The Rise of BICS: How it Impacts the Developed Countries and the Global Trading System

By Arvind Panagariya[1]

1 Introduction

During the three decades immediately following the Second World War, the developed countries systematically opened their markets in industrial products and services to one another and to the rest of the world. At the time, the developing countries including today's emerging giant economies such as China and India were frightened of competing against super-efficient producers in the world markets. They systematically chose to insulate their economies from such competition by erecting high walls of protection. The only exceptions were the East Asian tigers—Hong Kong, Singapore, South Korea and Taiwan—that saw an opportunity in the opening up by the developed countries and chose to go after their large markets. Subsequently, the success of the tigers gave other developing countries the courage to shed their fears, open up their economies, and exploit the vast world markets. The results have been spectacular, as reflected in the rise of India and China.

In an ironic reversal of attitudes, it is the developed countries that have now come to fear the world markets.[2] Lou Dobbs, with his tirades on China and India for stealing the U.S. jobs in manufacturing and services, respectively, has become a hero and commands one of the largest audiences on the U.S. television. And the debates in the United States on free trade agreements with countries such as Honduras, Guatemala and Costa Rica have produced acrimony that is well beyond what would be justified by the economic sizes of these countries.

2 Two Debates: Leveling of Wages and Outsourcing of Skilled Jobs

Among the academics, these fears have found expression in two related but distinct debates:

- Does trade with the developing countries level the wages in the rich countries?
- Does outsourcing of arms-length services (mainly via the Internet) threaten the availability of skilled jobs in the rich countries?

On the first of the above two subjects, Richard Freeman of Harvard university expresses the fear most graphically when he argues that India, China and the former

[1] The author is Jagdish Bhagwati professor of Indian Political Economy at the School of International and Public Affairs, Columbia University. This note is prepared for presentation at the conference "Emerging Powers in Global Governance: New Challenges and Policy Options," organized by the School of International and Public Affairs at Columbia University; International Institute for Sustainable Development; Institute for Sustainable Development and International Relations; and Sciences-Po, Paris on July 6-7, 2007.

[2] See Bhagwati, Jagdish, "The World Trading System: The New Challenges," in Arvind Panagariya, M.G. Quibria and Narhari Rao, ed., *The Global Trading System and Developing Asia* Hong Kong: Oxford University Press for the Asian Development Bank, December 1997.

Soviet Union have added some 1.5 billion workers to the global work force since 1990.[3] Because these workers did not bring any capital with them, they have cut the capital-labor ratio to 55 to 60 percent of what it would have been otherwise. The implication is that they have contributed to either leveling unskilled wages or creating massive unemployment among them in the developed countries.

On outsourcing, Alan Blinder of Princeton University argues that in the long run, 30 to 40 million U.S. jobs in services are under threat of being outsourced.[4] He predicts that the U.S. workers will be reduced to supplying personal services that require direct contact between the recipient and the seller with the recipient is located in the United States. Assuming slow or no productivity growth in the provision of personal services and the migration of the other services abroad, he predicts a massive decline in the wages (or unemployment) among the skilled workers.

Trade economists, the present author included, disagree with this analysis.[5] They offer several counterarguments:

- So far, systematic empirical studies have failed to produce evidence of a large impact of trade with the developing countries on unskilled wages in the rich countries. Most empirical studies attribute at most 30 percent of the increase in wage *inequality* (the ratio of skilled-to-unskilled wage) between the late 1970s and early 1990s to trade. And the only study by Robert Feenstra and Gordon Hanson that allows us to infer the effect on the real unskilled wages finds it to be marginally *positive*.[6]
- This is reinforced by the fact that the share of imports from the developing countries in the total U.S. expenditure rose by less than two percentage points during the period of the massive rise in wage inequality.[7]
- Additionally, as the imports of the labor-intensive products from the Far Eastern developing countries expanded, imports of the same products from countries such as Japan contracted. Not all of the imports from the developing countries were additional imports.[8]
- Trade economists also point out that the bulk of the shift in the demand away from unskilled labor has its origins in the continuous shifts in technology that either replaces the demand for unskilled labor by capital or skilled labor. This factor also explains better the observation that skilled-to-unskilled wage ratio has also risen in the developing countries. If we go by the usual Stolper-

[3] Freeman, Richard, 2005, "What really Ails Europe (and America): The Doubling of the Global Workforce," *Boston Globe*, June 3, 2005. The Web version of the article may be found at http://www.theglobalist.com/StoryId.aspx?StoryId=4542.

[4] Blinder, Alan, "Offshoring: The Next Industrial Revolution?" Foreign Affairs, March/April 2006. See the Web version at http://www.foreignaffairs.org/20060301faessay85209/alan-s-blinder/offshoring-the-next-industrial-revolution.html.

[5] Mindful of my comparative (and absolute) disadvantage in the study of Europe, I will discuss these debates purely in the U.S. context.

[6] Feenstra, Robert C. and Gordon H. Hanson, 1999, "Productivity Measurement and the Impact of Trade and Technology on Wages: Estimates for the U.S., 1972-1990," *Quarterly Journal of Economics*, August , 114(3), 907-940.

[7] Krugman, Paul, 1995, "Growing World Trade: Causes and Consequences," *Brookings Papers on Economic Activity* 1, 327-362.

[8] Bhagwati, Jagdish, 1999, "Play it Again Sam: A New Look at Trade and Wages," in Gustav Ranis and L. K. Raut, eds. *Trade, Growth and Development: Essays in Honor of Professor T.N. Srinivasan*, Amsterdam: Elsevier.

Samuelson argument on which those attributing the wage effect in the developed countries to trade rely, the increase in the exports of the labor-intensive products from the developing countries should raise rather than lower unskilled-to-killed wage ratio.

The effects of outsourcing on jobs in the United States have been exaggerated even more. This is discussed extensively in my joint paper with Jagdish Bhagwati and T. N. Srinivasan.[9] Some important points are as follows:

- Once you get down to calculating the hard figures, the number services jobs outsourced through arms-length trade (mainly via the Internet) turns out to be tiny. The software industry in India, the focal point of everyone's attention, still employs approximately 1 million workers of whom a good proportion serves the domestic market. Our own calculation in Bhagwati, Panagariya and Srinivasan (2004) was that at most 100,000 jobs per year were being outsourced at the time. In contrast, the U.S. economy destroyed 30 million jobs and creates as many on the average annually.
- These figures do not include the jobs that are in-sourced or created by outsourcing. The latter follows from the possibility that some activities employing workers within the U.S. that are infeasible in the absence of outsourcing become feasible in its presence.
- The more relevant question is the effect of outsourcing on the total number of jobs. Here the evidence does not support the contention that outsourcing has an adverse effect on the total number of jobs. Lael Brainard and Robert Litan note that the number of jobs has flexibly adjusted to the growth in the labor force in the United States. Despite declining barriers to trade, rapid expansion of the volume of imports, and the innovation of what appear to be job-displacing technologies, the United States economy added 30 million workers to its payrolls between 1985 and 2004 including the 2001.[10]
- There are also reasons to believe that high-value jobs will continue to arise so that outsourcing will not result in the decline in wages predicted by Blinder. Some high-value jobs have been outsourced but that process is not going to go very far. The labs often have to be close to home where new products tend to be developed. This effect of outsourcing is like the first stage of what Raymond Vernon famously called the "product cycle" where innovating firms introduce and debug the product in the domestic market and once the product matures and is standardized, they shift its production to countries where it is cheapest to produce, with the home country eventually becoming an importer of the product.[11] Given the enormous U.S. lead in higher education and research, it economy can be expected to continue to innovate new products and processes that generate a stream of new jobs.

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[9] Bhagwati, Jagdish, Arvind Panagariya and T. N. Srinivasan, "The Muddles over Outsourcing," *Journal of Economic Perspectives*, Volume 18, Number 4 (November 2004), pp. 93-114.

[10] Brainard, Lael and Robert E. Litan. 2004. "'Offshoring' Service Jobs: Bane or Boon and What to Do?" Policy Brief #132, Washington, DC: Brookings Institution.

[11] Vernon, Raymond. 1966. "International Investment and International Trade in the Product Cycle." *Quarterly Journal of Economics* 80, 190-207.

- But what about the prediction by Blinder that in the long run, 30 to 40 million U.S. jobs are at risk? In my view, the best counterargument to it is Blinder's First Law: All long-run predictions are false. While Blinder himself used to state this law in zest in his macroeconomic classes in the early 1970s, there is great deal of truth in it.[12] I state this in zest but only partially. Social scientists and policy analysts are hopelessly incapable of making credible long-term predictions. For instance, in the 1950s, the consensus among economists, policy analysts and policy makers was that India was rising star among the developing countries and would serve as a model for other poor countries aspiring to overcome poverty. South Korea, on the other hands, was seen as a basket case. By 1980, exactly the opposite had come true: South Korea rose like a meteor and India turned into a basket case. No social scientist, surely no economist, was interested in studying India any longer. But, ironically, fortunes turned again and within another 25 years, India became an economy feared by such powerful and rich countries as the United States.

3 Implications for the Global Trading System

In policymaking, perceptions matter—some would go so far as to argue that only perceptions matter. This is certainly true in the area of trade policy. The perception that opening to the developing countries brings risks of lower wages for the unskilled and job losses for the skilled has had a major impact on the process of opening up of the global economy to trade. Let me make just three points.

First, the perception has led the United States and EU to replace their unilateral trade preferences by reciprocal trade preferences. The EU had insisted under the Cotonou Agreement that except in the case of the Least Developed Countries, its trade preferences be replaced by reciprocal preferences via free trade area (FTA) agreements. Likewise, the United States has insisted that the preferences it has given to the products imported from the poorer Latin American countries be replaced by FTA agreements.

Indeed, the fears of competition have been partially responsible for a general shift in the focus of trade negotiations by the United States and EU to the bilateral track. True, the Doha multilateral negotiations are proceeding on a parallel track but progress on that front has been illusive. But bilateral negotiations are moving apace successfully. This track gives the United States and the European Union the twin advantages that they can be selective in their choice of the partner and they can better control the agenda. The U.S. in particular has chosen to go for relatively small countries—Jordan, Morocco, Singapore, Australia, Chile, Guatemala, Nicaragua, Honduras, Costa Rica, Dominican Republic and now Peru and Panama. These countries pose no competitive threat to the U.S. And the U.S. is able to impose a whole host of trade-unrelated conditions on them. These conditions include WO plus

[12] Professor Blinder was my teacher of Macroeconomics at Princeton in the fall of 1974. Having finished his own graduate work at MIT only three years earlier, he once joked in the class how it was so very difficult to have a law named after oneself. He then went on to self-effacingly annunciate Blinder's Law. In the text, I have inserted "First:" before "Law" to distinguish this law from another Blinder's Law I have come across recently: The more economists agree on something the more they are ignored.

environmental and intellectual property standards, labor standards and restrictions on the use of capital controls.

The second consequence of the competitive pressures from the developing countries has been increased demand for the escalation of labor standards in the developing countries through the threat of trade sanctions in the future trade agreements. As technologies have moved the labor demand progressively towards skilled workers and away from unskilled workers, labor unions have felt the pressure on the wages of their membership. Because the WTO commitments do not allow trade barriers to be raised, one of the few options left to guard against competition from labor-intensive products imported from the developing countries is to raise their labor costs through ever-increasing labor standards.

The recent "Bipartisan Consensus" reached by the Bush administration with the Democrats seeks to do precisely this. At the moment, the hiked up standards are being imposed on Peru and Panama and possibly Colombia in the FTAs under negotiation with them. But if one goes by the statements made by the USTR Susan Schwab, this consensus will also form the basis of a future renewal of the trade promotion authority of the President. And if the labor requirements are then applied to a future Doha agreement, that will be the end of the Doha negotiations. Large developing countries such as Brazil and India will refuse any agreement with a labor clause in it.

Finally, the fear of competition from the large developing countries has rendered multilateral negotiations more complex. In the past, especially prior to the Uruguay Round, multilateral negotiations were driven by what I call the "Old Quad": the United States, European union, Japan and Canada. These countries had similar levels of income and trade among them was intra-industry type. Therefore, agreements were easier. Today, the rise of the developing countries as major players has changed the composition of the major negotiating countries. The "New Quad" consists of the United States, European union, Brazil and India, popularly known as the G-4. Having been burnt in the negotiations for the Uruguay Round, their first such negotiation, the developing countries are much better prepared today. They also recognize that together they will constitute a very large market 10 to 20 years from now. The developed countries cannot ignore this fact. Therefore, they have very substantial negotiating leverage.

At the latest Potsdam meeting of the G-4, the USTR Susan Schwab resorted to the usual tactic of pointing the finger at India (and to some degree Brazil as well) for stalling the negotiations. But that kind of tactic will not work. The U.S. itself will have to negotiate in earnest by making offers of genuine liberalization if that is what it wants in return from Brazil, China and India. Thus, consider just a few facts on each side.

At Potsdam, Ms. Schwab was willing to lower the ceiling on distorting agricultural subsidies to only $17 billion. The current applied level of the U.S. trade-distorting subsidies is $11 billion so that the $17 billion ceiling would in fact allow U.S. to actually raise its subsidy level in the future. This is not an academic matter because the U.S. Congress has every intention of doing so: even as the Potsdam was in progress, the House subcommittee on agriculture voted to retain the subsidy portion of the 2002 Farm Bill. Thus, the U.S. offer in agriculture amounts to no concession in actual disbursements and the possibility of a future reversal.

But rather asymmetrically, Ms. Schwab insisted at Potsdam that India and Brazil cut their bound tariffs (i.e., the WTO legal tariff ceiling) on industrial products sufficiently deeply to create substantial new market access. Now India has brought down its highest applied industrial tariff down from 38.5 percent in 2001 to 10 percent in 2007 (with the exception of some peak tariffs just as in the United States and European Union). In contrast, India's average bound tariff is 36 percent. Therefore, to create substantial new access, it will have to cut its industrial tariffs by 80 percent on the average. Almost the same applies to Brazil. But then, under the Special and Differential treatment already built into the July 2004 Framework Agreement, such a large cut would have to be matched by near free trade by the developed countries. It is not clear that Ms. Schwab can sell that kind of liberalization to the U.S. electorate.

Therefore, the problem in the Doha negotiations lies not in the position of India and Brazil but the United States and European union that must place genuine subsidy reductions on the table if they want genuine tariff reductions by their developing country counterparts. A deal is possible but not playing the blame game. Today, the developing countries are far too vigilant for that to work.