Globalisation: Source of Woe or Source of Wealth?

In western Europe "globalisation" is increasingly becoming a keyword for dramatic change in the structure of the welfare state. In this context the term stands for greater global economic integration via trade, capital and technology flows, but also for growing competition from low-wage countries and for labour outsourcing via foreign direct investment. Globalisation is also occasionally seen as a cause of rising unemployment and thus as a threat to democracy and prosperity in western countries. Many consider it to represent the start of a race to the bottom, during the course of which real wages would have to fall to the level of those in newly industrialising or even developing countries if western economies are to compete successfully on world markets.

In a study commissioned by the Dutch Ministry of Labour and Social Affairs, the DIW has asked whether globalisation really has the negative effects ascribed to it in western industrialised countries and whether economic policy is completely at its mercy.[1] Some of the main findings are summarised in this report.

The pace of globalisation

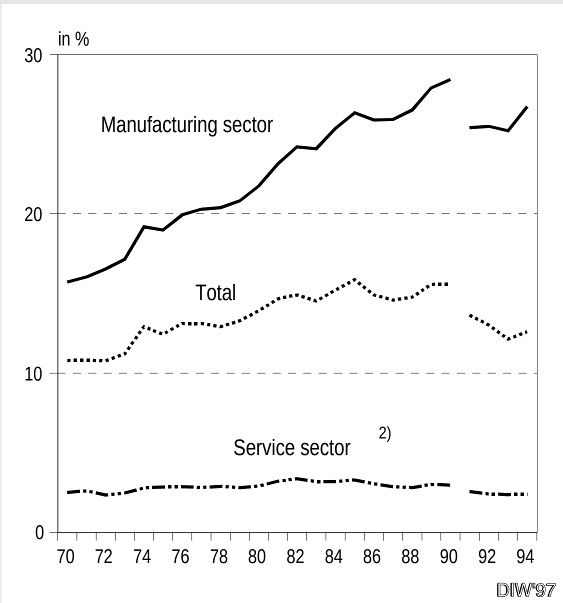
The view that the pace of globalisation seems to have accelerated rapidly in recent years is widespread. However, as far as trade flows are concerned, there is no evidence of such an increase in tempo. The degree of openness[2] of the German economy, for example, has grown only slowly and relatively constantly (cf. figure 1). While the value of this indicator has increased significantly in manufacturing, the strong growth of the service sector, where the degree of openness has remained almost constant, has practically neutralised this trend. A similar picture emerges for most of the other industrialised countries. Labour migration trends also fail to indicate an increase in the pace of globalisation. Although on balance there was an inflow of labour to most of the industrialised countries between 1970 and 1994, with the exception of Sweden and Germany these inflows remained almost constant and are low seen in relation to the total populations.[3]

A different picture emerges for capital flows (cf. table). There was a sharp increase in foreign direct and portfolio investments during the 1980s.[4] Although Japan and the United Kingdom showed a slight decline for the first half of the 1990s, the intensification of global economic integration is evidenced most clearly by capital flows.

All in all, one cannot make the sweeping claim that there has been a globalisation thrust during recent years, despite the opening up of eastern Europe. On the contrary, globalisation is a slow and relatively consistent process, which nonetheless requires permanent structural change. If, however, it is felt in some countries or sectors that the pressure to adapt has increased significantly, then this is a consequence, on the one hand, of the long-term failure of these sectors to adjust for the demands of the global economy and, on the other, an outcome of the generally bad economic situation.

Figure 1

Degree of Openness[1)] of the German Economy



1) The sum of the export and import quotas divided by two. — 2) Excluding public and private households.
Sources: Federal Statistical Office, national accounts; DIW calculations.

1 Fritz Franzmeyer, Ludger Lindlar and Harald Trabold, Employment and Social Policies under International Constraints, Den Haag, 1996.

2 The degree of openness of a national economy is defined as the sum of the share of exports in gross production plus the share of imports in total domestic demand divided by two.

3 Also see Fritz Franzmeyer, Ludger Lindlar and Harald Trabold, loc. cit., chapter 3.

4 The extremely high figure for Belgium–Luxembourg essentially represents portfolio investments for tax reasons.

Gross Foreign Direct Investment plus Portfolio Investment[1)]

in % of GDP

	1970 to 74	1975 to 79	1980 to 84	1985 to 89	1990 to 95
Belgium-Luxembourg	...	3.4	5.1	14.3	41.5
Denmark	...	0.6	0.9	3.5	7.2
Germany	1.2	1.3	1.7	5.2	6.3
Japan	...	0.6	2.6	5.9	3.7
Netherlands	7.3	4.7	6.0	10.9	11.1
Sweden	1.0	1.2	1.7	5.0	7.0
USA	1.0	1.5	1.4	2.9	3.3
United Kingdom	3.6	4.0	5.4	14.4	11.9

1) Sum of inward and outward foreign direct investment and portfolio investments.
Source: IMF, World Economic Outlook, May 1997, Washington, D.C.

Globalisation and unemployment levels

There is no proof of a direct relationship between globalisation and unemployment levels in the industrialised countries, and there is not even a convincing theoretical basis for such a claim. Neo-classical trade theory does, however, point to the factor price equalisation theorem, which states that remuneration for production factors is equalised internationally. Within the context of the globalisation debate, this consideration is sometimes used to suggest that one of the causes for the emergence of unemployment in the industrialised countries is the much higher wage level in comparison to newly industrialising or developing countries. According to this argument, western industrialised countries would have to reduce wages and accept a loss in prosperity if they are to remain competitive and avoid unemployment.

However, there is much to suggest that international wage differences can be sustained in the long term without unemployment necessarily ensuing. The theoretical support for this view comes from the neo-technology approach based on Ricardo's ideas. It explains the differences between countries' wage levels on the basis of differences in the generation and use of technology: the better a country is able to produce economically exploitable knowledge or to absorb it from external sources and use it efficiently for product and process innovation, the higher its wage level. Neo-classical trade theory abstracts from such technological differences and thus comes to the almost unavoidable conclusion of international wage equalisation.

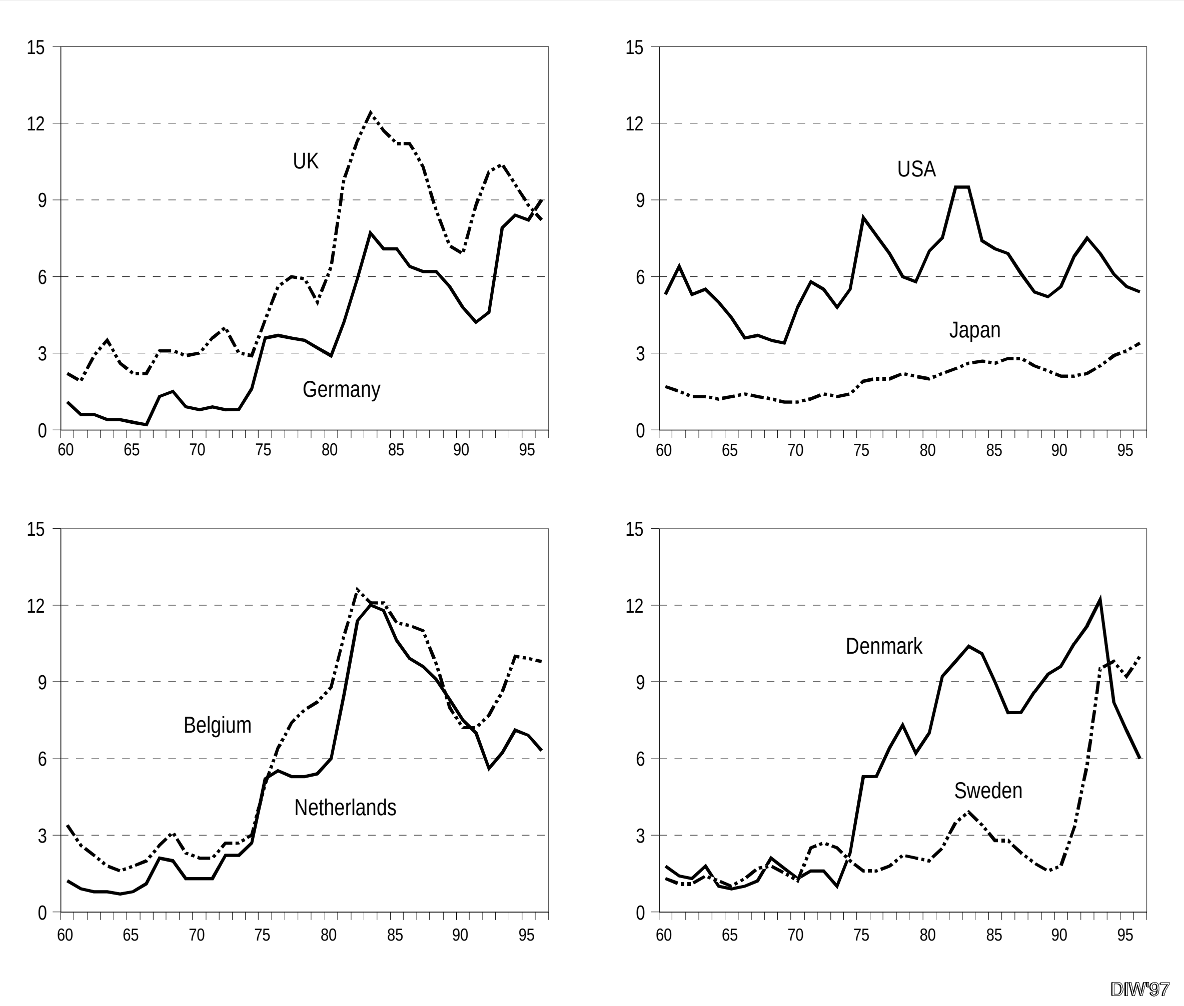
The argument that the industrialised countries must reduce their wages in order to remain competitive also fails to recognise the dynamics of global economic competition. While enterprises in countries with high wage levels are losing labour-intensive and low-tech production areas to low-wage countries, at the same time the high-wage countries are gaining access to new markets for human-capital-intensive and high-tech products. Although the fact that the newly industrialising countries are beginning to catch up does mean that the traditional high-wage countries are gradually losing market shares both overall and in particular sectors, this loss can nonetheless be accompanied by high absolute export growth because of the overall increase in the volume of world trade. Thus, it does not by any means follow from the catching-up process in the newly industrialising countries that economic development in the industrialised countries is negatively influenced by foreign trade.

It would make no sense at all for a technologically highly developed country to relinquish its position at the top of the wage hierarchy and attempt to lessen competitive pressure from the newly industrialising countries through wage reductions. Such a defensive reaction would mean forfeiting the possibility of temporary monopoly profits from innovative products and production processes, which are most common in the case of high-tech products. Sooner or later the consequence would be declining productivity and falling wages, while competitive pressure would not diminish as a result, because the other positions in the wage hierarchy are already occupied. The country would then be competing with a lower wage level on other product markets, but the competition would be no less severe.

However, besides these theoretical considerations, empirical findings also belie a link between globalisation and unemployment levels in the industrialised countries (cf. figure 2):

- Between 1982 and 1996, when the globalisation process is widely considered to have been at its strongest, the USA managed to reduce its unemployment rate from just under 10% to under 6%. During the entire period from 1960 to 1996, the unemployment

Figure 2
Unemployment Rates in Selected OECD Countries, 1960 to1996
Standardised unemployment rate[1)] in %



1) Danish rate non-standardised; Swedish rate standardised from 1971 onwards.
Source: Fritz Franzmeyer, Ludger Lindlar and Harald Trabold, Employment and Social Policies under International Constraints, Den Haag, 1996.

rate in the USA was subject to relatively strong cyclical fluctuations. The brief rise at the beginning of the 1990s can clearly be attributed to the weakened economy.

– Germany, Denmark, Sweden, the United Kingdom, Belgium and the Netherlands were all able to reduce their unemployment rates – in some cases significantly – during the 1980s. Up to the 1990s the standardised unemployment rate (OECD method) in western Germany was in fact almost always lower than the rate in the USA. The sharp increases in unemployment at the beginning of the 1980s and 1990s (in western Germany from 1993 onwards) were also recession-related. A "globalisation thrust" which would offer an alternative explanation for the rise in unemployment can neither be seen in Europe nor in the rest of the world.

– In Japan it was even possible to keep the cyclical fluctuations in unemployment at a very low level. However, from the mid-1970s to the end of the 1980s an almost constant rise in unemployment can be seen – albeit at a relatively low level. Unemployment fell between 1988 and 1991 and did not rise again until 1993. Since then, it has risen again and reached 3.4% in 1996.

The intensification of international economic relations thus fails to provide an either theoretically or empirically satisfactory explanation for the emergence and persistence of unemployment. Partial analyses are often used to validate a link between globalisation and unemployment, claiming that a trade surplus can be equated with the creation or maintenance of jobs, while a deficit in foreign direct investment can be equated with exports of jobs. Although both claims appear plausible in isolation, they disregard the macroeconomic context. If a country wants to achieve a surplus in commodity trade, it must either import services from abroad, e.g. in the form of tourism, or send capital abroad, e.g. in the form of portfolio or direct investments. However, as a result of such service imports or capital exports a country "loses" jobs again to other countries. It is therefore unwise to draw conclusions about overall employment gains or losses on the basis of individual balance of payments surpluses or deficits. This point is exemplified by the USA and Japan: the "employment miracle" in the United States goes hand in hand with a high trade deficit, while in Japan the unemployment rate is remaining relatively stable despite large deficits in foreign direct investment.

Globalisation and technological progress reduce demand for low-skilled workers

If globalisation has no effect on the level, does it nonetheless affect the structure of employment and unemployment and likewise income distribution? In particular, does it lead to greater income inequality within a country and diminish the employment prospects of the low skilled? According to the neo-classical theory of international trade, an increase in *foreign trade* with developing countries leads to lower demand for low-skilled workers in the industrialised countries and to higher demand for the highly qualified. As a consequence of this effect, remuneration for the low-skilled should then fall in relation to wages for the highly qualified.

The pressure on low-skilled workers is intensified by foreign *direct investment* flowing from North to South and recently also from West to East. The objective of such investment is either to improve the conditions for marketing export products or to enable the industrialised countries to benefit more from the low wages paid to unskilled or low-skilled workers in the South and East. Because an increase in exports from the North can only be achieved through greater use of high-quality labour, the demand for qualified workers thus rises. An increase in imports from the South leads to a decline in demand for low-skilled workers because relatively labour-intensive production processes are outsourced. Thus, direct investment tends to reduce the demand for unskilled labour compared to qualified labour in the North. While this increases the wage pressure emanating from international trade and the pressure on the employment opportunities of the unskilled, at the same time it improves the income and employment prospects of qualified workers.

There is a close link between technological progress and globalisation. On the one hand, the higher competitive pressure on global markets forces enterprises to apply the most recent scientific findings more rapidly. On the other hand, technological progress itself generates the conditions for further globalisation, e.g. through more efficient communication networks. However, technological progress has indeed reduced the demand for low-skilled workers for several reasons. First, unskilled workers are easier to replace by machines than the highly qualified. Second, the design and construction of such machines requires even more qualified workers. Third, qualified workers are better able to adapt to changing technical conditions. All in all, technological progress tends to have the same effect on the demand for, and remuneration of, low-skilled workers as foreign trade and direct investment.

However, these are not the only factors that influence the demand for labour in the industrialised and developing countries. In addition to the international division of labour, structural change in all countries is also influenced by changes in the structure of demand, e.g. the growth in demand for services. Although the international division of labour reduces demand in the industrialised countries for less well-trained workers on its own, at the same time – besides jobs for the highly qualified – additional jobs for the low skilled are being created by the increase in demand for services. The expansion of the service sector can thus partially compensate for the decline in demand for low-skilled labour.

Labour inflows increase the supply of low-skilled workers

Labour migration changes the level and the structure of labour supply. Immigration into economically highly developed countries increases the supply of low-skilled workers in relation to qualified workers and exerts a corresponding pressure on wages. This has been the case in the USA, for example, since the beginning of the 1970s.[5] There are also clear indications that immigrants tend to compete more with low-skilled than high-skilled workers in western Europe.[6] This probably

[5] Cf. George Borjas, The Economics of Immigration, in: *Journal of Economic Literature,* vol. 31, 1994, pp. 1667–1717.

[6] For Germany see: John Haisken-DeNew, Migration and the Inter-industry Wage Structure in Germany, Berlin/Heidelberg, 1996.

also applies to illegal immigrants, who usually find work in agriculture, forestry and construction, and in certain segments of the service sector. Thus, illegal immigrants also exert pressure on the wages of the low skilled in particular.

Empirical findings on income distribution and the structure of unemployment

At first glance the theoretical considerations are supported by empirical findings. All in all, the demand for low-skilled workers has declined in recent years – sometimes dramatically – in western industrialised countries.[7] One consequence has been that the unemployment rate among low-skilled workers has been much higher than among skilled workers. Moreover, the incomes of low-skilled workers in some countries have decreased in comparison to those of skilled workers. A significant increase in income inequality can be seen in particular in the USA and the United Kingdom for the period from 1979 to 1995 (cf. figure 3). In 1995 both countries exhibited a much higher degree of income inequality than the other countries studied. A slight increase in income inequality could be observed for Japan and the Netherlands, while the difference has remained constant in Denmark and – despite some fluctuation – also in Sweden. Germany and Belgium are the only countries where the distribution of gross income has become – slightly – more equal.

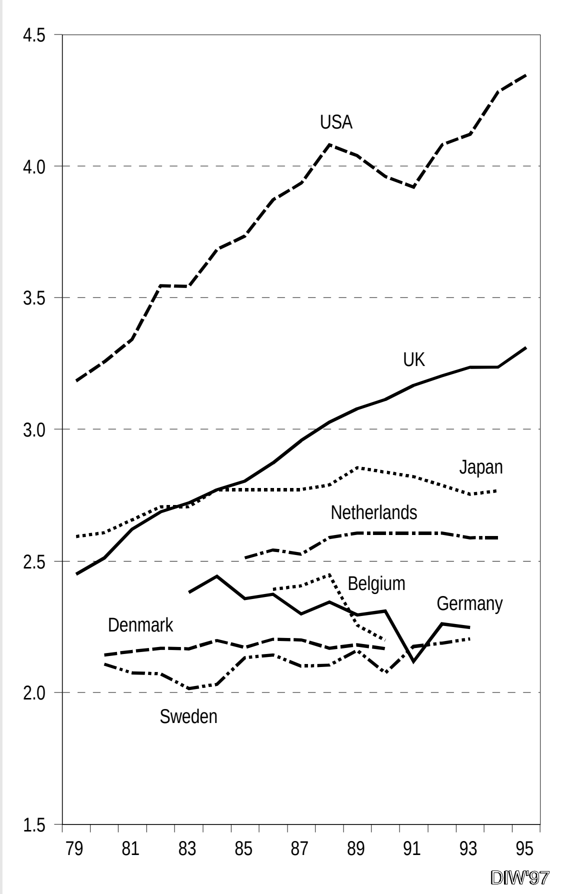
However, the substantial income gaps in the countries concerned have by no means led to a particularly low level of unemployment among low-skilled workers. On the contrary, in the USA and the United Kingdom around 13% of low-skilled workers were unemployed in 1992, whereas only 8% and 9% were unemployed in the Netherlands and Germany, respectively, and a mere 5% were out of work in Sweden. The argument commonly put forward in the globalisation debate that a larger wage gap would solve the employment problems of the low skilled proves to bear little weight in this simplified form. The fact that the countries of continental Europe faced similar global and domestic demand-side pressures to adapt, but that these led neither to higher unemployment among low-skilled workers nor to a wider wage spread in comparison to the USA and the United Kingdom allows only one conclusion: there must have been supply-side factors in continental Europe which compensated for the decline in demand for low-skilled workers.

[7] Cf. Stephen Nickell and Brian Bell, The Collapse in Demand for the Unskilled and Unemployment Across the OECD, in: *Oxford Review of Economic Policy,* vol. 11, no. 1, 1995, pp. 40–61.

Figure 3

Gross Earnings Dispersion, 1979 to 1995

D9/D1 rates[1)]



1) Lower limit of the highest income decile relative to the upper limit of the lowest income decile.
Source: Fritz Franzmeyer, Ludger Lindlar and Harald Trabold, Employment and Social Policies under International Constraints, Den Haag, 1996.

The role of education and training

The most promising long-term strategy to counteract the reduced demand for unskilled labour is to reduce the supply of low-skilled workers through education and training. An increase in the supply of skilled labour will lead to less inequality in income distribution on the market.

One aim of education and training is to provide newcomers to the labour market with initial training which enables them to satisfy higher qualification requirements. Those countries with well-functioning vocational training systems have the best institutional conditions for such endeavours, resulting in only relatively few unskilled workers overall. According to Eurostat, 43% of the labour force in the United Kingdom were low skilled in 1993, whereas the share in the Netherlands was only 16% and in Denmark and Germany a mere 13%. Moreover, the capacity for lifelong learning must be taught in schools as a central component of school education.[8] In future years nobody can expect to be able to practise their occupation in the way they learned it for their entire life. Lifelong learning for workers is thus the second component of a strategy to reduce the supply of low-skilled labour, the aim being that workers will be able to adapt to changing qualification requirements throughout their working lives. Publicly funded retraining and continuing training measures during unemployment are one element of this strategy; in-company continuing training is another. If it proves possible to adapt the skills and knowledge of low-skilled workers to the rising demands of the working world and thus to increase their productivity, the emergence of a large segment of working poor can be prevented.

Conclusion

Because technology and innovations are only developed by highly qualified workers, an appropriate education and R&D policy is necessary to secure the advantages of globalisation in the long term and to translate them into an increase in real income. The industrialised countries can only maintain and increase their high wage levels if they increase their technological capacity and their stock of human capital. A reduction of public expenditure on R&D and education, which are essentially investments in technological capacity and human capital, is thus not the answer to the challenges of globalisation. This is especially true because a share of the high real income in the industrialised countries can be traced back to innovation rents, which will be lost if the pace of innovation slows down in comparison to the newly industrialising countries.

Globalisation offers enormous economic opportunities, but also entails risks for low-skilled workers. The latter can, however, be combated, in particular by an appropriate education policy. Of course, globalisation demands mobility and flexibility on the part of the individual. Defensive reactions are not the answer – they will lead only to the feared race to the bottom. Countries which exploit the opportunities presented by globalisation through an increase in their education and R&D endeavours can compete in the other race, i.e. the race to the top.

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[8] Cf. OECD, Lifelong Learning for All, Paris, 1996.