Popular Myths about the World Economy

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In remarks before the January 1997 meeting of the American Economic Association, Professor Robert M. Solow of M.I.T. drew upon his previous experience with the President's Council of Economic Advisers to offer this advice for policymakers: "It ain't the things you don't know that hurt you, it's the things you know that ain't true." Many of us "know" such things, and sometimes act, or urge our representatives to act, on our mistaken beliefs. This article examines three common myths, or misconceptions, about the international economy. As with most myths, these embody grains of truth, but if accepted without qualification could lead to grievous policy errors.

I. Global Competition Prevents Inflation

Experienced analysts have been surprised by the low rates of inflation in the United States over the past year or so, because the accompanying relatively low rates of unemployment had been expected to generate significantly higher wages and prices. In seeking an explanation, numerous observers have focused on intensified global competition. They have argued that this competition inhibits firms and workers from boosting wages and prices and that it has forced much of the restructuring of the U.S. economy in recent years, including corporate downsizings. In this view, the firm that raises prices faces swift discipline in the form of increased competing lower-priced imports or decreased export sales, and the union that secures an inflationary wage increase soon finds its workers being laid off as the jobs they perform are transferred to lower-wage workers abroad. Thus, it is argued, there is little or no need to tighten monetary policy in order to prevent an acceleration of inflation.

Although such reasoning seems plausible, a nation's macroeconomic policies, particularly its monetary and exchange-rate policies, surely have much more influence on the nation's rate of inflation than global

competition does, especially if the nation's economy is relatively large, as in the case of the United States. Indeed, it can readily be shown that, as a general principle, high involvement in the world economy provides no immunity against high inflation.

In Table 1, for example, data are presented for four foreign countries that have experienced bursts of inflation, in differing degrees, during the 1990s, even though their interdependence with the world economy (as measured by the ratio of their foreign trade to GDP) has been much greater than that of the United States. Other countries could be added to buttress the point, but the four selected comprise a diverse group, with marked differences both in economic structure and in per capita income. In spite of their diversity, all have endured periods of inflation that are high by U.S. standards.

All four countries have also experienced significant depreciations of their currencies against the leading exporting countries' currencies (whose weighted average value is represented in Table 1 by the SDR, or special drawing right, an international unit of account and reserve asset). The correspondence of high inflation and exchange-rate depreciation is, of course, no accident. With relatively high inflation, a country tends to lose competitiveness in world markets, and its currency must become cheaper in terms of other currencies to preserve or restore that competitiveness. Global competition need not stop the country from continuing along the dual paths of high inflation and exchange-rate depreciation.

Table 1
Economic Interdependence and Inflation, Selected Countries and Years

Country and Year	Exports plus Imports of Goods and Services as a Percent of GDP	Percent Change in Consumer Prices[a]	Percent Change in SDR Value of the National Currency[b]
United States			
1995	23.6	2.8	−1.8
Mexico			
1990	32.3	26.6	−17.2
1991	30.4	22.7	−4.6
1992	30.3	15.5	2.5
1993	34.4	9.7	.4
1994	38.1	6.9	−45.1
1995	61.8	35.0	−31.6
Greece			
1990	44.9	20.3	−7.5
1991	43.1	19.5	−10.6
1992	43.6	15.8	−15.0
1993	42.5	14.5	−13.8
1994	43.1	10.9	−2.3
1995	n.a.	9.3	−.5
Sweden			
1990	59.5	9.9	.9
1991	54.3	9.0	2.5
1992	54.0	2.8	−18.3
1993	61.9	4.5	−15.1
1994	68.9	2.6	4.7
1995	75.3	2.5	10.1
Iceland			
1990	67.0	15.5	2.0
1991	64.3	6.8	−1.0
1992	61.1	3.9	−9.5
1993	62.7	4.1	−12.0
1994	67.0	1.6	.2
1995	66.9	1.6	2.8

n.a. - Not available.
[a]From previous year average.
[b]From previous end of year.
Source: International Monetary Fund, *International Financial Statistics*, January and March 1997.

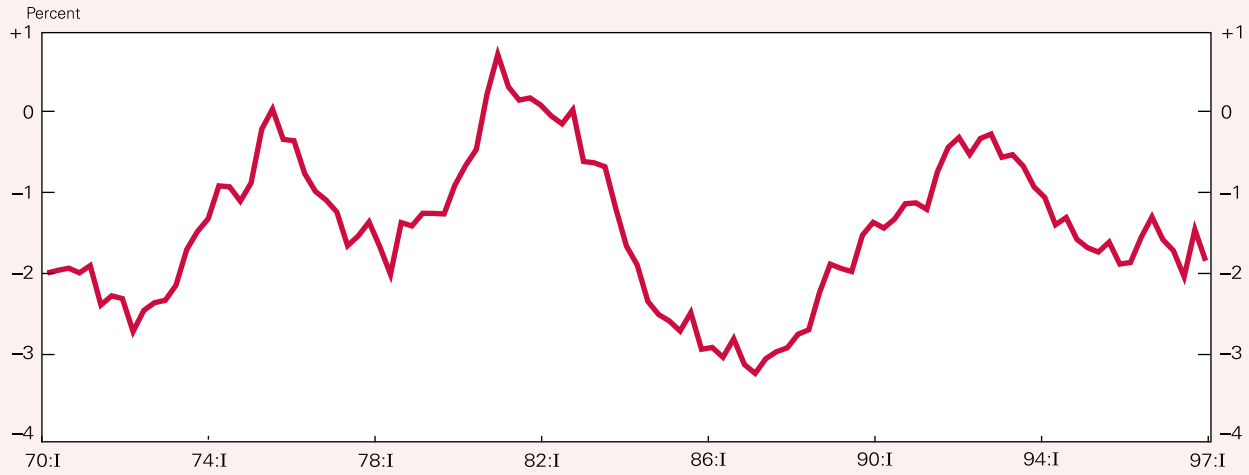
Some analysts would argue that exchange-rate depreciation in such cases may well be excessive—more than is required to compensate for the country's loss of competitiveness caused by the underlying inflation—and that the depreciation therefore exacerbates the inflation. If so, growing interdependence, or globalization, could render such inflation-prone economies even more, rather than less, vulnerable to inflation, through the feedback effects of exchange-rate depreciation.

While general international involvement and global competition do not immunize countries against high inflation, one particular form of international interdependence can do so. If a country successfully fixes the value of its currency in terms of the currency of a second country with low inflation, the first country will share a similarly low inflation. The fun-

Figure 1

U.S.Real Net Exports (+) or Net Imports (-) as a Percent of Real GDP

Quarterly; seasonally adjusted



Note: Last observation plotted is for 1997:QI.
Source: U.S. Bureau of the Census.

damental reason for this outcome, however, is not global competition, which is present whether or not the country fixes its exchange rate in this way. The true reason is that linking its currency to that of a low inflator requires the country also to link its monetary policy and prices to those of the low inflator.

An extreme case of such linkage is one country's use of another's currency, rather than issuing its own, such as Panama's use of the U.S. dollar. As long as U.S. monetary policy prevents high U.S inflation and thus protects the purchasing power of the dollar, Panama will enjoy the same sound currency and a similarly low rate of inflation.

With respect to recent U.S. experience, if the U.S. economy had begun to overheat, or to tax its capacity and put upward pressure on prices, one would expect that net imports into the country would have grown as U.S. purchasers turned to cheaper foreign sources of supply, a phenomenon that would be perceived by U.S. producers as foreign competitive pressure restraining their price increases. In fact, as shown in Figure 1, real net imports as a percentage of GDP have fluctuated in recent quarters, but were no larger in the first quarter of 1997 than in the first quarter of 1995, and have been considerably smaller recently than at other times since 1970.

Moreover, one would suspect that inflation in the United States could be prevented by global competition only if inflation abroad were relatively low. If prices were soaring abroad, they could hardly act as a restraining influence over U.S. price and wage increases. While inflation has been low in some countries, it has been high in others, and as reported in Table 2, both world commodity prices and world consumer prices have risen much faster than U.S. consumer prices in recent years.

Table 2

Percent Change in Commodity and Consumer Prices, 1992 to 1996

	World Commodity Prices (in U.S. dollars)	Consumer Prices	
		World (weighted average)	United States
1992	.1	18.1	3.0
1993	1.8	19.6	3.0
1994	13.6	23.7	2.6
1995	8.2	11.6	2.8
1996	−1.3	7.5	2.9

Source: International Monetary Fund, *International Financial Statistics*, January and March 1997.

Also, price levels abroad could serve to restrain U.S. prices only if foreign and U.S. prices were fairly closely linked. To be sure, some prices, especially for homogeneous commodities such as oil or copper, are rather closely linked across countries where they are traded relatively freely, once prices are measured in the same currency. However, different countries use different currencies, and exchange rates between those currencies can change dramatically, as illustrated in Table 1, so that price movements measured in the various currencies and countries can diverge widely even for these homogeneous, freely traded commodities.

Moreover, even when prices in all countries are measured in the same currency, prices in one country often change relative to those abroad, especially for nonhomogeneous or nontraded goods, so that a country's goods may become more or less expensive relative to goods in other countries. In other words, the country's real exchange rate may change, and the United States is no exception. Indeed, the experience of the United States in the 1980s affords a dramatic illustration of such real exchange-rate variation. As indicated by the black line in Figure 2, U.S. consumer prices relative to those in major foreign industrial countries rose by roughly 70 percent, after incorporating nominal exchange-rate change, between 1980 and 1985, then declined to approximately the 1980 level by the end of 1987.

A nation's macroeconomic policies, particularly its monetary and exchange-rate policies, surely have much more influence on the nation's rate of inflation than global competition does.

Unlike this real exchange rate, the "nominal" index plotted in the chart represents only the foreign-currency price of the dollar, ignoring domestic and foreign consumer prices. Clearly, it was nominal exchange-rate change, rather than changes in domestic or foreign prices, that accounted for the large swings in the U.S. real exchange rate (that is, in U.S. relative prices when measured in foreign currencies) over this period. Nonetheless, those swings did occur, and significant, although smaller, swings have continued in subsequent years.

These variations in exchange rates plainly show that exchange-rate movements may in fact enlarge, rather than offset, inflation differentials between countries, once the differentials are measured in a common currency. In other words, not only can inflation rates differ sharply across countries, but exchange-rate movements can amplify the cross-country price differentials that result from differences in inflation—subject, however to the following qualification: Large divergences in inflation do typically generate largely offsetting changes in exchange rates, especially over extended periods of time. This is no more than a qualification to the general proposition that real exchange rates can vary, especially in the short run, but it is an important qualification, because it helps to answer the following rather puzzling question.

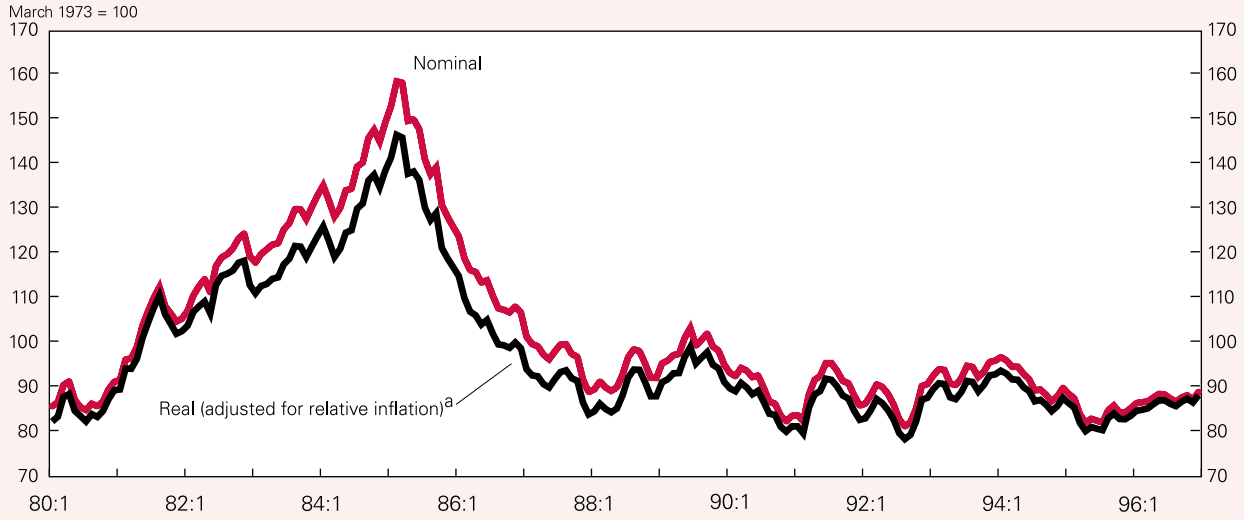
If globalization does not prevent U.S. inflation, why do U.S. firms and workers often perceive that foreign competition compels them to hold down their prices and wages? Broadly speaking, the answer is that they commonly experience such competition regardless of the rate of U.S. inflation, because U.S. inflation markedly different from that in the rest of the world will be largely offset by change in the foreign-exchange rate of the dollar as time goes by, leaving particular firms and groups of workers exposed to roughly the same price pressures from abroad. Suffering the most from foreign competition over the years will be those industries with a growing comparative disadvantage in international trade. Without government protection, such industries will experience painful foreign competition, regardless of how low the U.S. rate of inflation becomes, while industries whose comparative advantage is growing will continue to expand, even with a high rate of overall U.S. inflation.

In brief, then, while global competition can in some circumstances mitigate inflationary pressures in a country, such competition is a weak reed on which to rely for control of the overall price level, and its significance in restraining U.S. inflation remains to be shown. Far more important are the nation's monetary and exchange-rate policies, whose potency has been demonstrated many times over.

Figure 2

Weighted Average Foreign Exchange Value of the U.S. Dollar, 1980 to 1996

In terms of 10 other currencies weighted by foreign trade shares; based on monthly averages of daily rates



[a]Inflation measured in terms of consumer goods prices.
Source: Board of Governors of the Federal Reserve System.

II. Fair Trade Requires Equal Labor Standards

For many years U.S. firms and workers encountering strong import competition have commonly complained that foreign firms gained an unfair advantage by paying wages and benefits well below those in comparable U.S. industries. In recent years these import-competing industries have sought redress partly through a drive for fair international labor standards, with trade penalties assessed against offending nations.

That fairness should be observed in international competition seems indisputable. What constitutes fairness is not so obvious. Does the abundance of cheap labor in China render it an unfair competitor in the production of goods requiring relatively large amounts of unskilled labor? If so, does the less densely populated arable land mass in the United States make it an unfair competitor in the production of corn and soybeans, and do the plentiful coconut trees in the Philippines render it an unfair competitor in the production of coconut oil? Clearly, what comprises fair international labor standards merits some consideration.

A recent study by the Organisation for Economic Cooperation and Development (OECD) identifies four labor standards, or goals, that it views as "core," or key:

(l) the elimination of exploitive child labor;
(2) the abolition of forced labor;
(3) nondiscrimination in employment;
(4) freedom of association and collective bargaining.

Essentially the same standards have been included in various United Nations covenants, in International Labour Organisation conventions, and in the Declaration of the 1995 World Social Summit in Copenhagen. The widespread multilateral endorsement of these standards reflects a shared conviction that they embody basic human rights without which other labor standards would have little meaning (hence, their characterization as "core"). For example, working-time standards, present in many countries, would have little value to workers who were not free to leave inhumane working conditions or who could not get jobs because of discrimination (OECD 1996, pp. 25–28, 33–34).

The widespread formal acceptance of these standards does not mean that they are equally widely enforced. Unfortunately, information on enforcement is sparse in many countries, especially regarding child labor, forced labor, and nondiscrimination in employment. But the OECD study does offer a tentative assessment of the degree of enforcement of freedom of association and collective bargaining rights in 73 countries, which collectively account for almost all of world trade (OECD 1996, pp. 41–43).

Key international labor standards are the elimination of exploitive child labor, the abolition of forced labor, nondiscrimination in employment, and freedom of association and collective bargaining.

It happens that freedom of association and collective bargaining—essentially, the right to found and join independent unions and to strike—is well established in 27 countries, including 22 of the OECD countries, but is subject to varying degrees of restriction in most of the remaining countries. Some restrictions include political interference in union activities, such as closely linking the ruling party with a single union structure, which the party can then manipulate against the interests of the workers. Other limitations take the form of discretionary registration and recognition requirements, such as allowing only one union to be registered in each enterprise or occupational category. In addition, the right to strike may be severely undermined in various ways.

If then, as seems to be the case, core labor standards are violated in many countries, what are the consequences for world trade? In particular, can countries gain competitive advantages by failing to observe the standards?

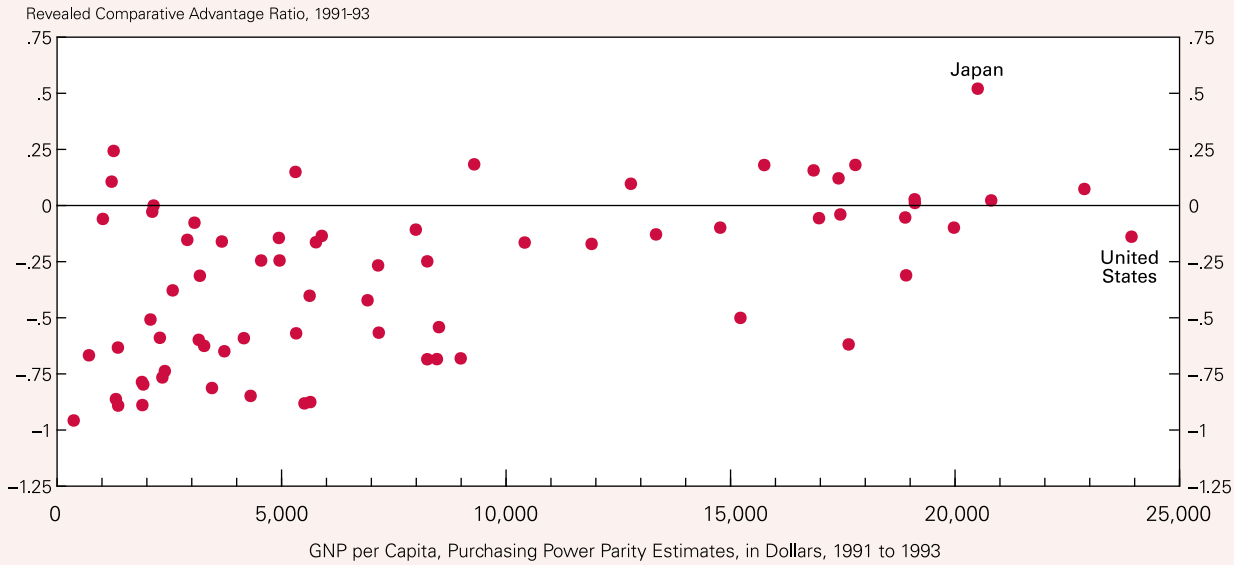
Contrary to popular opinion, nonobservance of the standards probably impairs, rather than enhances, overall competitiveness. To be sure, exploitive child labor and forced labor may suppress wage rates, but such practices also prevent those victimized from shifting readily into activities that best match their skills and goals, and thereby reduce their productivity. Employment discrimination has a similarly adverse impact on the allocation of labor resources. In addition to these efficiency-reducing short-term effects, all three of these practices impede the long-term development of a skilled labor force: Discrimination withholds suitable work experience, exploitive child labor denies youngsters a basic education, and both exploitive child labor and forced labor commonly expose workers to unsafe conditions and exhausting hours.

The impact of collective bargaining is more problematic. Union activity may improve efficiency by raising morale and helping to modernize production methods, but may lower efficiency by unduly raising member wages, benefits, and working conditions. Because a priori reasoning is less conclusive regarding the effects of collective bargaining than of the other core standards, it is fortunate that the OECD was able to amass enough information about the enforcement of collective bargaining rights to conduct an empirical assessment of its impact on international trade. The tentative conclusion is that among the 73 countries examined, very little relationship exists between the degree of freedom of association and collective bargaining, on the one hand, and trade performance, on the other hand (where trade performance is measured by changes between 1980 and 1990 in export market shares, both for manufactures and for all exports). This finding, together with the reasoning in the preceding paragraph, implies that countries are at least as likely to worsen as to improve their overall productivity and trade performance by failing to observe basic labor standards.

Nonobservance of key labor standards probably impairs, rather than enhances, overall competitiveness by reducing efficiency and impeding the long-term development of a skilled labor force.

Figure 3

Relationship between Revealed Comparative Advantage in Manufactured Goods Trade and GNP per Capita, 70 Countries



Note: Revealed comparative advantage was calculated by dividing the sum of exports and imports into the difference between exports and imports, where an excess of imports was given a negative sign. Where data for exports, imports, and PPP GNP per capita were all available for 1992 and 1993, the averages of these two years were used. Otherwise, the averages of 1991 and 1992 were used where possible. If the previous two options were not possible, the averages of 1991 and 1993 were used where possible. If none of the above was possible, one of the three years was used where all data were available.
Source: World Bank, *World Development Report*, 1993, 1994, and 1995, Tables 1 and 30; United Nations Conference on Trade and Development, *Handbook of International Trade and Development Statistics*, 1992, 1993, and 1994, Tables 4.1 and 4.2.

But the analysis can be taken a step further. Aside from the issue of labor standards, do countries with low wages enjoy a omparative advantage in the trade in manufactured goods? As can be seen in Figure 3, no such advantage is readily discernible. On the contrary, if one accepts GNP per capita as a proxy for the wage, the higher-wage countries are more likely, other things equal, to have a comparative advantage in manufactured goods trade.[1] Revealed comparative advantage is measured here in a standard fashion, as the excess of exports over imports (given a minus sign if imports are larger) divided by the sum of exports and imports, and can assume any value between −1 and +1.

The higher-wage countries are more likely, other things equal, to have a comparative advantage in manufactured goods trade.

Similarly, U.S. competitiveness in its manufactures trade seems just as strong, on average, with low as with high per capita GNP countries. As shown in Figure 4, no statistically significant relationship exists between the degree of U.S. comparative advantage or disadvantage in manufactures trade with the countries represented and the per capita incomes of those countries.[2]

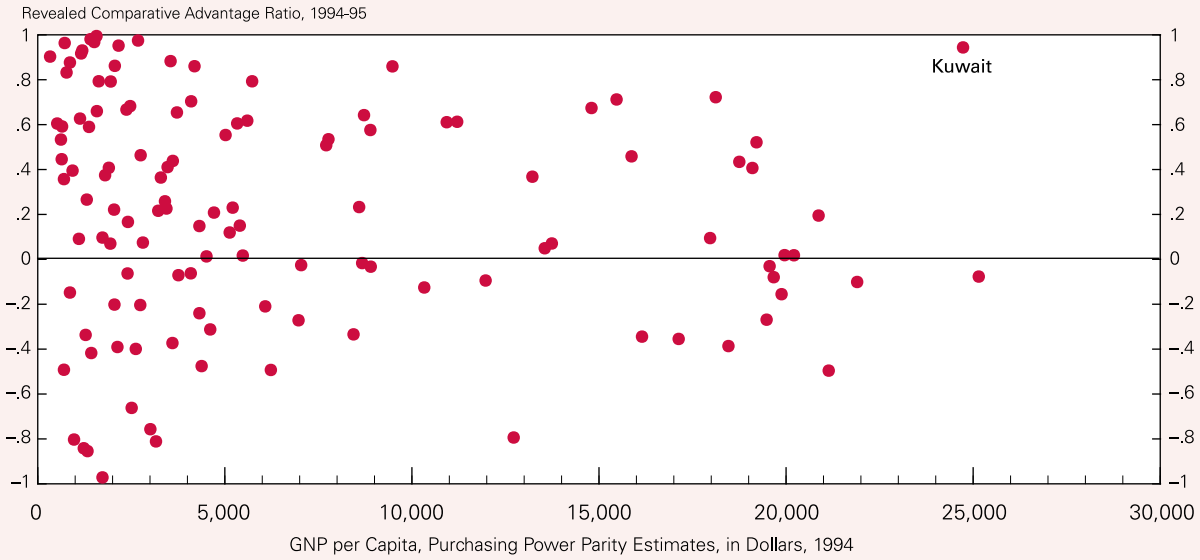
Of course, comparative advantage may well be influenced in some individual industries by international wage differentials, but it remains to be shown that any such influence is pervasive and dominant over the other factors that make for competitive-

[1] The simple coefficient of correlation is 0.53, significant at the 0.01 level.

[2] The simple coefficent of correlation is −0.12, with a t-statistic of −1.28.

Figure 4

Relationship between Revealed Comparative Advantage in U.S. Manufactures Trade with 121 Countries and Their GNP per Capita



Note: Revealed comparative advantage was calculated by dividing the sum of exports and imports into the difference between exports and imports, where an excess of imports was given a negative sign.
Source: Trade data are from U.S. Department of Commerce, *U.S. Foreign Trade Highlights 1995*, Tables 14 and 15. PPP GNP per capita data are from the World Bank, *World Development Report 1996*, pp. 188-89 and 222, Tables 1 and 1a.

ness.[3] These other factors include the skills of the labor force, the level of the technology applied, and the amount of capital used per worker. Once these factors are taken into account, the comparative advantage of the wealthier countries in many manufacturing activities, despite their higher wages, becomes readily understandable.

III. Small Firms Can't Export

While few would subscribe fully to the myth that small firms can't export, it is not uncommon to encounter the similar opinion that firms must be quite large in order to have much success at exporting. Formidable obstacles seem to confront the smaller firm. How can it marshal the resources to scout foreign markets, to adapt its products for those markets, and to advertise and sell abroad something that may be little known even in its home country? If the product requires servicing, how will the firm render it? With such hurdles, it may seem that small firms will seldom reap the rewards of exporting.

The evidence on exporting, however, supports a somewhat different conclusion. Not only large firms and plants, but also the smaller ones, typically perform better in key respects if they engage in exporting. More specifically, when exporting firms and plants with fewer than 250 employees were matched against non-exporting firms and plants in the same size category and in the same manufacturing industries for the year 1992, it was discovered that:

(1) the exporters paid substantially higher compensation to workers, both skilled and unskilled;
(2) productivity (value added per employee) was appreciably higher among the exporters; and
(3) employment increased by a considerably higher percentage between 1987 and 1992 in the exporting firms and plants.

Among the larger firms and plants, too, those

[3] For a discussion of the impact on selected U.S. industries of non-observance of core labor standards in developing countries, see Aggarwal (1995), pp. 23–24.

that exported generally performed better than the non-exporters, but the differentials were no more favorable than those enjoyed by the exporters among the smaller firms and plants (Richardson and Rindall 1996, pp. 1, 7–15). It follows, then, that relatively small firms as well as large firms can thrive while exporting.

Not only large firms and plants, but also the smaller ones, typically perform better in key respects if they engage in exporting.

Further insight into this issue can be gained from investigating the following question: Do small manufacturing establishments engage as intensively in export activities as the larger ones do, other things equal? If so, it would seem that the small ones expect to gain relatively as much from exporting as the larger ones.

A tentative answer to this question can be gleaned from data gathered by the U.S. Census Bureau. Defining a manufacturing establishment, or plant, as a single physical location where manufacturing is performed, the Bureau recently reported that in 1992 more than 82,000 such establishments exported their products from the United States, and that 77 percent of them were small, with fewer than 100 employees. On the other hand, 71 percent of the large establishments (500 employees or more) engaged in exporting, while only 19 percent of the small ones did.

A limitation of these export data, as well as the related employment data, is that all goods directly exported from a plant, but only such goods, are counted as the exports of that plant. If its products are exported from a separate distribution point, such as a company warehouse, no export is recorded for the plant; similarly, if its products are acquired and exported by a second plant, perhaps as a component of the second one's own products, the second plant receives full credit for what is exported (U.S. Bureau of the Census 1996, pp. iii–vii). Thus, if the products of small plants become components of products exported by large plants more commonly than the reverse, as seems likely, then the data underreport the export involvement of small plants and overstate that of the large.

Of course, a number of factors, not mere size, will influence an establishment's involvement in exporting. Among these factors, comparative advantage in international trade, which basically determines export competitiveness, will be crucial. Thus, to identify the influence of size, one should make allowance for differences in the revealed comparative advantages of the various industries that the different establishments inhabit.

This approach was followed, using standard statistical techniques and data for establishments of three different employment size categories—1 to 99 employees, 100 to 499 employees, and 500 or more employees—in each of 20 different industries. As reported in the Appendix, the results suggest that in manufacturing establishments a 1 percent increase in total employment is typically accompanied by a 1.15 percent increase in export employment, after adjusting for differences in revealed comparative advantage between industries. Thus, if an establishment were to increase its total work force by 100 percent, it would typically employ 115 percent more workers in export activity, other things equal. However, because of the problem already noted with the data, this result may overstate the influence of size.

While this outcome suggests that exporting becomes more appealing as establishments grow in size, it does not overturn the finding that smaller establishments can and often do profit from selling abroad.

IV. Conclusion

The conclusions of this brief article can perhaps be best expressed by amending the captions of the three previous sections to read as follows: Global competition does not prevent inflation; fair trade does not require equal labor standards; and small firms commonly succeed at exporting. The amendments are stylistically slight, but substantively great, and if generally accepted could have more than a minimal impact on the course of events.

Appendix

The following regression equation, discussed in section III, was estimated by ordinary least squares. T-statistics are in parentheses and, if starred, are significantly different from zero at the 0.01 level. All data are for the year 1992.

$$\underset{}{\ln EX_{ie}} = \underset{(-18.94)^*}{-2.61} + \underset{(21.11)^*}{1.15 \ln E_{ie}} + \underset{(3.07)^*}{0.83 C_i};$$

$$\bar{R}^2 = 0.89; \text{ 60 observations;}$$

where

EX_{ie} = employment in exporting per establishment in industry i, by establishment employment size category e, in thousands;

E_{ie} = total employment per establishment in industry i, by employment size category e, in thousands;

C_i = revealed comparative advantage, defined as $(X - M)_i/(X + M)_i$, where X and M represent exports and competing imports, respectively.

Three employment size categories (e) were available in the basic data: establishments with 1 to 99 employees, with 100 to 499 employees, and with 500 or more employees.

Sources of data:

E_{ie} and EX_{ie}: U.S. Bureau of the Census, *Analytical Report Series, Manufacturing, AR92-2, Selected Characteristics of Manufacturing and Wholesale Establishments That Export: 1992*, Table 3a, pp. 17–18.

C_i: U.S. Department of Commerce News, *U.S. Merchandise Trade: December 1992*, FT-900 Supplement, Exhibit 1.

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