Dennis J. Snower
President of The Kiel Institute for World Economy
Professor at Christian-Albrechts-University, Kiel

Globalization Challenges for the Euro Area

To understand Europe's role in the global division of labour, we need to start from first principles. We need to understand clearly the driving force that propels globalization ahead, as well as the opportunities and threats it brings. Only then can we gain a clear view of where Europe lies in this sea of change.

Basic Principles

Perhaps the most far-reaching influence of globalization on the world economy is that it changes the global division of labor. The global division of labor – that describes which country, region, locality produces what with which resources – has a fundamental influence on our standard of living, our economic growth rate and, beyond that, our identities as productive individuals.

Imagine that there was a global law that prohibited everyone from trading. We would no longer be able to buy and sell goods and services. Everything we consume we would have to produce. The food we eat would be home-grown and hunted, the clothes we wear would be homespun. The immediate consequence would be a precipitate descent into something resembling the stone age. We would have no electricity, no computers, no cars, no telephones. Our standard of living would have shrunk to what we witnessed in the early stages of human history. Our personal and social identities would be similarly diminished.

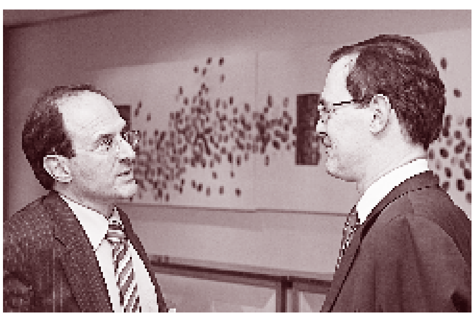
Now run this thought experiment in reverse. Suppose a law was introduced that permitted trade among people living within the same village. Our standard of living would improve, for now we could start to specialize in those activities that we do best and trade with one another. If we then allowed trade among villages, we would be even better off, for the same reason.

The reason is simple. Human beings have achieved greater comfort and security than other animals not only because of their mental capacities, but also because they have found ways of sharing the fruits of their knowledge through trade. Different people have different abilities and wants. By allowing each of them to concentrate on doing what he or she is relatively good at and then giving them the opportunity to trade among themselves, we have found a means that permits each of us to benefit from the talents and insights of everyone else.

The means is the free market mechanism. If each of us is allowed to exchange goods and services voluntarily, we will do so only if that is to our own advantage. Thus, under voluntary exchange, buying and selling only takes place if it benefits both the buyer and the seller. Consequently, the seller has a natural incentive to meet the buyers wants.

People's wants are highly diverse and changing continually. So are the technologies and skills through which these wants are satisfied. So satisfying these wants is an extremely complicated problem, requiring an enormous amount of information. This information is individualized – each customer has distinctive preferences. More importantly, the information is tacit – that is, each seller may know the particular wishes of his or her customers, but this knowledge is too detailed to be transmitted to a central planner. So even if governments always acted in the public interest, they could not gather, digest, and marshal this information appropriately. Rather, the only way of mastering this information problem is to allow individuals, operating largely in their own self-interest, to find trading opportunities for themselves.

It is important to keep these simple truths in mind when we seek to comprehend the process of globalization that is taking place nowadays. What we are witnessing these days is a fabulous expansion of our trading possibilities.



It is clearly not the first time in history that we have experienced such an expansion. Thus successive stages of the Industrial Revolution that took place over the past three hundred years would have been unthinkable without it. But nevertheless the current wave of globalization has something unique about it. Whereas the Industrial Revolution was largely about improved trade within and between countries and between large firms and large groups of consumers, the current wave of globalization is primarily about rising trade among *individual economic actors*, not necessarily large ones.

Over the last 2–3 decades of the last century, this primarily took the form of trade within and among large-scale multi-national companies. Many commentators observed that these multi-nationals – which were able to switch their production, marketing and development operations easily from one subsidiary to another across the globe – heralded the economic end of the nation-state. National boundaries ceased to be the dominant criterion for the organization of economic activities, as international differences resource availability, labor costs, tax regimes, industrial infrastructure became increasingly important for the location of large-scale multi-national business.

Since the beginning of this millennium, globalization has begun to take a new form. As information and communication technologies have advanced explosively, it is now becoming possible for small-scale individual producers and individual consumers to exploit trading opportunities among themselves. Customer needs can be identified in a far more differentiated form than ever before, and these needs can be satisfied by combining the skills and resources of economic agents across the globe. Through the combined use of flexible production techniques, the internet, and modern communication platforms, the age of mass production and mass marketing is coming to a close. As economies of scale are declining in importance, so economies of scope – involving the bundling of heterogeneous goods and services to satisfy a broad spectrum of complementary customer needs – a becoming progressively more significant as the globalization process unfolds.

In short, from the perspective of economics, national boundaries are being eroded not just by the large multi-national companies, but by microeconomic agents everywhere. In the process, an enormous wealth of new opportunities to gain from trade will be uncovered. This development can be understood quite simply as a continuation of our previous thought experiment. Just as the move from self-sufficiency to trade within a village makes us massively better off, and just like the move from trade within villages to trade among villages does so even more powerfully, so the new gains from trade have the potential to initiate another quantum increase our standard of living.

This is the message we must keep in the back of our minds when considering Europe's role in the global division of labor.

But this message raises two vital sets of questions.

First, when we say that the new gains from trade have the potential to make us better off, who is "us"? Is everyone made better off? Or are there winners and losers? If the latter, will Europe belong to the winners or the losers?

Second, how is the potential to be realized? What must European governments do to make this happen?

Let's consider each of these questions in turn.

Winners or Losers?

In the conventional policy debate, there are two popular accounts of winners and losers from globalization.

The first, which may be called the "displacement story," is by far the most popular. It claims that there is a fixed amount of work to be done in each country, so that it can produce all the goods and services it needs to satisfy its own needs and those the countries it trades with. This means that if production is outsourced, then work that was previously done in this country is now done abroad, and this country's workers have been displaced. International trade may be viewed in equivalent terms. The more Europe imports from the Far East, for example, the more European jobs are displaced by Far Eastern workers. The foreign countries gain is then is Europe's loss.

Like the theory that the sun revolves around the earth, this is account is intuitively, simple, powerful in its explanatory power – but unambiguously false. There is no fixed amount of work to be done in a country. The amount of work to be done depends on how well we are able to satisfy consumer needs and how large the consumer needs are. The greater the level of employment in a country, the greater the incomes of the employed individuals, the more they will want to consume, and thus the more work there is to be done in the country. On this account, immigration need not lead to higher unemployment, because the immigrants don't just compete for jobs, they also have needs to be satisfied and these require more jobs to be filled. Furthermore, nowadays the amount of work to be done in a country depends on how effectively the country is able to compete in the global market place. Thus, globalization is not a zero-sum game: one country's gain is not necessarily another country's loss. By creating more gains from trade, globalization can lead to the greater fulfillment of people's needs in all countries, and thereby all countries could gain.

The second account, which may be called the "comparative advantage story," is more insightful. It is the standard argument made by economists. It starts from the premise that trade can be beneficial for all countries, since it allows each country to specialize in the production of goods in which it has a comparative advantage. If all countries produce what they are best at and then trade with one another, the resources of the world are used more efficiently. Thus, although there are winners and losers from free trade, it should be possible for the winners to compensate the losers, so that everyone be made better off.

Specifically, the rich countries have relatively abundant supplies of skilled workers and thus, through globalization, they specialize in the production of goods that use skilled labour intensively. Thus the demand for skilled labor in the rich countries rises. The poor countries, by contrast, have relatively abundant supplies of unskilled workers, and consequently they specialize in the production of goods that use unskilled labor intensively. This means that, in the poor countries, the demand for unskilled labor rises, leading to a corresponding fall in the rich countries' demand for the unskilled.

For Europe, this means that the skilled workers are the winners, while the unskilled are the losers. But the skilled win more than the unskilled lose, and thus the skilled could compensate the unskilled, so that both groups are left better off than before.

The practical problem, however, is that this compensation usually does not take place. The free market provides no mechanism for spreading the gains throughout a country's population. The tax and transfer systems in Europe redistribute some income, but this redistribution is not sufficient to ensure that the unskilled workers do not become worse off through globalization.

If wages are responsive to the rise in the demand for skilled workers and the fall in the demand for unskilled ones, the result is greater wage inequality. If wages are rigid, inequality increases in terms of employment opportunities. In this sense, the relatively flexible wages in the U.S. gives rise to the problem of the "working poor," whereas the relatively inflexible wages in the large continental European countries generates unemployment. These two problems, so the story goes, are flip sides of the same coin.

This comparative advantage story has greater intellectual cogency and appeal than the displacement story. But here, too, we have reason for serious doubts.

It is not true that the rising demand more skilled labor in rich countries (like those of Europe) is matched by a falling demand for skilled labour in poorer countries (such as China, India and Mexico). Rather, the demand for skilled labor is rising relative to the demand for unskilled labor just about everywhere in the world.

Most economists have come to the conclusion that trade has played a small, probably insignificant, role in depressing the wages of unskilled workers in Europe and the U.S.

It is safe to say that globalization does not automatically create losers, even in the absence of a mechanism whereby winners can compensate losers. Whether losers are created depends importantly on two things:

First, it depends on the degree to which globalization creates complementary relationships among the global trading partners. Increasingly, globalization involves the decomposition of value chains. The processes of production, design and marketing a subdivided finely into their component activities and each activity is undertaken where it is most profitable, regardless of national boundaries. In the process, the efforts of European workers (say, engineers and product designers) are supplemented by the efforts of foreign workers (say, production operatives and call centre employees in Asia). Whenever the foreign labor is complementary with the domestic labor – so that the two together are more productive than European workers on their own – then the demand for domestic labor will rise as a result of globalization. There is a growing body of evidence that this has happened in many sectors of the U.S. economy, so that globalization has wound up creating more jobs domestically than it has destroyed. This phenomenon is not surprising: whenever globalization creates complementary relations among workers, domestic and foreign, the demand for both groups of workers will rise. The verdict is still out whether a similar phenomenon is occurring in Europe. The greater the degree of labor market regulation that prevents the reorganization of productive enterprises so as to allow the exploitation of such complementarities, the less likely is globalization to have this welfare-promoting effect.

Second, whether globalization creates losers depends on how easy it is to avoid being a loser. The more opportunities and incentives people have to move from declining sectors and occupations into expanding ones, the higher the chances that, after a readjustment process, the losers join the winners in reaping the benefits from globalization. Here, too, economic policies and institutions have an important role to play. The more they discourage people from responding to the changing economic realities – for example, through generous, passive unemployment support, job security legislation that gives employees title to rigid job definitions, protectionism that makes it unnecessary for firms to compete with their counterparts abroad – the less readjust-

ment will take place across sectors and occupations, and the more long-term losers will be generated through globalization.

Is Europe able to rise to these challenges? Foremost, we must be aware that there is no such thing as a homogeneous “Europe” in this regard. Some European countries have made significant progress in achieving the labor and product market flexibility that is necessary to exploit complementarities in production and work and to enable the readjustment from declining to expanding enterprises to proceed reasonably smoothly. Denmark, Great Britain, Ireland, and the Netherlands are among those in this group. But the large, mature continental European countries – France, Germany, Italy and, in some respects, Spain – remain heavily regulated, with relatively weak incentives for flexible employment. It is no accident that these are the countries with Europe's highest unemployment rates.

Policy Implications

What are the policy implications of these challenges? In my judgement, European policymakers should take the following lessons from globalization to heart.

First, *protectionism is not the answer.* It is not surprising that the mistrust of globalization and the political pressure for protectionism are particularly strong in the large continental European countries. Spain's Prime Minister Rodríguez Zapatero is looking for measures to protect Endesa from a takeover by the German energy giant EON. And Germany's politicians were not amused when the French-German pharmaceutical company Aventis was bought by the French rival Sanofi. The recent French student protests against reducing job security for young workers are yet another form of protectionism.

The large continental European countries are indeed the ones with population groups – particularly the unskilled – who may sustain persistent losses from globalization. These groups deserve support. But insulating these groups from the pressures of globalization is not the answer. On the contrary, in the long term such policies make the underlying problem worse.

Second, *government should not attempt to find global niches for their country by supporting "national champions."* It is madness of policymakers to assume that they are better than the free market at predicting where the comparative advantages of their countries lie. As noted, the information necessary for this purpose – continually changing technologies and customers' continually changing needs – are available primarily at the local level. This localization of information is not necessarily geographic; in fact, with the spread of the internet and communication technologies, the geographic aspect is becoming progressively less important. Rather, it is localization in the sense that the business people who are closest to a particular set of technologies and customers know best what these technologies are capable of and what these customers want.

The frequently-asked question in policy circles – "What are the sectors and occupations that deserve government support, so that my country can hold its own in global competitive markets?" – is at heart a communist question. Communism has failed to deliver the living standards achieved in the West precisely because governments are poorly placed to answer this question. This lesson should be kept in mind, when government officials in France and Italy develop their lists of companies that they believe should be immune from foreign ownership.

The big break-through inventions of the past century – such as airplanes, helicopters, portable computers – were made by independent inventors, entrepreneurs, and financiers. The subsequent incremental technological improvements in these inventions have also occurred primarily in private sector firms. These advances have occurred because the market mechanism empowers people to make a living by seeking new ways to meet each other's needs. When the government creates national champions, it disempowers people and robs society of the resulting initiatives.

The Lisbon strategy formulated by European leaders in March 2000 recognized this simple truth and advocated the creation of business conditions that would enable private enterprise to create the most competitive economy in the world by 2010. The rise of industrial strategies and national champions in Europe, combined with the absence of international competition in Europe's labor markets marks a return to the failures of the past, since as France's industrial strategy of the 1960s. The national champions policy also goes against the spirit of the European Union, since it implies that ownership should reside within the nation state.

The heavy cost of a national champions policy can be seen in the German energy market. Politicians have pushed mergers against the will of the national cartel office and overruled its decisions. The result is an oligopoly with four suppliers who share 90% of the energy market. Similarly to Energie de France, Germany's champions now go on shopping tours outside the home market; all financed by monopoly rents. Germany's customers pay more for their energy than most of their European neighbours.

And third and finally, *people's natural desire for economic security should not be satisfied at the expense of economic flexibility, but through economic flexibility.*

The new global division of labor can, in principle, lead to two alternative outcomes: it could raise living standards and promote social cohesion through greater equality of opportunity, or it could raise unemployment and increase the gulf between the skilled and unskilled workers in their earnings and employment prospects.

To achieve the former outcome, it is vitally necessary to allow the economy to adjust to the new trading opportunities that globalization creates, particularly in the labor market. The job turnover rate in continental Europe is much lower than that in the United States. While monthly unemployment outflows in Germany and France amount to about 5–10% of the unemployed, the corresponding numbers for the United States are around 25–30%.

As we can see in the large continental European countries, the absence of labor market adjustment, leads to social inequality and economic insecurity by creating large pockets of long-term unemployment. In Germany, for example, about 50% of unemployed have been without job for more than one year. As these people's skills deteriorate and they become increasingly discouraged and stigmatized in the labor market, their chances of supporting themselves continues to fall. The resulting inequality of opportunity is in blatant conflict with Europe's purported "social model."

The current policy of some EU countries of subsidizing low-paying jobs – whether through tax breaks or in-work benefits – is misguided. On the one hand it reduces people's monetary incentives to acquire skills. The reason is simple: with increasing qualification a worker's productivity rises and thereby his wage, but his entitlement to subsidies falls. On the other hand, it is silly to imagine that European countries could compete with India and China and other emerging economies in the low-paying jobs. Instead, the EU countries need education and training policies that create incentives to acquire skills – and not just at the beginning of one's working lifetime, but throughout it as well.

What policymakers should seek is to create economic security through economic flexibility. A wide variety of European countries have pursued this course successfully. Denmark's "flexicurity" system and Britains "Welfare to Work" program are two worthy examples. The large continental European countries would do well to think along these lines as well.

This policy approach needs to be supplemented by education and training systems that enable European countries to build skilled, versatile, and adaptable workforces.

These are important lessons that the new global division of labor should teach us. Let us hope that Europe's policymakers will have the insight and conviction to pursue them.