Nine Common Misconceptions About Competitiveness and Globalization

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Occasional Paper 73

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Occasional Paper
No. 73

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Published by
Group of Thirty©
Washington, DC
2007

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Introduction

The current debate on competitiveness and globalization, in particular the arguments made by opponents in developed and developing countries, are based on a series of misconceptions that, having observed the level of debate in the press, I felt needed to be addressed directly. Protectionist lobbies, primarily but not exclusively those in developed countries, representing sectors such as agriculture, textiles, labour interests, and others, are responsible for minimizing the chance of achieving a successful Doha round of multilateral trade talks before the expiry of U.S. “fast track” authority. They resist the very changes in industrialized nations’ and developing countries’ trade policies that would be of greatest benefit to the largest number of world citizens. These same critics attack free trade using a series of positions which are fundamentally flawed. In the remarks below, I will endeavor to remind, once more, why these arguments have very little theoretical or factual basis. My aim is to provide a primer for the non-specialist reader so that he or she might better be able to understand and engage in the current debate over competitiveness, globalization, and free trade. Before going through the different misconceptions, it is important to give the two internationally accepted definitions of globalization and competitiveness.

Globalization is a dynamic process of liberalization and integration of the world markets for goods, services, capital, labour, technology, knowledge, and ideas, which expands the world markets, increases global competition, and enhances global productivity through a better and more efficient allocation of the potential factors of production.

Competitiveness is the capacity of an economy to compete successfully in the national and international markets while, at the same time, maintaining an increasing and sustainable standard of living.

The nine common misconceptions about globalization and competitiveness are:

1. Competitiveness depends exclusively on relative costs and prices.
2. Competitiveness should be measured by export performance.
3. Competitiveness is mainly a static concept.
4. Developing countries are engaging in "social dumping."
5. China and India will remain very competitive for many decades.
6. All jobs in an economy compete globally.
7. Large numbers of graduates in science and engineering are required for a country to remain competitive.
8. Competitiveness is a "zero-sum game."
9. Globalization threatens the survival of the welfare state in developed countries.

Competitiveness Depends Exclusively on Relative Costs and Prices

The first common misconception revolves around the belief that economic competitiveness is based exclusively on relative costs and prices. This argument is only partially true. It is based on the neoclassical model of perfect competition in international trade and is still valid in the case of basic commodities such as oil and gas, gold, metals, soybeans, coffee, maize, and wheat, and some perfectly homogeneous products, such as some iron and steel products, basic chemicals, and some textiles, which are mostly quoted at international or local exchanges. For these basic homogeneous products, the relative levels of production costs and exchange rates determine a large part of their competitiveness.

Today, however, other forms and ways to compete in the international markets for heterogeneous goods and services have arisen—mainly in developed countries. This fact was recognized decades ago by economist Nicholas Kaldor (1978), who showed that there was no clear correlation between reductions in relative costs and prices of an economy and its market share in international markets (known as the "Kaldor Paradox"). In the 1970s and 1980s, new theories and models of international trade, developed by Avinash Dixit and Joseph Stiglitz (1977), Paul Krugman (1980), Avinash Dixit and Victor Norman (1980), Wilfred Ethier (1982) and Elhanan Helpman and Paul Krugman (1985) demonstrated that international trade and competitiveness are based mainly on the existence

of increasing returns to scale in the specialization of production and distribution of goods and services, as well as on product differentiation and on the level of quality, design, innovation, embedded technology, and brand recognition. That is, developed countries have other ways to compete that can be more efficient than costs and prices in the international markets for heterogeneous goods and services.

Today, most heterogeneous manufactured goods compete internationally based predominantly on these new parameters, and not on their relative costs or prices. This form of "imperfect" or "monopolistic" competition is extremely important among economies that are very similar in terms of income levels, tastes, and revealed comparative advantages. It is even more important between countries with a single currency or with a peg between their currency and a major international reserve currency such as the U.S. dollar. In these cases, competing economies do not have recourse to competitive nominal exchange rate depreciations, which could give them a temporary cost advantage. Competition via these alternative parameters may also be important in cases of "intra-industry" or "intra-firm trade," where different companies within the same sector of production or subsidiaries of companies within the same group engage in foreign trade. It tends to be less important in trade of heterogeneous products between developed and developing countries.

Finally, there is an increasingly clear distinction between a country's external competitiveness based exclusively on its short-term trade results or export market shares, and its long-term global competitiveness, which is based mainly on its relative levels of productivity. A country's level of productivity determines—in the long term and in the final instance—not only its relative level of competitiveness but also its potential GDP growth, its real wage levels, and its well-being.

It is this concept of productivity that is used by the World Economic Forum and by the IMD to rank countries' global competitiveness each year. Thus in these rankings, China is not considered a highly competitive country, because it is only very competitive in labour-intensive manufactured products, it has lower wages (because of its lower relative productivity), a medium (but fast-growing) level of technology, and an artificially depreciated currency. In contrast, Germany and Japan are ranked as very competitive countries, because they are able to compete internationally despite their very often appreciated currencies and higher costs and wages. Their sustained success in exporting amply

demonstrates that their productivity, technology, and innovation levels are higher than in most other developed countries.

Technically, the only way that productivity and competitiveness may differ is when a country's purchasing power grows at a slower rate than its output, or—what amounts to the same thing—when its terms of trade deteriorate; that is, when the average price of its imports becomes higher than the average price of its exports. In this case, its purchasing power and its standard of living would be deteriorating while competing successfully in international markets, and thus would not be truly competitive.

In general, developed countries have seen their terms of trade improving over the long term, despite occasional temporary short-term declines, mainly due to energy shocks. In contrast, developing countries have often suffered from deterioration in their terms of trade. In the past few years, for instance, many developing countries appear to be exporting manufactured goods at flat or falling prices as they import commodities at rising prices.

Competitiveness Should be Measured by Export Performance

The second misconception is that the only real way to measure a country's level of competitiveness is through its export performance in foreign markets. Those countries which hold this belief see export competitiveness as a key target of economic policy.

But this view of competitiveness can be "a dangerous obsession," as Paul Krugman (1994) warned, as it is not based on solid evidence. Historically, those countries that have engaged in such a policy have tended to erode their living standards (Posen 2006). That is, in a misguided search for improving their export performance and competitiveness, some countries have:

- Depreciated their currency, adversely impacting the purchasing power of their population;

- Depressed wages in their export sectors, either directly or through a relative deflation compared to their trading partners (that is, cutting real incomes and domestic demand);

- Subsidized and protected their exporters—wasting public money and distorting investment decisions;

- Promoted national champions through large discretionary subsidies;

- Protected their main exporters from foreign take-over bids, or forced domestic mergers among their large companies, at the expense of other smaller and competitive businesses and the taxpayers.

Such policies tend to undermine living standards rather than improve them. In fact, rather than focus on export performance, a substantial body of empirical evidence shows by contrast that engagement in international trade and the openness of countries' markets to trade are highly correlated to faster overall economic growth. Trade liberalization tends to strengthen an economy. Costs may fall due to the ability to import a greater variety of goods and services at lower prices than offered in the domestic market. Efficiency gains may also be seen via increasing competition in the domestic market. Further benefits may accrue from the clear signals to business people that the government is honestly engaged in promoting openness and market-oriented policies, which tend to be a key to innovation and competition, instead of supporting a framework of discretionary intervention that protects incumbents and avoids new entrants into the marketplace.

Again, the key to competitiveness for any country is the ability to increase its average productivity and achieve increasing terms of trade when opening up to the rest of the world. To do this a country must be able to continually produce new and more diversified, differentiated, and valuable goods and services ahead of other countries. It must be able to efficiently exploit economies of scale and scope in production and distribution. Only in this manner can a country become and remain competitive by moving up in the value-added chain so that its citizens can prosper in the long term.

Competitiveness is Mainly a Static Concept

The third misconception is to believe that competitiveness is essentially a static concept, when in actuality it is highly dynamic. To remain competitive, countries must improve their levels of productivity and of innovation progressively, along a "value chain" that never seems to end.

Recall that all counties that are now developed were once underdeveloped; they started to compete, long ago, by exploiting their comparative advantages based on their relatively low labour costs or their abundant natural resources, just as many developing countries are doing today to catch up with developed ones. Later, they were able to increase their levels of technology and productivity by improving the levels of education and human capital of their labour force, by using their physical capital more effectively, by investing heavily in research, development, and innovation, and by introducing incremental discoveries. This enabled them to start producing more diversified and differentiated products with higher prices and margins, while abandoning the production of other manufactured goods that were not compatible with their now higher wages and higher productivity.

However, moving up that "value chain" can be increasingly difficult for developed countries, which must develop new technologies and engage in a process of continuous innovation. This task is somewhat easier for developing countries, which can grow faster just by imitating and adopting technologies and innovations from developed countries and thus increasing total factor productivity and catch up.

Evidence of this move up the value chain is easy to find. For instance, at the beginning of the twentieth century, agriculture, cattle-raising, and fishing constituted an average of 68 percent of total employment in Japan, 46 percent in the nations that now constitute the EU-15, and 44 percent in the United States. By contrast, today their respective percentages of total employment are 4.4 percent, 3.4 percent, and 1.2 percent. Around 1900, industrial employment constituted 40 percent of total employment, on average, in the countries that are now members of the Organisation for Economic Co-operation and Development (OECD). More than a century later, their respective averages are 27 percent in Japan, 26 percent in the EU-15, and 20 percent in the United States. The shares may drop much further in the next four decades (World Bank 2005; OECD 2006).

As a result of these dynamic changes in sector-by-sector employment, these nations' levels of productivity and output have increased many times. Does this mean that these OECD countries have been forced to reduce their employment rate levels? Not at all: they have increased both their employment rates and their wage levels substantially because they have achieved a higher level of productivity in their new production mix. As a result, they are now many times wealthier than a hundred years ago. Their labour forces have shifted slowly towards the construction and the services sectors, which today represent around 70 percent of their total employment, on average (OECD 2005).

A similar process can be seen in emerging economies and countries. Although agricultural employment still accounts for the largest part of total employment—50 percent on average—their industrial employment has reached levels close to those in developed countries one hundred years ago: that is, around 35 percent of the total. (Only in the poorest countries is 80 percent of their total labour force still engaged in subsistence agriculture; this is the reason why they are so poor.) For instance, only two decades ago, most U.S. and European imports of textiles, apparel, and shoes came from China, Taiwan, Hong Kong, and South Korea. Today, these countries have reduced the relative weight of these cheap labour-intensive manufactures exports; now they are also exporters of chips, personal computers, cell phones, and automobiles. Meanwhile, Bangladesh, Vietnam, Indonesia, and the Philippines are some of the countries exporting most of these highly labour-intensive manufactures (WTO 2006).

When developed countries wish to maintain a competitive edge in textiles, apparel, and shoes, they must move up the value chain. Thus, companies in Italy, France, and Spain still export some of these labour-intensive products competitively. But they do so at a much higher quality, price, and margin, thanks to their skills in fashion and styling, design, finishing, quality, and brand recognition. They have sought to produce better and more differentiated products, but, at the same time, they also manufacture a large part of these more labour-intensive products or their component parts in countries with a lower-cost labour force.

Developing Countries are Engaging in "Social Dumping"

The fourth misconception is based on the idea that workers in developing countries do not have the comparable levels of trade union representation, wages, working regulations and conditions, and political and social rights as in developed countries. Developing countries are said to be exploiting badly paid workers who labour under very hard working conditions and, thus, are engaging in "social dumping"—that is, sending excessively cheap exports to developed countries. Adversely affected domestic producers of similar goods argue that products manufactured under these circumstances should be subject to an antidumping duty to eliminate "unfair" competition. This concept of "social dumping" is faulty for various reasons.

First, each country should specialize in what it can produce more competitively by using its revealed comparative advantages in its relative unit labour costs (including productivity), as well as its level of physical capital and human capital accumulation. Developing countries with lower productivity levels will tend to specialize in sectors that maximize the benefits of their cheaper labour force, cheaper land, or their abundant natural and energy resources. Developed countries will tend to specialize in sectors that benefit most from their higher level of education and human capital, their more abundant physical capital, technology, and innovation, and as a result, in their higher levels of productivity.

Second, "social dumping" cannot really be classified as dumping. Technically, this term means that the country in question is exporting a service or a good to another country at a price below its domestic market price. This is exactly the opposite of what it is happening with developing country exports to developed countries. In developing countries, wages in labour-intensive industries that produce for exports are much higher than in those that produce only for their domestic market. As a consequence, their export products have a higher price than their domestic products in the national market. Moreover, many if not most exporting companies in developing countries are owned by developed country multinationals or have outsourcing or off-shoring contracts with them. A wide body of empirical evidence shows that foreign-owned companies pay higher wages than domestic companies, both in developing and in developed countries. Only in those cases that governments have clearly subsidized exports by these domestic companies would protests be justified and should an antidumping procedure be initiated.

Third, accusations of social dumping based on relative levels of social spending are misplaced and unfair. Protests in developed countries that point to the very low level of social security contributions that exporting companies in developing countries must pay lack an appropriate historic perspective. Many developed countries have a long democratic tradition, and universal social security and healthcare services are a hard-won social gain achieved over many decades. It is unrealistic that some advocates for labour in the developed countries would seek to try and impose such services and their associated costs on poorer countries that are struggling with low incomes, low budget revenue, and many other pressing basic social needs. Moreover, relative social spending and contributions can be low in some developed countries such as the United States and Denmark, yet no one dares to claim that these two countries are engaging in social dumping.

Fourth, "child labour" is condemned not only on moral and ethical grounds, which are entirely understandable, but also because it is alleged to be another factor contributing to "social dumping." Some business associations, trade unions, and nongovernmental organizations are demanding a ban on imports on all manufactured goods produced using child labour in full or in part.

However, most empirical evidence shows a positive correlation between more international trade and less child labour over time (Edmonds and Pavcnik 2002, 2004). Therefore, developed country markets should

be opened further to goods from developing countries if we are to make progress in eliminating child labour.

The solution to this problem is not to concentrate on banning manufactured goods produced by children. A far better approach would be to generate more and better jobs for poor countries. One way to do this is to drastically reduce the unproductive protectionist attitudes and practices of developed countries (and some emerging countries) against agricultural goods and labour-intensive manufactures produced by these developing countries. These products are exactly the ones that they can export more competitively to the rest of the world. Trade barriers against these products impede the growth of these sectors, which hinders parents who want to find better-paying job in export businesses, and this stops them from being able to send their children to school instead of forcing them to take a job to support their families.

Most exporters do not wish to employ children, and indeed pay their workers higher wages than those involved in domestic production. Thus currently, only 12 percent of children in developing countries are employed in exporting companies.

Finally, banning child labour in those countries would have a positive effect only if all of the following conditions were to apply simultaneously: If the reduction in the supply of working children would imply a similar increase in the demand for adult workers (who are natural substitutes); if this larger demand for adult workers would translate into an increase in their wage levels to totally compensate for the loss of children's wages; and if the adult workers now employed would use their higher wages to send their children to school (Basu and Van 1998; Brown, Deardoff, and Stern 2001). If these three conditions are not fulfilled, such a prohibition would make working children worse off and total welfare in the developing country would deteriorate. The main factor behind child labour in those countries is extreme poverty, thus, quite simply and starkly, a low-paid job is better than no job at all (Krugman 1998). Parents need their children's wage to complement their total income in order to survive.

China and India will Remain Very Competitive for Many Decades

The fifth misconception is to think that China will dominate in manufactured goods and India will dominate in services in the long term, because they have much lower relative wages and a reasonable and increasingly higher level of productive technology. The available empirical evidence does not support this argument.

First, the United States is still the world's largest producer of goods and services followed by Germany and Japan in manufactured goods, and by the United Kingdom in services. Germany is still the largest exporter of manufactured goods, having an average hourly cost that is forty times higher than that of China.

Second, as Paul Krugman has pointed out, "to say that a country can be able to combine developing country wages with developed country productivity is an oxymoron" (Krugman 1996a). If China's average wage levels are so low, it is because its average productivity levels are also very low. Thus as its productivity goes up, so will its average wage, until it reaches a level of income, purchasing power, and prosperity in which it will not be so competitive in intensive labour manufactures and it will have to outsource some of them to other countries with cheaper labour and lower productivity levels (or import them from those countries). In the meantime, China will be shifting its production to other manufactured goods with higher levels of productivity, technology, price, and value added per worker, compatible with its higher average wages—as has already happened in most developed countries.

It is important to remember that, as in the case of China and India, countries grow richer on the back of appreciating currencies. Currencies tend to rise as higher productivity leads economies to converge on Purchasing Power Parity (PPP) exchange rates. There is a clear tendency for countries with higher income per capita to have exchange rates closer to their purchasing power. Those developing countries that are far from the PPP exchange rates tend to have much lower levels of productivity. As their productivity levels rise, their currencies will tend to appreciate toward Purchasing Power Parity. This effect was identified (at the same time and independently) by Balassa (1964) and Samuelson (1964) and called the "Balassa-Samuelson" effect, by which, prices in the non-tradable sector tend to grow faster than in the tradable sector given that the prices in the latter are set by international competitive markets while the prices in the former are set at the national level. The larger the difference between the two price levels, the higher tends to be the potential real appreciation of their exchange rate, until productivities in both sectors converge.

Third, China is currently the largest final assembler rather than a very large exporter of domestically manufactured products. Almost two-thirds of the value of Chinese exports of manufactured goods to Europe and the United States are first imported into China (IIE and CSIS 2006). A similar percentage comes from EU and U.S. multinationals established in India and China and other developing countries; this is, intra-firm trade. The same can be said of India's exports of services, which are largely produced by U.S. and European firms established there. This increasing multinational presence allows both countries to benefit from large foreign direct investment flows, and from increasing exports, employment, education, training, and technology levels. At the same time, it allows those multinationals to be more competitive and to increase their higher and more skilled domestic employment.

Moreover, cheap imports from these developing countries benefit *all* citizens in developed countries. The low prices of these imports moderate the rate of inflation or compensate for the inflation pressures originating from the hike in commodities and energy prices. This helps maintain the purchasing power of firms and consumers in all importing countries. In addition these cheap imports may allow central banks to avoid or delay raising short-term interest rates, helping to maintain a moderate and stable cost of capital and level of debt for households and companies. In sum, most people in the world become winners as consumers and

borrowers. Even those workers who lose as producers, because they lose their jobs or suffer a loss in real wages due to increasing competition from cheap imports may, as consumers, enjoy some compensation in terms of increasing purchasing power.

This process of increased globalization of capital and trade is very important and it is relatively new. Using an extreme example can help to illuminate the dimensions of the change. Today, foreign trade is conventionally defined as flows of goods and services between residents in one country and residents in the rest of the world. If instead of using the "country of residence" criterion of the exporting or importing company or consumer as the key to the accounting system for foreign trade, we could substitute the "country of ownership" of the exporting and importing company, the trade and service balance-of-payments results would be very different. Using this definition, the United States, which has a huge trade and current account deficit, would have a surplus, and the Euro-area current account surplus would be much larger than as measured at present. This is because most trade today is done within the same company or group of companies (either between the parent company at home and its own subsidiaries abroad, or among its own subsidiaries located in different countries). By contrast, many developing countries that now show a foreign trade surplus would have a deficit (except some energy and commodity exporters). This is because they do not own many of the producing and exporting companies at home and abroad, even if they benefit greatly from their presence in terms of greater employment, investment inflows, and exports.

This type of "intra-firm trade" accounts for more than 40 percent of world's total trade in manufactured products. More than 70,000 multinationals, with annual sales of $19 trillion and total assets of $37 trillion, are operating with more than 700,000 affiliates around the world (UNCTAD 2005). More than half of them are located in developing countries. Sales by U.S. affiliates alone are nearly four times larger than total U.S. exports; sales by EU affiliates are twice as large as total EU-15 exports. Total sales by multinational affiliates account for 10 percent of total world sales; their exports account for 33 percent of total world exports (UNCTAD 2005).

Fourth, even if we suppose for argument's sake that China, as an autocratic country, can maintain or impose limitations on the movement of people domestically and can keep part of its poor population in rural and interior areas, as a reservoir of cheap labour, while it continues to

accumulate more capital and develop new technologies, ultimately securing an absolute advantage in all manufactured goods, China would still specialize in particular sectors. David Ricardo (1817) provided an explanation for that rational behaviour almost two-hundred years ago: even if a country has an absolute advantage in all products, it will tend to specialize its exports in those products in which it has a larger comparative advantage and thus a larger net value added. It will leave its absolute advantage in other products to be exploited by other countries with similar comparative advantages, and import those products (Woodall 2004).

All Jobs in an Economy Compete Globally

The sixth misconception is the increasingly popular belief that all jobs must compete globally and are subject to competitive risk. This belief is also untrue. Every economy, even the most open one, has two clearly differentiated productive sectors. One sector produces goods and services that are exported. Producers in this sector, called the "tradable sector," compete with other exporters in foreign markets or with imports from other countries in their own domestic market. This sector is composed mainly of manufactured goods, some agricultural goods, commodities, energy, and some services.

Another and usually larger productive sector—the "non-tradable sector"—does not produce goods and services that are tradable. Thus a country's domestic producers compete only among themselves and not with foreign producers, unless the latter are established locally. This sector is composed mainly of services, construction, and some very heavy products with very high transport costs, such as cement. Within the service sector, certain jobs can be easily relocated to other countries with lower wage costs (such as accountancy and back-office jobs, computer processing, and call centers) as well as some more sophisticated jobs (such as architecture, construction and engineering services, and medical diagnosis). However, a study by McKinsey Global Institute (2005) estimates currently only 11 percent of total services can be supplied from a distant location, whether in the country itself or abroad. This percentage is expected to increase in the future through the

deployment of new technologies. Welsum and Vickery (2005) estimate that off-shoring could eventually affect up to 20 percent of the total employment in services, but until now its impact has been rather small. Moreover, some basic service jobs, which are not tradable, may indeed compete locally with those provided by new low-skilled immigrants. But, the latter will tend to compete mostly for jobs that locals do not supply because of poor working conditions or low pay. At the other extreme, holders of and candidates for highly sophisticated jobs may compete with high-qualified immigrants when there is not enough local supply to meet their demand or there is a need for more competition, given their increasing costs.

In sum, a relatively small part of the productive jobs in the primary and secondary sectors and most service and construction jobs in developed countries do not compete with imports locally, or are exported and compete with other exports internationally. In the developed countries, these non-tradable sector jobs represent close to 60 percent of total employment, on average being closer to 70 percent in the United States (OECD 2006).

In developing countries, the share of jobs in the non-tradable sector is lower: less than half of total employment (World Bank 2005). It is thus ironic to witness protests against trade and globalization concentrated mainly in developed countries, which are more protected against them, rather than in developing ones, whose populations are less protected. This unbalanced concentration of protests can perhaps be traced to the fact that civil societies tend to be more developed and better organized in rich countries than in poor ones.

Large Numbers of Graduates in Science and Engineering are Required for a Country to be Competitive

The seventh misconception, which is related to the previous erroneous belief, is to think that the only way that developed countries can compete globally is to ensure that most of their labour force will achieve a postgraduate education or a Ph.D. university degree: mainly doctorates in sciences (math, physics, chemistry, and biology), and in engineering. This misconception is only partially based on reality. Certainly, an essential condition for any country that seeks to grow faster is that it must invest in human capital and it will need an increasing proportion of its labour force to have higher university education. These skilled individuals are required to ensure continuous innovation in the sciences, to deliver productive research, to foster technological development, and to nurture new process and product ideas. All of these are keys to improving a country's total factor productivity and potential growth.

Moreover, it is true that today most scientists and engineers study, live, and work in developed countries and predominantly in the United States, which still represents the world's science and technology frontier (Aghion and Durlauf 2005). The United States sees huge benefits to its economy accruing from this concentration of talent. But these individuals represent a very small proportion of the total labour force in most developed countries for a very important reason: the need to match job supply with job demand.

Today, in the large majority of developed countries, most of the demand for employment by government, institutions, companies, and households are concentrated on jobs that do not compete globally. This trend is likely to increase. However, even if they work in non-tradable sectors, workers do need to a have a deep knowledge of the new general-purpose technologies, including computers, the Internet, and telecommunications in general, and know how to use them in order to be productive and to earn higher wages. The non-tradable sector can be as productive as the tradable one, depending on the quality of its labour composition, as well as its physical capital and technology content.

In developed countries, most employment demand is today concentrated in the following specialties: social services (education, health, long-term care to the elderly, social assistants); administration (government and company employees); accountancy; sales and marketing; information and communication; retail and wholesale trade and finance; hotel and restaurant services; leisure; tourist services; transport; household services; maintenance and cleaning; after-sales services; security; construction and real estate; art and culture; and application and diffusion of new technologies (Lind 2005).

Most of these jobs are in non-research and science sectors and in non-tradable sectors and are part of the long-term trend that has seen an increase in services employment and a large decrease in agricultural, industrial, and manufacturing employment in developed countries. Paul Krugman (1996b) predicted this shift in employment "will continue as mere consumer goods become steadily cheaper than services." What economies will need, he concludes, are "well-paid occupations" in the service sector "that will receive an ever-growing share of our expenditure" (at the expense of cheaper consumer goods).

One potential reason for the fast-increasing number of jobs in the non-tradable sector is the changing nature of globalization. In the last sixty years, globalization has produced two great "unbundling" processes (Baldwin 2006; Grossman and Rossi-Hansberg 2006a). Until the middle of the twentieth century, the high cost of moving goods, people, and ideas forced the geographic clustering of production and workers.

The first unbundling was caused by a large fall in transport costs, which largely ended the need to produce goods close to the point of consumption (except the cases where import tariffs were very high).

The second one has resulted from not only another drop in the costs of transporting goods, but also in the costs of transporting information and

ideas thanks to a steep drop in communications and coordination costs, which largely ended the need to perform most stages of manufacturing production of goods close to one another, producing a very large trend to outsourcing production stages to developing countries. More recently, this second unbundling has spread from factories to offices, allowing for the off-shoring of service-sector tasks to developing countries. The first unbundling allowed the spatial separation of factories and consumers. The second has allowed the geographical separation of stages of production in factories and different tasks within offices.

Before the second unbundling, the level at which globalization was really felt was firms and sectors. Since most firms in a sector rose or fell together, the type of labour used most intensively in the sector shared the fortune of the sector firms. Thus sectoral labour groups were a useful aggregate for analytical purposes. In the United States and Europe, the first unbundling adversely affected unskilled labour-intensive sectors. Unskilled workers were negatively affected, while skilled workers were net gainers. As the second unbundling opened up firms (viewed before as a "black box" of different tasks), global competition came directly into factories and offices.

Today, competition occurs on a stage-by-stage and task-by-task basis, rather than on a firm-by firm or sector-by sector basis. This trade-in-tasks and production stages versus trade-in-goods has an important implication for employment policy. The old paradigm of competition at the sector level could allow one to predict which sectors would be expanding and which would be contracting—and thus which skills would be in growing demand and which would be falling.

In that situation, the "information society" was considered a quickly expanding sector in developed countries by upgrading education and skills, and was seen as a way to lower adjustment costs. But the new unbundling paradigm suggests that this may be not the case. Competition now is at the level of tasks rather than sectors. Today globalization may help one highly skilled worker because his or her task is maintained, but may hurt another because his or her task is off-shored to a country with cheaper labour and similar skills—even if both are working in an expanding sector. The previous correlation between skill and education and winner status may no longer hold true in all cases. Krugman (1996b) was one of the first to warn about this fact by showing that the key competitive distinction lies more in the tradability of goods and services than in the levels of skills.

If these trends continue to grow, policymakers in developed countries will be pushing workers into jobs that only *seem* to be good jobs because they do not yet face international competition. Governments should also be cautious about expending too many resources to push workers into specific "information society" jobs, which today look like high-valued-added ones but which may be off-shored later.

However, some economists, such as Anthony Venables (2006), although being aware of the fast trend of falling transport and communication costs, think that agglomeration forces are still huge. For instance, other things being equal, moving production from a city of 100,000 people to another of 10 million raises productivity of all factors of production by 40 percent. Venables argues that production will be off-shored only when the potential benefits of agglomeration are relatively small or exhausted or when the actual benefits of off-shoring are very large. Thus, the relocation of activity may prove both difficult and uneven. London, for instance, has been a world-class financial centre for about three centuries, and continues to prosper despite the emergence of other centers such as New York, Frankfurt, Singapore, Hong Kong, Shanghai, and Rio de Janeiro and their fierce competition as newcomers.

The above suggests that the results of globalization are more complex than expected. In fact, developing countries may have more reason to fear the entrenched advantages of the high-income countries than the other way round, and low-skilled developed country workers may not lose as much from outsourcing and off-shoring as predicted.

In any case, educational policy in developed countries needs to aim mainly at providing those jobs that are most in demand to avoid a mismatch between supply and demand and to try to achieve higher employment and productivity growth rates.

At the same time, it is extremely important, at every level of educational skill, to prepare for a rapidly changing future to develop a culture of entrepreneurship to foster the creation of new firms and ventures, which are a key to the future growth of jobs in the economy, as well as a culture of risk taking, to foster innovation and be able to develop new products and processes, and compete both domestically and globally.

Competitiveness is a "Zero-sum Game"

The eighth misconception is that international competitiveness among countries is a "zero-sum game." This is often the case between two firms that compete in the same sector and in the same market with very similar or totally homogeneous products or services. In these cases, if one firm gains market share, it is mostly at the expense of the other. If this trend continues, the losing or less competitive firm will eventually close down or be bought by its competitor—which then achieves cost reductions (euphemistically called "synergies") by reducing redundant jobs and closing down overlapping and less productive plants. This is what many businessmen still think (although David Ricardo proved the contrary as early as 1817), perhaps because some of them have experienced it, in very special competitive circumstances. However, it is not the case for countries as a whole, for several reasons.

First, while uncompetitive firms can go broke or be taken over, uncompetitive countries, even after defaulting on their debt, never close down, disappear, or get taken over by another country. As discussed, a large part of a country's productive economy, its non-tradable sector, does not compete with that of other countries. Moreover, for an uncompetitive country to survive, it needs to continue exporting in order to be able to import essential goods and services that it either does not produce at all, or not in the volume demanded. Thus its exchange rate will start to depreciate against most other currencies, at the cost of temporarily increasing its inflation rate and of reducing its citizens' purchasing power

and real income in terms of foreign currency, until it regains sufficient competitiveness and export proceeds to pay for its imports.

Second, unlike individual firms, countries not only compete in the international market with other countries, but they also need one another as each country is an export market of another. If, for example, the European Union increases its exports to the United States, this does not mean that it achieves that success at the expense of U.S. income or the U.S. GDP. On the one hand, the EU is exporting goods and services to the United States, competitively and at a reasonable price, because they are demanded and bought by U.S. companies and households to increase their utility and well-being. On the other hand, by exporting more to the United States, the EU will enjoy higher employment and income growth so that it will eventually increase its internal demand, which may translate into increased imports from the United States.

Thus international trade is not a zero-sum game. When the United States increases its productivity, its real wages improve and its employees spend part of their higher wages in the consumption of goods and services from other countries. This allows real wages to increase in the rest of the world as well. For instance, in the ten years from 1995 to 2004, the rapid expansion of U.S. domestic consumption and investment, fuelled by a simultaneous increase in productivity, innovation, and employment, contributed to almost 55 percent of the world's growth over the period. This was the case even though the U.S. GDP was only 33 percent of the world's total (at current exchange rates) and its imports of goods and services from the rest of the world were only 11.4 percent of its GDP. In contrast, the EU's contribution to total world growth over the same period was only 10 percent, while its relative GDP weight represented 28 percent of the world's total (at current exchange rates). During the same period Japan provided only 10 percent of the world's output growth, while its GDP weight represented 11 percent of the world total (IMF 2005, 2006a).

The United States will probably be forced in the medium term to reduce its domestic demand and rate of growth of imports and to save more, given its large trade and current account deficit. Pressure on the dollar will continue and the Euro and the Yen may further appreciate. The Euro area and Japan have been growing very slowly for some years, and their growth has been based, almost exclusively, on the contribution of their external sector (thanks in part to the fast growth of U.S. internal demand and to a strong dollar). The Euro area and Japan may see a

reduction in the growth of their exports to the United States as their currencies appreciate and to start increasing their internal demand as their main motor of growth. This will reduce their current account surplus and help the United States reduce its large current account deficit.

Nevertheless, as explained by Woodall (2006), the most recent important shift in the contribution to world growth has been the rapid growth of the emerging countries. They now represent 50 percent of the world's GDP, compared to 22 percent for the United States, 7 percent for Japan, and 18 percent for the EU-15 (all at PPP-weighted exchange rates)—and more than 20 percent of world GDP (at current ones). Moreover, their share of world exports has jumped from 20 percent in 1970 to 43 percent in 2005, and their share of world imports is also increasing quickly, absorbing almost 50 percent of OECD exports.

This major shift resulted from the opening of most large emerging countries to world trade and globalization. It is very clear that trade is not a zero-sum game. Rising exports from emerging countries to developed countries give emerging countries more resources in foreign currency to spend on imports from developed nations, as well as other developing countries. The more they export, the higher their income and the larger their market. It is expected that 1 billion new consumers may join the world markets in the next ten years (Woodall 2006).

Third, given the internationalization of world markets, the markets for both totally homogenous products, and differentiated products and services are increasing. For a totally homogeneous product, it is obvious that the size of the international market is not fixed but increases over time, as shown by the ever expanding volumes of trade, the only exception being during brief periods of negative growth, such as the Great Depression. A homogeneous product is rendered redundant only when a new discovery or technology appears (which is usually produced in a developed country). The market for the old product declines, but slowly, since new technologies take a long time to be diffused worldwide (as was the case with synthetic rubber).

In contrast to the market for homogenous products, the market for differentiated products or services is almost infinite, given that consumer tastes are very diverse and continuously changing and that innovations in the product and process are moving increasingly quickly to meet those changes in tastes and preferences—or even to create new ones. Moreover, every year since 1980, when globalization began accelerating, both developed and developing countries have opened their economies

further to international competition. Global markets appear to be expanding faster than ever before, for most products and services.

Fourth, if emerging and developing countries are increasing their production and exports to developed countries, their income will grow accordingly (unless their terms of trade are deteriorating faster than their growth of output). They will spend more in consumption and investment; part of that will translate into increasing imports from the rest of the world. This dynamic means that it is impossible for any developing country to maintain a permanent or even long-term surplus in its trade or current account balance. If a developing country is successful in exporting to the rest of the world, it will receive larger flows of foreign direct and portfolio investment to exploit its faster growth in purchasing power and the increasingly larger size of its market. These inflows will allow it to invest more than it saves. Eventually, it will attain a current account deficit (given that the current account balance is defined by the difference between national saving and investment). Accordingly, a large inflow of foreign investment, which generates a large surplus in its capital account, must be matched by a deficit in its current account, in order to achieve a net end balance.

Paradoxically, China is currently maintaining a surplus in its current account while attracting large sums of foreign direct investment. This is a temporary phenomenon, for two reasons. First, it is not a clear which part of the current account surplus is due to Hong Kong and which part is due to China. Second, China does not invest all the net foreign direct investment inflows it gets domestically.

China is a very important outsourcer and off-shorer to other countries in Asia that have even lower labour costs. In addition, China is a major investor in other developing countries and a growing investor in developed countries, particularly as it seeks to assure a stable long-term supply of energy and basic commodities, of which it has a short supply or whose supply is very cyclical. China also invests heavily abroad to build and maintain large networks to distribute part of its exports in other countries. Finally, with the huge level of accumulated foreign exchange reserves (close to US$1 trillion) it has been buying massive amounts of U.S. Treasury debt, to both finance the U.S. current account and make room for more Chinese imports. Now China is also investing in Euro and Yen government bonds, to diversify its financial and exchange rate risks.

If developed countries maintain their current protectionist barriers against imports from developing countries many people will feel their negative impact. A misguided effort to preserve some jobs in inefficient and uncompetitive agricultural production (instead of employing them to preserve the rural environment), or to maintain other low-skill jobs in a rapidly decreasing labour-intensive local manufacturing production, or to stop or reduce outsourcing and off-shoring of labour-intensive production processes to developing countries, or to keep local uncompetitive jobs, will create many, many losers around the globe.

The first group of losers due to protectionist policies would be, paradoxically, the large majority of citizens in developed countries and the poorest in developed countries, which will lose the most. Given that consumption represents a higher proportion of the poor's disposable income, they must, in effect, pay an extra tax when they consume, because of the very high tariffs charged on the imported foreign agricultural produce and foodstuffs that they buy, as well as the high indirect value-added tax (VAT) rates that they must pay to finance their huge agricultural subsidies. Thus they will pay their meager disposable incomes to protect a rather small minority of jobs, and to maintain huge subsidies that benefit mainly rich agricultural landowners (de la Dehesa 2007).

The second group of losers would be most citizens of developing countries. They will suffer lower employment rates and lower levels of income, because they cannot export what they can produce competitively to developed countries, because of the maintenance of excessively high protectionist barriers to free trade.

The third group of losers would be many competitive firms in developed countries, which, because governments are protecting their domestic and declining markets, are going to lose their main future export markets in developing countries which will not open up their markets until protectionist barriers (on agriculture and labour-intensive products) in developed countries are lifted. The growth potential of these emerging markets is enormous.

In the next forty-five years, world population will increase by about 2.6 billion people. All of them will be born in developing countries. Meanwhile, the population of developed countries will shrink. It fell from 25.8 percent of the world total to 18.7 percent from 1975 to 2005, and is projected to decrease to 13.6 percent in 2050 (United Nations 2005). If the larger markets in developing countries grow at a slower

rate because of protectionist policies in developed countries, companies and households in developed countries will earn less from exporting to and importing from them, as well from investing in them. As a result, world growth overall will be much lower.

Finally, if these developing countries, are not able to export enough to developed countries or are not receiving enough flows of foreign direct investment to meet their larger growth potential (or worse, not even receive enough aid to prepare their institutions to open their economies and take advantage of globalization), they will be doomed to a lower rate of growth and a higher rate of unemployment, at the same time that they are facing a much higher population growth rate. Residents of these countries may be forced to migrate in increasing numbers to developed countries, legally and illegally. These migration flows will be very difficult to stop and may result eventually in situations of conflict, violence, or even war (de la Dehesa 2007).

Globalization Threatens the Survival of the Welfare State in Developed Countries

The ninth and final misconception is to believe that low-wage competition from developing countries will produce an increasing erosion of developed countries' welfare states or, conversely, that developed countries' large and generous welfare states will tend to reduce their competitiveness. According to ill-informed critics, globalization and a generous welfare state are deemed incompatible. This misconception has two main arguments.

First, as a consequence of globalization, many workers in developed countries are alleged to be about to lose their jobs or suffer a reduction in their wages, either because of competition from low-wage countries, inflows of new immigration, or from the outsourcing and off-shoring of their jobs to developing countries. On the one hand, it is argued, these workers will reduce or resist paying higher social security contributions. At the same time, they will demand higher social security service subsidies as unemployed workers, or as retirees, as they age. On the other hand, governments will not be able to react by increasing debt or raising taxes, as they used to do before globalization, because they will be punished by the markets with higher debt spreads, and because many of their citizens and companies may move to other countries with lower levels of taxes and debt, reducing their tax base. Critics conclude that globalization may threaten the survival of the welfare states, which are considered by most European social democrats to be one of the great accomplishments of the working class in the twentieth century.

Second, it is argued that generous welfare states in some European countries absorb a huge amount of governmental budgetary resources, which need to be financed by a very high level of taxes on the private sector. Private firms, in turn, will be "crowded out" from productive investment because they must pay higher taxes. Therefore, these countries will become less and less competitive and will have to reduce their welfare state to be able to regain competitiveness by investing in more productive assets.

Available empirical evidence does not support either argument. First, if one looks at increasing competition from developing countries in the form of cheap exports, we see that this has had a relatively moderate impact on real wage reductions, and an even smaller impact on job loses and unemployment increases so far. Cheap imports from developing countries have caused a widening of the wage dispersions among employees and some unemployment. But at the same time, they have helped maintain inflation at low levels and increased the purchasing power of workers. Overall the level of relocation of production to developing countries has been rather small in terms of total production and jobs. Thus off-shoring of services affected a total of 1.5 million up to 2004 (McKinsey Global Institute 2005), although the trend is increasing. By 2015, the number of jobs off-shored may reach 3.4 million, according to Forrester Research (McCarthy 2004). These figures are still small if one considers that in an average year around 30 million jobs are destroyed and created both in the United States and in the EU-15.

Moreover, firms that have relocated to developing countries have been able not only to survive and avoid closing their labour-intensive production, totally or partially, but they have also become more competitive, avoiding further reductions or even increasing their total headcount. Those workers who have lost their jobs, mainly because of their lower skills, have engaged in training to improve them or have found other jobs, on average, one year later at the same or slightly lower wage (the exception is seen among older workers, many of whom have been forced into early retirement).

Finally, part of the wage and job problem for workers in developed countries that has been attributed to globalization and foreign competition is the result of the implementation of new information and communication technologies (created and diffused by the developed countries themselves) in the productive sectors. These technologies have also contributed to wage dispersion according to skill and to some

unemployment, but, at the same time, they have helped increase average productivity and wages in developed countries. However, in some sectors or industries, the combination of greater foreign competition due to globalization and the increasing trade-off between labour and technology have helped companies moderate wage demands from trade unions in developed countries, because the latter fear more unemployment in the future, which has slightly reduced real wages.

Nevertheless, it must be recognized that there has been a clear increase in inequality in many developed countries, mainly those that have very flexible labour markets (notably, the United States and the United Kingdom). There, as expected, we have seen a drop in real wages—and in a few cases in nominal wages—in low-skill jobs. In countries with more rigid and regulated labour markets, there has been a temporary increase in unemployment and another, but smaller decrease in real wages.

This trend could be attributed as much to more competition through trade from developing countries as to the introduction of new technologies. Both forces tend to reduce the demand for low-skilled and some middle-skilled workers and increase the demand for high-skilled workers, thus increasing the wages of the latter at the expense of the former, and creating more inequality.

There are also economists who believe that the increasing inequality originates from globalization. They argue that the huge increase in the world's labour force has benefited more capitalists than workers in developed countries, producing a shift in the distribution of income from labour to capital (exactly the contrary effect to what has happened in emerging countries). According to this line of thought, globalization is helping more to lift profits (thus benefiting shareholders) than wages (thus penalizing workers). Profits have increased as a result of large cost reductions due to off-shoring and outsourcing to developing countries, as well as from cheaper imports. Wages have deteriorated as unions have accepted wage moderation because of their fear of losing jobs from production shifts to cheap labour countries and from greater domestic competition from more immigrants (Woodall 2006).

This argument can also be countered. On the one hand, this trend will be only temporary; higher competition will eventually reduce profit margins and distribute benefits to consumers and workers through lower prices of goods and services. On the other hand, in those countries where inequality has increased faster, such as the United States, another more important reason for inequality has been the large tax cuts introduced

by the U.S. government that have benefited disproportionately those with the highest incomes, which appear to have made rich people even richer, while not benefiting the poor. Inequality has increased mainly between the top 5 percent of the rich and the bottom 20 percent of low-skilled workers.

As for the second argument, which alleges "crowding out": in the EU-15, where welfare states are more generous, there appears to be no evidence whatsoever of any loss of competitiveness or any correlation between the volume of cheap imports or relocation and the size of the welfare states. For example, countries such as Ireland, Sweden, Finland, Norway, and Denmark, which are among the most open to international trade, are also among the top ten most competitive countries in the world, according to many rankings (IMD 2006; WEF 2006; Forbes 2006). At the same time, they have been able to keep their welfare states (which are among the most generous in the world) healthy, and to remain competitive, despite collecting extremely high tax revenues. Indeed, the tax revenues in the four Nordic countries are nearly 50 percent of GDP—the highest in the world.

The underlying dynamic associated with this final misconception may be due to the tendency among some pundits and commentators in developed countries who prefer to blame globalization for the uncertain future that faces their welfare states, rather than trying to solve their own main domestic problem: namely, the demographic trends that are undermining those social welfare systems. Their populations, especially in the EU-15 and Japan, are ageing dramatically (U.N. Population Ageing 2006). At the same time, the EU-15 and Japan face very low fertility rates, (1.3 children per woman compared to a replacement rate of 2.1), very high life expectancy rates (around 80 years), and very early retirement rates (around 60 years) (European Economy 2006). This combination is explosive in the long term for the finances and the solvency of their welfare states (de la Dehesa 2006b).

On the contrary, globalization can be an important part of the solution to the progressive ageing of the population in most developed countries. If these demographic trends continue over the next four decades, their total labour force (people between the ages of 15 and 59) will shrink by almost one-third on average, from 70 percent of the total to 50 percent by 2050. Their retired population will increase accordingly; the mean age will go up to close to 50 years, and the number of retired people (aged 65 and more) will represent 140 percent of the employed population aged 15 to 64, on average (European Economy 2006).

There are only four ways—or a combination of them—that these countries can rejuvenate their ageing populations: (1) by increasing the age of retirement in accordance with the increases in their life expectancy; (2) by increasing the productivity of their labour force; (3) by trying to give very large incentives to their own families to encourage them to have more children (as the French have done, with marked success); or by allowing increasing inflows of young immigrants from developing countries, who not only can compensate for their shrinking labour force but also who tend to have more children than the nationals—the route taken by the United States, Canada, and Australia (de la Dehesa 2006b).

If for reasons of security or identity, some developed countries do not want to accept many more immigrants, the other available alternative is to relocate their labour-intensive production to developing countries and keep the most sophisticated or skilled jobs for their own decreasing labour force. But this final alternative does not solve the problem of how to avoid the future insolvency of their welfare states.

Conclusion

My task in this paper has been to address key misconceptions about the nature of competitiveness, globalization, and free trade, and I hope I have succeeded. A productive, two-way discussion and debate over the impact of such central economic forces in the world can only be embarked upon if some degree of understanding of the nature of the economic changes can be achieved. Such an understanding should allow each side in the debate to move beyond claim and counterclaim to a more productive dialogue and policy-making process.

Proponents of globalization—and I am one—can rightly claim that the process has benefited a great many millions of people and continues to drive global economic growth with positive effects accruing to both developed and developing countries. But we must recognize that the localized consequences of this dynamic process can at times be painful for those affected and left unemployed as their factory and industrial sector contracts due to domestic or external competitive forces. Free trade does not benefit all of the people all of the time, only most of the people most of the time. A failure to acknowledge localized impacts weakens the case for globalization.

Critics of the process of globalization should not be dismissed out of hand, as they are voicing the fears of many who worry about their livelihoods, social welfare systems, and future prospects. These legitimate concerns must be addressed by the political, economic, and trade policy-making communities in the developed and developing world at an appropriate level.

But critics of globalization should be challenged when they demonize a process based on faulty facts and figures and questionable economic analysis. The World Trade Organization and freer trade are not the real villains here. Instead, critics in developed countries would do well to focus their ire on the actual policies which impoverish millions of workers in the developing world, such as highly protected and subsidized agricultural production and labour-intensive manufactures or developed country antidumping procedures that shield inefficient home industries from legitimate competition from some of the poorest nations on the globe.

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1726 M Street, N.W., Suite 200
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ISBN 1-56708-137-1