frontier economics

Competitiveness

STILL CRAZY AFTER ALL THESE YEARS?

Almost exactly a quarter of a century ago, Paul Krugman wrote an article in Foreign Affairs in which he described competitiveness as a “dangerous obsession”. Commenting on the use of the word by politicians, technocrats and some academics, he dismissed the hypothesis that the living standards of nations rose or fell depending on their ability to compete as “flatly wrong”. He added that “it is simply not the case that the world’s leading nations are to any important degree in economic competition with each other, or that any of their major economic problems can be attributed to a failure to compete on world markets”. Krugman went on to say that the obsession with competitiveness skewed domestic policies towards the wrong priorities and also threatened the international economic system, notably by raising the prospect of a global trade war.

Fast forward to the current day, and competitiveness is still an obsession. Donald Trump was elected president in good part on the basis of his promise to tackle bilateral US trade deficits, particularly with China, and to help America win so often that people would be “sick and tired of winning”. The US is currently threatening to levy duties on imports of EU and Japanese cars on “national security” grounds. Despite this risk and other tensions, the EU, the US and Japan have jointly started a process to ensure an international “level playing field” – a thinly veiled expression of their concern at the emergence of China as a trade and economic superpower. France and Germany are pushing for well-established EU rules on competition *internal* to the single market to be changed to allow the creation of EU industrial champions that would boost the EU’s *external* competitiveness. And apprehension about globalisation have been a driving force behind Brexit and the gilets jaunes (yellow vest) protests in France.

Underlying these concerns about the ability to compete, and specifically to compete against China and other emerging nations, is a deeper worry about inequality. Distributional issues have long played second fiddle to questions related to growth, not least because of the assumption that if the latter is taken care of first, the former will sort itself out.

But inequality has been on the rise across continents in the last two decades. It is worth quoting from Krugman again. Writing in June 2007, just before the global financial crisis exploded, he observed that the fragmentation of production and the rise of China had led him to revise his view that the effects of trade on inequality were small. They were quite big and getting bigger. Economists needed “better answers” to deal with the anxieties of those worried about trade.

Is revisiting this notion of competitiveness one such “better answer”, or at least part of one? To address this question, we need to tackle of the points Krugman raised in 2007. These are directly connected to how trade has changed over the last two decades and, just as importantly, to our understanding of those changes.

Trade has changed because technological progress – leading, for example, to more powerful computers and lower transport costs - has enabled the creation of globally unbundled value chains. Countries increasingly trade in tasks, the iconic example being the production of the Apple iPhone:

physical and intangible inputs (including services and IP) are bundled together and repeatedly cross regional and intercontinental boundaries as part of the manufacturing process,.

Our understanding of trade has changed because economists have started looking more closely at two issues: the spatial aspects of trade, and what drives trade at the level of individual firms.

Spatial characteristics attracted the attention of researchers because trade was not evenly spread across or even within countries. Productive activity tends to cluster where skills and infrastructure come together to reduce costs. These effects tend to be reinforcing. We call them agglomeration effects.

The second new focus is on the basic unit of production: the firm. Within any particular sector there is a distribution of firms - some less productive, others more so. When exposed to competition through trade liberalisation, productive firms grow, while underperformers leave the market. Because it is expensive to recruit and retain productive workers in a global market, some workers can command higher wages.

Both issues have implications for economic inequality. We may well see a greater disparity between high-productivity firms in regions deeply integrated into the global economy, on the one hand, and lagging regions on the other.

This analysis is useful because it gives some intellectual underpinning to the links between business competitiveness and living standards. It goes beyond the fairly standard business environment indicators on which the burgeoning industry of country competitiveness “rankings” is built. These league tables are not wrong – they are simply a little too glib as the basis for serious policymaking.

So, what would good policy look like? One place to start is with the old medical adage, “first, do no harm”. Protectionism should be ruled out. The principle that a tax on imports is a tax on exports applied in the old world of trade and applies in spades in the new one. After all, while the fragmentation of production may have impacted inequality, it has made the world more *interdependent*. Consider, for example, the US, Japan, Germany or the UK. Not only are they major exporters in their own right, they are important suppliers of inputs to other countries’ exports: the value they contribute to foreign exports is between 25% and 30% of the value of their own exports. The trade and economic performance of any country is therefore heavily influenced by the performance of its trading partners. Raising trade barriers – and potentially starting a trade war – is thus a sure-fire way to shoot yourself in the foot. Much as President Trump believes it to be the case, his tariffs will not hand America a win or make it great again.

Beyond that, if productivity differentials explain how far businesses and regions get to participate in and benefit from trade, perhaps we ought to begin by looking at impediments to productivity. After all, reviving stagnant productivity as a way of stimulating growth has been a long-standing objective of industrialised countries. The UK is a prime example. The government’s industrial strategy puts a heavy emphasis on ‘place’ and improving productivity and living standards in regions outside London and the South East. To quote Krugman for a third and final time, “productivity may not be the whole story regarding growth, but in the long run it is nearly the whole story”. The difference is that when Krugman first penned those lines, trade liberalisation was seen as a means of stimulating productivity. We now know that it does so unevenly. Businesses benefit once they have already surpassed a certain productivity threshold. The trick, then, is to get more firms - and firms within particular regions - above that threshold in the first place.

This is less a matter for trade economists and macroeconomists than for applied microeconomists working on innovation, skills and labour markets. Government support for innovation can help if done right. For example, a growing body of robust evaluation evidence from the UK shows that public grants and other aid helps businesses to innovate more and grow faster. The risk for policymakers is that such benefits are captured mainly by firms that are already productive. Hence the imperative of targeting public assistance in a way that helps address some of the growing disparities between firms and regions.

In summary, talk about competitiveness is on the table in part because of distributional questions that arise from trade and globalisation. And though we can refine Krugman’s initial analysis, it remains largely correct. The notion of competitiveness is misleading because the real issue is not countries competing against one another. If anything, the world is more interdependent. The issue is *within* countries – more specifically, at the level of individual businesses and at the regional level, where trade

can exacerbate disparities owing to agglomeration effects. This raises questions about what makes firms competitive and the role of policy, particularly in areas such as business innovation. Here we can speak more appropriately of competitiveness, though again it would be better framed as a matter of productivity.

Because of its political appeal, the notion of competitiveness will not disappear. But at least economists now have a more developed toolkit to guide such discussions towards well-grounded solutions.