On the hiking trail

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Globalisation is generating huge economic gains. That is no reason to ignore its costs

VISITORS to Jackson Hole, Wyoming, normally see a few moose and buffalo and sometimes even a bear. But in late August each year some really strange creatures can be spotted: central bankers and economists, meeting for the annual symposium of the Federal Reserve Bank of Kansas City, one of the high points (literally) of the economic calendar. This year's conference focused on how the rise of China, India and other countries is reshaping the world economy.

Take wages. It is commonly believed that the wages of unskilled workers in rich countries are being depressed by the shift of jobs to low-wage countries. However, a paper presented at the symposium by Gene Grossman and Esteban Rossi-Hansberg of Princeton University offered a much rosier view, arguing that offshoring can actually increase the wages of unskilled workers. Moving jobs abroad boosts firms' productivity and profits and so enables them to take on more workers at home, which pushes up the wages for work that cannot easily be outsourced abroad. The authors are right to point out that the impact of offshoring on jobs is not as bad as it is usually portrayed. But their own calculations show that between 1997 and 2004 this positive "productivity effect" was not large enough to offset the downward pressure on wages, both from having more workers in the world and from cheaper labour-intensive goods as a result of imports from low-wage countries. The net impact is still to depress the wages of low-skilled workers.

Indeed, the evidence is that the low-skilled are not the only people being squeezed. In America, the euro area and Japan, total wages have fallen to their lowest share of national income in decades, whereas the share of profits has surged. This is exactly what would have been expected, given that the integration into the world economy of the emerging economies has sharply increased the ratio of global labour to capital. Yet this fact barely got a mention in Jackson Hole. In their eagerness to applaud the benefits of globalisation to economies as a whole, economists were strangely reluctant to admit that in recent years the average real pay of rich-country workers has stagnated or even fallen.

Ben Bernanke, the chairman of the Federal Reserve, was one of the few to voice the case for helping the losers. The scale and pace of globalisation, he argued, is unprecedented and the overall gains will be huge. But there is a risk of social and political opposition as some workers lose their jobs. Policymakers, he said, need "to ensure that the benefits of global economic integration are sufficiently widely shared" so as to maintain support for free trade and to stem protectionism. The snag is that the number of losers--including those facing lower real wages--may be bigger than he thinks.

Flowing uphill

Another consequence of global integration has been the build-up of bigger current-account imbalances. According to the economic textbooks, capital should flow from rich countries to poor ones, which have less capital and offer higher returns. Instead capital is flowing "uphill". The average income per head of countries with current-account surpluses is now much less than that of countries with deficits (see chart). Most notably, America's deficit is largely being financed by poor countries' purchases of treasury securities. Does the lack of foreign capital hurt emerging economies' growth? By borrowing from abroad, a developing country should be able to boost its investment and hence its rate of growth. However, a paper by Eswar Prasad, Raghuram Rajan and Arvind Subramanian of the International Monetary Fund surprisingly finds that developing countries that run current-account deficits (ie, that borrow from abroad) have grown more slowly than those that run surpluses.

One explanation is that developing countries have limited capacity to absorb foreign capital, because of their underdeveloped financial systems, which makes it hard for firms and households to borrow. If productivity growth increases, households save much of the rise in income instead of spending it, while firms' investment remains limited by internally generated funds. So faster growth boosts saving relative to investment and creates a current-account surplus (or a smaller deficit). For some participants at Jackson Hole this suggested less need to lose sleep over global imbalances. If fast-growing developing countries generate more saving than they can use, America can continue to finance its deficit. But by running surpluses, emerging economies are enjoying less investment and consumption than they could. Over time, more mature financial systems will allow higher spending and their external surpluses will disappear. According to some estimates, American bond yields are up to two percentage points lower than they otherwise would be, thanks to the purchase of treasury securities by China and other emerging economies. If these countries lose their appetite for such assets, bond yields could jump and the dollar plunge.

Emerging economies have also allowed central banks to hold short-term rates lower, by making it easier to meet their inflation goals. Ken Rogoff of Harvard University argued in his paper that China's integration into the world economy has helped to hold down inflation by reducing the bargaining power of workers, thereby also bolstering the credibility of central banks. He suggested that central bankers should have responded to the fall in import prices from China by allowing inflation to fall below target. But the Fed held interest rates unusually low to prevent that.

America's economy has benefited hugely from lower interest rates and bond yields, thanks to the emerging economies. Cheap money helped to fuel a housing bubble and support consumer spending. But what happens if the impact of globalisation on inflation goes into reverse, or if emerging economies lose their lust for dollars? Both would push up the cost of borrowing, with unhappy consequences for America's debt-ridden economy.

The papers are available at www.kc.frb.org/publicat/sympos/2006/sym06prg.htm