

European industry's place in the International Division of Labour: situation and prospects

SUMMARY (NON-TECHNICAL)

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In 1990 Japanese industry employed 15 million people in Japan and 1.2 million abroad. Ten years later it employs only 13 million in Japan and 2.8 million abroad.

In the United States Ross Perot had predicted a "giant sucking sound" caused by the loss of 5 million US jobs to Mexico if Congress ratified the Agreement on the North American Free Trade Area (NAFTA). People are saying the same today about the supposed loss of skilled jobs to India or China when services are delocalised. Gregory Mankiw in his *Economic Report of the President* submitted to Congress in February 2004 took a lot of flak for asserting in this respect that the expected benefits of delocalisation were not fundamentally different to the traditional gains from trade and international specialisation.

WHAT IS THE FUTURE FOR EUROPEAN INDUSTRY?

There is nothing new about the emergence of new competitors. However, a number of developments are today undermining the logic behind the international division of labour (ILD) between North and South:

- substantial cuts in transaction, transport and communications costs;
- the opening-up of large economies with an abundance of cheap labour;
- the scope for overseas subsidiaries of multinational corporations to tap this labour by using advanced technologies.

In these circumstances it is far from certain that an analysis based on the idea of comparative advantage and international specialisation as a win-win game remains valid. The emergence of competitors with a

very broad spectrum of comparative advantages in industrial activities, as exemplified by China, and sometimes in services too, as is the case of India, has revived the issue of the future of manufacturing industry in the industrialised countries in the face of competition from low-wage economies.

Has Europe the means to hold on to manufacturing? Or will it have to abandon its industrial base and become instead a major market for imported products and producer of services? Are services themselves not in danger of widespread delocalisation to countries which combine lower labour costs with strong skills in certain areas (the “Bangalore syndrome”)?

WHAT ARE THE CONSEQUENCES FOR PUBLIC POLICIES?

Were greater exposure to competition from the South to lead to large-scale factory closures in Europe, the impact on European living standards could well be permanent and considerable. It is primarily in factories that the productivity gains which raise living standards occur. Were European industry gradually to shut up shop, productivity increases in the European economy would become aligned with those in services, which are low. This trend is exacerbated by Europe's difficulties in applying new information and communications technologies, a source of productivity gains, in services. In Europe the new technological revolution is having difficulty finding its way into offices and shops.

The public policies to be introduced are hard to identify. Should manufacturers be encouraged not to delocalise? Should there be massive investment in research and development in an effort to maintain a technological edge? Should barriers be restored at the EU's frontiers to protect European industry? President Clinton proposed restoring manufacturing's share of US employment from 17% to 20% as an economic policy objective. The recent “Manufacturing in America” report commissioned by President Bush from the US Department of Commerce echoes these concerns: *“Strengthening American manufacturing is a top priority for the President. America’s manufacturers provide our nation and our people with good jobs, a better quality of life, and inventions that have established our national identity. Manufacturing is the backbone of our economy and the muscle behind our national security”*.

A POST-INDUSTRIAL ECONOMY?

Yet for all the decline of manufacturing in total employment (what is commonly called “deindustrialisation”), industry continues to play a key role in Europe’s economy:

- When the statistics are adjusted to take account of the development of temporary work, the outsourcing of certain activities by manufacturers (cleaning, accounting, catering, etc.) and the increasingly blurred boundaries between services and manufacturing in many sectors,

manufacturing industry is actually more or less maintaining its volume share of GDP, though its share in the wealth created is declining rapidly.

- The bulk of the relative decline of industry in terms of value added and jobs is attributable to price movements, reflecting industry's faster productivity gains and greater exposure to competition (Siemens being more exposed to international competition than hairdressers).
- Many service activities owe their very existence to the presence of manufacturing industry.
- Low-skilled or unskilled workers in industry are often better paid than their counterparts in the service sector.
- Manufacturing industry remains the fount of technological change and innovation and productivity gains; it plays a strategic role in terms of Europe's independence (space industry, arms, information technologies, etc.).

It is therefore difficult to imagine Europe's economy becoming wholly tertiary, which is not to deny the increasing dematerialisation of industrial production: there is no longer any smoke coming out of the factory chimneys. But factories are still needed.

THE LESSONS OF ECONOMIC ANALYSIS

Opening up the economy can contribute to the decline - though not the disappearance - of industry in a number of ways: specialisation according to comparative advantage, downward pressure on prices exerted by new competitors, global reorganisation of firms, shift in markets and therefore in the factories supplying them.

The advantage of the old industrialised economies is shifting from the factory to the office, distribution network or trading desk. Hence the closure, sometimes through delocalisation, of European factories confronted by imports from newly industrialised countries. This is the "Nike syndrome": Europe imports and distributes goods that it designs but no longer produces. The current account therefore has to be kept in balance by service exports (finance, royalties, tourism,...).

International prices are driven down by new competitors with very low labour costs and lax environmental rules. Only the most productive firms survive; only upmarket products with no competition from low-cost imports hold their own; only the most advanced, least labour-intensive technologies are chosen. Manufacturing jobs will decline and tend to be occupied by the most skilled workers. The number of European firms will shrink in every industry, making their strategic errors even

more costly; in the long run a management error may lead to the disappearance of a European industry, not just a firm.

European firms are reorganising themselves on an international level to take advantage of international cost differentials; they are specialising their overseas subsidiaries in different segments of the production process (e.g. by assembling goods in low-wage countries). The growing recourse to imported parts and components from the South is reducing the Community value added in every euro exported by European manufacturers.

Factories are located near the markets and the new markets are in the South. With the new markets growing by 10% a year, Europe cannot grow at a rate of 2% a year without losing its factories. Selling in China often entails producing in or around China. The shift in the international economy's centre of gravity, exacerbated by the sluggishness of the European economy, is inevitably leading European manufacturers to relocate to these dynamic new markets.

A HISTORIC TREND ...

For all these concerns, deindustrialisation is above all an *internal* development in the European economy.

The structure of European households' demand is distorted as their purchasing power increases. During a lengthy industrialisation phase the spread of industrial goods in society combined with the industrialisation of certain tasks (preparing meals, housework, etc.) and, possibly, a taste for technology and material goods to sustain demand for industrial goods.

As needs are saturated and European consumers' personal wealth increases, society dematerialises, consumption shifts to services (health, culture, leisure), the sale of material goods includes a growing service content (guarantees, user support, insurance, credit, etc.), the taste for technology or hard sciences wanes (as attested to by the difficulty of attracting students to the relevant courses) and high value is attached to conserving the environment (animal welfare, etc.). Technological developments bring faster productivity gains in manufacturing than in services and the ensuing distortion in prices cushions the expected fall in consumption of material goods. Above a certain level of income, however, industry holds its own in terms of volume, but its share in the production of value - and therefore of jobs - declines inexorably.

The developing countries' share of the leading industrialised countries' trade has so far been too small for imports from those countries to be the main determining factor in labour-market trends in the North. Most European trade used to be between European countries, i.e. between similar countries specialising in products or quality ranges within industries (Philips versus Miele or Lacoste versus Benetton), rather than

between industries (electrical goods versus clothing). There was no question of abandoning large sectors of production. Nor was there any question of competition in activities that were intensive in technology, skilled labour or “intangible assets”. So the impact of imports on the labour market remained small, concerning at most 1% of the active population.

Moreover, European consumers have both profited from the falling price of their shopping basket owing to new competition (the plummeting price of television set) and obtained considerable variety gains because they can now choose from the entire range of products manufactured in Europe (Polo, Clio, Tempo, Corsa, Fiesta, etc.).

... AMPLIFIED BY OPENING-UP

The scale of emergence of international production both as it now stands and as it is forecast to develop over the next fifteen years changes the situation completely. There is an urgent need for the European countries to realise that the world is changing and that this very rapid change seems unlikely to grind to a halt.

The Union's successive enlargements have not strengthened its position on the international scene, they have simply, by a series of jumps, made up a little of the ground lost. The United States, which has not enjoyed this margin for manoeuvre, saw its share of world GDP decline until the mid-1980s, when the decline was halted. The US economy therefore managed to find in its own dynamism the bounce lacking in Europe, which is further handicapped by its ageing population. Until the mid 1990s European integration saw intra-Community trade accounting for a growing share of world trade, peaking at 30%. That share has since fallen considerably and will soon be down to only 20%. This trend contrasts with that observed for NAFTA.

Meanwhile new big countries are emerging. Already big in absolute terms, their fairly rapid growth should make these countries key players on the world scene in the very near future. Brazil, Russia, India and China (BRIC) fall into this category. The world economy is therefore facing a new phenomenon: big open economies, where average standards of living will remain consistently lower than in the old industrialised countries, are playing an increasingly important role in the world economy. Owing to significant internal inequalities and the fluid movement of capital and technology at international level, these countries also enjoy comparative advantages in a wide range of goods: soya cake and aircraft, footwear and computer hardware, clothing and IT services.

At the same time a number of smaller countries are making the most of integration in the global economy and making very rapid progress in international trade without being held back, as the BRIC are, by the

sheer mass and backwardness of whole swathes of the “domestic” economy. These countries are using their trading success to catch up fairly quickly, which should tend to limit their long-term impact on competition. However, the regular topping-up of this list, especially in Asia, shows that the competitive challenge to the European economies is here to stay.

Overall, the countries of the South are now playing a major role in the recent development of international trade. Whereas the North continued to drive world trade from 1995 to 1998, accounting for two thirds of the growth in world exports and over four fifths of the growth in world imports, the situation has since been reversed. The South now accounts for more than half of the growth in world exports and already more than 40% of the growth in world imports.

This turnaround in the world economy, the emergence of a global factory, is beginning to have a very appreciable impact. It is based on the modularity of products (i.e. the fact that products can be broken down into sub-assemblies that can be produced separately: a computer is a tower, printed circuits, a power supply and a monitor). It is based on the specialisation of sites (design in California, manufacture of electronic components in Japan, assembly in China). And it is a factor in delocalisations (Nokia transfers part of its R&D to China). This fragmentation of the value-added chain is reflected in the growing share of parts and components in world trade. The global factory, which capitalises on differences in costs or productivity between the various possible sites, had been on the cards for a long time, but it was the sharp fall in transaction costs (in particular plummeting communication costs) and the large-scale opening-up of the South's economies that unleashed all this potential.

We are seeing a radical redistribution of comparative advantages between countries: whole sectors of industry are destined to leave the North. The traditional view of the North as specialising in recent industries (telecommunications, computers, etc.) and the South in traditional industries (textiles, toys, etc.) is misconceived. With the global factory, the countries of the South are increasingly specialising their industrial apparatus in both areas of activity. Only a few industries, those involving processes which are intensive in capital or skilled-labour, cumulative technology or transport difficulties, are better able to buck these underlying trends, e.g. aeronautics, electronic components and the automobile sector.

FIRST KEY ISSUE: THE NORTH'S TECHNOLOGICAL EDGE

Since the mid-1990s there has been a major redistribution of market shares between emerging and developing countries and among developing countries themselves. The EU has emerged relatively unscathed from this trend despite the unfavourable geographical focus of its trade. The EU's share has fallen by only 1.4 in volume. Of the BRIC, only China and India are gaining market share. China's gains are dramatic (+62%), while India's are more modest (+16%). Competitiveness is the only explanation for

their performance. The emerging countries' results vary considerably, though some have seen their market share increase by as much as 76% (Mexico).

The problem of European performance is essentially a problem of sectoral adaptation: EU products are out of step with trends in world demand. A detailed analysis shows that Europe has missed the technological boat of the 21st century: Europe's second fastest growing export is pork and poultry fat; another fast growing export is ships ... for scrap. We are therefore a very long way from exporting products that would make Europe a player in world technological competition and the information society.

The very rapid decline of the Triad in the area of high-tech products contrasts with China's catching-up. The United States was overtaken by China at the end of the 1990s and is now in the worst position in the Triad. Japan has seen its position on the world market halved in seven years. In 2000 the EU 15 stopped its very rapid fall, but there is nothing to indicate any lasting improvement in its position. Naturally, market positions are very strongly affected by macroeconomic imbalances, especially in the United States. Nonetheless, from the point of view of US producers, the situation really has worsened and is fuelling the public perception of an industrial disaster that has reached the cutting edge of the US economic lead, namely high technology. In the area of high technology, the most innovative, higher margin products ought to be the last bastion against competition from the South. It is perfectly possible for a country of the South, if it has a sufficient level of technology, to import components and to assemble upmarket technological products. This has very clearly been the case in China since 1997.

Depending on whether trends continue at the rate observed since the mid-1990s or are reversed by a proactive policy, Europe's technological positioning in 2025 could differ completely owing to the speed of change. The technological variable is clearly a matter for European policies at the level of the Member States and the Union. In 2000 the Lisbon European Council set the objective of making the European economy a world leader by 2010, a knowledge-based society combining sustainable development with full employment, macroeconomic stability and social cohesion. These objectives have been reiterated regularly at subsequent European Councils and a battery of indicators developed to track their achievement. At the half-way stage the strategy would appear to have run aground, with innovation and productivity declining in comparison with the United States.

SECOND KEY QUESTION: THE SOUTH'S INSTITUTIONS

The second question is that of the narrowing gap in living standards (and not in economic terms, i.e. GDP) between North and South. The quality of institutions determines growth in productivity and therefore the speed at which standards of living in the South catch up with those in the North. This, for

instance, is why freedom from corruption contributes as much as levels of education to the international productivity gap. In many countries poor quality institutions are retarding growth by several points per year.

If the new competitors catch up quickly, the medium-term development of international trade will basically be intra-industry (variety trade); as has been seen in the EU, this trade will bring gains for producers and consumers and keep European industry alive. But in extra-Community trade the move to the intra-industry type of trade is proving difficult owing to the differences in living standards between trading partners. As the Member States' share in intra-Community trade falls, so the adjustment costs related to international trade automatically increase.

Were the new competitors to drag their feet in raising wages, because they have a “reserve army” or because of the continued existence of undemocratic governments, then competition from the South, which has so far played only a limited role in European deindustrialisation, would prove far more destructive. This is where Europe's position in international trade negotiations, the “depth” of bilateral agreements or the importance accorded to social issues in the EU's discourse on the international stage will be able to make a difference.

SIX SCENARIOS

These two frames of reference – technology and institutions - can be combined to produce six scenarios, the consequences of which in terms of the nature of international trade, EU specialisation, labour market trends, income and inequality pose difficult policy challenges.

Concerning the EU's technological capacity, there are three hypotheses: further decline, maintenance of the status quo, or catch-up leading to a serious reactivation of the Lisbon process. We assume that the United States will remain the “technological frontier”, namely the country with the highest average technological level, that the most dynamic followers will catch up, throughout the first half of the century, while Japan reaps the benefits of its research efforts over the last decade to recover its former position or at least hold its ground.

As for the possible trajectories of the emerging and BRIC economies, two diametrically opposed hypotheses are considered: rapid convergence towards living standards in the North versus institutional blockage, which could give rise to endless financial crises or major social and political crises impeding any prospect of their catching up for a long time.

The combination of these two sets of hypotheses shape six scenarios.

First scenario: The emerging countries catch up quickly owing to appreciable progress in the institutional sphere combined with technological decline in the EU, leading to a *European retreat* into sheltered activities. This scenario involves a degree of inability on the part of Europe to reform itself, resulting in slow growth, a confirmed trend towards delocalisation, a weak euro to protect against international competition and capital flight. European industry finds itself trapped between two poles of competition: the United States and Japan consolidate their edge in the communication and information industries, while Europe misses the boat on biotechnology (jeopardising its pharmaceuticals industry) and loses its lead in the space and aeronautical industries. The situation continues to deteriorate, as the weakness of the euro makes access to new technologies more costly and stops them from spreading through the production fabric. Concerning more ordinary products, the only choice if European companies are to survive is the large-scale delocalisation of their production.

If, however, the EU's technological capacity stabilises, the swift catching-up of the emerging economies will not lead to a fallback on prestigious activities but to a marked selection effect on firms. The EU will continue to specialise in certain technologies and upmarket products. We term this *marginalisation* since Europe will lose ground on the world market. Were the South to catch up quickly, the EU's current situation, in which its market position in skilled-labour- and intellectual-property-intensive upmarket products is holding up well, would be confirmed. Upmarket products, which account for one third of global exports, represent almost half of European exports. The EU is the world's second biggest exporter, ahead of the USA and behind Japan; China is bringing up the rear.

The Lisbon process might succeed, even if the half-way evaluation is rather negative: potential GDP growth of 3% based on the reform of the market for goods and labour, the dissemination of ICTs throughout the production fabric and the reconquest of the field of science. Such a success would help maintain market share in a fast growing world economy if the emerging countries were to catch up quickly: we term this *shared prosperity*. In an enlarged market, Europe recovers market shares in both high-tech and upmarket products.

These three scenarios are based on the optimistic assumption that the low-wage economies modernise their institutions. If, however, institutional and/or democratic problems in the South were to sustain the cleavage between productivity and pay in today's low-wage economies, the result would be the co-existence of a rich North with an ageing population and substantial social safety nets, alongside a South which is pressing home its cost advantage. The hypothesis of a technological decline in the EU would then lead to a worst-case scenario: *levelling down*.

Last but not least, were the Lisbon process to succeed in this context, we would have a scenario of marked international disparities and the *technological domination* of North over South. Growing imbalances

between North and South in terms of living standard and the danger over time of a rift in the world economy make this an unacceptable scenario. In the latter scenario, which is very much non-cooperative at international level, it would be vital to maintain a technological edge, and intellectual property would become totally strategic.

Between these two scenarios, the *drift* scenario, in which slow growth and maintenance of the EU's technological level is combined with institutional stasis in the South, reflects further splitting-up of value-added chains and increasing EU specialisation in the last segments of value-added where an advantage is maintained (design, etc.), namely industrial activities bordering on services.
