



## The New Economic Geography: Effects and Policy Implications (Federal Reserve Bank of Kansas City, 2006)

by Mahalia Jackman\*

Over the last few decades, advancements in communications and information technologies have significantly reduced the time and costs of international interactions. As a result, economic distances have shrunk, international trade has increased and there has been a shift in the location of economic activity. Essentially, a new economic geography has evolved.

Even though the emergence of this new economic geography has stimulated a large body of research, two key questions still remain. First, what are the recent factors driving the change? Second, what are the challenges that arise when dealing with changing economic distances and increased integration? The publication “The New Economic Geography: Effects and Policy Implications” attempts to address these two fundamental questions.

The book is based on the proceedings of a symposium sponsored by the Federal Reserve Bank of Kansas City and consists of a series of articles and discussions by several distinguished central bankers, academic economists and financial market experts. The symposium was organised under three main sub-themes:

1. why changes in economic geography occur and the consequences for the product, labour and financial markets;
2. strategies to enhance openness and growth in developing countries and
3. the implications that greater openness can have on monetary policy.

In his opening address, Bernanke explains that economic integration is an old process, dating back some two thousand years. Today, the changes that we observe are being driven by the same basic force: technological improvements. However, the current episode of integration differs in three ways:

1. the scale and pace of today’s integration is unprecedented;

2. international capital markets have become substantially more mature and
3. the production processes are becoming geographically fragmented to a remarkable degree.

### Changes in Economic Geography and Their Consequences

The opening paper ‘Shifts in Economic Geography and their Causes’ by Venables explains how geographical economics may provide an additional explanation as to why and how economic activity tends to be spatially concentrated. The author stresses the need for a general theory of location of economic activity. Mainstream economic theory is aspatial and predicts that increases in trade should lead to convergence of incomes. It, therefore, cannot account for the observed persisting divergence in incomes. The “new economic geography” has magnified these deficiencies: the more productive countries are able to attract more economic activity, which, in turn widens these income disparities. In closing, Venables suggests that as globalisation causes dispersion of activity, economic development will be in sequence, not in parallel.

In contrast, Grossman and Rossi-Hanberg assess how increased integration has altered the type of international trade. More specifically, how globalisation has led to the evolution of trade in tasks which they refer to as ‘offshoring’. In their paper “The Rise of Offshoring: It’s Not Wine for Cloth Anymore”, the authors focus on the consequences of increased offshoring on production, prices, employment and wages. The impact of offshoring on wages is decomposed into three parts: a productivity effect, a relative-price effect and a labour supply effect. They show that the productivity impact may dominate the others. Contrary to the common notion that off-shoring reduces wages, improved possibilities for off-shoring may raise the wages of domestic workers.

Grossman and Rossi-Hansberg also find evidence that the combined labour supply effect and productivity effect of offshoring, represented by a residual, has a positive influence on low skilled wages in the United States. However, in discussing the paper by Grossman and Rossi-Hansberg,

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\* Miss Mahalia Jackman is a Research Officer in the Research Department of the Central Bank of Barbados.

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Taylor re-emphasises the need to modernise international trade theory to include trade in services but criticises the use of a residual to represent the effects of offshoring, given the many alternative explanations. Other participants were also concerned with the long run impacts of offshoring such as changes in skill distribution.

In the paper “Patterns of International Capital Flows and their Implications for Economic Development” Prasad, Rajan and Subramanian address new dimensions of the Lucas paradox. In direct conflict with traditional economic theory, the authors show that the recent direction of overall capital flows has been from poorer countries to richer countries. They then empirically test the knowledge-based economic theory that countries, which attract more foreign capital, should grow faster. Prasad, Rajan and Subramanian examine the correlation between foreign capital inflows and economic growth. With the exception of foreign direct investment, their results suggest that there is no significant relationship between financial integration and growth. In addition, the authors report a positive correlation between current account deficits and long-run growth in non-industrialised countries. They believe that the underdevelopment of the financial sector in poor countries, and the need to avoid currency overvaluation caused by rapid inflows, may have limited their ability to absorb foreign capital and hence, may be responsible for strengthening the link between the current account and growth.

In her commentary, Collins focused on the linkages between current account balances and growth. She believes that in the simple framework, the positive relationship found by Prasad, Rajan and Subramanian is not that surprising. Elaborating on other explanations of the “new stylised fact”, Collins questions whether these findings are a result of ne new geography or a “slowly dissipating pattern that became more pronounced as the volume of international capital flows exploded” (p.166). Collins also points out that the results recorded may have been influenced by the significant difficulties in measuring key variables such as financial integration. Additionally, the empirical evidence of Prasad, Rajan and Subramanian is suggestive at best since correlation does not imply causation, a point repeated

by other participants in the general discussion.

Fischer discusses how the rise of Asia, particularly India and China, has reshaped the world economy and provides an analysis of the economic and political implications of the growth of Asia. In his luncheon address, he highlights that Asia’s impact on the international economic system relies solely on how important Shanghai and Mumbai will become as financial centres. Reflecting on the major wars and instability which followed the rise of Japan, Germany and the Soviet Union, Fischer states that the political consequences of two more great powers, and the relative decline of others, is disturbing.

### **Strategies for Openness and Growth**

Discussing the case of India, Srinivasan outlines the country’s experience since the reforms and its future challenges. Until the systematic reforms in the 1990s, the State played a dominant role in the Indian economy, exercising controls on prices, foreign exchange earnings and investment projects. The Government also isolated agricultural producers from domestic and international competition. In 1991, the Indian economy slumped into macroeconomic and balance of payments crisis. Consequently, the State reformed the economy by reducing capital controls and trade barriers. Srinivasan contends that regardless of the crisis, the main reasons for India undertaking the reforms were:

1. the collapse of the Soviet Union and its planned economy, on which Indian planning was modelled, and
2. the rapid growth of China, its only relevant economic rival.

Since then, India has experienced rapid growth, but according to Srinivasan, the country still faces a challenge in sustaining growth. Many other institutional reforms are needed. The restrictions on labour laws and costly banking procedures have limited growth in the manufacturing sector, and despite India’s comparative advantage in agriculture, expansion is hindered by infrastructural bottlenecks and institutional rigidities on land use. Unless these problems are addressed, Srinivasan laments that potential growth may be compromised.

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Discussant Svejnar summarises the experience of Central and Eastern Europe while making the transition to market economies. Initially, all transition economies experienced a large decline in economic activities. However, there were disparities in the patterns of gross domestic product evolution between western transition countries and those in the east. But, what accounts for this difference? Svejnar suggests that economic geography may give part of the explanation. He argues that the physical proximity to Western Europe provided an important advantage for western transition economies in terms of trade.

Svejnar also investigated the differences in the countries' strategies for transition. He divided the reforms undertaken into two categories:

1. type I reforms which focus on macro-stabilisation, price liberalisation and dismantling of the institutions of the communist system, and
2. type II reforms which involve the development and enforcement of laws conducive to the functioning of the market economy.

He found that countries which placed emphasis on type II reforms early on performed better in the 1990s.

In conclusion, Svejnar suggested six important elements for successful strategy in the future:

1. preserving macroeconomic stability;
2. retaining competitiveness and creating "good" jobs;
3. maintaining and increasing FDI flows;
4. improving the level and effectiveness of human capital;
5. containing the discontent of the population with respect to the transition reforms and
6. maintaining liberal democracy and protecting human rights

Finally, Collier reviews how Africa's distinctive physical and human geography has shaped its economic opportunities. The major features of Africa's physical geography are its abundant but unevenly distributed resources and its many diverse countries. Collier divides African countries into three categories: resource-rich, resource-scarce and landlocked and finally, resource-

scarce and coastal. Consequently, growth strategies of each category of countries need to be differentiated. Small populations and ethnic diversity are the distinctive characteristics of African human geography. Each, according to Collier, creates problems. A corollary of small countries is that reforms and maintenance of internal security are more difficult. In cases of ethnic diversity, democracy is key for economic performance and public provision should be kept small and decentralised.

In his concluding remarks, Collier notes that the issues generated from Africa's human geography may be problems of the past as the region has democratised over the past decade, and has reduced the size of government and decentralised spending. He added that despite recent developments, the interactions of physical and human geography have created two intractable problems: how to manage resources in the context of ethnic diversity and how to compete with Asia given Asia's head start?

### **The Implications of Globalisation on Monetary Policy**

In the paper "Impact of Globalisation on Monetary Policy", Rogoff discusses the core issues in the recent monetary policy and globalisation debate: the impact globalisation has on inflation, continuing asset price volatility despite reductions in output volatility and the implications of greater integration on monetary policy.

Addressing the "China is exporting deflation" theory, Rogoff argues that such a paradigm is 'hopelessly naïve'. He contends that general price levels depend only on the policy carried out by Central Banks. Alternatively, globalisation may help support lower inflation in the long run by steepening the output-inflation trade-off central banks face. Rogoff stresses that one of the major challenges confronted by the monetary authorities during the globalisation period is persisting asset volatility. He stipulates that part of the volatility in asset prices may be transitory, as investors may still be engaged in a learning process on the economy's risk level. His explanation for the remaining long-run volatility is that as long-term interest rates and risk premia fall, the prices of long-lived assets rise. Prices simultaneously become more sensitive to changes in the expected risks, thereby, offsetting the effects of reductions in macroeconomic stability.

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In his concluding remarks, the author notes that central banks should be less worried about asset price volatility. Rather, they should focus on ensuring that frameworks and institutions can maintain general price levels and macroeconomic stability in the event that the globalisation process is compromised.

Discussant Bean generally agrees with Rogoff's paper. However, he is less convinced that globalisation results in a steepened short-run output inflation trade-off. As mentioned by Bean, the evidence from open economies suggests that "increased specialisation resulting from globalisation reduces the response of inflation to the domestic gap and makes it more sensitive to the world output gap, leading to a flatter trade-off" (p.398). Bean also disagrees with the view that volatility has troubled policy makers. Instead he believes that their main challenge was recognising whether asset prices were justified by changed fundamentals.

The book concludes with Feldstein, Fraga and Mohan providing an overview of the papers and issues discussed at the symposium. Feldstein addresses the issue of global economic imbalances and notes as the US trade deficit declines, central banks will be either forced to ease monetary policy to maintain demand and employment or tighten policy in order to reduce demand, and hence, inflation. In contrast, Fraga focuses on Latin America and presents four reasons for the recent lack of growth in Latin

America: macro-instability, low savings and investment, the poor quality of education and finally, governance. Looking to the future, Mohan sees the growing Asian population accelerating the global labour force and adding to the further shrinking of the world.

### **Conclusion**

The publication highlights the many challenges that countries face as a result of increased integration and rapid changes in the global economic geography. Hence, "The New Economic Geography: Effects and Policy Implications" is a 'must read' for policy makers and researchers alike. A major critique of the book, however, is its disregard of the implications of fiscal policy. It is highly unreasonable to assume that fiscal measures adopted by countries would remain unaffected in light of the changes in the global economy.

Despite this neglect, the book should be a reference of Caribbean economies. With the renewed focus on furthering integration within the region, the book may provide policy makers with useful insight into the potential impact integration can have on economic activity. For instance, greater integration may result in shifts in the location of factors of production, which in turn can lead to greater economic disparities between Caribbean countries: some countries may experience rapid growth while others may be left behind.