Introduction

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Europe's reaction to the challenge of globalisation

Think of globalisation as unbundling, two unbundlings in fact. Since the rise of human civilisation, economic production and economic consumption have tended to be clustered geographically to avoid the cost of moving goods. For example, in the 1970s, we could speak of 'national systems' of industrial competition. German technology and German management was bundled with German capital, and skilled and unskilled German labour to produce German goods, most of which were consumed in Germany. As transportation costs fell, the first unbundling occurred. The market for industrial goods became global and this eroded the tendency for goods to be made close to the point of consumption. European industry became increasingly internationalised; some sectors, such as clothes and shoes, lost out to import competition, but other sectors, such as pharmaceuticals and telecoms won new export sales. This engendered an important reallocation of European labour. Some sectors, especially labour-intensive manufacturing sectors shed labour. Other sectors, especially services and export-oriented manufacturing sectors hired more workers. This might be called the first unbundling – the geographic separation of production and consumption.

More recently, Europe has seen a second unbundling. This unbundling involves the termination of the tendency to group all manufacturing tasks geographically, for example all in one factory. This second unbundling, which has variously been called fragmentation, offshoring, vertical specialisation and slicing up the value-added chain, shares many similarities with the first unbundling, but it differs in many important ways. In particular, it means that the winners and losers from future globalisation may differ from those in the past. In the past, one could speak of winning and losing sectors – the production of simple cotton clothes was a losing sector, while the production of wide-bodied commercial aircraft was a winner. Every worker in the cotton t-shirt industry had to find a new job. The second unbundling, however, does not affect sectors. It affects tasks regardless of the sector. The linchpin difference between the two unbundlings lies in the nature of the trade cost change. In the first unbundling, the most important change was in the cost of trading goods – the nature of the change affected all manufacturing sectors in a similar manner. This is why Europe's more competitive sectors won and its least competitive sectors lost. In the second unbundling, the key change is the drop in the cost of "transporting" ideas, but this does not affect all tasks. Not all tasks can be sent down a fibre optic cable. For example, the rapid fall in telecommunication costs has made it profitable to offshore data-entry tasks to low-wage nations such as India. This became true for data-entry in the German car industry but also for the German ship-building sector – what matters is the nature of the task, not the sector in which the task is done. By contrast, cheap telephone calls and high-speed internet access has done nothing to encourage the offshoring of truck drivers regardless of whether they are working for Nokia or Leyland Motors. More specifically, the second unbundling seems to be affecting tasks that are easily codified and transmitted electronically. These tasks used to be non-traded so the rewards to workers performing these tasks were not linked to the global market – they were set in local markets. This meant that the North-South wage gap in these tasks could greatly exceed the North-South productivity gap (just as was true in the manufacturing sector before the cost of trading goods fell). As these tasks become increasing tradable, i.e. offshore-able, the wage gap will have to shrink and/or the jobs will disappear from Europe.

This alters the identity of the winners and losers from future globalisation. From about 1970 to the mid-1990s, the losers from globalisation were, generally speaking, low-skilled workers while highly educated workers tended to win. Going forward, however, the split may fall not between high- and low-skilled workers, but rather between workers involved in tasks that switch from non-traded to

traded and those that do not. Some low-skilled jobs, for example the task of loading boxes into trucks, will not be affected by the second unbundling, while others, for example phone operators, will. At the other end, some high-skilled jobs, for example the analysis of MRI medical scans can be offshored, while other high-skilled jobs, for example investment banking, cannot since it does not involve a service that can be sent down a fibre optic cable.

The first unbundling has proceeded at a remarkable pace with foreign markets opening up on both the supply and demand side (the key markets being the former Soviet-bloc nations, China and India). For Europeans, these openings created opportunities for both extra sales and for further optimisation of production structures. The second unbundling has come more recently and indeed has not, to date, involved much in the way of job loss or job creation. In these short comments, the first sections consider these opportunities in turn. The subsequent section considers how Europe has risen to the challenges created by these new opportunities.

Opportunity #1: Access to new markets

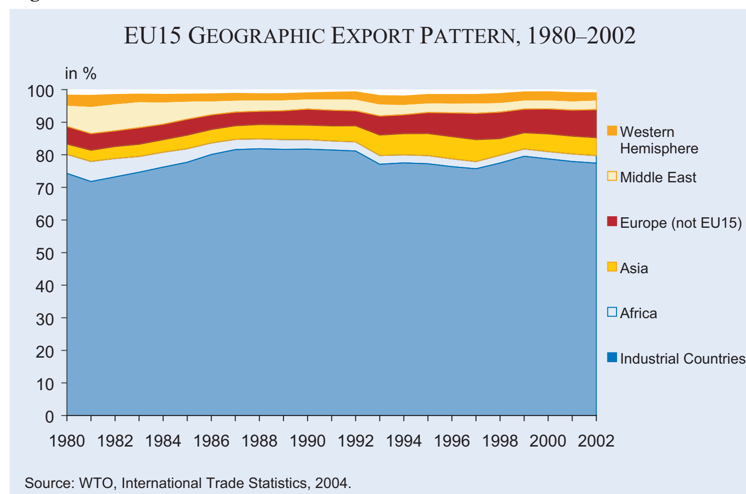
On the sales side, the opening of Central Europe, China and India has not had a transformational impact on Europe's pattern of exports. It is true that sales to these markets have risen quickly, but the differences are not so great as commonly portrayed in popular debate. The point is made in which shows the share of EU15 exports going to various regions in the world. From 1980 till the present, the lion's share of West European exports have gone to other rich nations, mainly other West European countries and North America. Since 1990, there has been a decline in the share of exports to 'industrial nations', but this has been quite modest. The rising shares have been in Central and Eastern Europe including Russia, and Asia, although Asia's share contracted in the aftermath of the 1997 Asia Financial Crisis and is now recovering.

Future income and trade patterns

Although the shift in sales patterns has been modest to date, a few facts and a bit of reasoning suggests that going forward, Europe is likely to see a much more important shift in its export pattern. We start with the Central and Eastern European nations. The ten Central and Eastern European nations that are or soon will be members of the EU are very small economically. In 2004, the sum of their incomes (GDP) was only about 5 percent of EU27 total. Here incomes are measured in euros and not adjusted for local price differences so that they reflect the true purchasing power of these nations when it comes to importing goods from Western Europe. The ten nations' population, by contrast, amounts to about 20 percent of the EU27 total. Since most of the newcomers are growing two or three times as fast as the EU15 nations, the next decades should see the newcomers' market rising in importance as a destination for Western Europe's exports.

The mismatch between population and income is much more marked for India and China, as shows. The chart plots the world share of GDP and population for various regions and nations. The left bar shows the shares of world population. India and China account for 38 percent of the world's population, but only 6 percent of world income. For the EU, US and Japan the imbalance is just the other way around; they account for 70 percent of world income but only 13 percent of world population.

Figure 1



Source: WTO, International Trade Statistics, 2004.

If Indian and Chinese incomes continue to expand at the growth rates observed over the past decade, the two sets of bars will look a great deal more like each other. From the perspective of European exporters this means that China and India are likely to be major sources of growth in future years.

Adjustment to new market opportunities

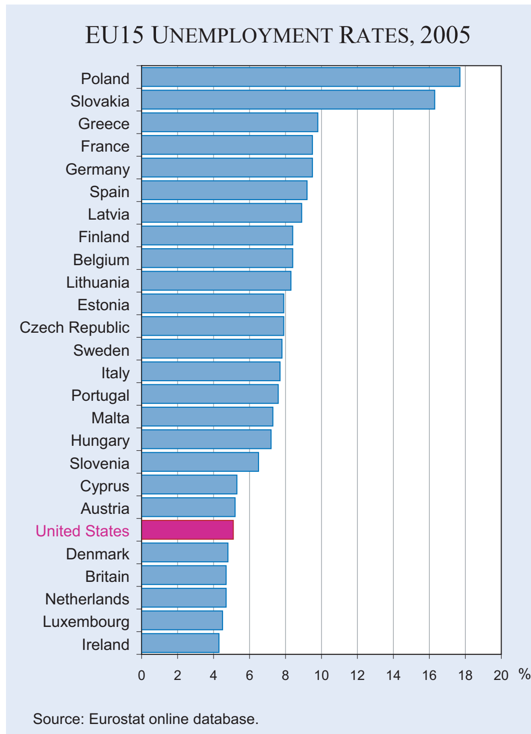
Market opening creates new opportunities. Exploiting these opportunities requires nations to adjust. Adjustment is hard in the real world and this is why globalisation is a topic of concern. Adjustment, in short, is the real topic of this conference. From this perspective it is useful to classify this adjustment into two broad categories:

#1 – Cross-sector specialisation, e.g. expanding the transport equipment sector while shrinking the clothing sector.

#2 – Within-sector specialisation and scale economies, e.g. firms focus on few products and lower costs by raising scale economies.

The first type is typically predominant when the market opening occurs among rich nations that have similar wage structures. The second type tends to be dominant when the integration is between nations with very different income levels and very different wage profiles.

Figure 2



Source: Eurostat online database.

Under both types of adjustment, there are winners and losers. Although the winners win more than the losers lose, the heart of the adjustment question is what the losers lose. The two types of adjustments, however, imply very different ratios of winners and losers. Under the second type, some sectors have to downsize and other sectors have to expand. This will require workers to switch jobs, maybe even move to a new city. Under the first type of adjustment, changes more typically involve a reorganisation within the sector, sometimes even within individual firms.

In the 1960s, 1970s, and 1980s, most of the market opening was among rich nations and so involved adjustment of type #2. This was not easy politically, but compared to recent experience it was a walk in the park. In the 1990s and new century period, most of the market opening has been between rich and poor nations. Much of the adjustment of has been of the #1 type and so very difficult politically.

Low wage, low productivity

The new markets that have opened in to last couple of decades – the former Soviet bloc nations (especially the Central Europeans), China and India – involve nations that are very different from those in Western Europe, at least in terms of per capita income and profile of the labour force. These nations are endowed with a relative abundance of low-productivity, low-wage labour. The point can be seen clearly in . GDP/population is a measure of output per person and income per person since, apart from a few unusual cases, a nation's income equals its output (the unusual cases involve nations that have a significant share of their labour or capital working abroad). From the table we see that average output per person in the ten Central and Eastern European

GDP per person, Central & Eastern Europe, and Russia with comparator nations.

2004	GDP/ Population (US $)	Population (Billions)	Comparator Nation	GDP/ Population (US $)
EU15	32,765	376.7		
CE10	7,106	95.9	Mexico	6,586
Russia	4,021	146.9	Argentina	4,060
Ukraine	1,303	49.9	Angola	1,309
China	1,486	1.30		
India	623	1.07		

Notes: CE10 stands for Central Europe 10 (3 Baltic States, 4 Central European States (where central refers to north-south rather than east-west) and Bulgaria, Romania and Slovenia.

Source: IMF, World Economic Outlook online database.

nations is on par with Mexico, while Russia's average output per person is at the level of Argentina; Ukraine's is close to Angola's. The differences are even more pronounced when looking at India and China.

One point that I would like to stress is the connection between output per hour and wages. As a matter of basic economic definitions, a very low GDP is an indication of very low labour productivity. It may sound harsh, but it is a simple economic fact that poor nations are poor because they do not produce very much per worker. Why this output per hour is low is a complex question. But it is almost surely not a matter of personal attributes but rather a lack of training, poor economic and societal infrastructure, etc. The way the market keeps these low productivity workers employed is by lowering the wage to match the productivity. A key surely is that this wage adjustment can result in a uneven competitiveness of poor nation workers. For example, Chinese managers are not very productive compared to their wages, while manual workers in China have very low unit labour costs despite the fact that their wages are much higher than those in places like Bangladesh. The Table thus tells us that the newly open European markets will tend to have an edge in goods whose production is relatively intensive in low-productivity/low-wage labour. As a consequence, this opening will tend to foster adjustment of type #1.

Opportunity #2: Access to cheaper, eager, well-educated labour forces

The second opportunity that arises from the opening of markets entails international re-optimisation of production. I like to think of this as the second unbundling, although others have called it fragmentation, slicing up the value-added chain, and international production networks. To explain unbundling, consider first bundling. In the old days, say the 1970s, we could speak of 'national systems' of industrial competition. Taking Germany as an example, German technology and German management was bundled with German capital, and skilled and unskilled labour. This bundle competed with other nations' bundles of technology, management, capital and labour.

As often happens when things are bundled and sold as one, the bundling tended to overvalue some elements and undervalue others. In general, the productive factors that were relatively abundant in Germany tended to be undervalued, while the relatively scarce factors got overvalued. In Germany's case that meant that managers and technology were remunerated at below their true value in the world market and German labour got wages above their values.

When the cost of moving goods, people and ideas fell rapidly, the production bundle got undone. This unbundling meant that German managers could organise production of Polish workers using Polish capital and German technology. Or, German technology – embodied in German capital goods – could be used by Chinese managers employing Chinese capital and labour.

This unbundling changed the relative scarcity of the various productive factors in all nations, but here we are especially concerned with what happened in Europe. Before turning to the implications of this unbundling, it is worth noting that the cost of moving people, goods and ideas did not fall in proportion. The cost of moving people, in particular, did not fall anywhere near as much as the cost of moving goods. The basic reason is that although the price of plane tickets fell, the main cost – the time cost of moving people – continued to rise. For example, if a technician takes two half-days for travel per week, his company will have to hire a fifth more technicians to get the same job done that could have been done if the work came to the technicians rather than the technicians to the work. The cost of moving goods fell by more but since oceanic shipping was containerised decades ago, the main evolution has been a big drop in the price of shipping goods by air. Finally, and most dramatically, the cost of shipping ideas – here I am talking about telecommunications of all forms – has experienced a revolutionary reduction. It is easy to cite examples involving the internet, but I think the example that hits home best with modern managers concerns telephone calls. Just two decades ago a 'long distance' call was something important, especially if it was trans-Atlantic or even further. Long distance calls had to be booked, managed and kept short. Today, I see managers often making a few calls in the time its takes them to get off the plane and into the air terminal; judging from the languages, many of this are long distance and judging from the side of the conversation I can hear, they most definitely are not booked, managed or kept short!

The different drops in the cost of 'trading' people's time, goods and ideas goes a long way to explaining the particular pattern of unbundling that we have seen. In both Europe and East Asia, complex supply networks have been set up where a good (or its various parts and components) crosses international borders several times before finally being shipped to customers. That is, goods are doing a lot more moving than people. Moreover, ideas are doing even more moving and this has made it conceivable to organise and manage complex cross-nation production networks.

Again taking Germany as an example, we can think of the 'old days' situation as one where the relatively abundant factors (relative to world supplies that is) were 'exploited' by the relatively scarce factors. For example, in the 1970s, automobile technology was relatively abundant in Germany compared to the world at large and German factory labour was relatively scarce by world standards. Since the only way to exploit German auto technology on the world market was to combine it with German labour, German technology tended to earn less than it would have and German factory labour tended to earn more than it would have. When improvements in telecommunications and shipping (especially air transportation) made it feasible to produce some automobile parts abroad, the demand for German technology and management rose while the demand (from the auto sector) for German factory labour fell.

Challenge #1: Reallocating productive factors in the face of rigid labour markets

Globalisation provides nations with new opportunities. The economies of well governed nations can seize these new opportunities to improve the well-being of citizens. As already mentioned, new opportunities of almost any type create winners and losers. To put it starkly, each job that is offshored is an opportunity for Europe to allocate its labour more efficiently. To think this through, consider why the job was offshored in the first place. The job is offshored because the European worker's productivity edge over his or her replacement in, say, India, does not justify the Europe/India wage gap. This is not true for all jobs. The same cannot be said of, for example, German auto workers. German auto workers earn far more than Malaysian auto workers, but they are also far more productive. Indeed, if it were not for Malaysian trade barriers against cars, German-made cars would be extremely competitive in the Malaysian market. In short, the German-Malaysian productivity gap more than compensates for the German-Malaysian wage gap in the automobile industry. Since the productivity gap does not compensate for the wage gap in offshored jobs, it stands to reason that labour will be more efficient when it is reallocated to another task.

It is exactly this reallocation that causes all the problems. One colloquial way of putting it, is to say that job offshoring is good for society as a whole, but you would not want your sons and daughters to find themselves performing tasks that were to be offshored. This is where government comes in. Good governance is required to ensure that society as a whole supports the changes that are necessary to exploit the new opportunities. In some sense, good government is like a pre-signed contract that ensures most members of society that the pains and the gains of the changes will be shared. Since all know about the sharing, the nation can muster a political consensus to embrace the new opportunities.

One approach to these challenges is the one adopted by US society. There, a majority of citizens firmly believe that the basic notion should be sauve-qui-peut, i.e. that it is the individual's duty to adjust to changes so the government largely leaves individual workers to their own devices. European societies do not accept this approach and so have implemented the so-called social market economy. This entails massive programmes that insure all workers against adverse developments – whatever the cause (globalisation, aging of the population, technological change, etc.). These programmes come in many forms. The basic pillar is income support that ensures a minimum living standard for all members of society regardless of their employment status and earnings. But in some European nations, the state's intervention into the economy is far more extensive, including active re-training programmes, state-paid education and the subsidisation of specific economic enterprises.

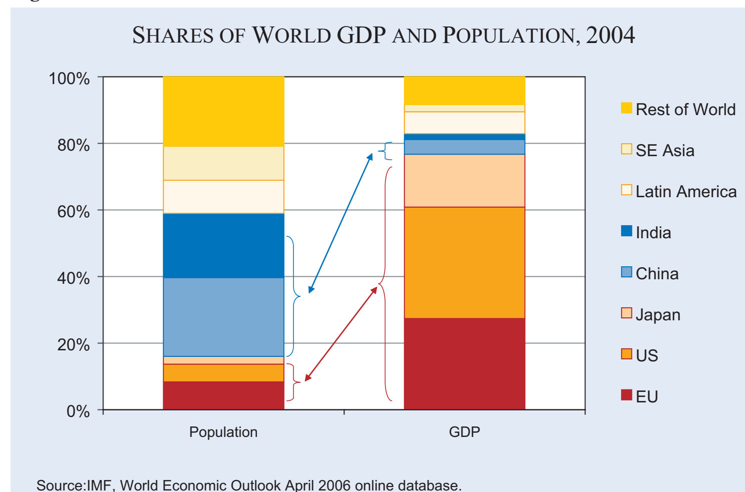
When it comes to the challenge of reallocating labour to take advantage of the opportunities posed by globalisation, it is important to distinguish between two types of income insurance – employment protection legislation (i.e. laws that make it hard to fire workers) and employment insurance (programmes that replace part of a worker's earn-

ings when he/she loses his/her job). In a nutshell, employment protection laws tend to hinder adjustment while employment insurance tends to foster adjustment. Another important element in a nation's ability to reallocate labour is its labour market institutions. In nations where labour market institutions are either very loose or very centralised, adjustments can occur easily. In the unstructured labour markets, say Britain's, workers and firms come to terms with each other. In nations with highly centralised labour markets, like Sweden, everyone feels responsible and it may be possible to agree on major changes. The nations with in-between labour markets, such as France and Germany, find it much harder to make adjustments.

The results of these different policies can be seen in the widely varying unemployment rates in the EU15 shown in . While European unemployment is high overall – over 8 percent for the EU15 – several European nations have unemployment rates that are below that of the United States, namely Britain, the Netherlands, Denmark, Ireland and Luxembourg. Indeed, the high European unemployment stems from Germany, France, Italy, and Spain, but even among these, the performance over time has varied enormously. For example, Spain's unemployment rate has fallen from over 20 percent in the 1990s to under 10 percent today. Germany's unemployment rate in contrast is up from its low pre-reunification level, and shows sharp regional differences between the West and the East.

As Blanchard (2005) argues, the high unemployment rates reflect a failure of the labour market to encourage the reallocation of labour between sectors. To see this, note that Europe's labour market is a very dynamic place, there is a great deal of hiring and firing of workers. 1.5 percent of all jobs are destroyed in France *each month* and roughly as many are created. This is about the same as in the United States. Moreover, workers leave jobs even when the job is not destroyed; about 4 percent of workers leave their jobs per month as demonstrated by Cahuc and Zylberberg (2004). Given this high job turnover, the process of matching workers and jobs becomes critical. In Europe, especially in the large Continental nations, government policies and labour market institutions have slowed down the process. Workers and firms are taking their time to find matches. In European nations with better run labour markets, the matches happen faster, so workers spend less time on the dole between jobs. The result is a lower unemployment rate.

Figure 3



Source:IMF, World Economic Outlook April 2006 online database.

Concluding remarks

This short discussion of a complex topic ends with two observations on policy changes. The first is in no way novel, the second somewhat more so.

European societies do not accept the US model where individuals bear the brunt of both the pains and the gains of globalisation. European voters consistently reject politicians who push the US model of market economics. In short, European voters are willing to pay for the social harmony that comes with the social market model. While this holds true straight across Europe, the burden of sharing the pains and gains is quite different. In some European nations, institutions and policies have resulted in over 10 percent of the workforce on the dole. This implies a high cost to taxpayers in terms of transfers, but it also means an important loss in national production. In Denmark and Holland, voters also vote for social policies but they have arranged the labour market in a way that reduces the pure waste of having so many workers idle. The challenge for politicians in Italy, France and Germany is to convince their voters that there is no contradiction between caring and reforming labour markets in a way that gets people back to work more quickly.

The second comment concerns European governments' reaction to the second unbundling. Much of Europe is embarked on the Lisbon agenda that is supposed to push Europe towards the information society. While this sounds like a good idea from the perspective of the first unbundling – after all it seems to be pushing Europe's resources towards the 'winning' sectors – it may be less of a good idea in the face of the second unbundling. Many of the jobs in the information society are today non-traded and thus may seem like good jobs, safe jobs. But many of these jobs involve services that can be sent down a fibre optic cable and thus are subject to new competition from abroad. Of course, this new opening due to lower costs of trading ideas constitutes an opportunity for Europe as a whole, but seizing the opportunity will require a reallocation of labour. Thus it might not be prudent to embark on large projects to train European workers to do jobs whose existence is likely to be temporary. More generally, one can say that the impact of the second unbundling is far less predictable than that of the first unbundling. The simple reason is that no one really understands what sort of jobs can be or will be offshored. The lesson stemming from this suggests that Europe might want to focus its education and training on encouraging workers to acquire skills that make them more flexible and able to learn new tasks. Moreover, it is not at all clear that more education is a way of ensuring that a larger fraction of the workforce is in the winners' category. The second unbundling seems to be especially prevalent in office jobs, many of which now require higher education.

References

Blanchard, O. (2005). "European Unemployment: The Evolution of Facts and Ideas," Paper presented at the October 2005 Panel of Economic Policy.

Cahuc, P. and A. Zylberberg (2004). *Labor Economics,* MIT Press.

Panel

In addition to the above speakers, the panel, which was chaired by **Michael Ackermans,** Editor-in-Chief of the Dutch weekly, *FEM Business,* consisted of four business representatives:

Anton Kathrein is Managing Partner and Owner of Kathrein-Werke KG, the largest producer of antenna system technology, worldwide. He explained how his German-based company has managed to remain an industry leader with world-wide distribution and a high investment rate in R&D. Kathrein had ties to Eastern Europe before the fall of the Iron Curtain and now produces in Romania and the Czech Republic, where it has achieved the same product quality standards as in Germany. Currently, his company's R&D is all in Germany, but some of this will also eventually go offshore.

Kulpreet Singh is an Indian national working as general manager of the UK and Europe Division of the US corporation, EXL Services, an outsourcing specialist in the banking, financial services and insurance sector. He described his task which is to create more value for companies by helping them rediscover what initially made them successful and to examine what functions need to be outsourced or offshored. He maintained that companies that properly assess the risks and rewards of outsourcing stand to benefit from more value creation.

Klaus J. Jacobs is Chairman and Chief Executive Officer of Adecco SA, an international human resources services company based in Switzerland. He made the following suggestions for keeping Europe's industry competitive: 1) manage the transition from school to work to prevent young people from falling into unemployment; 2) encourage life-long learning involving an investment of at least two weeks a year in competence building programmes; 3) initiate programmes for elite interdisciplinary education at the universities to retain Europe's best brains for know-how development and research; and 4) introduce compensation programmes to increase commitment to longer work.

Lars Pettersson is President and Chief Executive Officer of Sandvik AB, a Swedish high-tech engineering group with business activities in 130 countries. Ninety-eight percent of his company's sales is outside Sweden. The growth of Sandvik is also much faster outside than inside Europe. He maintained that Europe's productivity is too low, its educational system needs improving and its immigrants must be better integrated. "We must face the fact that Europe is the laggard and try to understand why. The longer we wait, the bigger the problem will become," he emphasised.