securities), FDI, other investments (including various debt instruments), financial derivatives and reserve assets. Deriving from these raw data the authors offer two main outcome-based (or as they call them, 'volume-based') indicators for measuring the scale of international financial integration of countries. The indicator 'IFIGDP' adds up the *stock of all external assets and liabilities* of a country as a percentage of the country's GDP. A subset of these financial instruments, called 'GEQGDGP', focuses on *equity holdings* in portfolio investments and FDI. Tables 3.8 and 3.9 present the results of the calculations of these two indices for the EU countries for every fifth year since 1970. Data in Table 3.8 reflect the extraordinary acceleration of financial integration in the EU-14 since the middle of the 1990s, also experienced worldwide. Beyond this general tendency, we see a wide variation among the economies with Ireland, Belgium, the UK and the Netherlands being on the highly open end, and Greece, Italy, Spain and Germany on the less open end. Clearly, the difference between these groups of countries in international financial integration depends not only on the extent of liberalisation of their capital markets, but also on many other circumstances, such as the differences in how their domestic markets are habitually financed (i.e. by bank loan or equity financing).

Table 3.9 presents similarly dynamic developments in the new member states, naturally starting from (and reaching) a lower level than the old member states of the Union. As expected (for instance after inspecting Figures 3.3 to 3.6), the less developed EU countries have based their integration relatively more on equities versus debt instruments than the more developed EU countries. This corresponds to the tendency that Lane & Milesi-Ferretti (2006) found for two broader categories of countries, the "industrial country group" and the "emerging markets/developing countries" group, not only for all asset and liability instruments but also for liability instruments alone. This finding implies that, through increasing financial integration, these less developed countries are becoming gradually less vulnerable to the more mobile and volatile international financing instruments. As for the variation in terms of financial openness within the EU-10 and the EU-2, we find the traditionally highly open economies of Cyprus and Malta on the one hand, and a more or less balanced development for the rest of the countries on the other. Among this latter group of countries, Estonia stands out with its relatively fast financial integration and Romania is noteworthy for its slow pace.

²² See the IMF's website <http://www.imf.org/external/pubs/ft/wp/2006/data/wp0669.zip>.

²³ See Lane & Milesi-Ferretti (2006), as their latest publication on the database.

²⁴ Used by the IMF, the methodology of the International Investment Position is described in IMF (1993).

Table 3.8 Volume-based measures of international financial integration (IFIGDP) and its equity part (GEQGDP) in the EU-14 group (% of GDP)

		1970	1975	1980	1985	1990	1995	2000	2004
Austria	IFIGDP	43.5	55.2	96.2	160.7	133	145.7	291.9	393.1
	GEQGDP	7.6	6.2	5.3	8.6	12.5	17.9	62.8	81.9
Belgium	IFIGDP	74.5	90.9	154.6	365.6	394.8	414.6	599.1	819.5
	GEQGDP	8.8	10.6	14.4	42.5	70	96.5	224.6	300.2
Denmark	IFIGDP	49.8	53.3	81.8	158.7	199.9	166.3	329.4	403.1
	GEQGDP	11.2	14.4	15.4	17.1	26.4	41	135.8	136.5
Finland	IFIGDP	64.3	43.6	52.4	83.5	93.9	129.4	397.2	403
	GEQGDP	1.9	2.3	2.7	6.4	13.1	29.9	250.4	155.3
France	IFIGDP	36.9	43.6	67.8	113.3	131.5	176.1	344.7	418.1
	GEQGDP	11.8	8.9	10.4	26.3	35.4	56.9	164.5	164.1
Germany	IFIGDP	43.5	48.5	59.2	100.2	118.6	126.7	267.3	326.2
	GEQGDP	7.6	8.9	8.7	17.5	21.1	24.3	95.7	91.7
Greece	IFIGDP	26.6	35.6	45.6	81.6	81.3	98.4	145.8	207
	GEQGDP	2.6	2.2	5.8	8.6	11.3	14.7	26.7	36.1
Ireland	IFIGDP	111.2	149.7	180.1	191.6	203.2	390.6	1337	1880
	GEQGDP	9.8	16.9	25.8	52.6	47.8	131.1	528.6	692.5
Italy	IFIGDP	60.7	45.2	43.6	64.7	76	116.4	212	229.1
	GEQGDP	7.6	6.3	4.6	11.1	15	23.7	69.9	65.5
Netherlands	IFIGDP	128.7	112	136.9	227.9	260	270.3	624.9	810.9
	GEQGDP	60.7	45.9	45.3	83.1	89.6	122.9	310.4	318.1
Portugal	IFIGDP	0	41	58.6	133.8	88.2	142	300.9	421.8
	GEQGDP	2.5	4.8	5.5	10.6	17.1	26.9	67.9	102.6
Spain	IFIGDP	30.7	29.1	44.5	64.9	63.8	115.3	232.5	300
	GEQGDP	7.9	6.3	6.1	13	20.7	35.2	97	111.7
Sweden	IFIGDP	33.5	43.3	53.5	96.8	149.5	235.4	451.3	436.4
	GEQGDP	8	7.8	7.9	18.8	39.5	86.2	278.5	215.3
UK	IFIGDP	128.4	166.5	195.2	349.1	351.2	423.8	618.2	728
	GEQGDP	38.7	33.3	34.6	58.5	78.3	101	201.9	183.7
EU-14	IFIGDP	59.4	68.4	90.7	156.6	167.5	210.8	439.5	555.4
	GEQGDP	13.3	12.5	13.7	26.8	35.6	57.7	179.6	189.7

Notes: IFIGDP = sum of the stock of external assets and liabilities (% of GDP); GEQGDP = sum of the stock of portfolio equity assets and liabilities and direct investment assets and liabilities (% of GDP); the group average is unweighted.

Sources: Own calculations based on Lane & Milesi-Ferretti (2006) and the IMF's External Wealth of Nations database.

Table 3.9 Volume-based measures of international financial integration (IFIGDP) and its equity part (GEQGDP) in the EU-10 and EU-2 groups (% of GDP)

		1970	1975	1980	1985	1990	1995	2000	2004
Cyprus	IFIGDP	-	108.9	100.4	174.5	239.5	236.2	573.1	513.2
	GEQGDP	-	27.3	22	26.9	21.4	23.1	69.5	110.2
Czech Rep.	IFIGDP	-	-	-	-	-	100.1	146.4	162.6
	GEQGDP	-	-	-	-	-	19.6	50	67.4
Estonia	IFIGDP	-	-	-	-	-	69.9	146.1	251.5
	GEQGDP	-	-	-	-	-	20.1	61.4	121.2
Hungary	IFIGDP	-	-	-	69.4	63.7	123.7	157.7	181
	GEQGDP	-	-	-	0	1.5	27.3	60.1	80.7
Latvia	IFIGDP	-	-	-	-	-	75.7	128.6	190.1
	GEQGDP	-	-	-	-	-	17.9	28.5	36.7
Lithuania	IFIGDP	-	-	-	-	-	48.6	83.4	105
	GEQGDP	-	-	-	-	-	6	22.3	31.7
Malta	IFIGDP	489.8	322.3	190.6	240.8	178.9	226.6	572.8	820.2
	GEQGDP	24.2	21.9	16.3	25.2	22.3	29.1	91.2	114.3
Poland	IFIGDP	-	34.1	54.4	61.5	117.1	65.7	86.5	116.6
	GEQGDP	-	0	0.4	0.6	1.2	6.7	24.5	42.3
Slovak Rep.	IFIGDP	-	-	-	-	-	93.4	126.6	156.5
	GEQGDP	-	-	-	-	-	14.7	32.9	51.8
Slovenia	IFIGDP	-	-	-	-	-	66.9	100.3	150.8
	GEQGDP	-	-	-	-	-	11.8	20.6	36.9
EU-10	IFIGDP	-	-	-	-	-	110.7	212.1	264.8
	GEQGDP	-	-	-	-	-	38.9	96.5	109.6
Bulgaria	IFIGDP	-	-	-	-	-	125.2	175	173.3
	GEQGDP	-	-	-	-	-	4.6	19.7	40.4
Romania	IFIGDP	-	-	-	-	-	41.5	74.6	95.8
	GEQGDP	-	-	-	-	-	1.5	18.3	28.4
EU-2	IFIGDP	-	-	-	-	-	83.3	124.8	134.5
	GEQGDP	-	-	-	-	-	3	19	34.4

Notes: IFIGDP = sum of the stock of external assets and liabilities (% of GDP); GEQGDP = sum of the stock of portfolio equity assets and liabilities and direct investment assets and liabilities (% of GDP); the group averages are unweighted.

Sources: Own calculations based on Lane and Milesi-Ferretti (2006) and the IMF's External Wealth of Nations database.

