



Off-shoring, Insecurity and the Protectionist Threat

The financial crash of 2008 threatens economic insecurity in industrialized countries to an extent not experienced since the Great Depression. But as discussed in the *World Economic and Social Survey 2008* (WESS) (<http://www.un.org/esa/policy/wess/index.html>), concerns about the security of employment, fairness of pay and effectiveness of social protection have been mounting for years and perhaps decades prior to this crisis. Many have made the connection between growing insecurity and globalization, and in particular, the outsourcing of jobs. But this explanation, because it abstracts trade from its wider macroeconomic setting, runs the risk of encouraging misguided protectionist responses, especially in developed countries. Globalization is neither an automatic nor a predetermined process, the choice of policies, including macroeconomic and financial policies, to manage it matters. This Policy Brief shows how this aspect of economic insecurity can be reduced without sacrificing trade and development.

A debt-dependent trading system

Over the past 20 years, the volume of trade has grown on average by 9 per cent per annum with particularly rapid growth in the period 2002-2007, averaging 14.5 per cent per annum and faster still in developing countries. Four significant forces have helped shape the pattern of international trade in this period: the rise of export-orientated industrializing developing countries; the growth of intra-firm trade in global supply chains (itself made possible by new information and communication technologies and expanded capacity and skill in developing countries); rapid trade liberalization for goods and services, embodied in both multilateral and bilateral agreements; and the explosion of unregulated financial flows. These factors are often treated separately but in a globalized world they need to be seen as closely interconnected.

The share of developing countries in world trade has risen from around 20 per cent in the mid-1980s to over 37 per cent in 2007. There has also been a much discussed shift in the composition of that trade towards “high-tech” manufactures. But this can be misleading. In many cases, the apparent switch to high-tech exports hides the fact that many countries are really engaged in mostly low-tech assembly activities rather than exporting the final good itself. In many cases, production takes place within enclaves, connected though trade and foreign direct investment (FDI) flows to other parts of a corporate supply chain, but with only limited ties to the domestic economy.

The spread of intra-firm exchanges in these chains explains much of the growth of world trade, albeit with the final product

still destined for a small number of markets, dominated by the United States. However, given that wages have, since the 1980s been largely stagnant in the United States and sluggish elsewhere, this growth of trade has coincided with rising levels of household debt and dwindling domestic savings in a number of large industrial economies along with ever-widening global imbalances.¹

The New Global Business Model

The shifting patterns of international trade have been closely associated with a new global business strategy adopted by many larger firms in the industrialized countries, which emphasizes a focus on “core competence” and a greater attention to shareholder value. This focus has driven firms to break up the production process and take advantage of low-cost offshore production for all but the highest value added aspects of production. At the extreme this has created manufacturing firms that do no manufacturing at all, such as *The Gap* or *Dell Computers*. The focus on shareholder value has meant an increase in the use of profits for dividend payments, stock buybacks and mergers and acquisitions.

In this context, offshoring has served the new business model in two ways: first, it has led to cost reductions and thus increased mark-ups over cost, despite the fact that firms face stiff price competition in product markets. Figure 1 shows how since the 1970s the share of corporate profits in value added in the United States has risen to new highs in each successive business cycle, at the same period that imports from developing countries were steadily rising.

Second, by limiting the scope of the firm and especially its domestic operations, offshoring has reduced investment needs, increasing its’ ability to return value to shareholders. This, has supported a “financialization of non-financial corporations” in many industrialized countries, oftentimes at the expense of productive investment.

This interplay of financial and corporate dynamics has had far-reaching implications for the real economy, particularly in advanced countries. In many countries, the rise of the financial sector has coincided with the introduction of more flexible hiring practices and less secure employment conditions. Episodes of exceptionally rapid economic expansion driven by speculative financial flows have brought periods of growing prosperity, but have often ended very suddenly in recession or longer periods of slow growth. Moreover, losses of investment, employment and

¹ See UN-DESA Policy Brief No. 4 (<http://www.un.org/esa/policy/policybriefs/policybrief4.pdf>).

income incurred during recessions have not fully recovered when the economy turns up.

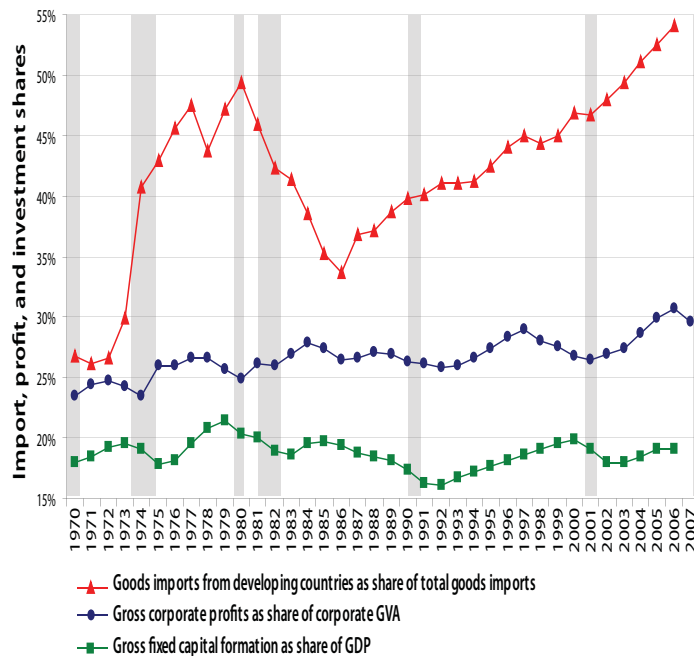
All of these factors together spell considerable income and job insecurity, even under conditions of relatively strong expansion. Also, in the majority of developed countries, growth of wages has not kept pace with labour productivity, resulting in greater income inequality.

Spreading the gains from offshoring

Available evidence suggests that offshoring has affected pay and employment opportunities of low-skill workers in industrialized countries. Recent research has also found similar pressures on job and income conditions for high-skill workers, following the expansion of services offshoring. As supply chains extend to high-tech goods and high skill-intensive services, there are massive possibilities for the expansion of offshoring in the future. However, this needs to be put in context. The first offshoring activities emerged in the early 1960s linked to a first wave of newly-industrializing economies in East Asia. This coincided with declining employment levels in industries intensive in the use of low-skilled workers in more advanced countries, but it did not provoke a backlash there because the pace of investment and technological progress was consistent with industrial upgrading, full employment and rising real wages.

The prospect of a rapid expansion of offshoring following a prolonged period of labour market insecurity raises real concerns. The lesson from the past two decades is that whether growing vulnerabilities linked to offshoring translate in to actual

Figure 1: United States: Import Profit and Investment Shares, 1970-2006/07



Source: UN-DESA, based on data from U.S. Bureau of Economic Analysis, National Income and Product Accounts; UNCTAD Handbook of Statistics.
Note: Gross profits are calculated by adding net operating surplus and consumption of fixed capital. Their sum is divided by gross value added. Gray bars correspond to U.S. business cycles recessions according to the definition of the NBER.

insecurity can vary across countries depending on their regulatory structure and in particular on the degree of labour market support provided by governments. Policy responses in the developed world have differed from country to country. On one extreme, the United States, the United Kingdom and a few others have lax hiring and firing regulations, low unemployment benefits, and very limited spending on active labour market policies. On the other extreme, is the Rhineland model including France and Germany, which have relatively high levels of employment protection, large unemployment benefits and significant spending on active labour market programs. Denmark, the Netherlands and a few other countries have found a combination of the two, combining greater labour market flexibility with high replacement income programs for the unemployed and extensive and pro-active labour market programs. France and Germany have also moved towards “flexicurity”, but are still quite a distance from a Danish-type system.

For countries providing more labour market support in the form of greater spending on active labour market policies and higher earnings replacement rates in unemployment benefits, offshoring had a more favourable (or less unfavourable) effect on the labour share of national income. Moreover, the provision of a solid and portable set of social protection does not appear to have reduced trade competitiveness and in fact may raise it as increased worker security leads to greater possibilities for innovation and rapid productivity growth.

These institutional differences affect the distribution of the static gains from trade liberalization. But the key to capturing the dynamic gains from offshoring lies in the need to ensure profits from offshoring are reinvested. That is, the macroeconomic effects of offshoring—the growth in profits and the profit share—must be re-directed from financial assets towards their reinvestment in new capacity and employment, in product and process innovation, and in skills development. That will depend, in part, on the pace of the global economic recovery and the revival of trade. But it will also require that the financial system in advanced countries, including through the incentives it creates for non-financial corporations, does not simply channel any renewed flow of credit into yet another asset boom. Rather reform of this sector must ensure banks get back to the business of securing people’s savings, undertake prudent credit assessment in line with borrowers expected income flows and build stable networks and levels of trust with business—both large and small—which can support more socially productive investment opportunities. ■

Prepared by:
 Richard Kozul-Wright, William Milberg and Deborah Winkler

For further information please contact:
Rob Vos, *Director*, Development Policy and Analysis Division
 Department of Economic and Social Affairs, Rm. DC2-2020
 United Nations, New York, NY 10017, U.S.A.
 Tel: +1 212 963-4838 • Fax: +1 212 963-1061
 e-mail: vos@un.org • website: <http://www.un.org/esa/policy>