

Session 1: Globalization: Economic Development and Inequality: What is the evidence?

Trade and inequality, revisited

Source: VOX, <http://www.voxeu.org/index.php?q=node/261#comment-31> [Downloaded 26 Feb 09]

Paul Krugman
15 June 2007



It's no longer safe to assert that trade's impact on the income distribution in wealthy countries is fairly minor. There's a good case that it is big, and getting bigger. I'm not endorsing protectionism, but free-traders need better answers to the anxieties of globalisation's losers.

During the 1980s and 1990s, there was considerable concern about the possible role of globalisation in contributing to rising income inequality, especially in the United States. This concern was based on standard economic theory: since the 1941 Stolper-Samuelson paper, we've known that growing trade can have large effects on income distribution, and can easily leave broad groups, such as less-skilled workers, worse off.

After economists looked hard at the numbers, however, the consensus was that the effect of trade on inequality was probably modest. Recently, Ben Bernanke cited these results – but he recognised a problem: “Unfortunately, much of the available empirical research on the influence of trade on earnings inequality dates from the 1980s and 1990s and thus does not address later developments. Whether studies of the more recent period will reveal effects of trade on the distribution of earnings that differ from those observed earlier is to some degree an open question.”

But the question isn't really that open. It's clear that applying the same models to current data that, for example, led William Cline of the Peterson Institute to conclude in 1997 that trade was responsible for a 6% widening in the college-high school gap would lead to a much larger estimate today. Furthermore, some of the considerations that once seemed to set limits on the possible inequality-promoting effects of trade now seem much less constraining.

There are really two key points here: the rise of China, and the growing fragmentation of production.

First, thanks to the rise of China, OECD imports of manufactured goods from developing countries have continued to rise rapidly since the early 1990s. Cline's

estimate of income distribution effects was based on data from 1993, when US imports of manufactures from developing countries were approximately 2% of GDP; now that number is close to 5%, and rising rapidly.

At the same time, the rise of China has prevented, for the time being, a development that I and others expected to mitigate the effects of trade on income distribution: up-skilling by the developing country exporters. “As newly industrializing countries grow,” I wrote in 1995, “their comparative advantage may shift away from products of very low skill intensity.” And that’s exactly what happened – for the countries that were the major exporters of manufactured goods to the OECD then. As John Romalis has shown, the exports of the original group of Asian newly-industrialising economies have shifted dramatically away from labour-intensive toward skill-intensive products.

But along has come China, which is far more labour-abundant now than the NIEs were then. A simple indicator is relative wage rates: in 1990, according to the US Bureau of Labor Statistics, the original four Asian NIEs had hourly compensation costs that were 25% of the US level. Now the BLS estimates that China’s labour costs are only 3% of US levels.

In 1995 I also believed that the effects of trade on inequality would eventually hit a limit, because at a certain point advanced economies would run out of labour-intensive industries to lose – more formally, that we’d reach a point of complete specialisation, beyond which further growth in trade would have no further effects on wages. What has happened instead is that the limit keeps being pushed out, as trade creates “new” labour-intensive industries through the fragmentation of production.

For example, the manufacture of microprocessors for personal computers is clearly a highly sensitive, skill-intensive process. Intel’s microprocessor production, however, now takes place in two stages: the “fabs,” which print the circuits on disks of silicon, are all located in high-wage advanced countries, but the assembly and testing, in which those disks are cut into individual chips and tested to be sure that they work, is conducted in China, Malaysia, and the Philippines.

Outsourcing of services, in both directions, adds to the possibilities of unequalising trade. The skill-intensive pieces of production processes that mainly take place in the third world are often now located in the OECD – for example, Lenovo, the Chinese computer company, has its executive headquarters in North Carolina.

What all this comes down to is that it’s no longer safe to assert, as we could a dozen years ago, that the effects of trade on income distribution in wealthy countries are fairly minor. There’s now a good case that they are quite big, and getting bigger.

This doesn’t mean that I’m endorsing protectionism. It does mean that free-traders need better answers to the anxieties of those who are likely to end up on the losing side from globalisation.

The globalisation paradox: more trade less inequality

Source: VOX, <http://www.voxeu.org/index.php?q=node/524>

[Downloaded 26 Feb 09]

Robert Z. Lawrence
4 September 2007



US income inequality has grown but not in a way that suggests trade with developing countries is the major reason. It's not the least skilled who have fallen behind, but profits and the wages of the very richest Americans that have raced ahead.

It is fairly widely accepted that in the aggregate trade generates gains and promotes economic growth but it can also create winners and losers. In America's case, trade with developing countries is viewed as particularly problematic because it could put downward pressures on the earnings of lower-wage workers. And indeed, it is precisely this type of trade that has expanded especially rapidly over the past decade, partly because countries such as China and India have emerged as major global competitors and partly because the US has vigorously implemented Free Trade Agreements with Mexico (NAFTA) and other developing countries.

Whereas most studies concluded that in the 1980s trade accounted for a relatively small share of the increase in US wage inequality, many now argue that the volume of trade has now grown to the point that much larger effects should be expected. For example, Paul Krugman recently wrote a [Vox column](#) making precisely this case.

It is true that by virtually all quantity and price indicators there were powerful globalisation forces operating during this period that might have been expected to increase wage inequality. Not only have imports from developing countries increased dramatically, but the relative prices of manufactured goods from these countries have declined steadily since the early 90s. Yet the big surprise is that over the past fifteen years wages of the least skilled Americans – the lowest 10 percent – have kept pace with the median.¹ Moreover, since 1999, while real wage growth in general has been sluggish, most US relative wage and compensation measures indicate little evidence of increased inequality. This is true when workers are distinguished by skill, education, unionization, occupation and major sectors.

- Apparently, the shocks from trade (or immigration) have not increased conventional wage inequality. This is surprising given the growing scale of the competition from low wage countries. There are two lines of explanation.
- One is that the goods that the US imports are actually very sophisticated and

produced in the US by relatively skilled workers. While it may cause displacement and could put downward pressure on wages generally, therefore, this competition does not increase wage inequality.

- A second more benign view is that a significant amount of what America imports today is no longer produced domestically. Thus declining import prices simply yield consumer benefits but do not exert downward pressure on US wages nor cause dislocation of US workers. Paradoxically, globalisation is actually causing less inequality because specialisation is more advanced.

It appears that US trade today combines these two elements in proportions that are hard to disentangle, particularly at levels of disaggregation that allow for a sufficiently precise matching of products and the wages earned in producing them. At relatively high levels of aggregation the data indicate that manufactured imports overall, and even those from developing countries such as China, are concentrated in US manufacturing sectors which pay significantly higher than average US wages. This means that import displacement does not fall disproportionately on less skilled workers. While there has been considerable displacement from trade during this period, it has not increased wage inequality. At more disaggregated levels, however, the data suggests that goods imported from developing countries such as China are associated with relatively less skilled labor inputs and – judging by their unit values – qualitatively different from those produced by developed countries such as the US. This provides support for the view that much of this trade reflects more complete specialisation and as such does not result in either wage inequality or downward pressure on wages generally.

It will take more research to quantify the relative magnitudes of these two effects. Nonetheless, it does appear that over the past decade, US income inequality has continued to grow but not in a way that suggests trade with developing countries is the major reason. It's not the least skilled who have fallen behind but profits and the wages of the very richest Americans that have raced ahead.

Footnotes

¹ This article draws on a study on Trade and US Inequality to be published this fall by the [Peterson Institute for International Economics](#).

Globalization for Whom? - Globalization Good for Whom?

by Dani Rodrik

Source: downloaded from <http://hbswk.hbs.edu/archive/3029.html> [20 Feb 09]

7/29/2002

The rules of globalization aren't fair to poor countries, says Harvard University professor **Dani Rodrik**. In this article from *Harvard Magazine*, Rodrik, a specialist in international political economy and a professor at the John F. Kennedy School of Government, shares his belief that rich and poor can bridge the gap. "Economic development often requires unconventional strategies that fit awkwardly with the ideology of free trade and free capital flows," he says.



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Globalization has brought little but good news to those with the products, skills, and resources to market worldwide. But does it also work for the world's poor?

That is the central question around which the debate over globalization—in essence, free trade and free flows of capital—revolves. Antiglobalization protesters may have had only limited success in blocking world trade negotiations or disrupting the meetings of the International Monetary Fund (IMF), but they have irrevocably altered the terms of the debate. Poverty is now the defining issue for

both sides. The captains of the world economy have conceded that progress in international trade and finance has to be measured against the yardsticks of poverty alleviation and sustainable development.

For most of the world's developing countries, the 1990s were a decade of frustration and disappointment. The economies of sub-Saharan Africa, with few exceptions, stubbornly refused to respond to the medicine meted out by the World Bank and the IMF. Latin American countries were buffeted by a never-ending series of boom-and-bust cycles in capital markets and experienced growth rates significantly below their historical averages. Most of the former socialist economies ended the decade at lower levels of per-capita income than they started it—and even in the rare successes, such as Poland, poverty rates remained higher than under communism. East Asian economies such as South Korea, Thailand, and Malaysia, which had been hailed previously as "miracles," were dealt a humiliating blow in the financial crisis of 1997. That this was also the decade in which globalization came into full swing is more than a minor inconvenience for its advocates. If globalization is such a boon for poor countries, why so many setbacks?

Look closer at the Chinese

Globalizers deploy two counter-arguments against such complaints. One is that global poverty has actually decreased. The reason is simple: While most countries have seen lower income growth, the world's two largest countries, China and India, have had the opposite experience. (Economic growth tends to be highly correlated with poverty reduction.) China's growth since the late 1970s—averaging almost 8 percent per annum per capita—has been nothing short of spectacular. India's performance has not been as extraordinary, but the country's growth rate has more than doubled since the early 1980s—from 1.5 percent per capita to 3.7 percent. These two countries house more than half of the world's poor, and their experience is perhaps enough to dispel the collective doom elsewhere.

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— Dani Rodrik

The second counter-argument is that it is precisely those countries that have experienced the greatest integration with the world economy that have managed to grow fastest and reduce poverty the most. A typical exercise in this vein consists of dividing developing countries into two groups on the basis of the increase in their trade—"globalizers" versus "non-globalizers"—and to show that the first group did much better than the second. Here too, China, India, and a few other high performers like Vietnam and Uganda are the key exhibits for the pro-globalization argument. The intended message from such studies is that countries that have the best shot at lifting themselves out of poverty are those that open themselves up to the world economy.

How we read globalization's record in alleviating poverty hinges critically, therefore, on what we make of the experience of a small number of countries that have done well in the last decade or two—China in particular. In 1960, the average Chinese expected to live only 36 years. By 1999, life expectancy had risen to 70 years, not far below the level of the United States. Literacy has risen from less than 50 percent to more than 80 percent. Even though economic development has been uneven, with the coastal regions doing much better than the interior, there has been a striking reduction in poverty rates almost everywhere.

What does this impressive experience tell us about what globalization can do for poor countries? There is little doubt that exports and foreign investment have played an important role in China's development. By selling its products on world markets, China has been able to purchase the capital equipment and inputs needed for its modernization. And the surge in foreign investment has brought much-needed managerial and technical expertise. The regions of China that have grown fastest are those that took the greatest advantage of foreign trade and investment.

But look closer at the Chinese experience, and you discover that it is hardly a poster child for globalization. China's economic policies have violated virtually every rule by which the proselytizers of globalization would like the game to be played. China did not liberalize its trade regime to any significant extent, and it joined the World Trade Organization (WTO) only last year; to this day, its economy remains among the most protected in the world. Chinese currency markets were not unified until 1994. China resolutely refused to open its financial markets to foreigners, again until very recently. Most striking of all, China achieved its transformation without adopting private-property rights, let alone privatizing its state enterprises. China's policymakers were practical enough to understand the role that private incentives and markets could

play in producing results. But they were also smart enough to realize that the solution to their problems lay in institutional innovations suited to the local conditions—the household responsibility system, township and village enterprises, special economic zones, partial liberalization in agriculture and industry—rather than in off-the-shelf blueprints and Western rules of good behavior.

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— Dani Rodrik

The remarkable thing about China is that it has achieved integration with the world economy despite having ignored these rules—and indeed because it did so. If China were a basket case today, rather than the stunning success that it is, officials of the WTO and the World Bank would have fewer difficulties fitting it within their worldview than they

do now.

China's experience may represent an extreme case, but it is by no means an exception. Earlier successes such as South Korea and Taiwan tell a similar story. Economic development often requires unconventional strategies that fit awkwardly with the ideology of free trade and free capital flows. South Korea and Taiwan made extensive use of import quotas, local-content requirements, patent infringements, and export subsidies—all of which are currently prohibited by the WTO. Both countries heavily regulated capital flows well into the 1990s. India managed to increase its growth rate through the adoption of more pro-business policies, despite having one of the world's most protectionist trade regimes. Its comparatively mild import liberalization in the 1990s came a decade after the onset of higher growth in the early 1980s. And India has yet to open itself up to world financial markets—which is why it emerged unscathed from the Asian financial crisis of 1997.

By contrast, many of the countries that have opened themselves up to trade and capital flows with abandon have been rewarded with financial crises and disappointing performance. Latin America, the region that adopted the globalization agenda with the greatest enthusiasm in the 1990s, has suffered rising inequality, enormous volatility, and economic growth rates significantly below those of the post-World War II decades. Argentina represents a particularly tragic case. It tried harder in the 1990s than virtually any country to endear itself to international capital markets, only to be the victim of an abrupt reversal in "market sentiment" by the end of the decade. The Argentine strategy may have had elements of a gamble, but it was solidly grounded in the theories expounded by U.S.-based economists and multilateral agencies such as the World Bank and the IMF. When Argentina's economy took off in the early 1990s after decades of stagnation, the reaction from these quarters was not that this was puzzling—it was that reform pays off.

What these countries' experience tells us, therefore, is that while global markets are good for poor countries, the rules according to which they are being asked to play the game are often not. Caught between WTO agreements, World Bank strictures, IMF conditions, and the need to maintain the confidence of financial markets, developing countries are increasingly deprived of the room they need to devise their own paths out of poverty. They are being asked to implement an agenda of institutional reform that took today's advanced countries generations to accomplish. The United States, to take a particularly telling example, was hardly a paragon of free-trade virtue while

catching up with and surpassing Britain. In fact, U.S. import tariffs during the latter half of the nineteenth century were higher than in all but a few developing countries today. Today's rules are not only impractical, they divert attention and resources from more urgent developmental priorities. Turning away from world markets is surely not a good way to alleviate domestic poverty—but countries that have scored the most impressive gains are those that have developed their own version of the rulebook while taking advantage of world markets.

The regulations that developing nations confront in those markets are highly asymmetric. Import barriers tend to be highest for manufactured products of greatest interest to poor countries, such as garments. The global intellectual-property-rights regime tends to raise prices of essential medicines in poor countries.

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But the disconnect between trade rules and development needs is nowhere greater than in the area of international labor mobility. Thanks to the efforts of the United States and other rich countries, barriers to trade in goods, financial services, and investment flows have now been brought down to historic lows. But the one market where poor nations have something in abundance to sell—the market for labor services—has remained untouched by this liberalizing trend. Rules on cross-border labor flows are determined almost always unilaterally (rather than multilaterally as in other areas of economic exchange) and remain highly restrictive. Even a small relaxation of these rules would produce huge gains for the world economy, and for poor nations in particular.

Consider, for example, instituting a system that would allot temporary work permits to skilled and unskilled workers from poorer nations, amounting to, say, 3 percent of the rich countries' labor force. Under the scheme, these workers would be allowed to obtain employment in the rich countries for a period of three to five years, after which they would be expected to return to their home countries and be replaced by new workers. (While many workers, no doubt, will want to remain in the host countries permanently, it would be possible to achieve acceptable rates of return by building specific incentives into the scheme. For example, a portion of workers' earnings could be withheld until repatriation takes place. Or there could be penalties for home governments whose nationals failed to comply with return requirements: Sending countries' quotas could be reduced in proportion to the numbers who fail to return.) A back-of-the-envelope calculation indicates that such a system would easily yield \$200 billion of income annually for the citizens of developing nations—vastly more than what the existing WTO trade agenda is expected to produce. The positive spillovers that the returnees would generate for their home countries—the experience, entrepreneurship, investment, and work ethic they would bring back with them—would add considerably to these gains. What is equally important, the economic benefits would accrue directly to workers from developing nations. There would be no need for "trickle down."

If the political leaders of the advanced countries have chosen to champion trade liberalization but not international labor mobility, the reason is not that the former is popular with voters at home while the latter is not. They are both unpopular. When asked their views on trade policy, fewer than one in five Americans reject import

restrictions. In most advanced countries, including the United States, the proportion of respondents who want to expand imports tends to be about the same or lower than the proportion who believe immigration is good for the economy. The main difference seems to be that the beneficiaries of trade and investment liberalization have managed to become politically effective. Multinational firms and financial enterprises have been successful in setting the agenda of multilateral trade negotiations because they have been quick to see the link between enhanced market access abroad and increased profits at home. Cross-border labor flows, by contrast, usually have not had a well-defined constituency in the advanced countries. Rules on foreign workers have been relaxed only in those rare instances where there has been intense lobbying from special interests. When Silicon Valley firms became concerned about labor costs, for example, they pushed Congress hard to be allowed to import software engineers from India and other developing nations.

It will take a lot of work to make globalization's rules friendlier to poor nations. Leaders of the advanced countries will have to stop dressing up policies championed by special interests at home as responses to the needs of the poor in the developing world. Remembering their own history, they will have to provide room for poor nations to develop their own strategies of institution-building and economic catch-up. For their part, developing nations will have to stop looking to financial markets and multilateral agencies for the recipes of economic growth. Perhaps most difficult of all, economists will have to learn to be more humble!

The article, "Globalization for Whom?" originally appeared in [Harvard Magazine](#), Vol. 104, No. 6, July-August 2002.