

## 2008 KOF Index of Globalization

The KOF Index of Globalization was introduced in 2002 (Dreher, 2006) and is updated and described in detail in Dreher, Gaston and Martens (2008). The overall index covers the economic, social and political dimensions of globalization. Following Clark (2000), Norris (2000) and Keohane and Nye (2000), it defines globalization to be the process of creating networks of connections among actors at multi-continental distances, mediated through a variety of flows including people, information and ideas, capital and goods. Globalization is conceptualized as a process that erodes national boundaries, integrates national economies, cultures, technologies and governance and produces complex relations of mutual interdependence.

More specifically, the three dimensions of the KOF index are defined as:

- ◆ *economic globalization*, characterized as long distance flows of goods, capital and services as well as information and perceptions that accompany market exchanges;
- ◆ *political globalization*, characterized by a diffusion of government policies; and
- ◆ *social globalization*, expressed as the spread of ideas, information, images and people.

The 2008 index introduces an updated version of the original index, employing more recent data than has been available previously.

### Economic Globalization

Broadly speaking, economic globalization has two dimensions. First, actual economic flows are usually taken to be measures of globalization. Second, the previous literature employs proxies for restrictions to trade and capital. Consequently, two indices are constructed that include individual components suggested as proxies for globalization in the previous literature.

*Actual Flows:* The sub-index on actual economic flows includes data on trade, FDI and portfolio investment. Data on trade and FDI flows is provided by the World Bank (2007), stocks of FDI are provided by the UNCTAD's World Investment Report. Portfolio investment is derived from the IMF's International Financial Statistics. More specifically, trade is the sum of a country's exports and imports and portfolio investment is the sum of a country's assets and liabilities (all normalized by GDP). We include the sum of gross inflows and outflows of FDI and the stocks of FDI (again all normalized by GDP).

While these variables are straightforward, income payments to foreign nationals and capital are included to proxy for the extent that a country employs foreign people and capital in its production processes.

*Restrictions:* The second index refers to restrictions on trade and capital using hidden import barriers, mean tariff rates, taxes on international trade (as a share of current revenue) and an index of capital controls. Given a certain level of trade, a country with higher revenues from tariffs is less globalized. To proxy restrictions of the capital account, an index constructed by Gwartney and Lawson (2007) is employed. This index is based on the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions and includes 13 different types of capital controls. The index is constructed by subtracting the number of restrictions from 13 and multiplying the result by 10. The indices on mean tariff rates and hidden import barriers are also derived from Gwartney and Lawson (2007). Mean tariff rates originate from various sources. Gwartney and Lawson allocated a rating of 10 to countries that do not impose any tariffs. As the mean tariff rate increases, countries are assigned lower ratings. The rating will decline toward zero as the mean tariff rate approaches 50 percent (which is usually not exceeded by most countries among their sample). The original source for hidden import

barriers, finally, is the World Economic Forum's Global Competitiveness Report (various issues).

### Social Globalization

The KOF index classifies social globalization in three categories. The first covers personal contacts, the second includes data on information flows and the third measures cultural proximity.

*Personal Contacts:* This index is meant to capture direct interaction among people living in different countries. It includes international telecom traffic (outgoing traffic in minutes per subscriber) and the degree of tourism (incoming and outgoing) a country's population is exposed to. Government and workers' transfers received and paid (in percent of GDP) measure whether and to what extent countries interact, while the stock of foreign population is included to capture existing interactions with people from other countries. The number of international letters sent and received also measure direct interaction among people living in different countries. While the first four variables derive from the World Bank (2007), the latter is taken from the Universal Postal Union's Postal Statistics Database.

*Information flows:* While personal contact data are meant to capture measurable interactions among people from different countries, the sub-index on information flows is meant to measure the potential flow of ideas and images. It includes the number of internet users, cable television subscribers, number of radios (all per 1000 people), and international newspapers traded (in percent of GDP).<sup>1</sup> All these variables to some extent proxy people's potential for receiving news from other countries – they thus contribute to the global spread of ideas. The variables in this sub-index derive from the World Bank (2005, 2007).

*Cultural Proximity:* Cultural proximity is arguably the dimension of globalization most difficult to grasp. Dreher (2006) suggests the number of English songs in national hit lists or movies shown in national cinemas that originated in Hollywood. However, these data lack for the majority of countries in our sample. Instead, we thus use imported and exported books (relative to GDP), as suggested in Kluver and Fu (2004). Traded books proxy the extent to which beliefs and values move across national borders.

According to Saich (2000, p.209) moreover, cultural globalization mostly refers to the domination of U.S. cultural products. Arguably, the United States is the trend-setter in much of the global socio-cultural realm (see Rosendorf, 2000, p.111). As an additional proxy for cultural proximity we thus include the number of McDonald's restaurants located in a country. For many people, the global spread of McDonald's became a synonym for globalization itself (see, e.g., Datum 9/06, <http://www.datum.at/0906/stories/2760960/>). In a similar vein, we also use the number of Ikea per country.

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<sup>1</sup> The number of internet hosts has been excluded from the index as it is no longer provided in the World Telecommunication Indicators Database. This dimension of globalization can be captured by the number of internet users.

## Political Globalization

To proxy the degree of political globalization we follow A.T. Kearney (2001), employing the number of embassies and high commissions in a country, the number of international organizations to which the country is a member and the number of UN peace missions a country participated in.

## **Method of Calculation**

In constructing the indices of globalization, each of the variables introduced above is transformed to an index on a scale of one to hundred, where hundred is the maximum value for a specific variable over the period 1970 to 2005 and one is the minimum value. Higher values denote greater globalization. The data is transformed according to the percentiles of the original distribution.<sup>2</sup> The weights for calculating the sub-indices are determined using principal components analysis for the entire sample of countries and years.<sup>3</sup> The analysis partitions the variance of the variables used in each sub-group. The weights are then determined in a way that maximizes the variation of the resulting principal component, so that the indices capture the variation as fully as possible.<sup>4</sup> The same procedure is applied to the sub-indices in order to derive the overall index of globalization.

Data are calculated on a yearly basis. However, not all data are available for all countries and all years. In calculating the indices, all variables are linearly interpolated before applying the weighting procedure. Instead of linear extrapolation, missing values at the border of the sample are substituted by the latest data available.<sup>5</sup> When data are missing over the entire sample period, the weights are readjusted to correct for this. When observations with value zero do not represent missing data, they enter the index with weight zero. Data for sub-indices and the overall index of globalization are not calculated, if they rely on a small range of variables in a specific year and country. Observations for the overall index are reported as missing if more than one-third of the underlying data are missing. The thresholds for the economic, social and political sub-indices are 0.3, those for the lower-level sub-indices 0.2. The indices on economic, social and political globalization as well as the overall index are calculated employing the weighted individual data series instead of using the aggregated lower-level globalization indices. This has the advantage that data enter the higher levels of the index even if the value of a sub-index is not reported due to missing data.

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<sup>2</sup> In the 2002 version of the KOF-index, the original variables have been transformed to indices employing the formula  $(V_i - V_{\min}) / (V_{\max} - V_{\min}) * 10$ . This has the major disadvantage that a variables' actual weight in the index is to some extent affected by its distribution. As a consequence, the results were sometimes driven by extreme outlying observations and missing values.

<sup>3</sup> There is a methodological change as compared to the 2002 index of globalization, where the variables have been normalized for each particular year. Normalising over the whole period yields better comparability over time. One drawback is that the resulting globalization index is affected by the inclusion of additional years.

<sup>4</sup> In the 2002 release of the globalization index the weights were calculated for the year 2000 and were then used to calculate the indices back to 1971. The present version of the index calculates the weights on the basis of all data currently available.

<sup>5</sup> Note that this represents a methodological change with respect to the 2005 version of the index, where missing values have been only interpolated for hidden import barriers, mean tariff rates, capital account restrictions, number of embassies in a country, membership in international organizations, foreign population, costs of telephone calls to the United States and the number of McDonald's restaurants.

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