A joint initiative of Ludwig-Maximilians-Universität and the Ifo Institute for Economic Research

CESifo Forum

Autumn 2006

Volume 7, No. 3

Europe and the New Division of Labour

Introduction

Jürgen Chrobog
Hans-Werner Sinn

Keynote Addresses:
Pascal Lamy
Michael Glos

The New Global Division of Labour

Panel 1

John Whalley

Europe's Answer to the Global Changes in the Division of Labour

Panel 2

Keynote Address:
Günter Verheugen

Richard Baldwin

Challenges for Europe's Political Institutions and Society

Panel 3

Donald R. Davis

Statistics Update

Trends

Documentation of the
MUNICH ECONOMIC SUMMIT
4–5 May 2006
Jointly organised with BMW Foundation Herbert Quandt

5th Munich Economic Summit

INTERNATIONAL POLICY FORUM

ORGANISED BY

BMW Foundation Herbert Quandt
CESifo Group Munich

EXECUTIVE COMMITTEE

BMW Foundation Herbert Quandt
Hanauer Strasse 46
80788 Munich, Germany
Phone +49-(0)89-382-11630
Fax +49-(0)89-382-11636

CESifo Group Munich
Poschingerstr. 5
81679 Munich, Germany
Phone +49-(0)89-9224-1410
Fax +49-(0)89-9224-1409

PATRON

Edmund Stoiber
Minister-President, Free State of Bavaria,
Federal Republic of Germany

CONFERENCE VENUE

Hotel Bayerischer Hof
Promenadeplatz 2-6
80333 Munich, Germany
Phone +49-(0)89-2120-0
Fax +49-(0)89-212-906

SPONSORS

BMW Foundation Herbert Quandt	BMW Foundation Herbert Quandt
	CESifo Group Munich
SIEMENS	Siemens AG
	Hypo Real Estate Group
	Swiss Re
e·on Energie	E.ON Energie AG
FULBRIGHT & Jaworski L.L.P. Attorneys at Law	Fulbright & Jaworski L.L.P.

CESifo Forum

Volume 7, Number 3 Autumn 2006

EUROPE AND THE NEW DIVISION OF LABOUR

Introduction

Jürgen Chrobog 3
Hans-Werner Sinn 5

Keynote Addresses:
Pascal Lamy 9
Michael Glos 13

Panel 1

The new global division of labour

John Whalley 18

Panel 2

Europe's answer to the global changes in the division of labour

Keynote Address:
Günter Verheugen 24

Richard Baldwin 29

Panel 3

Challenges for Europe's political institutions and society

Donald R. Davis 36

Trends

Statistic Updates 42

Welcome Address by

JÜRGEN CHROBOG,
Former State Secretary
Chairman of the Board of the BMW Foundation Herbert Quandt

Dear Minister Glos,
Director-General Lamy,
Sponsors of the Summit,
Ladies and Gentlemen,

On behalf of the BMW Foundation Herbert Quandt, I welcome you most cordially to the fifth Munich Economic Summit in the Bavarian state capital. I am pleased to note that the Summit, in its fifth year of existence, has firmly established itself as a major economic forum on the international conference agenda. Given its wide range of subjects, which include the economic consequences of EU enlargement and the global division of labour, which we will discuss today, the Summit has succeeded in giving important impetus to both public and academic debates. We want to continue along this path in the future.

One key strength of the Summit is its international orientation, gathering every year top-level representatives and experts from different fields in business, academia, politics and the media in Munich. Again this year, we have successfully realised our aim of internationalism and diversity. 155 participants representing both medium-sized businesses and large companies, state parliaments and national governments from twenty-five, mostly European countries have accepted our invitation.

Today and tomorrow, we want to advance the discussion on how the new global division of labour changes the global economy and, in particular, the European Union. Please allow me some introductory remarks on this topic:

The trend to outsource jobs and production sites to the new EU member states and beyond, which has received increasing attention since the most recent EU enlargement by 10 member states in 2004, has led to worries about the destruction of jobs in the old core countries of the European Union.

For example, the public debates on outsourcing and offshoring frequently feature catch-phrases such as "unfair competition" because of lower and more transparent, that is to say, more attractive taxes in the reform-oriented enlargement countries. Or they evoke the danger of "social dumping" because of the low-wage policies supposedly prevalent in those countries that fail to adhere to costly social standards.

Frequently, this perspective misses the fact that the actual roots of high unemployment and the offshoring of investment and production – and increasingly of administrative tasks – reach back much further and have to do with political neglect. Structural reforms to liberalise the labour market and to reorganise the health and social systems, which are long overdue but difficult to communicate, are only gradually getting off the ground. In this respect, competition from the so-called low-wage or low-tax countries has a rather positive effect by serving as a catalyst to speed up the reform process in the Western European countries.

Moreover, one must not forget that, all in all, the Eastern enlargement of the EU so far has been a big economic success, generating hundreds of thousands of jobs in Central and Western Europe, earning high profits for the investing companies from the EU-15 and massively stimulating internal trade within Europe. In addition, the public is not sufficiently aware that the outsourcing of production is a kind of survival guarantee for local firms by strengthening their competitiveness and enabling them to expand in other areas.

It should not be denied that there are not only winners of the new division of labour – such as companies and highly qualified employees –, but also losers: the lesser qualified employees. It is in this area where it becomes apparent that we need a more flexible labour market, national models of support and an education offensive.

Only if the European Union sees the challenges of the new global division of labour as an opportunity, will it be able to better position itself in global competition and get fit for continuing globalisation. This entails, in the first place, that the EU of 25 takes seriously the Lisbon Agenda and its objectives reaching into the year 2010 and drastically increases its investments in the fields of research and innovation.

Already today we can spot the trend that outsourcing and offshoring are no one-way streets, neither within the EU nor in the direction of other global regions such as South or East Asia. Emerging Indian and Chinese high-tech companies also outsource certain activities and jobs abroad by setting up so-called "competence centres" in Europe. They do this knowing that concentration on regional strengths pays off for the whole company in global competition. This development gives us cause for a positive view of the future. A win situation for all countries and global actors that are affected by the new division of labour, both within and outside the European Union, seems perfectly possible in the long run.

Welcome and introduction to the
5th Munich Economic Summit 2006 by

HANS-WERNER SINN
President of the Ifo Institute and CESifo

Dear Minister Glos,
Director-General Lamy,
Sponsors of the Summit,
Ladies and Gentlemen,

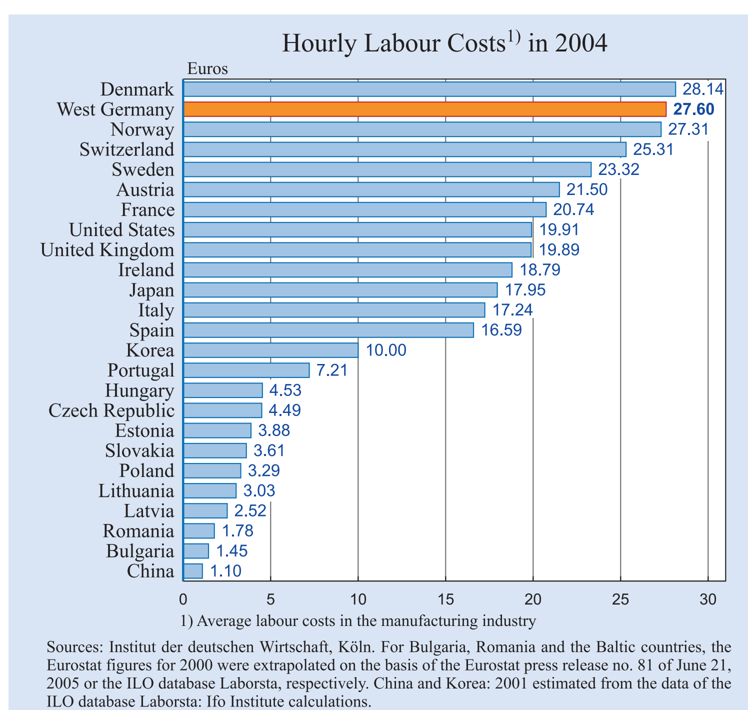
I would also like to welcome you to this year's Munich Economic Summit and extend my best wishes for an interesting and informative conference.

By way of introduction, let me say something on the division of labour as I see it. I want to remark briefly on the effects on the German economy of globalisation, the fall of the Iron Curtain as well as outsourcing and offshoring, and then make some comments on the welfare state.

I think the most important thing to realise is that we are in the middle of an economic experiment in peace times. The world has never known such an experiment before, with the Iron Curtain suddenly falling and more or less changing an historical perspective overnight. No less than 28 percent of mankind has decided to participate in the market game. These people are well educated, but willing to work for an apple and an egg, as we say in Germany.

The wage differences are enormous: The Chinese work for €1.10 per hour, Norwegians for €27, the Germans for €28, the same as the Danish. That is an enormous difference of more than 1 to 25. Even if you take the eastern European countries, with the Poles working for €3.30 or so, you can see that on average their wage costs per hour are 1/8 of the German ones.

These enormous differences in wage costs bring about economic reactions of all kinds. Capital moves to these low-wage countries. We are forced to specialise in capital-intensive activities. Labour migrates in. In the end, the gap will narrow, but it is difficult to say by how much. Our experience says that within 35 years the gap will be reduced by 50 percent (a sigma convergence rate of 2 percent per year), and that will make life difficult for the West. I believe personally that the world will not have reached its new equilibrium in the labour market in our lifetime. I think that it will take at least one generation, if not two.



Hourly Labour Costs[1)] in 2004

1) Average labour costs in the manufacturing industry

Sources: Institut der deutschen Wirtschaft, Köln. For Bulgaria, Romania and the Baltic countries, the Eurostat figures for 2000 were extrapolated on the basis of the Eurostat press release no. 81 of June 21, 2005 or the ILO database Laborsta, respectively. China and Korea: 2001 estimated from the data of the ILO database Laborsta: Ifo Institute calculations.

Germany reacts by exporting a lot of capital. Germany invests 50 percent more capital abroad in net terms than it invests in net terms at home. But there is also an internal structural change and this is the topic of this Summit. There is a horizontal change and a vertical change. We are giving up entire branches of industry that are labour-intensive like textiles or leather goods. I am from Bielefeld – I know what it means when the textile industry dies. Instead we expand capital- and knowledge-intensive branches like the automobile industry or

Share of foreign intermediaries in total intermediaries

Countries	Year	Share (%)	*)
Italy	1995 2000	17 19	**+ 2**
Denmark	1995 2000	22 26	**+ 4**
Finland	1995 2000	20 24	**+ 4**
Netherlands	1995 2000	29 30	**+ 1**
Austria	1995 2000	25 29	**+ 4**
Sweden	1995 2000	23 28	**+ 5**
Germany	1995 2000	20 26	**+ 6**

Legend: All numbers refer to total economy. Those countries are mentioned for which Eurostat data are available.
*) Change of share in percentage points.

Sources: Eurostat, Ifo Institute calculations.

the chemical industry or high-tech branches. So that's horizontal specialisation. And then we have vertical specialisation: within the production chains the upstream activities, which tend to be very labour-intensive, are cut off and are shifted to other countries via offshoring or outsourcing. The final stages of production, which are human-capital-intensive and real capital-intensive, tend to stay and so the country just assembles the products it had produced abroad and ships them from here to the rest of the world. And this is not only true for Germany, it's the same thing for other countries. What are the figures? Well, we don't have very good data on all of this because this is a new way of thinking about phenomena, but EUROSTAT has provided data for a few countries. You see here how from 1995 to 2000 the share of foreign intermediate goods and total intermediate goods of these economies have increased. As you can see, the share has increased everywhere – here are European countries: Italy + 2 percent, Denmark + 4 percent, Finland + 4 percent, Netherlands + 1 percent, Austria + 1 percent, Sweden + 5 percent and Germany which is affected most, where this effect is stronger than in other countries.

And unfortunately or fortunately – we can discuss this –, the result is that employment in manufacturing is typically declining. There are few countries where, since the fall of the Iron Curtain, employment in manufacturing has increased: these are Ireland, Canada, Spain, New Zealand, Australia. But in most countries it has declined and enormously so: United States – 14 percent, Sweden also – 14 percent, West-Germany – 22 percent and Germany as a whole – 27 percent, which is partly the east German story. Germany, the UK and Japan have had the largest loss of manufacturing employment among all OECD countries. The production depth, that is the share of value added in manufacturing output, has declined – in Germany from 38 percent to something like 33 percent since unification, and a similar development has taken place in the other old EU countries, although there the share is lower. It is clear that it is lower because the smaller a country is, the less likely it is that the intermediate products are produced at home. That is nothing special, but the downward trend that we see here in Western Europe is remarkable.

And Germany is affected more because the gap to the other EU countries has narrowed. And if we compare Germany with the average of the United States, Japan, France and the UK, you see this enormous special development here in Germany where production depth has declined much more than in other countries. We used to be above the average of

1) Australia 1991-2001. 2) France 1991-2002. 3) West Germany including Berlin.

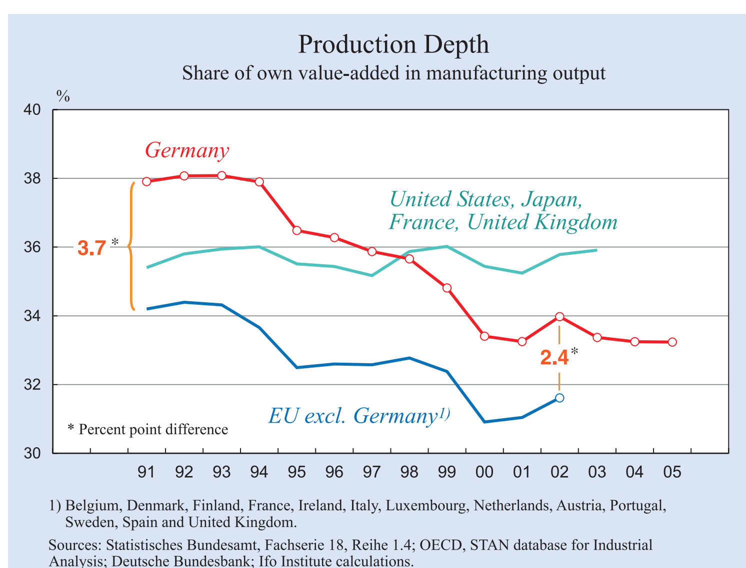
Sources: OECD STAN Industry Volume 2005, release 03; Arbeitskreis VGR der Länder, Volkswirtschaftliche Gesamtrechnung, Ländergebnisse, Reihe 1, Band 1, February 2005; Ifo Institute calculations.

these countries in the early 1990s and now we are way below. This is what I have termed the "bazaar economy".

We are the bazaar anyway because I think we have the richest range of industrial products of the intermediate kind in the world. The tool making shop is located in Germany, not in Japan, not in the United States. We have 450 world leaders in some market niches. However, this bazaar is separating itself from the workbench. The workbench used to sit in the back yard and produce directly for the bazaar, but now this workbench is increasingly being shifted to the lower-wage countries. You don't realise that because the goods still go over the same counter and are distributed via this counter to the world, but the jobs are being lost. And the label "Made in Germany" becomes a relevant question. What does it mean? "Sold in Germany" it often means. It does not really mean that the value added is generated in Germany. I had a little debate with Porsche about this because they had claimed that more than 50 percent of the value added of their production cost is in Germany. Ferdinand Dudenhöfer, however, an expert on the automobile industry, has now looked into the details and arrives at just 33 percent. Two thirds of the value of a Porsche Cayenne is generated abroad. The question is: is that good or bad? What do we make of it? Do we like it or don't we? There is no clear answer. The answer depends on your level of abstraction. It depends on the angle from which you see it. If you see it from a business perspective, the answer is trivially: good because otherwise the clever managers wouldn't do it. It increases profits and it helps to run the business. Actually, Germany has been very successful because it has been able to outsource labour-intensive parts of the production chain to Eastern Europe. Otherwise there would not be the success story of Germany's manufacturing firms. The second point of view is economic rather than business, it is from a general economic perspective. Here we have to distinguish between second best and first best.

Second best is to take the world as it is, take our institutional setting as it is. Is outsourcing good or bad from an economic point of view? The answer is again: good. Why is it good? Because without outsourcing, industry could not survive at all and then you would lose even more jobs than you do now. So it is a rational strategy also from an economic point of view.

But now comes economic first best and that is a different question! That is the question posed by David Ricardo: Is it an improvement in the division of labour? If so, it would also be good. But here I have my doubts. Whether something is an improvement in the division of labour has to be reflected by the labour market, of course it can only be seen there. So, here is a sector where the jobs disappear and then there should be another sector offering new jobs, so that we have a structural change for the better. That means specialisation: you have as many new jobs in services, in construction, in high-tech as you lose in manufacturing. In that case the whole thing would make sense from an economic point of view. But the reality is different in Germany. I don't have the data for other countries, but it would be useful to look into this. In Germany, from 1995 to 2005, the manufacturing industry lost 1.21 million jobs in full time equivalent terms and the nice economic theory that we find in our textbooks would now say: OK, these people moved to the other sectors: to construction, to services, to high-tech industries to produce better things with higher value added in which we have a comparative advantage. Lets be happy about the Chinese and the Poles doing the dirty industrial work for us while we sit at the computer and do high value stuff. But the reality is – no new jobs! Virtually no jobs were created in the rest of the economy



1) Belgium, Denmark, Finland, France, Ireland, Italy, Luxembourg, Netherlands, Austria, Portugal, Sweden, Spain and United Kingdom.

Sources: Statistisches Bundesamt, Fachserie 18, Reihe 1.4; OECD, STAN database for Industrial Analysis; Deutsche Bundesbank; Ifo Institute calculations.

in net terms. Yes, services have gained, construction has lost, but in net terms the entire rest of the economy has not created a single job during the past ten years. In fact, there was a loss of 150,000 full time equivalent jobs in the rest of the economy. What has happened, where have these people gone? There is only one possibility – they have gone to the welfare state. That is the division of labour à l'allemande. We do the one half – we cut the industrial jobs here, but we forget about the other half – creating new jobs elsewhere in the economy. Why is this so? It is obviously the rigidity of the German labour market which brings about that result. We have strong unions that defend existing wages despite the worldwide competition of low paid labour, despite the fact that equilibrium wages in Germany have declined with the opening of the Iron Curtain, and in this way we are creating a lot of unemployment.

High and rigid wages, which do not react to the forces of globalisation, lead to pathological overreactions of the economy. There are two types of overreaction: the first is that the bazaar effect is too strong – that is, the part of the production chain that we cut off here is too large. In principle, outsourcing is a good thing. A well functioning economy would shift some of the labour-intensive activities to other countries. This would create more jobs elsewhere. Our economy is not well functioning, however, as the data on the labour market show. We cut off too many jobs and don't create enough jobs elsewhere in the domestic economy. And why? Because our wages are too high and sticky and are remaining there despite the Poles, despite the Chinese. And there is another pathological overreaction. Horizontal specialisation is also too strong. In fact, there is a landslide, as the labour-intensive industries are being killed and the factors of production, labour, real capital, human capital, are driven out of these industries into the capital-intensive export sector that can more easily withstand low-wage competition from elsewhere.

Normally, a well functioning market economy, opening up to international trade with low-wage countries, would react efficiently. It would also specialise in the same direction, but because this specialisation makes jobs redundant, wages would fall. And the decline in wages, which an efficient market economy would bring about, would impose a brake on this process. This brake is absent in Germany. Therefore we get excessive horizontal specialisation and we overexpand the capital-intensive export sector – so we get too many exports in value-added terms, not just in volume, and the bazaar effect, i.e. the fact that we specialise in downstream activities, reinforces the export boom, making export volume grow faster than value added. That explains why Germany is world champion in merchandise exports.

What can we do? We have to reinvent the German model. The old German model has come to its end. The welfare state, which fixes the lowest wages at the level of replacement incomes paid, that is incomes that are paid on the condition that you do not work, cannot survive in times of globalisation. It is impossible to withstand the forces of globalisation, which demand lower wages for simple labour, by keeping the welfare state in tact, by defending existing wages. This is what we have done for 35 years, and as a result unemployment has increased in west Germany along a linear trend despite the cycles. I believe that we cannot continue for another 35 years. The Federal Republic of Germany will have ceased to exist before these 35 years are over. So, something has to be done. We have to re-invent the welfare state – create a better welfare state – and then we will be able to efficiently integrate into the world economy and capture gains from trade and be winners of globalisation. I don't believe that Germany has been able to increase its gains from trade in the last ten years. Germany was a big winner in the postwar period, no doubt about that, at a time when it was the low-wage competitor whom the Americans allowed to participate in world trade. But that time is over. Now Germany is the high-wage country competing with Poland, China and so on and it is making many mistakes. And because it is making these mistakes, Germany is unable to further increase its gains from trade. Germany is the laggard in Europe in terms of growth. It is obviously doing something wrong, and I think not only Germany is doing something wrong. I believe that all of Europe is on the wrong track.

Thank you very much.

Keynote Address by

PASCAL LAMY,
Director-General
of the World Trade Organization (WTO), Geneva

Ladies and gentlemen,

There is a popular story among economists that when a critic asked Paul Samuelson, a Nobel-prize laureate, to provide a meaningful and non-trivial result from his discipline, Samuelson responded: "comparative advantage." The theory by David Ricardo, who uses the example of England producing cloth and Portugal producing wine, and both of them growing their output of these products through specialization, is the basis for the idea of the benefits of open trade.

By producing goods and services in which it has a comparative advantage – and importing others – a country manages to create more value than it would otherwise do. In ideal conditions, trade allows countries to specialize in products that they produce best – and import others, and everyone stands to gain. As a consequence, the economies of all countries grow.

For the man in the street, trade is often associated with exports and imports of consumer goods. According to this common view, a country like Germany, for instance, would export cars and import tropical fruits. That was certainly true in the past. But new forms of the international division of labour appeared, like offshoring or outsourcing, whereby certain production stages are allocated abroad, thus leading to an increased trade of inputs, rather than finished consumer goods only.

Offshoring and outsourcing have contributed to a complex system of inter-linkages between countries that produce and export different final and intermediate goods. Thus, a country like Germany ends up importing not only bananas but also car parts, while it continues to export cars. This increasing division of production stages – and the division of labour it entails – is driven by companies' desire to increase productivity and to create more value than they would do otherwise.

The evidence of this growing specialization lies in the numbers: in the 1950's, world GDP grew by 5 percent, and world merchandise exports grew by 7 percent. In 2004, the proportion is much higher: World GDP grew by 4 percent and world merchandise trade grew by almost 10 percent. International trade is now growing at a multiple of the growth of our economies. This multiple, which is increasing, is the best measurement of this trend.

The challenge for countries – big or small, rich or poor – is to be able to capture the positive growth effects of trade for themselves. To do so, economies need to change. What does this mean? It means that production factors need to be reallocated to different activities. Change can be painful, and often requires investment in a broad range of factors, both of a social and economic nature. While trade opening can be beneficial for the economy as a whole, some individuals may be negatively affected by it. Trade opening thus represents a challenge to countries, because it requires governments to find ways to deal with the pains and difficulties arising from change, and also with distributive consequences of change.

In this regard, international trade works like technological progress: it creates efficiency gains, which economists love; it reshuffles the economic and social fabric, which politicians tend to resist. In between, entrepreneurs know that the ability to lead, the courage to change and the capacity to address transition costs are preconditions for reaping the benefits of these changes.

Trade and technological progress not only pose similar challenges to economies – they are two interlinked phenomena. Trade fosters technological change, as new technologies incorporated in imported products become accessible. In its turn, technological change facilitates trade – for example, through modern means of communication and transport technologies. All this explains that it is some-

times difficult to distinguish which of the two forces is driving the other.

What is true is that changes – and pains – caused by this combination of trade opening and technological advance are often attributed only to trade opening. Either consciously or unconsciously, societies and governments know that they cannot turn back the clock on new technologies. But history has shown that they can go backwards in terms of trade opening.

Hence the importance of the WTO that has adopted a set of rules and procedures to lock in trade opening. This was already true in the GATT that contained three basic rules: (1) non-discrimination between trading partners (the Most-Favoured-Nation rule); (2) non-discrimination between domestic and imported products once goods have gone through customs; and (3) binding of import tariffs, or the "security of concessions" – i.e. the obligation to respect the maximum import tariff for goods, usually agreed with other countries during a multilateral round of trade negotiations.

The WTO agreements expanded these three basic principles to a 500-page set of rules that has become the cornerstone of world trade in goods, services and intellectual property rights. The WTO also developed a powerful mechanism of the settlement of trade disputes – a remarkable achievement in international law, for its ability to solve disputes in a peaceful manner. The WTO's dispute settlement mechanism is the arbitrator of those rules – and a credible arbitrator, because it has the power to authorize sanctions in case of lack of compliance with those rules. Over 300 trade disputes have been brought to the WTO in the ten years of its existence, and the system has ensured that the rule of law is applied and respected by the whole Membership, no matter their size or economic power. Since 1995, thanks to the dispute settlement mechanism, a consistent body of decisions has been developed, interpreting and clarifying many of those rules.

As we all know – and it suffices to read the economic press to check some worrying current trends – there will always be pressures on governments to find quick-fix protectionist solutions to certain trade problems, particularly those that attract (or are given) a high level of popular attention. WTO rules help governments to defuse those pressures by providing the domestic political process with an external point of reference to bolster its position in favor of a more measured response.

The WTO, in this respect, functions like an anchor, helping governments to resist the waves of protectionism. That, of course, does not make the WTO a popular institution with the public or with politicians – I myself have been witness to (and the object of) occasional but forceful expressions of dislike of the WTO on the part of NGOs or students. But the WTO does help to dispel the illusion that protectionism is a relatively low cost way of dealing with trade problems. Imposing trade restrictions is quickly done – removing them can take decades.

Are the WTO rules perfect, are the critics of the WTO totally wrong ? The rules, of course, are not perfect, and some of the criticism is more than justified. The multilateral trading system needs to be improved, and that is mainly achieved through negotiations.

The current negotiations – the Doha Development Agenda – cover more than 25 different issues, being negotiated by 150 Members, decided by consensus. Any rational observer would say this is an impossible task, will point to a series of missed deadlines in the negotiations, will say that this Round is doomed. On my part, I am convinced it can be done, with the good will of all Members. It is extremely difficult, but it can be done.

At this moment, the key to the end game in the current negotiations lies, to a large extent, in the hands of the EU, the United States and the group of emerging developing countries, which we call the G-20. The main issues are tariffs on agriculture and industrial products, and agricultural subsidies.

This does not mean, of course, that other Members or groups, like those which group most of the poorest developing countries, do not play an important role in the negotiations, but somehow their main interests are being covered as far as these issues are concerned. Nor does it mean that issues such as opening trade in services or updating antidumping procedures are not important for the system.

But the reality is that the movement has to start now in this triangle of parties and issues: the G-20 and the United States want the EU to slash import tariffs on agricultural goods; the EU and G-20 want the

United States to reduce its agricultural subsidies; and finally the EU and the United States want emerging economies like Brazil, India and South Africa (which are included in the G-20) to lower tariffs on industrial goods.

This Round, as you all know, did not start yesterday. There has been a lot of work since 2001 – and notably during the Hong Kong Ministerial Conference in December 2005, and we have already made significant progress. What is already on the table ensures that this will not be a trivial round of negotiations, a "cheap round" as some commentators say.

Let me quickly summarize what is already on offer. On agriculture, it has been decided that 2013 is the end date for the elimination of export subsidies. There is agreement that the EU, the United States and Japan will undertake the biggest reductions on agricultural subsidies that distort trade, and that these will be effective cuts, which is a vast improvement as compared with the previous round. On industrial products, there is a broad understanding on a so-called Swiss formula to cut import tariffs, with high tariffs subject to bigger cuts. There has been a step forward towards completely duty-free and quota-free access for the world poorest country Members of the WTO. On Services, negotiations are focusing on certain sectors such as computer services, engineering and logistics and financial services, among others. Finally, an Aid for Trade package is being designed, to help developing countries address their supply-side constraints. The hope is that this will help those that now constitute around two thirds of our membership to translate the market access gains they make from the Doha Round, from theoretical into real commercial possibilities. As a whole, the round will provide a more level playing field in international trade, something which surely tallies with the theory of comparative advantages.

And where is Germany in this picture?

First of all, Germany has been, in recent years, the world's leading merchandise exporter – a true "Exportweltmeister". If services are also taken into account, Germany's exports rank second only to the United States. Exports therefore make a significant contribution to Germany's economy. The ratio of exports to GDP increased from 30 percent to nearly 40 percent over the last two decades.

It is difficult to quantify in exact terms Germany's gains from increased integration in European and world markets, as pointed out by some observers. What we know is that Germany, with its impressive export performance, has benefited from such increased integration. Again, there might be a debate on "how much", but surely not on "whether or not" Germany has gained from a more open international trading system.

Also, we have a fairly good idea on how countries can maximize the benefits they get out of integration into the world economy. We know, for example, that education and research and development (R&D) play an increasingly important role in the relationship between trade and the gains that a country derives from exports and imports. Labor market rules also affect the extent to which a country can take advantage of opportunities offered in global markets and how the gains resulting from trade are distributed.

It is true that Germany's main trading partner is the European Union. In 2005, 63 percent of German exports went to the other 24 EU Member States and 64 percent of Germany's imports were sourced from these countries. But German industry, according to its own statements, considers that it is trade with third countries that has the largest growth perspectives. According to a recent paper by the German Federation of Industries (BDI), China, Brazil and India are key export markets for Germany, with a significant growth potential.

The automotive industry continues to be key for Germany and is directly or indirectly responsible for one in seven jobs in this country. Already today, this industry generates more than a quarter of its sales outside the EU. The newly industrializing countries in Asia are expected to exhibit significant increases in demand for German cars over the coming years. The engineering industry is likewise one of Germany's most important export industries and generates 50 percent of its overall sales revenue outside the EU. Also important are the chemical and the electrical industries. Germany is also an important exporter of certain services, in particular insurance and reinsurance services.

Clearly, Germany has a lot to gain from a successful outcome of the Doha round. It is an extremely competitive country, with comparative advantages in manufacturing and services. The challenges for

Germany, as for all other countries, are to keep on with the hard work, to have the courage to adapt to ever changing circumstances, and in not getting discouraged. As you see, these challenges are not very different from the ones facing any national football team coming to the World Cup here in Germany next month – keep on with the hard work, adapt to changing circumstances, do not get discouraged. I am sure that, if it follows this advice, the "Mannschaft" will have great chances of success in the World Cup, as Germany will have in international trade. Like all good teams, Germany and Europe know that what they need are clear and transparent rules, a level playing-field and a trusted referee. This is why the WTO negotiations are so important to all of you.

Keynote Addresse by

MICHAEL GLOS
Federal Minister of Economics and Technology
of the Federal Republic of Germany

Good afternoon Mr. Chrobog,
Professor Sinn,
Ladies and Gentlemen:

Economic policy in the face of global markets

Johann Wolfgang von Goethe once wrote:

"There are four things a person should do every day:
listen to a pleasing song,
read a good poem,
look at an excellent painting,
and, if at all possible, speak a few words of reason."

I thought of these things on my way to Munich. As far as the first point is concerned, Munich boasts the Philharmonie concert hall in the Gasteig Cultural Center, for example. With respect to the second, Munich is where Thomas Mann wrote *The Magic Mountain (Der Zauberberg)* – which, although not a poem, surely meets Goethe's requirements. And on the third – the painting: Munich is home to the Alte and Neue Pinakothek art galleries, amongst others. On the fourth point – speaking "words of reason": by now, the Munich Economic Summit has become an established international institution. And, as in the past, so the subject of today's conference "Europe and the New Division of Labor" – is once again a hot topic in the current economic debate.

The challenge of global competition

But what do we really mean by "the new international division of labor"? For me, there are four aspects that deserve to be highlighted. To begin with, production processes can now be broken down into their component parts more than ever before. Secondly, the number of goods and services that can be traded across international borders is increasing rapidly. Thirdly, financial markets around the world are today more closely interwoven than they have ever been before. And fourthly, the individual locations with their economic policies and fiscal and regulatory systems, are competing internationally for investments and savings.

The speed at which international markets are integrating is breathtaking. Many of the current international key data have risen by a factor of two in barely more than a decade, and this applies to more than just total world trade volumes alone. The share of imports from emerging and developing countries contributing to the economic productivity of industrialized countries has also doubled. For instance, China is now our fourth most important importing country, after France, the Netherlands, and the United States. The energy consumption of many emerging countries has also doubled, as it has in China and India. As a consequence, over the next 15 to 20 years, China alone plans to build as many as 40 new nuclear power stations. Finally, the level of foreign direct investment worldwide in relation to global economic product has risen from less than 10 percent to over 20 percent.

However, many of the consequences of an intensified international division of labor are not directly apparent. We may all notice the increase in energy consumption as a result of higher petrol prices. We may also notice that more and more products are imported from emerging countries, as we come across the tag "Made in China" with increasing regularity. But consumers barely notice that a very significant proportion of the international division of labor is accounted for by the manufacture and trade of intermediate inputs. And it's not just multinational corporations that are involved. In Germany, 35 percent of SMEs have foreign suppliers. This is not a sign of weakness in our national economy. On the contrary: making use of international supply chains allows German companies to safeguard their livelihoods, and also to expand.

Notwithstanding the debate surrounding the "bazaar economy," we will soon experience much more tangible effects of the intensified division of labor; with the integration of China, India, and other nations

into the global economy, the global availability of labor is increasing rapidly. Millions of employees are prepared to work in these countries at much lower wages than their counterparts in industrialized countries. What's more, the potential of these workers has often been underestimated; the number of skilled workers in these countries is also increasing. China, for example, has more high school graduates than either the United States or the EU25. Lively investment activity – also from foreign companies – serves to increase the productivity of the workforce in these countries even more. The OECD estimates that, in the future, industrialized countries will be able to outsource around 20 percent of operations to other countries in sectors that require highly developed information and communication technologies. Competition is also becoming tougher in what was once the exclusive domain of the industrialized nations – the production of high-tech products and services.

The question must be asked, however, whether or not in the future we can continue to keep pace with the speed of China's export success. On the one hand, a purely quantitative growth that involves ever-increasing resources in production, but without making any technological progress, must necessarily reach its limits. On the other hand, the imbalances in foreign trade will, sooner or later, induce adjustment processes in the markets, which will again allow trade flows to develop in different directions. Finally, the development of wages in the dynamic hubs of Eastern Asia is progressing just as dynamically as their economic growth itself.

Globalization as an opportunity

Nevertheless, the public perceives globalization trends first and foremost as a threat. Despite this, I find it rather unlikely that emerging national economies should suddenly be identified as unwanted competition that needs to be suppressed. Ultimately, they are only doing what proponents of development policy have been preaching to them to do for decades: they have been resorting to their own strengths and facing up to international competition. A look back into history shows that an intensified international division of labor has, in fact, always been a blessing. A particularly good example of successful integration is the German "Economic Miracle" that followed World War II. Had we then had external foreclosure, a controlled-currency economy, protective tariffs, and no guest workers, our standard of living today might well be no better than it was in Eastern Europe in 1990. And even today, Germany's integration in the global economy may be regarded as an impressive success story.

Despite the rise in the value of the euro against the US dollar by around 40 percent since late 2001, not to mention the appearance of new competitors, Germany has managed to increase its international market share. We occupy an excellent global position, particularly in markets and sectors that show strong growth. This proves that our economy can capitalize particularly well on the benefits of an international division of labor.

In the future, the focus should be on rendering global market opportunities even more accessible. Here, it's worth considering that China and India alone represent 2.3 billion consumers!

Then there are our Eastern European neighbors, who are particularly keen to buy German products. Additionally, there is an as yet ungauged wealth of potential in the service sectors. In this respect, the strengths of the German service economy are often underestimated. Thanks to the high level of education of our skilled workforce and our state-of-the-art communications and transport infrastructure, we are well equipped to compete in open international service markets. We occupy an excellent international position, particularly in industries like logistics, insurances, and information services. Overall, we are the world's third-largest exporter of services, after the United States and Great Britain.

Admittedly, we can't be "world champion" at everything. Goods exports and the FIFA World Cup – that wouldn't be a bad start. Alongside accelerated economic growth, the demand for top-quality, high-grade, high-tech products is also increasing dramatically. This means better employment opportunities and earning potential for highly skilled workers. In this light, the chronic lack of university-trained engineers that we are currently experiencing in Germany should be seen first and foremost as an opportunity for our young people.

Workforce mobility

A further sign that our world is becoming more and more networked is the increasing mobility of the

workforce itself. Here, too, what we are experiencing now is only the forefront of coming developments. By that, I don't just mean the ever more acute migration problems in Europe. In future, the potential and dynamics of a location, and its quality of life, will have a stronger influence on the flow of migration, both outwards and inwards, of skilled workers. Seen in this perspective, the attraction that a country holds for immigrants provides a meaningful site index.

Every now and then, there are indications that Germans are increasingly inclined to emigrate. A few weeks ago, Uli Hoeness, manager of the medium-sized enterprise Bayern München, the Munich soccer club, summed up the issue in a nutshell. On the subject of Michael Ballack, currently Germany's most renowned active soccer player, and his move to Chelsea London, he said:

"It was clear from the outset that Michael didn't go for the sake of a new language and a new culture – he went for the new currency."

As Minister for Economics, I ought to be worried if our best minds – and indeed our best legs – are leaving the country for good. On the other hand, if they just want to spend some time gathering experience abroad, that will be an asset for our country. What Goethe once wrote about his sojourn in Italy may well hold true for Michael Ballack: "People know themselves only insofar as they know the world."

Commitment to the market economy

One thing is certain – there are no simple or conclusive answers to the questions posed by globalization. I make no bones about my own conviction: I believe that competition and open markets in Germany, in the EU and beyond are a central instrument for successfully shaping globalization. Competition allows personal initiative and responsibility to flourish. It provides a fair and reasonable opportunity for economic success on the part of companies and employees alike.

Competition fulfills key functions, especially in a global context: it promotes innovation and the spread of new technologies. I am reminded of the speed at which microelectronics has infiltrated almost all areas of daily life. Moreover, competition has the effect of lowering prices, also in an international context. It's not without good reason that the cost of a domestic telephone call in Germany has fallen by 95 percent in the last eight years. Effective competition means having recourse to alternative suppliers and alternative technologies. The importance of this is manifest in the current energy debate.

Central areas of action for economic policy

Three areas of action are particularly important for economic policy in the age of globalization. The first priority is to create in one's own country the appropriate basic conditions for the economic activity of companies and employees. As long-distance costs fall, especially the cost of transport and communications, the attractiveness of those basic conditions will become increasingly important. In this sense, economic policy *per se* will gain significance as a factor of regional economic policy, while physical considerations such as geographical location will take a back seat. For Germany this means that we must secure and develop the attractiveness of our country for investors and innovations. Admittedly, the tax burden in Germany measured against GNP is not particularly high in international terms. At the same time, it is a cause for concern that our business tax rates are, by international standards, too high. This will be addressed by the business tax reform, to take effect in 2008. By raising VAT in 2007, we will not just be taking a significant step towards consolidation. At the same time, the relief this will bring from non-wage labor costs will also improve employment incentives in the labor market. With the coming health reform, too, we must keep our sights focused on the urgently needed decoupling of statutory health insurance contributions from labor income. Furthermore, we must secure and expand our strengths in the field of capital- and knowledge-based products and services. This is the only way we can continue to afford wage levels that are high by international standards. To this end, we will strategically expand funding for education and research. By the end of this decade, we will increase state and economic spending on this area to 3 percent of GDP, or around $80 billion each year.

We also need to allow companies and employees more freedom in their decision-making. After all, it is they who must ultimately adapt to global competition. That is why the issue of deregulation and reducing bureaucracy deserves special attention.

However, the issue that most requires our attention is the development of the labor market. The central task of economic policy is to give people the opportunity to engage in economic activity in order to allow them to develop and pursue an independent lifestyle. To this end, the well-intentioned approach of the "Hartz" reforms needs to be developed further in certain areas. In so doing, I believe it is important to further strengthen the competition philosophy and the motivating and controlling function of wages. Flexible wages can give people a timely indication of which sectors and regions they should enter into. On the other hand, setting wage levels with rigid wage agreements, or even by legislation, will lead only to higher unemployment. And I remain firm on another point: rigid protection against dismissal, too, is acting as a brake on the inevitable structural changes. We must actively support the mobility and flexibility of employees, and we must promote schemes for skill development, training, and education.

A second field of action for which we must adapt the basic conditions to meet global challenges is that of the European Union. The densely populated and relatively homogenous EU economic environment offers excellent conditions for strengthening the networking of industrial production. This is even more relevant for the service sector. It is thanks to information and communication technologies that the still considerable productivity reserves in this sector can be exploited. To this end we must facilitate access to the national markets. I now wish we had shown a little more courage when it came to the compromise on the EU Services Directive. We must now ensure that consumer and environmental protection concerns do not serve as an excuse for protectionist measures. I intend to use the opportunity of the German EU presidency to lobby for stronger competition within the European networks, in particular in the telecommunication and energy sectors.

Finally, the third area of action consists of shaping global basic conditions for the international division of labor. The most important factor here will be the successful conclusion of the Doha talks. We must achieve the goal of substantially improving market access for goods and services of all participants. Emerging countries and advanced developing countries must make their contribution by significantly reducing applied tariffs and guaranteeing additional market access for service industries.

It is with concern that I observe the increasing tendency to adopt regional free trade zones instead of finding multilateral solutions. It will be to the detriment of medium-sized companies in particular if, depending on the target region for their foreign trade, they must constantly come to terms with different bodies of rules and regulations. With bilateral trade agreements, there is also the additional fear that whoever is the stronger partner will be the one that dictates the terms. In this light, it is small and developing countries that may stand to lose the most if the Doha talks fail. But it is also important that rules that have already come into force under the provisions of the WTO are strictly monitored and adhered to. This is the only way in which fairness in international competition can be guaranteed. This applies, among other things, to the existing rules for the protection of intellectual property. But despite this, I can still see in the future – beyond the Doha talks – plenty of potential for removing the still extensive non-tariff-related obstacles to trade and direct investment.

Limits to state intervention

The intensified international division of labor again raises the question of whether, where, and how much active economic policy we need. It is with a degree of skepticism that I notice that many people are increasingly inclined to call for the state to play a more active role. While the basic conditions are gaining importance in a dynamic international environment, individual measures and national attempts to "go it alone" are becoming demonstrably less effective. Limited public financial resources additionally reduce the room for manoeuvre. And it isn't always clear whether or not private commercial solutions may, in individual cases, be possible, or even preferable. However, I can see a few developments that may make an active economic policy necessary, even in the future. At times, multilateral agreements and institutions are still too unrefined to guarantee fair international competition. The targeted funding of industry and exports in individual countries often leads to a distortion of international competition. And global competitive markets without a globally effective competition watchdog do not yield the best possible economic results. In these instances a compensating intervention by the state may well be appropriate, for example in the area of research and innovation. In this sector, it is important to safeguard key technologies in particular, so that Germany and Europe can remain internationally competitive.

Another very topical issue is the question of a strategy for the supply of energy and raw materials. I consider it justifiable to actively promote the expansion and retention of certain energy sources, in order to be well prepared for any risk scenarios that may arise in the future. And I will actively accompany our enterprises through the sometimes turbulent waters of the global economy. This is where our chambers of foreign trade can make an important contribution, by promoting trade fairs and underwriting export credits and investments. That is what I consider to be a reasonable foreign trade policy.

On the other hand, the growing international tendency towards "economic patriotism" is extremely problematic. This phenomenon, incidentally, is not limited to Europe. Apparently, the United States is also not immune to it, as was evident in the effective resistance to the sale of a Californian oil group to a Chinese company, and the failure of an investor from Dubai, who wanted to take over the operation of a number of American ports. In both cases, the deciding factor was, no doubt, not the quality of the offer, but an objection to the nationality of the bidder. In my opinion, preventing competition in this way has very little to do with patriotism, but a great deal with protectionism. The citizens of our country will be best served if we remain an attractive location that can induce foreign capital, foreign expertise, and intelligent minds to come to our country and work productively here.

Conclusion

I am pleased to see that companies and consumers alike have clearly expressed their optimism in the most recent surveys. If the economic climate as portrayed by the Ifo Index is anything to go by, we are already in the middle of a strong economic recovery. We must support the present upturn by taking the right stance with our economic policy. By means of a clear, comprehensible economic policy that promotes competition, we hope to gain people's confidence, and also their trust that a strengthened international division of labor will lead to greater prosperity for all. Accordingly, I make a direct plea for an in-depth dialogue between politicians, academics, and business. This is, in fact, the aim of the Munich Economic Summit – which is why I would like to thank the BMW Foundation Herbert Quandt for its invitation.

I wish all participants a stimulating discussion, and I hope that afterwards we will all emerge the wiser.

Panel 1

THE NEW GLOBAL DIVISION OF LABOUR – HOW IS THE WORLD ECONOMY AFFECTED BY OUTSOURCING AND OFFSHORING?

Introduction

JOHN WHALLEY[1]
Professor, University of Western Ontario

Outsourcing

Outsourcing is a term which has been the focus of both a theoretical literature spawning models of a firm's decision to outsource and the impact on industry equilibrium outcomes, and an empirical literature which seeks to measure it. Broadly defined, the term outsourcing refers to the purchase of goods and services that were previously produced inside a company. The company providing the goods and services can be located in the same country (domestic outsourcing) or outside the country of the purchasing company (international outsourcing). The international component of outsourcing relates to switches of sourcing from within to between countries. Feenstra and Hansen (2005), for instance, explicitly formalize and estimate a model of ownership and control in outsourcing to China.

There are, however, many variants of and elaborations on outsourcing discussed in the literature. Grossman and Helpman (2002) emphasize the vertical disintegration of production which seems to be involved, but stress that to them outsourcing means more than the purchase of raw materials and standardized intermediate products. It also means "finding a partner with which a firm can establish a bilateral relationship and having the partner undertake relationship-specific investments so that it becomes able to produce goods and services that fit the firm's particular needs". They then model firm choice of relationship-specific partners in either a technologically and legally advanced North or a low-wage South emphasizing the search process involved, the need to convince potential suppliers to customize products for their needs, and the incompleteness of contracts available for enforcement.

[1] I am grateful to Xin Xian for comments and help and to Josh Svatek for assistance.

Bhagwati et al. (2004) in contrast focus their discussion of outsourcing on services, and specifically long distance purchases of services by electronic media such as phone, fax, or internet and discuss alternative cases where providers and purchasers of services have differing degrees of mobility along the lines of Modes 1 to 4 of the General Agreement on Trade in Services (GATS). The motivation they offer is the characterization by the US President's Council of Economic Advisors in 2004 of outsourcing of professional services as a new type of trade.

OECD (2006), in a recent survey of outsourcing literature, point out that outsourcing and offshoring are terms that are frequently used interchangeably. Offshoring refers to the purchase of goods and services previously produced inside the purchasing company from companies in locations outside the country. As such, to them the terms include not only international outsourcing but international insourcing with the foreign affiliates of domestic parent companies exporting to their parents.

These and other literature-based notions of outsourcing in part reflect attempts to delineate and categorize the various channels through which economic integration is proceeding globally between various economies, and centrally reflect the concern to better understand the changing nature of global production processes in both manufacturing and services. How this pattern of production is changing is conjectural, and theoretical literature often relies on anecdotal support. Examples such as the global production of American cars, the globally fragmented production of Barbie dolls, and other items are frequently appealed to. But for many years, large OECD manufacturing firms have had many component suppliers, and outsourcing as such is not new; Boeing is reput-

ed to use over a million components in aircraft assembly, and General Motors has long had thousands of component suppliers. The issue is how the process of working with these component suppliers is changing for large OECD manufacturers as global integration proceeds across national boundaries involving low-wage economies such as China's.

On the one hand, manufacturers seemingly prefer component suppliers to be geographically close so that it is easier to monitor them and communicate over product quality and dialogue over the frequent small changes to components that are required in meeting changes in market tastes. Just in time inventory management is also easier to accomplish with geographically close suppliers, and there can also be an accumulation of person to person links with individuals in supplying firms which makes switching suppliers costly. But if low-wage (and hence low-cost) reliable and high quality component suppliers become available elsewhere, the cost savings can justify resourcing across national borders even with the geographical barriers involved. The impression of recent outsourcing activity involving low-wage economies such as China is that improved infrastructure, growing reputation for product quality and on time delivery, the reliability of middlemen to organize transactions (often via Hong Kong), and an improved legal structure in China are also all important elements.

Public concern in the OECD over outsourcing, however, stands in some contrast to the research literature. It largely focuses on potential job loss and downward wage pressures as outsourcing abroad occurs rather than seeking to provide analytics for firm decision making on vertical cross-border unbundling (or disintegration) of production processes. As such, the policy concern is over the adjustments implied by international integration, rather than understanding exactly what form the production unbundling takes, and production disintegration via intermediate product outsourcing is but a part of this concern.

Given this adjustment focus, there thus seems to be little reason why debate on outsourcing should limit itself to resourcing of intermediate products and components. OECD retailers resourcing supplies from domestic to foreign firms generate adjustment pressures in the OECD in the same way that cross-border production unbundling does. Also, more channels for the impact of integration processes exist than the resourcing of component suppliers stressed in outsourcing literature.

These additional channels include firms in low-wage countries buying an OECD firm; keeping the firm's distribution system in the OECD, but moving production of manufacturing back to the low-wage country. One could term this insourcing, for want of a better term. Also, a considerable portion of China's integration into the global economy has been facilitated by trade transactions orchestrated and conducted via middlemen in Hong Kong, Taiwan and Korea. The size of these transactions is large, as are the trade impacts. There are speculative estimates that profits from Mainland China accruing to Taiwanese companies are around 70 percent of the profits of companies quoted on the Taiwanese stock exchange. This set of activities might be called through-sourcing, again for want of a better term, to distinguish it from conventional outsourcing.

There are often further elements of the integration process in the Chinese case that involve investment funds of Chinese origin flowing abroad and returning to China to benefit from preferential policies towards foreign invested enterprises. These include, among other things, considerably preferential tax treatment for foreign invested over domestic enterprises, but to qualify for this tax treatment threshold tests of export sales must be met. Xiao (2004) reports an estimate that the ratio of round trip FDI via Hong Kong to total FDI inflows to China could be 40 percent. Again the transactions seem large and have significant impacts on China's trade volumes. This could be termed roundabout sourcing, also for want of a better term.

Thus, not only is the definition of outsourcing in the current literature somewhat ambiguous and seemingly a little narrow but a wider variety of channels of interaction with the global economy are at issue and go beyond those that conventional outsourcing literature focuses on. And if the concern over outsourcing in OECD countries is adjustment costs, more so than understanding changes in the nature of production processes, then all of these seemingly merit discussion when outsourcing is under investigation.

Measurement of outsourcing

Attempts to both measure outsourcing and assess its impact on OECD wage rates have accompanied the

analytical literature referred to above. Abraham and Taylor (1996) document an increase in the outsourcing of business services in thirteen U.S. industries. Campa and Goldberg (1997) measure outsourcing of imported intermediate inputs for various industries for Canada, Japan, the UK, and the U.S., and show that except for Japan there is a doubling in the share of imported inputs between 1975 and 1996 for all manufacturing in the US and that the UK demonstrates a large increase in outsourcing. Feenstra (1998) measures all imported components used in production by US firms and computes various measures of outsourcing, also arguing that all have increased since the 1970s.

In terms of wage impacts from outsourcing, there are two distinct trends in the literature; one on the indirect effects on bargaining power of unions in OECD labor markets from the threat to outsource production, and the other on the direct effects on OECD wage rates as production increases offshore. The first of these effects is emphasized in Rodrik (1999) and Gaston (2002). Recent empirical work by Dumont et al. (2006) and Dreher and Gaston (2005) reports results indicating that various measures of globalization are negatively correlated with union bargaining power and union membership.

In terms of impacts of outsourcing on wage rates, Feenstra and Hanson (1996, 1997) find that outsourcing has lead to an increase of the wage of skilled versus unskilled labor in both the U.S. and Mexico. Feenstra and Hanson (1999), in a subsequent paper, find that US outsourcing has raised the real wage of non-production workers by 0.16 percent/year and, in addition, also raises the real wage of production workers slightly (by 0.01 percent/year). Wage impacts in the OECD for now thus seem mild and positive, reflecting the efficiency gains from greater outsourcing raising the real wage of both skilled and unskilled labor.

While these findings seem to indicate to be a change occurring in the volume of outsourcing as more narrowly defined in the conventional literature, there is an issue of how large the initial base is around which this change is occurring and this is less well researched. Tomiura (2005) studies Japanese firms and their outsourcing activities and reports that relatively few Japanese firms outsource across national boundaries. The impression from US business activity is that still today a large part of component purchases occur from smaller component suppliers that are located in relatively close geographical proximity to larger scale manufacturing establishments so as to maintain close coordination and contact.

Thus, the issue is not only the rate of change of cross border outsourcing (however it is defined), but also the initial base around which changes are occurring. The impression (but with no firm data to confirm it) is also that more significant components of foreign trade of low wage countries involves final products than is true of OECD countries, indicating that outsourcing as conceived of in the theoretical literature may for now be relatively small. For instance, significant Chinese exports occur in clothing and assembled electronics; and much of Chinese export activity builds on relationships with retailers and distributors in the OECD anchored in Hong Kong, Taiwanese, and Korean businesspeople with long experience of how these distribution systems work. There are speculations, for instance, that WalMart is the eighth largest trading partner of China, and may have more trade with China than the whole of the UK.

Finally, there is recent literature on the productivity effects of US outsourcing. Amiti and Wei (2006) find that between 1992 and 2000 service outsourcing in the form of technical support, medical claims processing, and software development account for around 11 percent of productivity growth in US manufacturing, compared to a 3 to 6 percent gain from imported material inputs. Although service outsourcing is still seemingly small compared to intermediate component outsourcing, the potential is for it to contribute to OECD growth at ever more significant rates in the future.

Potential future adjustments from outsourcing

As I note above, the public concern in the OECD over outsourcing is not only a reflection of current job loss attributed to resourcing and production relocation through outward FDI, it is also a reflection (and seemingly predominantly so) of expectations as to how large the adjustments attributable to these integration processes might be in the future. The issue is whether we are at an early stage of a historic transformation in which large portions of global manufacturing and service activity progressively relocate to low-wage economies to arbitrage wage differences supported by OECD immigration restrictions; or whether this will be only a

more limited adjustment that will slowly dissipate in future years.

Seemingly, the betting money would be on a lengthy adjustment process which will accelerate in future years if growth in the low-wage economies continues at current rates. China figures as a central part of the concerns since China is so large and her GDP and trade are growing rapidly. Current estimates are that cumulative FDI inflows into China may run in the region of $500 billion (Whalley and Xian (2006)). If OECD GDP is in the region of $25 to 30 trillion (Antkiewicz and Whalley (2006)) and the OECD capital output ratio is in the region of 3, the OECD capital stock may be in the region of $75 trillion. The amount of capital that through depreciation and reinvestment could flow to China over a period of 30 to 40 years thus seems very large and hence the prospect is for even larger future adjustments in OECD markets if this process continues.

Mundell, in a well known paper some years ago (Mundell (1957)), showed a formal equivalence between goods flows in the presence of fixed factors across countries which achieved factor price equalization, and freely flowing factors across national borders where goods are immobile achieving the same result. To some degree, global integration and current developments with the low-wage economies mirror this situation. With international restrictions on factor flows (and especially labor), flows of goods are generated as a way of arbitraging international wage differentials indirectly through goods which embody labor. Were the world economy a single integrated economy in which factors, including labor, could flow without restraints across national borders, international factor price differentials (and especially wage rate differentials) would greatly narrow and trade in goods would fall significantly.

China is the largest of the low-wage economies currently outside of the OECD (China and India account for 40 percent of the world's population). The amount of labor that has been involved thus far in the trade which has been generated by these low-wage differentials is small since FDIs in China account for well over 50 percent of exports, but employ only 3 percent of the work force. The potential for even larger adjustments to occur globally, as the Chinese integration into the world economy, and the world's integration into China continues and even accelerates, would seem to be large.

Thus, outsourcing as a phenomenon is seemingly studied in recent academic literature in terms of strategic decisions to resource component supply across national borders, not so much in terms of the potential job loss and adjustments that such transactions create. The wider public concern over outsourcing in OECD media and public discourse is over job loss and labor market disruptions. Conventional outsourcing is but one part of the adjustment process associated with the global integration of the large low-wage economies, and this process may only be in its infancy given the size of the low-wage labor pool.

References

Amiti W. and S. J. Wei, 2006. "Service Offshoring and Productivity: Evidence from the United States," National Bureau of Economic Research Working Paper No 11926, Cambridge, Mass.

Antkiewicz A. and J. Whalley, 2006. "Shifting Global Economic Power to the BRICSAM from the OECD," Centre for International Governance Innovation (CIGI), Waterloo, Ontario. (mimeo)

Bhagwati J., A. Panagariya and T.N. Srinivasan, 2004. "The Muddles Over Outsourcing," *Journal of Economic Perspectives*, 18(4), 93–114.

Dreher A. and N. Gaston, 2005. "Has Globalization Really had no Effect on Unions," Swiss Institute for Business Cycle Research Working Paper No. 110.

Feenstra R., 1998. "Integration of Trade and Disintegration of Production in the Global Economy," *Journal of Economic Perspectives*, 12, 31–50.

Feenstra R. and G.H. Hanson, 1996. Globalization, Outsourcing and Wage Inequality, *American Economic Review Papers and Proceedings*, 86, 240–45.

Feenstra R. and G.H. Hanson, 1997. "Foreign Direct Investment and Relative Wages: Evidence from Mexico's Maquiladoras," *Journal of International Economics*, 42(3/4), 371–393.

Feenstra R. and G.H. Hanson, 1999. "The Impact of Outsourcing and High-Technology Capital on Wages: Estimates for the U.S., 1979–1990," *Quarterly Journal of Economics*, 114(3), 907–940.

Gaston N., 2002. "Unions and the Decentralization of Collective Bargaining in a Globalized World," *Journal of Economic Integration*, 17, 377–396.

Dumont M., G. Rayp and P. Willemé, 2006. "Does Internationalization Affect Union Bargaining Power? An Empirical Study for Five EU Countries," Oxford Economic Papers, 58(1):77–102.

Grossman G. and E. Helpman, 2002. "Integration versus Outsourcing in Industry Equilibrium," *Quarterly Journal of Economics*, 117(1), 85–120.

Mundell R., 1957. "International Trade and Factor Mobility," *American Economic Review*, 48(3), 321–335.

OECD, 2006. "The Internationalization of Production, International Outsourcing, and OECD Labor Markets," Economics Dept., OECD, Mar 2006. (mimeo)

Rodrik D., 1999. "Globalization and Labor, Or: If Globalization is a Bowl of Cherries, Why Are There so Many Glum Faces around the Table?" in ed R. E. Baldwin, Market Integration, Regionalism and the Global Economy, Cambridge U.P. for CEPR.

Tomiura E., 2005. "Foreign Outsourcing and Firm-Level Characteristics: Evidence from Japanese Manufacturers," *Journal of the Japanese and the International Economies*, 19, 225–271.

Whalley, J and X. Xian, 2006. "China's FDI and Non-FDI Economies and the Sustainability of Future High Chinese Growth," The University of Western Ontario. (mimeo)

Whalley J., 2006. "The Post MFA Performance of Developing Asia". (mimeo)

Xiao G., 2004. "People's Republic of China's Round-tripping FDI: Scale, Causes, and Implications," Asia Development Bank Institute Discussion Paper No.7.

Panel

The panel was chaired by **John Peet**, Europe Editor of *The Economist*, London. Panellists included, in addition to John Whalley and Hans-Werner Sinn, business executives from major international companies.

Samuel DiPiazza, Global Chief Executive Officer of PricewaterhouseCoopers introduced himself by saying that speaking after two "very capable academics" and before two executives active in the outsourcing business he was "only an accountant", but one who tries to deal "with what's happening in reality with PWC's clients all over the world" and as such representing "some sort of independent view": "What we have seen over many years is that companies and economies that do not allow markets to work and do not work to comparative advantage are not sustainable."

Markets, he emphasised, are an undeniable force. Outsourcing is clearly a driver, and it is not about lowering costs alone. If one looks at the new markets that are resulting from the outsourcing and offshoring phenomena, "there is no question that there is a huge win game going on". With most of the outsourcing contracts signed in the past 24 months coming out of Europe, it is also clear that this has become a European game.

But, he warned that outsourcing and offshoring are very complex. "If you're the IT programmer in Munich who loses his job to offshoring or outsourcing, this is only a lose game." This calls for being very sensitive to such issues, and playing the game "very, very carefully".

The next speaker, **N. Chandrasekaran,** Executive Vice-President and Global Head of Sales and Operations of TATA Consultancy Services in Mumbai, represents a firm active in every form of outsourcing. "The global division and migration of labor is a worldwide reality today", he said, illustrating the assertion with the fact that close to 200 million people worldwide live outside their countries of birth, that 25 percent of Switzerland's and 10 percent of Germany's and the Netherlands' populations are migrants, and that the Philippines, a country of 75 million that churns out 380,000 college graduates each year, has an oversupply of accountants trained in US accounting standards. India already has 520,000 IT engineers delivering IT solutions to global corporations.

Attributing this development to globalisation and the availability of new technologies, he asserted that the world is slowly moving beyond the information economy and towards a global knowledge-based economy. Outsourcing and offshoring, "fundamental drivers of change in labour and the world economy", will be more of a competitive necessity than a strategic advantage in the near future, one that works both ways, benefiting the outsourcing country as well as the host country.

The last speaker was **François Barrault,** President of BT International and another epitome of globalisation: a Frenchman working for a British company with a Dutch CEO located in Brussels. His views on the matter were crystal clear: "Without offshoring and outsourcing we could not have been successful in the past four years." The question of whether globalisation is good or bad, he said, "is totally obsolete". You may like it, you may dislike it, but the fact is "globalisation is there". He sees it as a journey, one that in not yet finished. "We are on that journey and there is no way we can stop it".

With the new business models and possibilities it has engendered, he regards globalisation as a *"new ecosystem that has been created, and we need to take advantage of that".* During the ensuing discussion, he stressed the point further: *"Globalisation calls for observing the dynamics of the world and playing with that, rather than just being a victim."*

Tapani Ruokanen, Editor-in-Chief of *Suomen Kuvalehti,* Helsinki, asked the panellists about the long-term risks of China and India being so different, the one the world's largest democracy, the other a communist country. Mr. Chandrasekaran diplomatically pointed out that progress is being made in China: WTO membership, respect for intellectual property and the like. Mr Barrault added that India and China have different agendas: the one is the back-office of the world, the other the world's workshop. John Whalley, however, warned that although they are two very different countries, it is a mistake

to think of them as separate cases. They have a commonality of interests and are an emerging block of very populous, fast-growing entities.

Mats Hellström, Governor of the County of Stockholm and Chairman of the Swedish Institute for European Policy Studies, said that Sweden's experience with outsourcing to Poland and the Baltics shows that not only profits have increased, but also employment in the mother companies. Still, he sounded a note of warning: if you outsource your core competencies, you might lose the competence to develop your core.

Kristiina Ojuland, Chairwoman of the Committee on European Union Affairs and a member of Estonia's Parliament, remarked on her country being mentioned during the panellists presentations in a positive light regarding globalisation. "One key is taxation policy and a business-friendly environment", she explained. While Mr DiPiazza echoed this strategy ("Tax policies drive the actions of companies"), Mr Sinn warned that low taxes are good, but one must not lose sight of the fact that the state has to finance itself. To this, **Martin Mansergh,** a Senator in the Joint Committee on Finance and the Public Service of Ireland, replied that his country's newish 12.5 percent tax rate maximised state revenues, inflows being now "many thousand percent higher than when the rate was 50 percent". Furthermore, he lauded the success of Ireland's policy of importing workers instead of exporting jobs, which prompted John Peet to wonder whether it was rational for countries such as Germany to keep the door shut to immigration, given that the countries that allowed immigration from eastern Europe seem to have benefited from it.

Panel 2

Europe's answer to the global changes in the division of labour

Keynote Address

Günter Verheugen
Vice President, Commissioner for Enterprise and Industry, European Commission, Brussels

Although I completely agree that the fall of the Iron Curtain inspires the picture of broken levees, I would put it more positively. Exactly two years after the largest enlargement in the history of the European Union, it might be more appropriate to speak about *broken chains.*

As a matter of fact, we are in a position to acknowledge that Europe has successfully addressed the major changes linked to the transition of [a number of] communist countries to democratic and market-oriented members of the European Union. It is a fundamental achievement in terms of politics, economics and civilisation, and has therefore strengthened the European Union.

I have to say, however, that we are not very good at selling our own successes. This is probably one of the major policy achievements in the history of the continent, and we should not allow that populist leaders in some countries use it to tell people that European integration is responsible for the loss of jobs and structural changes in our societies.

On the other hand, it is clear that a stronger European Union with an enlarged, integrated home market is in a better position to cope with the challenges of globalisation. It cannot be taken for granted that globalisation will lead to more growth and jobs for Europe in the future. For the time being it is obvious that we are not losers in global competition. We are winners. I am not sure whether we already have a win-win situation, but this has to be the objective. The objective has to be to create a win-win situation for both sides, an objective that can only be reached if the European economies continue with vigorous modernisation. I will now present the strategy of the European Union, but let me outline first what globalisation means for the European economy.

It is impressive that more than fifty years of increasingly intense international economic integration around the world and in Europe have confirmed what economists have always taught: that increased trade and foreign direct investment promote prosperity and thereby also promote stability, democracy and peace.

History has demonstrated that those countries that try to cut themselves off from globalised markets lose out economically. Most of them are also politically unstable, without well functioning market mechanisms and a tendency to be undemocratic. Since World War II no country has prospered by closing off trade, but there are many, especially in Asia, that have grown rapidly by opening to the world economy.

If we accept the challenges posed by globalisation we will clearly benefit from it, but this is often not correctly perceived within public debates. I would therefore like to address this issue now from the angle of the European Union.

Globalisation has indeed also worked well for the people in Europe, including the less affluent who probably benefit the most from the availability of affordable imports. Conservative estimates for the European economy published in 2005 by the European Commission suggest that about one fifth of the increase in living standards in the EU 15 over the past fifteen years is the result of our integration into the world economy. And there is nothing in the historical records to suggest that this has come at the expense of higher levels of unemployment.

But we also have to acknowledge that in Europe specific sectors such as textiles and clothing and the low-skilled labour force have been negatively affect-

ed by globalised competition. As a result, many people in our high-wage countries see little or no benefit from globalisation. Public perceptions of rising international economic integration are often dominated by anxieties concerning job losses. Fears are running strong that increased import competition from low-wage countries puts too much pressure on local producers and workers and may result in factories being closed at home and economic activities being relocated abroad. This is a very serious political problem and, by the way, one of the most important ones that we discuss between the European Commission and member states.

We in the Commission are of course in an ideal position. We must not defend our position in election campaigns. I know the difference very well and I respect that. The problem is that the benefits of an open and globalised, integrated economy are visible at the regional, national, European levels, but the pain, the suffering is always local. And in particular European, and particularly German politicians, and very particularly regional German politicians, have a tendency to create the impression that they can help in such a case. Like a fire brigade they rush to the place where a factory might be in a crisis to create the impression that they can do something. Very often – even worse – they do something and it does not really help.

The message that we have is very different. Our message is: we have to accept the fact that the market economy is the rule of the game, and the rule of the market economy is *competition*, and if you want to survive in competition, you must be competitive. That is the reason why *competitiveness* is the keyword for the growth and employment strategy that we have in Europe. I will come back to its meaning in a minute.

The available indicators show that the concerns that I have just mentioned are in general exaggerated. The share of the new Member States in the foreign direct investment (FDI) outflows from the old Member States only amounts to 1.5 percent. Old Member States are primarily directing FDI flows toward other old Member States and the United States. But you can believe me that the average citizen in Germany is convinced that German industry is investing more in Poland than in Germany. That is what average citizens believe.

This demonstrates that low costs and taxes do not play dominant roles for the allocation of capital. It indicates clearly that market size, human capital, skills as well as language and culture can play at least equally important roles. A Dutch study suggests that a mere 1 percent to 1.5 percent of the annual job destruction in recent years can be attributed to delocalisation, of which only a part relates to the new Member States. In Germany and Austria investment in the new ten members since the early nineties had only an estimated negative employment impact of between 0.3 percent and 0.7 percent, more than compensated by the fact that both countries, Germany and Austria, are the strongest beneficiaries from the open borders and the fact that neighbouring countries in Eastern and Central Europe are now integrated.

The Commission published a review this week in which we examine the situation, and the result is crystal, *crystal* clear: Enlargement was economically a success, in particular for Germany and Austria, and I expect – or I *request* – that political leaders in Germany and Austria tell it and sell it to the people. I mean, if political leaders in Germany and Austria do not tell the success story, but allow the impression to be created that European integration is responsible for economic problems, then of course we should not be surprised if opinion polls find that the majority of Germans and Austrians believe European integration is after all not such a good thing.

A recent review of existing literature on outsourcing and job destruction confirms our view, concluding that the impact of international outsourcing and delocalisation on employment has been small and, as I have said, has been compensated by better economic integration.

I also want to emphasise that the fear that tax competition would lead to a "race to the bottom" has not materialised, as illustrated by corporate tax revenues that have remained stable in both new and old member states. Notwithstanding that, the European Union as a central part of an increasingly changing and integrated world environment has to face serious economic challenges. The emergence of the "BRICs" – Brazil, Russia, India, China – and other countries as more and more important actors in international trade and investment constitutes a fundamental competitive challenge for the European Union as a whole. Therefore I will now explain our strategy to seize the opportunities of globalisation.

Last year, the European Commission proposed a bold revision of the way we conduct economic reforms in Europe to address the challenges posed by globalisation and demographic changes. We agreed to work together in a partnership between Member States and community level focusing on growth and jobs. The concept of our strategy, which is also called the Lisbon Agenda, lies in insuring Europe's competitiveness and decent environmental and social standards.

That also means the determination to carry out necessary reforms that take into account that economic growth will more and more depend on higher productivity due to the shrinking of the working-age population. The strategy for growth and jobs outlines an integrated framework of macroeconomic, microeconomic and employment guidelines.

The two main instruments to implement the new strategy are the Community Lisbon Programme, setting out what would be best done at community level, and the 25 national reform programmes. Each Member State's policy responds to the key challenges it faces. These instruments must work in tandem to achieve the best effect. And I would like to make you aware that the fact that we have got it, that we were able to bring our ducks in a row and to get 25 national reform plans, is indeed a major, major success, a very important step forward. This is the first time that we have such a policy in the European Union.

Much progress has been made with the Community Lisbon Programme. The Commission has already put forward proposals for most of the actions foreseen. Among its key actions, the Community Lisbon Programme includes initiatives to tackle the decisive cross-border impact of research and innovation and the fragmentation of European research efforts: the Seventh Framework Programme for Research, Technological Development and Demonstration, and the Competitiveness and Innovation Framework Programme.

The Commission has also set out concrete initiatives to improve the research and innovation environment in Europe. The Seventh Framework Programme introduced a new model of research support, joint technology initiatives in the form of public private partnerships, to back promising new research and the give European industry a head start in areas ranging from hydrogen- and fuel-cells, aeronautics and air transport to innovative medicines and nanoelectronics.

We now have twenty-five national reform programmes in place. Each national reform programme sets out to increase investment in research in order to provide more job opportunities for people of all ages, both sexes and all backgrounds, and to reduce administrative burdens on smaller and medium-sized enterprises. As part of the partnership, Member States are learning from each other's experiences. Everybody has something to offer and everybody has something to learn. This is a very interesting case. Whatever you take, you have at least one European Member State, one European region or one European company that is top. Top of the class, top of the world. At least one – always.

What does it mean? It means we can do everything, but not everywhere and not every time. Everybody has something to offer and everybody has something to learn. We can all draw inspiration from our European neighbours. If some neighbours try to keep the ball and play a separate game on their own, then we will all lose. We need a wider partnership among the twenty-five Member States, with the Commission acting as a catalyst and as a facilitator of reforms.

The title of the Commission's report to the Spring European Council says it all: *It is time to move up a gear.* Over the coming months we will work closely with the Member States to assist and monitor the implementation of the national programmes. The Member States and the Commission have committed to focus on four priority actions for growth and jobs:

1) More investment in knowledge, research and innovation. That's the key.
2) Unlocking business potential, especially of small enterprises.
3) Answers to ageing, and creating more employment, and
4) A common European energy policy.

1) Europe's economic future depends on having the best educated and trained people, with the full range of skills required in a knowledge economy. Member States should allow universities access to complementary sources of funding, including private funding, and remove barriers to public-private partnerships with businesses. It is not

acceptable – and really against European pride, I must say – that in the ranking of universities world-wide we only find two European universities among the top ten. This is really something that hurts me. And the two are in the United Kingdom, of course: Oxford and Cambridge, and that hurts me as a German even more.

All Member States have now set research and development targets. If all these targets are reached, the European Union will have increased its overall share of R&D in GDP from 1.9 percent to approximately 2.6 percent in 2010, which is an important step. But definitely not enough. And we are still trying, together with the Austrian presidency, to convince our Member States that the 3 percent target must be met by 2010. And I have to say, even the 3 percent share of R&D spending is not enough to close the gap that is widening between us and the Americans and emerging markets.

2) All the research in the world will not create real wealth without open markets and healthy competition between business. It is often cumbersome to start a business in Europe. EU Member States have welcomed the Commission's proposal to have one-stop shops in place by 2007 and to cut the start-up time by half. In 2010 it should not take more than one week to set up a business. It is important to send out the signal that Europe is a place where it is easy to do business, and, by the way, a place where it is socially respected and accepted to do business.

I do not want to elaborate on this, but I have to say that one of the major problems we have in Europe is a lack of entrepreneurial spirit. If I compare the situation in the United States and Europe, I find that in the United States we have more than twice as many people ready to run a business than in Europe. One can say that is embedded in the genes of the Americans, but it also has something to do with the cultural and social background and the fact that entrepreneurship in Europe is not appreciated enough, so we need to improve that.

Better regulation at the national and European levels is a core element in strengthening the business environment of our economies. Further work is needed to continue to make progress in all areas of better regulation: simplification of legislation, impact assessments, repeals and withdrawals, codification, sector analyses, reduction of administrative burdens, business involvement in smaller and medium-sized enterprises.

The next step will be to present a methodology to measure the cumulative effects of European and national regulations on the administrative costs of enterprises and then to reduce it step by step, setting quantity targets. At first there would be a 20 to 25 percent reduction which is realistic.

The new approach of the Commission is now widely appreciated and widely accepted, but I have to say that less regulation means definitely more responsibility for the stakeholders. Yesterday I announced that we will solve the problem of misleading labelling of sun-screen products, but we will not do it by regulation. In the past, the Commission would have said: "Ok, we will make a regulation". We will no longer do that. I told the industry that we have to solve that. There is a problem and here is a recommendation on how you can do it. And they will do it. You will see – they will do it.

On the other hand, it has to be noted that the Commission's better-regulation activities have already progressed well. Impact assessments have been required since January 2005 for all proposals on the priority list of the Commission's working programme. The Commission has completed over 120 impact assessments to date. They are a powerful tool and can ensure a comprehensive analysis of economic, social and environmental impacts, thus providing key insights into the policy-making process.

Last year, 68 regulatory proposals were withdrawn because they were not compatible with our strategy to support growth and create jobs. We follow the approach of Montesquieu, who stated that bad laws should be avoided, since they would weaken good laws. Furthermore, the Commission adopted a strategy for the simplification of the regulatory environment, which develops a methodology for streamlining and modernising the *Acquis Communautaire* and contains a series of commitments, the most ambitious of which is a rolling programme listing 220 basic legislative acts to be reviewed. Reviewed, and not simplified, only reviewed over the next three years.

3) Globalisation and demographic ageing call for an urgent improvement in the adaptability of workers and enterprises, in their capacity to anticipate, trigger and absorb change and restructuring, and to thrive in highly competitive markets. The Com-

mission is therefore insisting on more open and responsive labour markets in combination with policies to help workers to remain employed and to progress in work. This approach seeks to combine labour market flexibility and employment security in a life-cycle perspective.

As indicated a minute ago, the reallocation of resources due to increased globalisation competition may generate bridges, particularly in the labour markets. Workers have to acquire additional skills and/or to move between jobs, sectors, occupations and regions. There is no way to avoid this and we have to tell the truth: mobility and flexibility are absolutely needed, as change will be with us for the next decades. We cannot protect our citizens from change, we can only manage the change. Against this background, the European Union has recently created the European Globalisation Adjustment Fund in order to provide training for those people who are directly affected by the delocalisation of their enterprise. This also constitutes a contribution of the Commission to the European Social Model.

4) Finally, let me point out the key action of a common energy policy in Europe. Our main challenge is to ensure security of supply at competitive prices, while ensuring environmental sustainability. The energy questions of the 21st century require a common EU response. Therefore the European Commission has proposed a common approach in its Green Paper. It is our intention to further strengthen and deepen the internal energy market in order to promote competitiveness and security of supply. We will promote more competition in the electricity and gas markets. A wide set of measures will be taken to tackle insufficient market transparency and inadequate unbundling of network and supply activities.

Ladies and Gentlemen, I would like to say that in my view the economic stakeholders in Europe have a unique window of opportunity. You will not find in the near future another European Commission that is so determined to improve the business environment, that is so determined to improve the competitiveness of the European industries and that is so determined to defend the policy of open markets.

Contrary to conventional wisdom, especially in some Anglo-Saxon media, there is no backlash in Europe as far as protectionist practices are concerned. On the contrary, what we are experiencing, in the first months of this year, is the strongest wave of mergers and acquisitions that we have ever seen in the history of the European Union. Thousands of actions and hundreds of billions of euros worth, and 99.9 percent of them go without political interference. There are a handful of cases where we have seen political interference. These were mostly related to the fact that the energy market is not completely liberalised, but the Commission took legal action and it is already clear that nobody in Europe is in a position to violate the principle of the freedom of movement of capital. We can and we will guarantee that. And I think there is no danger that protectionist practices will come back.

Rhetoric aside, even in some member states where the rhetoric is different, the policy goes in the same direction. So my view today is slightly more optimistic than it was last year when we started the new process, and I hope, I very much hope, that the partnership proposal that we have chosen will find positive reactions, not only in the political community but throughout the European business community.

Thank you very much for your attention.

Introduction

RICHARD BALDWIN
Professor, Graduate Institute of International Studies, Geneva

Europe's reaction to the challenge of globalisation

Think of globalisation as unbundling, two unbundlings in fact. Since the rise of human civilisation, economic production and economic consumption have tended to be clustered geographically to avoid the cost of moving goods. For example, in the 1970s, we could speak of 'national systems' of industrial competition. German technology and German management was bundled with German capital, and skilled and unskilled German labour to produce German goods, most of which were consumed in Germany. As transportation costs fell, the first unbundling occurred. The market for industrial goods became global and this eroded the tendency for goods to be made close to the point of consumption. European industry became increasingly internationalised; some sectors, such as clothes and shoes, lost out to import competition, but other sectors, such as pharmaceuticals and telecoms won new export sales. This engendered an important reallocation of European labour. Some sectors, especially labour-intensive manufacturing sectors shed labour. Other sectors, especially services and export-oriented manufacturing sectors hired more workers. This might be called the first unbundling – the geographic separation of production and consumption.

More recently, Europe has seen a second unbundling. This unbundling involves the termination of the tendency to group all manufacturing tasks geographically, for example all in one factory. This second unbundling, which has variously been called fragmentation, offshoring, vertical specialisation and slicing up the value-added chain, shares many similarities with the first unbundling, but it differs in many important ways. In particular, it means that the winners and losers from future globalisation may differ from those in the past. In the past, one could speak of winning and losing sectors – the production of simple cotton clothes was a losing sector, while the production of wide-bodied commercial aircraft was a winner. Every worker in the cotton t-shirt industry had to find a new job. The second unbundling, however, does not affect sectors. It affects tasks regardless of the sector. The linchpin difference between the two unbundlings lies in the nature of the trade cost change. In the first unbundling, the most important change was in the cost of trading goods – the nature of the change affected all manufacturing sectors in a similar manner. This is why Europe's more competitive sectors won and its least competitive sectors lost. In the second unbundling, the key change is the drop in the cost of "transporting" ideas, but this does not affect all tasks. Not all tasks can be sent down a fibre optic cable. For example, the rapid fall in telecommunication costs has made it profitable to offshore data-entry tasks to low-wage nations such as India. This became true for data-entry in the German car industry but also for the German ship-building sector – what matters is the nature of the task, not the sector in which the task is done. By contrast, cheap telephone calls and high-speed internet access has done nothing to encourage the offshoring of truck drivers regardless of whether they are working for Nokia or Leyland Motors. More specifically, the second unbundling seems to be affecting tasks that are easily codified and transmitted electronically. These tasks used to be non-traded so the rewards to workers performing these tasks were not linked to the global market – they were set in local markets. This meant that the North-South wage gap in these tasks could greatly exceed the North-South productivity gap (just as was true in the manufacturing sector before the cost of trading goods fell). As these tasks become increasing tradable, i.e. offshore-able, the wage gap will have to shrink and/or the jobs will disappear from Europe.

This alters the identity of the winners and losers from future globalisation. From about 1970 to the mid-1990s, the losers from globalisation were, generally speaking, low-skilled workers while highly educated workers tended to win. Going forward, however, the split may fall not between high- and low-skilled workers, but rather between workers involved in tasks that switch from non-traded to

traded and those that do not. Some low-skilled jobs, for example the task of loading boxes into trucks, will not be affected by the second unbundling, while others, for example phone operators, will. At the other end, some high-skilled jobs, for example the analysis of MRI medical scans can be offshored, while other high-skilled jobs, for example investment banking, cannot since it does not involve a service that can be sent down a fibre optic cable.

The first unbundling has proceeded at a remarkable pace with foreign markets opening up on both the supply and demand side (the key markets being the former Soviet-bloc nations, China and India). For Europeans, these openings created opportunities for both extra sales and for further optimisation of production structures. The second unbundling has come more recently and indeed has not, to date, involved much in the way of job loss or job creation. In these short comments, the first sections consider these opportunities in turn. The subsequent section considers how Europe has risen to the challenges created by these new opportunities.

Opportunity #1: Access to new markets

On the sales side, the opening of Central Europe, China and India has not had a transformational impact on Europe's pattern of exports. It is true that sales to these markets have risen quickly, but the differences are not so great as commonly portrayed in popular debate. The point is made in which shows the share of EU15 exports going to various regions in the world. From 1980 till the present, the lion's share of West European exports have gone to other rich nations, mainly other West European countries and North America. Since 1990, there has been a decline in the share of exports to 'industrial nations', but this has been quite modest. The rising shares have been in Central and Eastern Europe including Russia, and Asia, although Asia's share contracted in the aftermath of the 1997 Asia Financial Crisis and is now recovering.

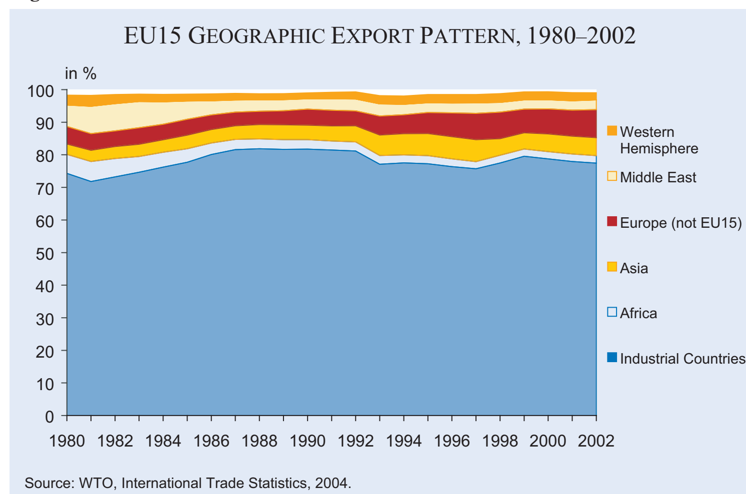
Future income and trade patterns

Although the shift in sales patterns has been modest to date, a few facts and a bit of reasoning suggests that going forward, Europe is likely to see a much more important shift in its export pattern. We start with the Central and Eastern European nations. The ten Central and Eastern European nations that are or soon will be members of the EU are very small economically. In 2004, the sum of their incomes (GDP) was only about 5 percent of EU27 total. Here incomes are measured in euros and not adjusted for local price differences so that they reflect the true purchasing power of these nations when it comes to importing goods from Western Europe. The ten nations' population, by contrast, amounts to about 20 percent of the EU27 total. Since most of the newcomers are growing two or three times as fast as the EU15 nations, the next decades should see the newcomers' market rising in importance as a destination for Western Europe's exports.

The mismatch between population and income is much more marked for India and China, as shows. The chart plots the world share of GDP and population for various regions and nations. The left bar shows the shares of world population. India and China account for 38 percent of the world's population, but only 6 percent of world income. For the EU, US and Japan the imbalance is just the other way around; they account for 70 percent of world income but only 13 percent of world population.

If Indian and Chinese incomes continue to expand at the growth rates observed over the past decade, the two sets of bars will look a great deal more like each other. From the perspective of European exporters this means that China and India are likely to be major sources of growth in future years.

Figure 1



Source: WTO, International Trade Statistics, 2004.

Adjustment to new market opportunities

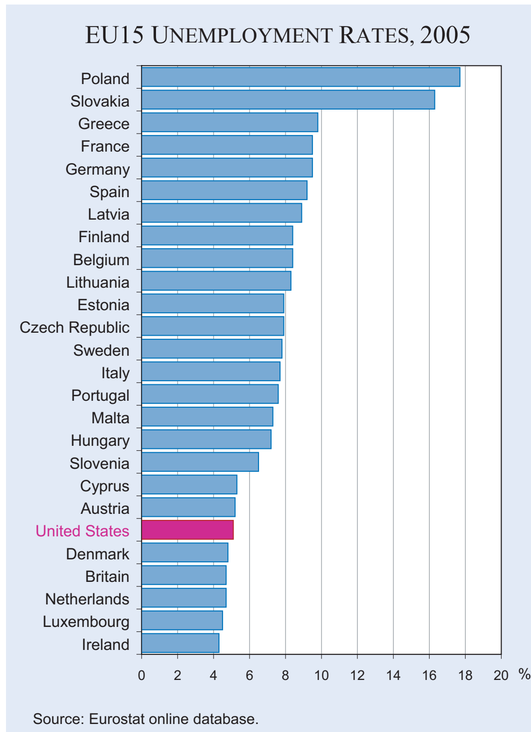
Market opening creates new opportunities. Exploiting these opportunities requires nations to adjust. Adjustment is hard in the real world and this is why globalisation is a topic of concern. Adjustment, in short, is the real topic of this conference. From this perspective it is useful to classify this adjustment into two broad categories:

#1 – Cross-sector specialisation, e.g. expanding the transport equipment sector while shrinking the clothing sector.

#2 – Within-sector specialisation and scale economies, e.g. firms focus on few products and lower costs by raising scale economies.

The first type is typically predominant when the market opening occurs among rich nations that have similar wage structures. The second type tends to be dominant when the integration is between nations with very different income levels and very different wage profiles.

Figure 2



Source: Eurostat online database.

Under both types of adjustment, there are winners and losers. Although the winners win more than the losers lose, the heart of the adjustment question is what the losers lose. The two types of adjustments, however, imply very different ratios of winners and losers. Under the second type, some sectors have to downsize and other sectors have to expand. This will require workers to switch jobs, maybe even move to a new city. Under the first type of adjustment, changes more typically involve a reorganisation within the sector, sometimes even within individual firms.

In the 1960s, 1970s, and 1980s, most of the market opening was among rich nations and so involved adjustment of type #2. This was not easy politically, but compared to recent experience it was a walk in the park. In the 1990s and new century period, most of the market opening has been between rich and poor nations. Much of the adjustment of has been of the #1 type and so very difficult politically.

Low wage, low productivity

The new markets that have opened in to last couple of decades – the former Soviet bloc nations (especially the Central Europeans), China and India – involve nations that are very different from those in Western Europe, at least in terms of per capita income and profile of the labour force. These nations are endowed with a relative abundance of low-productivity, low-wage labour. The point can be seen clearly in . GDP/population is a measure of output per person and income per person since, apart from a few unusual cases, a nation's income equals its output (the unusual cases involve nations that have a significant share of their labour or capital working abroad). From the table we see that average output per person in the ten Central and Eastern European

GDP per person, Central & Eastern Europe, and Russia with comparator nations.

2004	GDP/ Population (US $)	Population (Billions)	Comparator Nation	GDP/ Population (US $)
EU15	32,765	376.7		
CE10	7,106	95.9	Mexico	6,586
Russia	4,021	146.9	Argentina	4,060
Ukraine	1,303	49.9	Angola	1,309
China	1,486	1.30		
India	623	1.07		

Notes: CE10 stands for Central Europe 10 (3 Baltic States, 4 Central European States (where central refers to north-south rather than east-west) and Bulgaria, Romania and Slovenia.

Source: IMF, World Economic Outlook online database.

nations is on par with Mexico, while Russia's average output per person is at the level of Argentina; Ukraine's is close to Angola's. The differences are even more pronounced when looking at India and China.

One point that I would like to stress is the connection between output per hour and wages. As a matter of basic economic definitions, a very low GDP is an indication of very low labour productivity. It may sound harsh, but it is a simple economic fact that poor nations are poor because they do not produce very much per worker. Why this output per hour is low is a complex question. But it is almost surely not a matter of personal attributes but rather a lack of training, poor economic and societal infrastructure, etc. The way the market keeps these low productivity workers employed is by lowering the wage to match the productivity. A key surely is that this wage adjustment can result in a uneven competitiveness of poor nation workers. For example, Chinese managers are not very productive compared to their wages, while manual workers in China have very low unit labour costs despite the fact that their wages are much higher than those in places like Bangladesh. The Table thus tells us that the newly open European markets will tend to have an edge in goods whose production is relatively intensive in low-productivity/low-wage labour. As a consequence, this opening will tend to foster adjustment of type #1.

Opportunity #2: Access to cheaper, eager, well-educated labour forces

The second opportunity that arises from the opening of markets entails international re-optimisation of production. I like to think of this as the second unbundling, although others have called it fragmentation, slicing up the value-added chain, and international production networks. To explain unbundling, consider first bundling. In the old days, say the 1970s, we could speak of 'national systems' of industrial competition. Taking Germany as an example, German technology and German management was bundled with German capital, and skilled and unskilled labour. This bundle competed with other nations' bundles of technology, management, capital and labour.

As often happens when things are bundled and sold as one, the bundling tended to overvalue some elements and undervalue others. In general, the productive factors that were relatively abundant in Germany tended to be undervalued, while the relatively scarce factors got overvalued. In Germany's case that meant that managers and technology were remunerated at below their true value in the world market and German labour got wages above their values.

When the cost of moving goods, people and ideas fell rapidly, the production bundle got undone. This unbundling meant that German managers could organise production of Polish workers using Polish capital and German technology. Or, German technology – embodied in German capital goods – could be used by Chinese managers employing Chinese capital and labour.

This unbundling changed the relative scarcity of the various productive factors in all nations, but here we are especially concerned with what happened in Europe. Before turning to the implications of this unbundling, it is worth noting that the cost of moving people, goods and ideas did not fall in proportion. The cost of moving people, in particular, did not fall anywhere near as much as the cost of moving goods. The basic reason is that although the price of plane tickets fell, the main cost – the time cost of moving people – continued to rise. For example, if a technician takes two half-days for travel per week, his company will have to hire a fifth more technicians to get the same job done that could have been done if the work came to the technicians rather than the technicians to the work. The cost of moving goods fell by more but since oceanic shipping was containerised decades ago, the main evolution has been a big drop in the price of shipping goods by air. Finally, and most dramatically, the cost of shipping ideas – here I am talking about telecommunications of all forms – has experienced a revolutionary reduction. It is easy to cite examples involving the internet, but I think the example that hits home best with modern managers concerns telephone calls. Just two decades ago a 'long distance' call was something important, especially if it was trans-Atlantic or even further. Long distance calls had to be booked, managed and kept short. Today, I see managers often making a few calls in the time its takes them to get off the plane and into the air terminal; judging from the languages, many of this are long distance and judging from the side of the conversation I can hear, they most definitely are not booked, managed or kept short!

The different drops in the cost of 'trading' people's time, goods and ideas goes a long way to explaining the particular pattern of unbundling that we have seen. In both Europe and East Asia, complex supply networks have been set up where a good (or its various parts and components) crosses international borders several times before finally being shipped to customers. That is, goods are doing a lot more moving than people. Moreover, ideas are doing even more moving and this has made it conceivable to organise and manage complex cross-nation production networks.

Again taking Germany as an example, we can think of the 'old days' situation as one where the relatively abundant factors (relative to world supplies that is) were 'exploited' by the relatively scarce factors. For example, in the 1970s, automobile technology was relatively abundant in Germany compared to the world at large and German factory labour was relatively scarce by world standards. Since the only way to exploit German auto technology on the world market was to combine it with German labour, German technology tended to earn less than it would have and German factory labour tended to earn more than it would have. When improvements in telecommunications and shipping (especially air transportation) made it feasible to produce some automobile parts abroad, the demand for German technology and management rose while the demand (from the auto sector) for German factory labour fell.

Challenge #1: Reallocating productive factors in the face of rigid labour markets

Globalisation provides nations with new opportunities. The economies of well governed nations can seize these new opportunities to improve the well-being of citizens. As already mentioned, new opportunities of almost any type create winners and losers. To put it starkly, each job that is offshored is an opportunity for Europe to allocate its labour more efficiently. To think this through, consider why the job was offshored in the first place. The job is offshored because the European worker's productivity edge over his or her replacement in, say, India, does not justify the Europe/India wage gap. This is not true for all jobs. The same cannot be said of, for example, German auto workers. German auto workers earn far more than Malaysian auto workers, but they are also far more productive. Indeed, if it were not for Malaysian trade barriers against cars, German-made cars would be extremely competitive in the Malaysian market. In short, the German-Malaysian productivity gap more than compensates for the German-Malaysian wage gap in the automobile industry. Since the productivity gap does not compensate for the wage gap in offshored jobs, it stands to reason that labour will be more efficient when it is reallocated to another task.

It is exactly this reallocation that causes all the problems. One colloquial way of putting it, is to say that job offshoring is good for society as a whole, but you would not want your sons and daughters to find themselves performing tasks that were to be offshored. This is where government comes in. Good governance is required to ensure that society as a whole supports the changes that are necessary to exploit the new opportunities. In some sense, good government is like a pre-signed contract that ensures most members of society that the pains and the gains of the changes will be shared. Since all know about the sharing, the nation can muster a political consensus to embrace the new opportunities.

One approach to these challenges is the one adopted by US society. There, a majority of citizens firmly believe that the basic notion should be sauve-qui-peut, i.e. that it is the individual's duty to adjust to changes so the government largely leaves individual workers to their own devices. European societies do not accept this approach and so have implemented the so-called social market economy. This entails massive programmes that insure all workers against adverse developments – whatever the cause (globalisation, aging of the population, technological change, etc.). These programmes come in many forms. The basic pillar is income support that ensures a minimum living standard for all members of society regardless of their employment status and earnings. But in some European nations, the state's intervention into the economy is far more extensive, including active re-training programmes, state-paid education and the subsidisation of specific economic enterprises.

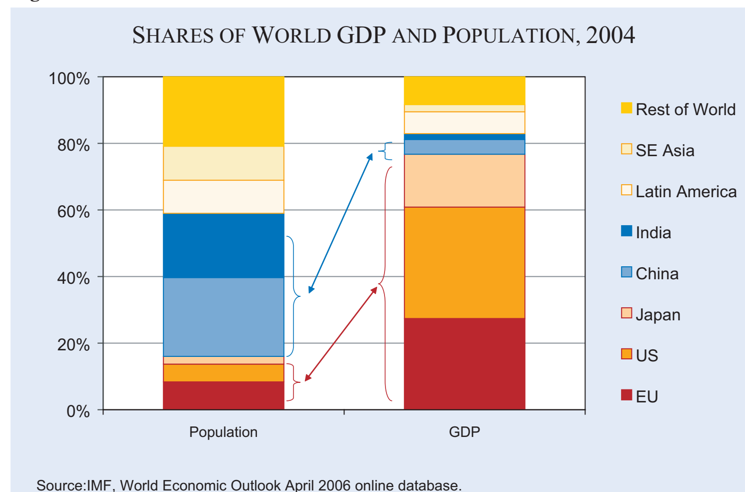
When it comes to the challenge of reallocating labour to take advantage of the opportunities posed by globalisation, it is important to distinguish between two types of income insurance – employment protection legislation (i.e. laws that make it hard to fire workers) and employment insurance (programmes that replace part of a worker's earn-

ings when he/she loses his/her job). In a nutshell, employment protection laws tend to hinder adjustment while employment insurance tends to foster adjustment. Another important element in a nation's ability to reallocate labour is its labour market institutions. In nations where labour market institutions are either very loose or very centralised, adjustments can occur easily. In the unstructured labour markets, say Britain's, workers and firms come to terms with each other. In nations with highly centralised labour markets, like Sweden, everyone feels responsible and it may be possible to agree on major changes. The nations with in-between labour markets, such as France and Germany, find it much harder to make adjustments.

The results of these different policies can be seen in the widely varying unemployment rates in the EU15 shown in . While European unemployment is high overall – over 8 percent for the EU15 – several European nations have unemployment rates that are below that of the United States, namely Britain, the Netherlands, Denmark, Ireland and Luxembourg. Indeed, the high European unemployment stems from Germany, France, Italy, and Spain, but even among these, the performance over time has varied enormously. For example, Spain's unemployment rate has fallen from over 20 percent in the 1990s to under 10 percent today. Germany's unemployment rate in contrast is up from its low pre-reunification level, and shows sharp regional differences between the West and the East.

As Blanchard (2005) argues, the high unemployment rates reflect a failure of the labour market to encourage the reallocation of labour between sectors. To see this, note that Europe's labour market is a very dynamic place, there is a great deal of hiring and firing of workers. 1.5 percent of all jobs are destroyed in France *each month* and roughly as many are created. This is about the same as in the United States. Moreover, workers leave jobs even when the job is not destroyed; about 4 percent of workers leave their jobs per month as demonstrated by Cahuc and Zylberberg (2004). Given this high job turnover, the process of matching workers and jobs becomes critical. In Europe, especially in the large Continental nations, government policies and labour market institutions have slowed down the process. Workers and firms are taking their time to find matches. In European nations with better run labour markets, the matches happen faster, so workers spend less time on the dole between jobs. The result is a lower unemployment rate.

Figure 3



Concluding remarks

This short discussion of a complex topic ends with two observations on policy changes. The first is in no way novel, the second somewhat more so.

European societies do not accept the US model where individuals bear the brunt of both the pains and the gains of globalisation. European voters consistently reject politicians who push the US model of market economics. In short, European voters are willing to pay for the social harmony that comes with the social market model. While this holds true straight across Europe, the burden of sharing the pains and gains is quite different. In some European nations, institutions and policies have resulted in over 10 percent of the workforce on the dole. This implies a high cost to taxpayers in terms of transfers, but it also means an important loss in national production. In Denmark and Holland, voters also vote for social policies but they have arranged the labour market in a way that reduces the pure waste of having so many workers idle. The challenge for politicians in Italy, France and Germany is to convince their voters that there is no contradiction between caring and reforming labour markets in a way that gets people back to work more quickly.

The second comment concerns European governments' reaction to the second unbundling. Much of Europe is embarked on the Lisbon agenda that is supposed to push Europe towards the information society. While this sounds like a good idea from the perspective of the first unbundling – after all it seems to be pushing Europe's resources towards the 'winning' sectors – it may be less of a good idea in the face of the second unbundling. Many of the jobs in the information society are today non-traded and thus may seem like good jobs, safe jobs. But many of these jobs involve services that can be sent down a fibre optic cable and thus are subject to new competition from abroad. Of course, this new opening due to lower costs of trading ideas constitutes an opportunity for Europe as a whole, but seizing the opportunity will require a reallocation of labour. Thus it might not be prudent to embark on large projects to train European workers to do jobs whose existence is likely to be temporary. More generally, one can say that the impact of the second unbundling is far less predictable than that of the first unbundling. The simple reason is that no one really understands what sort of jobs can be or will be offshored. The lesson stemming from this suggests that Europe might want to focus its education and training on encouraging workers to acquire skills that make them more flexible and able to learn new tasks. Moreover, it is not at all clear that more education is a way of ensuring that a larger fraction of the workforce is in the winners' category. The second unbundling seems to be especially prevalent in office jobs, many of which now require higher education.

References

Blanchard, O. (2005). "European Unemployment: The Evolution of Facts and Ideas," Paper presented at the October 2005 Panel of Economic Policy.

Cahuc, P. and A. Zylberberg (2004). *Labor Economics,* MIT Press.

Panel

In addition to the above speakers, the panel, which was chaired by **Michael Ackermans,** Editor-in-Chief of the Dutch weekly, *FEM Business,* consisted of four business representatives:

Anton Kathrein is Managing Partner and Owner of Kathrein-Werke KG, the largest producer of antenna system technology, worldwide. He explained how his German-based company has managed to remain an industry leader with world-wide distribution and a high investment rate in R&D. Kathrein had ties to Eastern Europe before the fall of the Iron Curtain and now produces in Romania and the Czech Republic, where it has achieved the same product quality standards as in Germany. Currently, his company's R&D is all in Germany, but some of this will also eventually go offshore.

Kulpreet Singh is an Indian national working as general manager of the UK and Europe Division of the US corporation, EXL Services, an outsourcing specialist in the banking, financial services and insurance sector. He described his task which is to create more value for companies by helping them rediscover what initially made them successful and to examine what functions need to be outsourced or offshored. He maintained that companies that properly assess the risks and rewards of outsourcing stand to benefit from more value creation.

Klaus J. Jacobs is Chairman and Chief Executive Officer of Adecco SA, an international human resources services company based in Switzerland. He made the following suggestions for keeping Europe's industry competitive: 1) manage the transition from school to work to prevent young people from falling into unemployment; 2) encourage life-long learning involving an investment of at least two weeks a year in competence building programmes; 3) initiate programmes for elite interdisciplinary education at the universities to retain Europe's best brains for know-how development and research; and 4) introduce compensation programmes to increase commitment to longer work.

Lars Pettersson is President and Chief Executive Officer of Sandvik AB, a Swedish high-tech engineering group with business activities in 130 countries. Ninety-eight percent of his company's sales is outside Sweden. The growth of Sandvik is also much faster outside than inside Europe. He maintained that Europe's productivity is too low, its educational system needs improving and its immigrants must be better integrated. "We must face the fact that Europe is the laggard and try to understand why. The longer we wait, the bigger the problem will become," he emphasised.

Panel 3

CHALLENGES FOR EUROPE'S POLITICAL INSTITUTIONS AND SOCIETY

Introduction

DONALD R. DAVIS
Professor, Columbia University, New York

Something there is that doesn't love a wall: An american perspective on the economics of immigration

Something there is that doesn't love a wall,
That sends the frozen-ground-swell under it,
And spills the upper boulders in the sun,
And makes gaps even two can pass abreast.
Mending Wall, Robert Frost

Robert Frost's poem, *Mending Wall*, popularized the proverb "Good fences make good neighbors." Yet this phrase fails to capture the richer imagery of fences and neighbors in Frost's words. The poem treats the case of two New England farmers walking a stone wall between their fields to repair Winter's depredations. It begins with the observation "Something there is that doesn't love a wall." Of course, for Germans and for Europeans, the observation that even the greatest wall is fragile is not news. My aim is to use the framework of economics to illuminate the forces that tear walls down and to consider these in the United States context, with the hope that there are useful insights beyond the US context.[1]

One of Frost's farmers suggests, impishly, that the walls are torn down by elves. In our world, elves are replaced by the invisible hand of trade, cross-country investment, and immigration. It is the last of these forces – immigration – upon which I will focus my attention. Of course, immigration itself responds to various motives, including security, freedom, and economic gain. Again, it is the last of these – the *economics* of immigration – to which I will attend.

The deceptively simple economics of immigration

On the surface, the economics of immigration could not be simpler. Immigrants move in order to earn the high wages available outside, but not inside, their country. That much is straightforward. However, if we want to understand the economic consequences of this migration, we are obliged to be more explicit about *why* wages differ.

Immigration: The Labor Shortage Model

In the context of immigration, educated public discussion of why wages differ across countries is overwhelmingly, nearly exclusively, dominated by a single framework – one we can call the labor shortage model. That is, wages are high in the countries that receive immigrants because labor is scarce there.[2]

The labor shortage model of immigration has many merits. It is thoroughly intuitive to anyone who grasps the elements of demand and supply. It yields interesting predictions about gains and losses for the world as a whole and for natives of each country, as well as providing a provocative perspective on the political economy of immigration.

In its most conventional form, immigration in the labor shortage model has the following consequences:

- World income rises by a *large* amount if the initial wage gap is large – the invisible hand is at work!
- In the country receiving immigration:
  – Natives of the receiving country, taken together, receive a *small* gain in total income.

[1] A Google search of *Mending Wall* and immigration will find many hits. It is unfortunate how much emphasis has been placed on the role of fences in neighborliness; Frost's actual point seems to the contrary. His narrator notes: "Spring is the mischief in me, and I wonder/If I could put a notion in his head:/'Why do they [fences] make good neighbors? Isn't it/Where there are cows?/But here there are no cows."

[2] Very interesting surveys of the labor literature on immigration can be found in Borjas (1994, 1999) and Lalonde and Topel (1997).

– There is a *large* redistribution of income away from labor (e.g. toward owners of capital). Wages fall.
- In the country that is the source of the migrants:
– Natives of the source country, when we include the migrant in the calculation, receive a *large* gain in total income.
– Those natives left behind, taken together, suffer a *small* income loss.
– There is a *large* redistribution within the source country toward labor (e.g. away from owners of capital). Wages rise.

The emphasis on the impacts that are large versus small is quite important. The effects on wages and internal income distribution suggest that labor should favor immigration in the low-wage source country, but oppose it in the high-wage destination country. Vice versa for owners of capital. And these should be relatively robust. The fact that aggregate gains in the receiving country are small and likewise for those staying behind in the source country suggests that other factors could dominate these effects. Just as an example, the net fiscal costs of immigration (positive or negative) could swing the aggregate impact on a country in either direction.

We should emphasize one additional important aspect of the labor shortage model – an aspect that at first seems counter-intuitive. If the country receiving the immigration is to receive gains in the aggregate, it is essential that immigration lead wages to fall there. As noted, this seems counter-intuitive, since falling wages would seem to be a source of loss for the receiving country, not gain. The paradox is resolved by recognizing that the falling wages imply that the labor flowing in captures less than all of the gains in income these flows create. Native workers of the receiving country do experience losses as their wages fall. But this is then more than compensated by the increased income of other factors in the receiving economy.

The labor shortage model of immigration has many merits. However it also has a serious shortcoming: It is at best incomplete and may even miss the central story of immigration. To understand why, we need to probe just a little deeper into the labor shortage framework. As conventionally developed, the only dimension in which source and destination countries differ is in the relative availability of labor. Because of this, the high wage paid to labor translates to low returns to some other productive factor in the economy (e.g. capital, land, or a grade of labor other than that considered as migrating). If labor wants to enter because of unusually high wages, some other productive factor has to want to leave because of its own unusually *low* returns.

The labor shortage model, taken alone, flies in the face of the facts in the United States case. The United States is an importer of unskilled labor, but it is also an importer of skilled labor and capital. Moreover, were it free to move, the United States would also almost surely be an importer of land! It seems implausible on its face that the United States has a shortage of skilled labor (of which it is an importer). The labor shortage model, by itself, cannot explain why all factors want to move to the United States. To explain this, we will have to turn to alternative models. Importantly, the economic consequences of these alternative models are quite distinct from those of the labor shortage model.

Immigration: Alternative models of technology and scale

The labor shortage model is at best incomplete and quite possibly misses the central factor motivating economic migration – the *technological advantages* of advanced economies that are the likely cause of wage differences. This alternative perspective on the roots of migration matters because the economic consequences of migration can be quite different when this responds to technological differences rather than labor shortages. If all factors are more productive in some countries than in others, then this productivity advantage could explain why the returns to all types of labor and to other factors is higher there, hence invite inflows of all factors from abroad. For the moment, we will ignore *why* some countries are more productive than others – the higher productivity could reflect technology per se; business organization and culture; returns on infrastructure; political institutions; public health conditions; or other factors. These need not concern us (although these questions are certainly important!). However, we will need to discuss two cases, which turn on whether or not the *scale* of the economy itself affects productivity.

We consider this first within the simplest possible framework, one essentially identical to that in which David Ricardo demonstrated the Law of Com-

parative Advantage.[3] Here scale per se does not affect productivity. Consider two countries, England and Portugal, producing two goods, cloth and wine. For simplicity, let England have an absolute (as well as comparative) advantage in the production of cloth, and similarly let Portugal have an absolute (as well as comparative) advantage in the production of wine. Suppose that the technological superiority of England in the production of cloth (combined with adequate world demand for cloth) leads English wages to exceed those in Portugal under free trade. Then, other considerations aside, Portuguese labor would have an incentive to migrate to England.

If such migration is allowed, who gains and who loses? In parallel to our earlier discussion in the labor shortage model, we can answer this for a *technological advantage* model:

- World income rises by a *large* amount if the initial wage gap is large – the invisible hand is at work!
- In England, which receives immigration:
  – The real income of English workers falls for sure.
- In Portugal, which sends migrants:
  – The real income of Portuguese workers (including migrants) rises for sure.

It is worth looking closely at both similarities and differences in the consequences of migration in comparing the *labor shortage* and *technological advantage* models. Note that both models suggest that migration raises income for the world as a whole. Adam Smith would have asserted the influence of the invisible hand. Robert Frost would have noted "something there is that doesn't love a wall" – viz. wage differences! However the two frameworks differ sharply in how the gains to world income from migration are shared between the source and destination countries. In the labor shortage model, natives of the receiving country do gain in the aggregate, even if those gains are small. In the technological advantage model, natives of the country whose technological strength initially gave it high wages have large *losses* from immigration. One can think about the source of those losses from a variety of perspectives. A first perspective is just demand and supply. As Portuguese labor flows in, English production of cloth expands and Portuguese production of wine diminishes, reducing the price of cloth in terms of wine and dragging English wages down. Alternatively, one can note that England's initial high wages are tied to its posited technological advantage in cloth. In effect, England initially has a monopoly access to the good technology for cloth which is eroded as Portuguese labor flows in and uses this technology. England's losses, from this perspective, come from the loss of monopoly access to a superior technology.

The contrast between the labor shortage and technological advantage models of migration are thus quite sharp. The labor shortage model suggests that migration is like trade – natives of both countries gain. By contrast, the technological advantage model suggests that this is quite misleading – that while migration raises world income, more than all of this gain is captured by natives of the source country and natives of the country receiving immigration actually lose.

We return for a moment to consider the role of scale in the technological advantage model. Thus far we have assumed that as labor flows to England, the productivity of the English cloth industry is not changed (although the terms at which cloth is traded for wine decline). One could consider instead the possibility that by expanding the scale of the English cloth industry, immigration may actually raise productivity. As Adam Smith noted, the degree of division of labor is limited by the scale of the market. At least in principle, the inflows of migrants, even in response to technological advantage, could so raise productivity in English cloth that English wages rise in spite of any decline in terms of trade. In addition, if the inflows lead to the introduction of new varieties of cloth, it is possible that the terms of trade losses that are the source of English woes may be muted or non-existent. This would be consistent with the models of economic geography that Paul Krugman and other have championed in recent years. We return to these questions in the discussion of what economists have done to examine these issues in the data.

The impact of immigration in the data

In this section we will discuss selected empirical work that seeks to understand the economic impact of international migration. This is overwhelmingly focused on the labor shortage model. We will also summarize an empirical project examining the consequences of considering this instead from a technological advantage framework.

[3] Both Findlay (1982) and Trefler (1997) comment on the losses in the receiving country from immigration in a classic Ricardian model, although neither tied this to the many-factor case of our own world or contemplated the United States as such a case.

Immigration in the data: The labor shortage model

Some of the early empirical work on the impact of immigration on wages in a labor shortage framework had a surreal quality. Let me use an analogy. Suppose we were interested in whether dumping an elephant into a pool would raise the water level. With suitable coaxing, we get the elephant to launch into the pool. Then we employ the following methodology. We use extremely precise instruments to examine the question of whether the water level is higher in the area of the pool into which the elephant has been launched than it is in other areas of the pool. If we find that the water is not significantly higher (in the statistical sense) in the area of the pool where the elephant sits than in other areas, we conclude that the elephant had no impact on water levels. This is scarily similar to a great deal of the early literature on the economic impact of immigration. That literature looked at whether wages were unusually low in areas where immigration was particularly concentrated. Most studies could find little impact of immigration (*qua* elephant) on the labor pool. The list of reasons why this might be true is legion, *inter alia* the possibility that there might be accommodating labor outflows, capital inflows, or changes in the composition of production.

More recent work in a labor shortage framework, particularly by George Borjas, has made important adjustments. Rather than look for impacts in local labor markets, where these can easily spill over to other labor markets, it looks for a national impact. In addition, rather than look for impacts on broad classes of labor, it stratifies those labor classes as well by years of experience, on the premise that within a class of labor those with similar levels of experience are closer substitutes. This is also important because immigrants are not evenly distributed across cohorts within each labor class. The main result of this work is that it is possible to identify a significant impact of immigration in lowering wages. While this is clearly bad news for labor that competes head to head with the immigrants, remember that such wage declines are also the *necessary* condition in the labor shortage model for the country receiving immigration to experience *aggregate* gains in income.

Immigration in the data: The technological advantage model

Countries differ tremendously in their aggregate productivity and indeed this is almost surely the main reason that wages differ across countries, hence also a prime reason for migration. When considering the US case, it is a net importer of unskilled labor, in which it is plausibly scarce. But it is also an importer of highly skilled labor, in which it is not plausibly scarce. It is also a major importer of capital. The advantages of highly productive technology provide a simple explanation for these coordinated movements.

We saw that the simplest model of migration based on technology differences and a single factor ("labor") yielded losses for the destination country. The same point goes through just as before if it is legitimate to think of all factors moving into the United States proportionally. Davis and Weinstein (2002) focused on the consequences of such coordinated inflows and showed that inflows at a single common rate is surprisingly close to what actually happened. In 2002, fully 14.3 percent of the US labor force was born outside the country while capital inflows accounted for 16.5 percent of the US capital stock. Roughly, the inflows of the two combined made the US economy 15 percent larger than it would otherwise have been.

We have indicated before that the consequences of such growth depend on the resulting impact on the terms of trade. Acemoglu and Ventura (2002) provide exactly the kind of exercise that is necessary to make sense of this. They started out with the observation that, although different countries had very different growth rates over long stretches of time, the world income distribution remained quite stable. Their explanation was that countries that grew faster suffered terms of trade losses passing part of their gains to the rest of the world. But this also provides the kind of estimates Davis and Weinstein needed to calculate the losses from migration. Davis and Weinstein estimate the costs of these inflows in two ways. One treats the United States as producing a composite good to which the inflows of labor and capital contribute. The other disaggregates and looks at the impact of these inflows (which are not precisely proportional across all categories of labor) on the composition of output. The calculations suggest that the aggregate cost to the United States in 2002 was between $50 and $100 billion.

Immigration in the data: Alternative models

Recently Gianmarco Ottaviano and Giovanni Peri (2005) developed a third approach. Their work

focuses on two main ideas. One is that foreign labor substitutes imperfectly for US labor, both across and within labor classes. Across labor classes, there is less than a perfect match between the proportions of foreigners in the labor force and that of US natives. Within a labor class, the foreign worker may bring unique skills that are complementary (rather than substitutable) to those of native workers. The second idea is that the inflows of labor may stimulate the accommodating accumulation of capital that keeps wages from falling.

This line of work seems promising and we will only note some caveats. The endogenous accumulation of capital that they appeal to as helping to hold wages up is not always a positive. As stressed in the technological advantage discussion above, this accumulation (from sources at home or abroad) could make the receiving country's output relatively abundant in the market, which could then depress its price (also limiting the extent of the accumulation). A second caveat comes from a recent study of Borjas (2006), who looked at the impact of immigration to the United States in high skill labor markets on the wages of participants in those markets. One might imagine that the high skill market would be precisely the kind where the novel ideas of foreign workers might give rise to complementarities with their counterpart high skill natives. Borjas finds instead that a 10 percent increase in the supply of foreign high skill workers depresses the wages of high skill US counterparts by 3 to 4 percent.

Conclusions

Even as we write, the United States is going through a convulsive discussion of the future of immigration. The President, Senate, and House are in a dance over legislation that could greatly affect the estimated 11 million immigrants in the United States without documentation. Meanwhile an immigrants rights movement has emerged with great power and vehemence. Some elements of that movement are using the traditional May 1 worker celebration for a day of economic boycott to demonstrate the power and importance of immigrant workers.

The jury is still out on the economic impacts of immigration. Even the more negative view of the aggregate impact on the US economy, as developed in Davis and Weinstein (1992), is ultimately not of overwhelming magnitude. The losses considered therein are almost surely dwarfed by the gains reaped by the immigrants themselves. In this respect, maintaining relative openness to immigration may well be the largest form of overseas assistance the United States engages in. While contested, right now the evidence seems to suggest that there really are some significant losses for specific groups that compete most closely with immigrants, particularly unskilled workers. However, given the stakes for the immigrants themselves, it is not clear that limits on immigration are in any way a preferred mode of support for this group. There may be many more direct paths that can be taken.

The recent events in the United States, like those earlier this year in Paris and beyond, have underscored that the issues at stake are economic, but they are also much more. They are about social inclusion. They are about opportunity. They are about helping peoples in our midst to see a path forward to becoming full members of our societies. Near the close of his poem "Mending Wall," Frost writes:

"Before I built a wall I'd ask to know
What I was walling in or walling out,
And to whom I was like to give offence."

References

Acemoglu, Daron; Ventura, Jaume, "The World Income Distribution," *Quarterly Journal of Economics*, May 2002.

Borjas, George J (1994) "The Economics of Immigration," *Journal of Economic Literature*, vol. 32, no. 4, December 1994, pp. 1667–1717.

Borjas, George J (1999) »The Economic Analysis of Immigration,« in *The Handbook of Labor Economics*, Volume 3A, edited by Orley Ashenfelter and David Card, North-Holland, pp. 1697–1760.

Borjas, George J (2003) "The Labor Demand Curve Is Downward Sloping: Reexamining the Impact of Immigration on the Labor Market," *Quarterly Journal of Economics*, vol. 118, no. 4, November 2003, pp. 1335–74.

Borjas, George J (2006) "Immigration in High-Skill Labor Markets: The Impact of Foreign Students on the Earnings of Doctorates" *NBER Working Paper Series*, # 12085, March 2006.

Borjas, George J, Richard B. Freeman and Lawrence F. Katz (1997) "How Much Do Immigration and Trade Affect Labor Market Outcomes? *Brookings Papers on Economic Activity*, 1997, pp. 1–67.

Davis, Donald R; Weinstein, David E, "Technological Superiority and the Losses From Migration" *NBER Working Paper Series*, # 8971, June 2002.

Findlay, Ronald (1982) "International Distributive Justice: A Trade Theoretic Approach," *Journal of International Economics*, vol. 13, no. 1–2, August 1982, pp. 1–14.

Hendricks, Lutz, "How Important is Human Capital for Development? Evidence From Immigrant Earnings," *American Economic Review*, vol. 92, no. 1, March 2002, pp. 198–219.

Lalonde, Robert J; Topel, Robert H., "Economic Impact of International Migration and the Economic Performance of Migrants," in Rosenzweig, Mark R; Stark, Oded, eds. *Handbook of population and family economics*. Volume 1B. 1997, pp. 799–850, New York: Elsevier Science, North-Holland.

Ottaviano, Gianmarco and Giovanni Peri (2005) *NBER Working Paper Series*, # 11672, October 2005.

Trefler, Daniel (1997) "Natives and Immigrants in General Equilibrium," *NBER Working Papers* #6209, October.

Panel

Also represented on the panel, which was chaired by **Robert Thomson,** Editor-in-Chief, *The Times,* London, were personalities from politics and business.

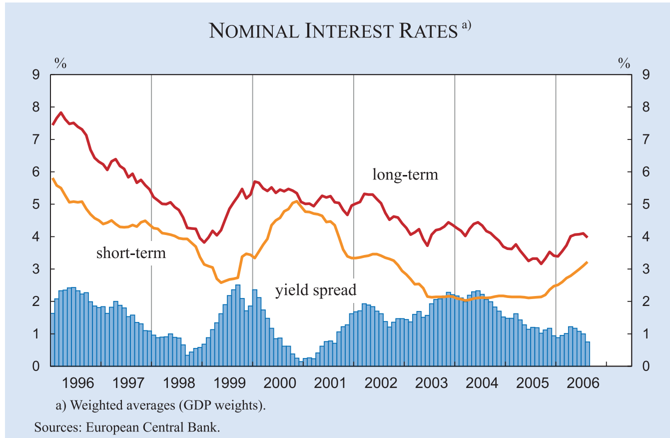
Martin Bartenstein, Austria's Federal Minister of Economics and Labour, represented the country that has gained more immediate neighbours from European enlargement than any other EU country. It was encouraging to hear him say that his country is a clear winner of EU enlargement with an additional 3.5 percent of GDP and a net gain of 77,000 jobs. Austria is also the largest investor in Slovenia, Romania, Bulgaria, Croatia, Serbia and Bosnia and the number three investor in Hungary, the Czech Republic and Slovakia. He emphasised that enlargement has also benefited Europe as a whole: the income gap between the old and new members has narrowed, and the new members have provided additional growth dynamics to the European economy. In addition, the national reform programmes for the second phase of the Lisbon strategy are all in place – Europe is moving in the right direction but must remain on course.

Didier Lombard is Chairman and Chief Executive Officer of France Telecom, a company active in more than 200 countries. He observed that EU Enlargement has given his company greater access to managers in the new member states, whose new, dynamic management culture is making an important contribution to France Telecom as a whole. In his opinion, one way to counter the wide-spread insecurity regarding the future is by stepped-up, product-based research and investment. His company would also benefit if the EU provided a new framework for competition. Rules on competition adapted to the world in which we are living would considerably improve the investment climate. Finally, he advised politicians to avoid talking about "big reforms", which helped trigger the recent strike over the First Employment Contract (CPE) legislation in France. Step-by-step changes without using the "reform" label may be the better course of action.

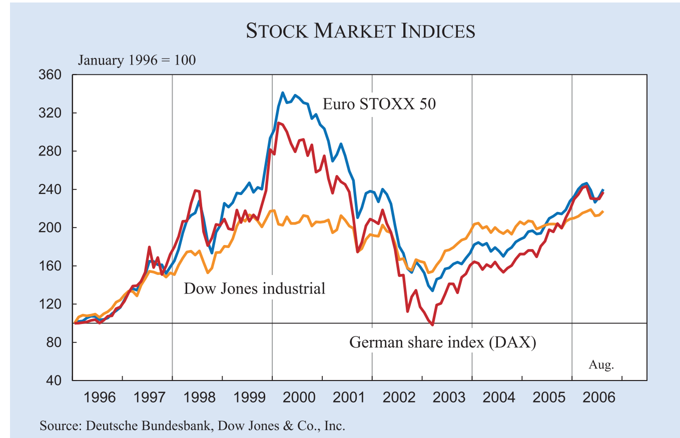
Günther H. Oettinger, Minister-President of the state of Baden-Württemberg since April 2005, identified new areas that call for action as the result of European enlargement and globalisation. He sees a critical problem in the state of education: too many children are not prepared for occupational training; too many students are not preparing themselves for the jobs of tomorrow. Research and innovation is not receiving the necessary support in Europe. Germany in particular needs more market incentives in the areas of infrastructure, education and health. In his view, it is also problematic that the voting population is not fully aware of the difficulties we are facing. Angela Merkel lost the election and had to form a coalition government with the Social Democrats because she was relatively honest with the voters on the issue of taxation. "In all the large economies in Europe, the problem is not only a failure to act but also a lack of awareness", Oettinger concluded.

James W. Robinson is Senior Vice-President of the US Chamber of Commerce. His organisation is currently producing a booklet on the benefits of global engagement, immigration and trade. He stressed that it is vital to influence public opinion on this point, especially to counter the current backlash on the issue of immigration in the United States, for which there are no compelling macroeconomic reasons. He proposed four ways to meet the challenges of immigration: 1) Create a path of economic mobility and social advancement through small business entrepreneurship and job creation. Here the U.S. is leading the way with small businesses owned by women and minorities being created at twice the rate of business start-ups in the economy as a whole. 2) Continue to reduce commercial barriers and other impediments to global growth. This is the only way to correct income inequalities in neighbouring countries and to reduce migratory pressure. 3) Access to quality education at all levels is fundamental to creating a level playing field for all individual and communities within our societies. Expanded access to education, more than any other single factor, has helped blur the lines of class, race, sex and ethnicity in the U.S.. The failings of many schools today is a recipe for disaster in a knowledge-based economy. 4) A definition of citizenship is needed that balances national identity with cultural diversity. An open society will not be afraid to ask all residents to play by the rules, obey the law and work together for the betterment of their country.

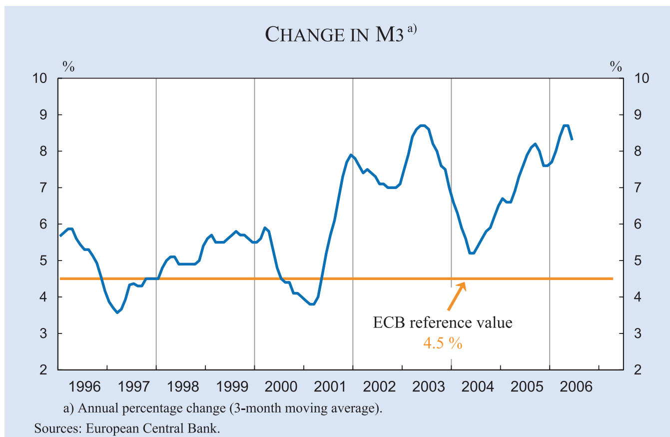
FINANCIAL CONDITIONS IN THE EURO AREA



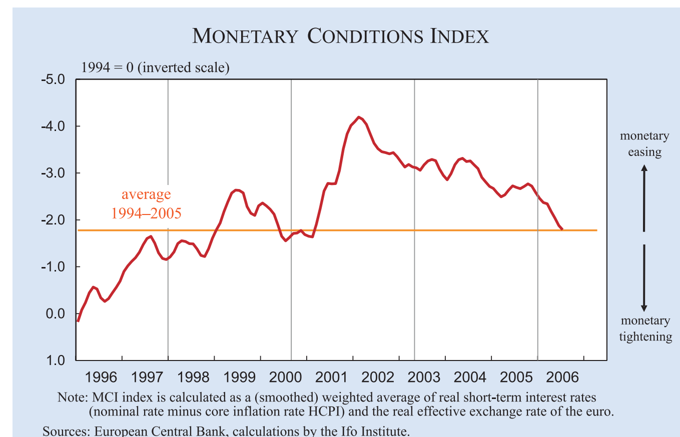
On 3 August 2006, the ECB raised its key rates by another 25 basis points. As a consequence, the three-month EURIBOR rose to an average 3.22% in August. Ten-year bond yields averaged 3.97%, a decline from 4.10% in July. The yield spread shrank to 0.75 points.



The German stock index DAX had peaked in April averaging 6,009 points, but declined through July. In August it recovered to an average of 5,859. The Euro STOXX followed the same pattern, averaging 3,841 in April and 3744 in August. Compared to the performance of these two European indices, the Dow Jones Industrial continued its upward trend with a dip in June, averaging 11,257 in August.

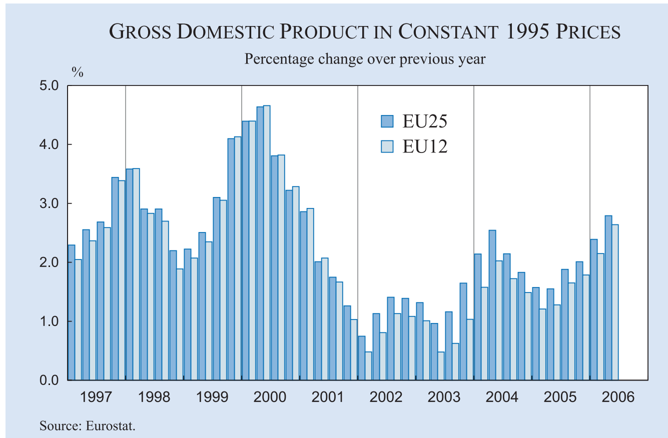


Monetary growth remained high in the first half of the year. In the second quarter 2006 annual M3 growth rose to 8.7% after 7.9% in the first quarter, marking the highest rate of growth since mid-2003. In the last two months, however, there has been a slight slowdown from 8.8% in May to 8.5% in June and 7.8% in July. The three-month moving average of the annual M3 growth rates over the period from May 2006 to July 2006 declined to 8.3% from 8.7% in the previous three-month period.

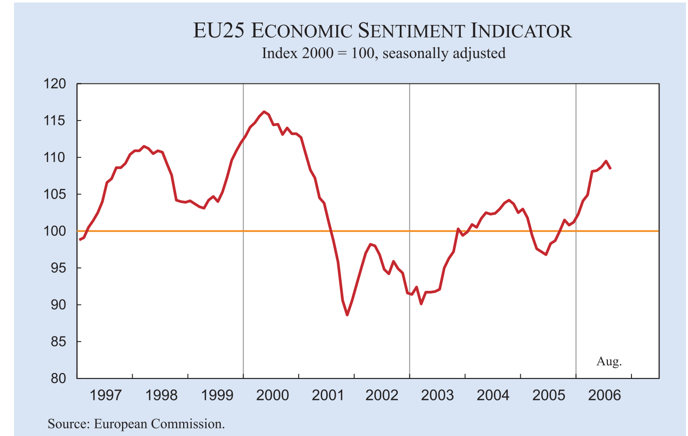


In July, the monetary conditions index continued its decline that had started in late 2005, signalling further monetary tightening. This is the result of rising real short-term interest rates and a rising real effective exchange rate of the euro.

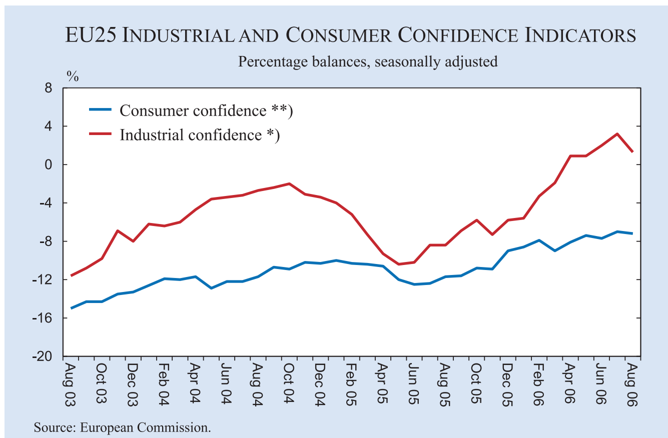
EU SURVEY RESULTS



According to initial Eurostat estimates, EU25 and euro area real GDP grew by 0.9% in the second quarter of 2006 compared to the previous quarter. In the first quarter of 2006, growth rates were 0.8% in both the EU25 and the euro area.
Compared to the second quarter of 2005, GDP rose by 2.8% in the EU25 and by 2.6% in the euro area, after 2.4% and 2.1% respectively in the previous quarter, due mostly to strong growth in investment.

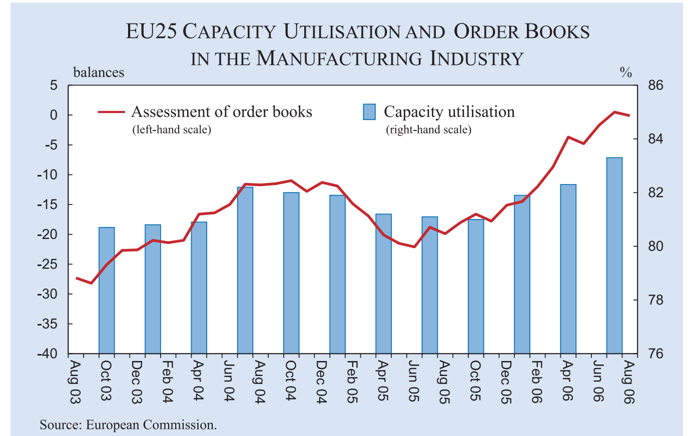


After an almost continuous rise over the last 14 months, the EU *Economic Sentiment Indicator* fell by more than a point. However, at 108.4, the indicator continues to perform well above its long-term average. While Spain recorded an increase of 2.6 points, sentiment fell in all other larger Member States, ranging from a 1.5 point drop in Germany to a 10.8 point drop in Poland.



* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).
** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

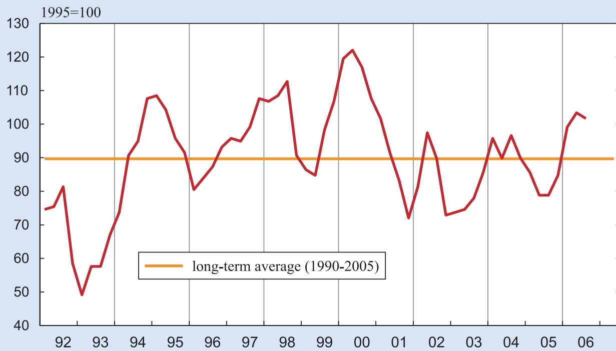
The EU *industrial confidence* indicator fell by 2 points after having risen strongly since the second quarter of 2005. Most of the larger EU Member States reported a fall in industrial confidence: Germany (– 1), Spain (– 3), Italy (– 3) and the UK (– 5). The EU *consumer confidence* indicator remained stable in August after a rise in optimism since the middle of 2005. At the country level, the results were also fairly stable. Of the larger Member States, only Italy registered a pronounced drop in confidence of 2 points.



The fall in industrial confidence was mainly due to production expectations turning less positive, whereas managers' assessment of order books has not changed much, declining by 0.1. Capacity utilisation rose to 83.3% in July from 82.3% in April.

Euro area indicators

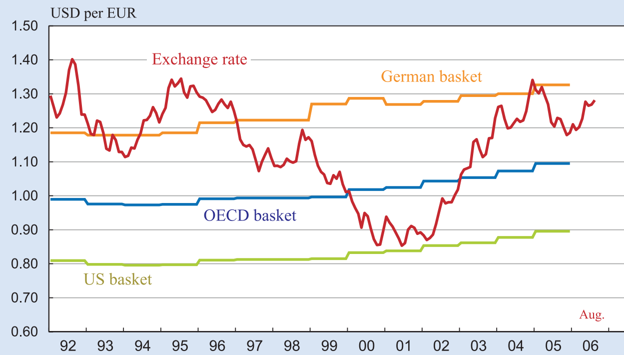
IFO Economic Climate for the Euro Area



Source: Ifo World Economic Survey (WES) QIII/2006.

The Ifo indicator for the economic climate of the euro area declined to 101.7 points in the third quarter of 2006 from the five-year high of 103.4 points in the second quarter. It remained well above its long-term average of 89.7. The decline was due to falling expectations for the coming six months while the assessment of the present economic situation continued to rise.

Exchange Rate of the Euro and PPPs

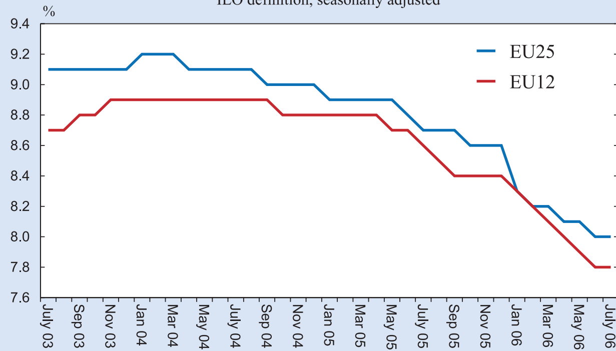


Sources: European Central Bank, Federal Statistical Office, OECD and calculations by the Ifo Institute.

The exchange rate of the euro against the US dollar averaged 1.28 $/€ in August 2006, continuing the recovery since the low of 1.18 $/€ of November 2005.

Unemployment Rate

ILO definition, seasonally adjusted

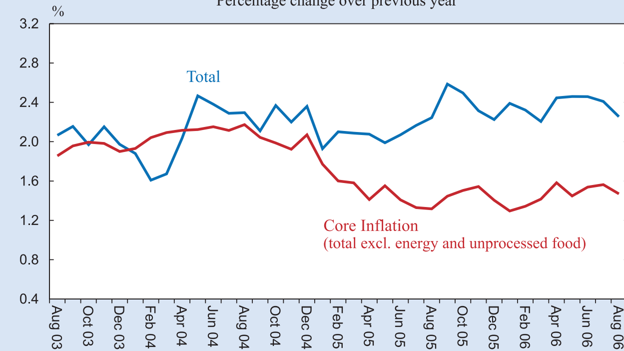


Source: Eurostat.

Euro-area unemployment (seasonally adjusted) remained unchanged at 7.8% in July 2006 compared to the previous month, but was much below the year earlier rate of 8.6%. EU25 unemployment stood at 8.0% in July 2006, also unchanged from June, but 0.7 points lower than a year earlier. The lowest rates were registered in the Netherlands (3.9%), Denmark (3.9% in June), Estonia (4.2%), Ireland (4.4%), and Luxembourg (4.8%). Unemployment rates were highest in Poland (15.0%), Slovakia (14.0%), Greece (9.2%), France (8.9%), and Belgium (8.7%).

Inflation Rate (HICP)

Percentage change over previous year



Source: Eurostat.

Euro area annual inflation (HICP) was 2.35% in August 2006, down from 2.4% in July. A year earlier the rate had been 2.2%. Monthly inflation was 0.1% in August 2006. The lowest annual rates were observed in Finland (1.3%), Sweden (1.6%), and Poland (1.7%), and the highest rates in Latvia (6.8%), Slovakia and Estonia (both 5.0%) Year-on-year core inflation (excluding energy and unprocessed foods), fell to 1.47% in August 2006 from 1.56% in July.

CESifo Forum ISSN 1615-245X
A quarterly journal on European economic issues
Publisher and distributor: Ifo Institute for Economic Research e.V.
Poschingerstr. 5, D-81679 Munich, Germany
Telephone ++49 89 9224-0, Telefax ++49 89 9224-1461, e-mail ifo@ifo.de
Annual subscription rate: €50.00
Editor: Heidemarie C. Sherman, Ph.D., e-mail sherman@ifo.de
Reproduction permitted only if source is stated and copy is sent to the Ifo Institute

www.cesifo.de