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Trade, Growth and Jobs Discussion Note 2

Introduction

1. Over the course of the last half century, the global expansion of trade has reshaped the world economy. Trade opening has enabled economies to reap the benefits of specialisation and focus more productively on what they do best, through the sectors where they demonstrate comparative advantage. Trade has fuelled competition, innovation and economies of scale, allowing the world to ration its finite resources more efficiently. As a consequence, consumers (both individuals and businesses) have enjoyed lower prices and increased choice, while competitive firms have gained reliable access to needed inputs and larger markets. Greater market openness goes hand in hand with better economic performance in both developed and developing economies and it has contributed to lifting millions out of poverty in the latter group of countries.

2. At the same time, there have been significant adjustment costs. Subject to the appropriate policy framework, the relationship between trade and jobs is generally positive, but also complex. While trade is only one of many variables that influence labour market outcomes, it can be very important in certain contexts. Trade is clearly correlated with increased real incomes and enhanced productivity, albeit with significant variation depending on local conditions. While some of these conditions – such as geography – are relatively fixed, others can be influenced by institutions and policies. Government decisions help shape important complements to market openness such as the supply of qualified labour, the ability of the labour market to adjust to new economic opportunities, the availability of social protection to facilitate adjustment and redistribute gains, and the adequacy of other inputs, such as physical infrastructure.

3. The current weak economic recovery and the slow pace of job creation in many countries have heightened interest in the potential role of trade in stimulating lagging labour market performance, as well as concerns about the cost of adjustment. How can trade opening stimulate economic growth? What conditions must be in place to optimise the outcomes for society as a whole, and for vulnerable segments of society? Given the dominant role of services in all economies, how can services trade be promoted?

4. This document was drafted by OECD and WTO, taking into account preliminary findings from the International Collaborative Initiative on Trade and Employment (ICITE)¹.

¹ Participating ICITE partner organisations include: ADB, AfDB, ECLAC, IADB, ILO, OAS, OECD, UNCTAD, World Bank & WTO. The views expressed in this document do not necessarily reflect those of OECD Member Countries or ICITE Partner Organisations.

Why does trade matter for jobs?

5. While the positive relationship between trade, growth and economic development is well-documented, the relationship between trade and jobs begs further analysis. This is in part because trade is only one of the factors affecting labour market outcomes, and in part because complementary policies matter a lot in determining outcomes. There are at least six distinct ways in which trade can influence labour markets, through effects on employment, wages, or the level of risk.

- **Employment level:** By affecting relative demand for a country's products, trade can affect the aggregate level of employment in a country, either increasing or reducing demand for labour.
- **Jobs distribution:** By promoting reallocation of resources from least productive firms and sectors of the economy to the most productive ones, trade may lead to restructuring with employment effects within and across various sectors. Depending on the sector, this adjustment may affect absolute employment levels or the demand for workers by location, gender or level of skill.
- **Overall wage levels:** By promoting increased competition and driving innovation and increased productivity, international trade can influence overall wage levels in a country. Historically, greater trade openness has, on average, been associated with higher levels of income.
- **Wage distribution:** Trade can also impact wage inequality, though it is not a major contributor compared, say, to technological change (OECD, 2011). Where there are trade-related effects, the direction of change may vary, with trade either reducing or exacerbating inequality depending on its effects on demand for labour by sector and by type of labour (e.g., high skilled versus low skilled).
- **Innovation and dynamic gains from trade:** By providing access to a greater variety of inputs and unleashing competitive pressures, trade serves as an important channel for technology transfer, innovation and increased productivity (Onodera, 2008). OECD research confirms that trade indeed enhances productivity and spurs innovation and entrepreneurship (Miroudot et al, 2009; Stone and Shepherd, 2010).
- **Level of risk:** Trade may also produce so-called second-order effects associated with risk to labour market participants. By increasing global linkages, trade may infuse domestic systems with greater short-term volatility due to greater exposure to external shocks. At the same time, it is these same global linkages that decrease dependence on domestic demand, fuel innovation and growth.

6. Actual labour market outcomes of trade opening depend on a multiplicity of factors, including the degree of "openness" or exposure to the global marketplace, the underlying structure of a country's economy, institutional strength and orientation, labour market rigidities, the level of human capital development, robustness of social safety nets, adequacy of infrastructure and other elements. To be able to predict accurately the possible impact of market openness on a given economy and provide appropriate policies in a timely fashion, policymakers must understand well the channels through which trade can influence jobs and supplementary factors required for achieving optimal results.

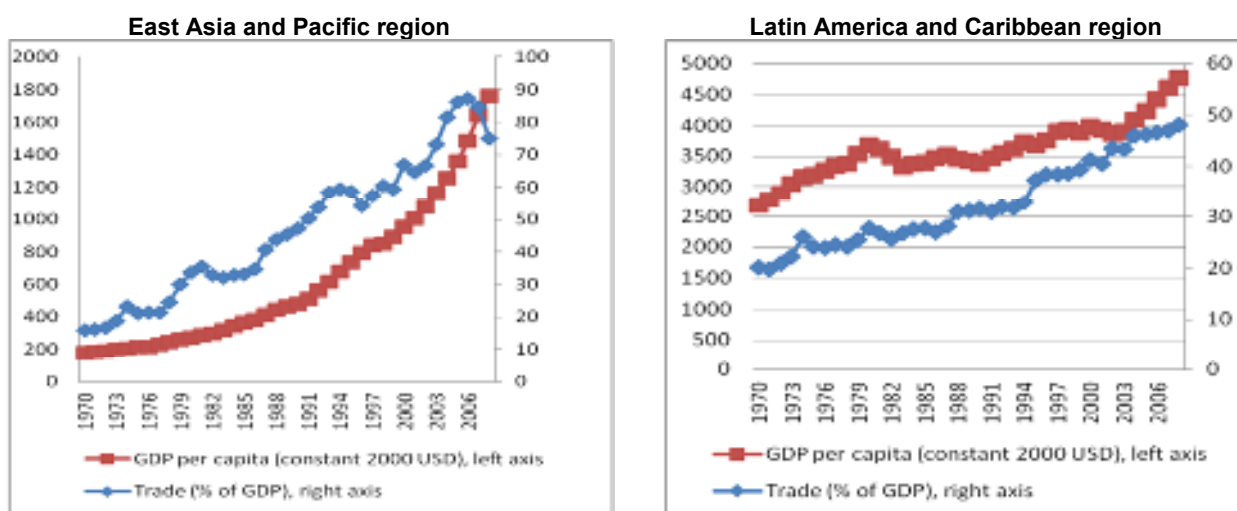
Trade, jobs, wages and working conditions

7. Through an ambitious research agenda, the ICITE project is helping to provide further empirical evidence as an input to fact-based policy formation. Some preliminary insights are already emerging from ICITE country case studies (Table 1) and three regional ICITE conferences held in 2011 (in Africa, Asia

and South America). Overall, the central message is that, subject to the implementation of a coherent policy framework, trade carries significant potential for driving growth and employment.

- **Employment:** The pace of economic growth is central to rising incomes and job creation, and it is mainly through its impacts on national income that trade promotes employment growth. One study (Noguer and Sicart, 2005) suggests that a 1 percent increase in trade openness is associated with a 1 percent increase in per capita incomes. Another found that per capita growth in countries opening their markets was 1.5 times faster than before opening (Wacziarg and Horn, 2008). Finally, there is evidence that opening intermediate and capital goods markets raises growth rates significantly – by about 1% annually (Estedevordal and Taylor, 2008).
- **Working conditions:** A forthcoming ICITE study compares a broad sample of open and closed economies around the world between 1970-2000 and finds that openness was associated with improved working conditions (Flanagan and Khor, 2011, forthcoming). Also, in terms of fatal accidents and life expectancy, open economies fare significantly better than closed ones. An ICITE case study of Japan provides a confirming example of improved conditions. During 1995-2006, trade openness there was associated both with an increase in the number of workers employed and a reduction in the number of hours each worked on average (Kiyota, 2011). Exports in manufacturing created more jobs and better working conditions, while also creating jobs in non-manufacturing sectors through inter-industry linkages.
- **Wages and incomes:** According to Flanagan and Khor (2011, forthcoming), open economies outperform closed economies most notably in terms of pay. Workers in the manufacturing sector in open economies benefitted from pay rates that were between 3 to 9 times greater than those in closed economies, depending on the region. An ICITE study jointly prepared by ECLAC and ILO for the case of Chile (Friedman et al, 2011) finds that sectors open to trade and investment deliver a wage premium and are characterised by higher levels of unionisation. In 2008, a worker in a high-openness sector in Chile earned on average about €1100 more per year than a worker in a low-openness sector. Moreover, besides driving wages up, trade also positively affects incomes by lowering prices of goods and services as a consequence of increased competitive pressures. As a result, trade has played a crucial role in helping sustain per capita income growth (Figure 1).

Figure 1. Evolution of per capita GDP and trade intensity (trade as % of GDP)



Source: World Bank (2010), World Development Indicators

Complementing an open trade policy

8. ICITE case studies also provide insight into policy areas that interact to shape the labour market outcomes associated with open markets. The discussion in the foregoing sections highlights some of the complexity in the relationship between trade and employment, as well as some of the diversity in the policy challenges faced by countries around the world. In particular, four policy areas emerge as particularly important across countries and regions in allowing societies to reap full benefits of trade and facilitate smooth adjustment.

- **Labour market flexibility:** Long-term OECD studies such as the Jobs Strategy (OECD, 2006) highlight the role of employment flexibility in enabling firms to adapt to changing economic conditions and the role of wage flexibility in ensuring that markets are able to transmit clear signals to workers and firms. Undue labour market rigidities can impede the ability of openness to deliver anticipated labour market benefits. For example, trade has provided new export opportunities for French firms, to which they have successfully responded. Trade has helped to increase productivity and global competitiveness of French firms. However, the increase in exports has, surprisingly, not had a positive echo in terms of employment (Kramarz, 2011). An ICITE case study suggests market rigidities have led to relatively high labour costs and encouraged increased outsourcing. This highlights the importance of a coherent policy approach that permits markets to respond positively to changing patterns of demand.
- **High-quality education and training:** Trade contributes to accelerated innovation and technological change, which can increase the demands for workers to adapt to change (OECD et al, 2010). Appropriate education and training are important inputs to human capital development needed for such adaptability. In several of the ICITE case studies, trade is found to be associated with increased demand for skilled labour. For example, in Korea, most skill upgrading in firms was accounted for by exporters. In Chile, relatively high returns to skills and experience were found, with increased demand for skills in open sectors. Poor-quality education, an inadequate skills set or shortages in the number of skilled workers, however, may affect countries ability to profit from these benefits of globalisation. For example, an ICITE study comparing the experience of Denmark and Spain (Arnal, 2011) notes that differences in education have been an important factor determining the extent to which workers have been able to adapt to business cycle fluctuations and progressive introduction of new technologies. In 2008, 74% of the population in Denmark had completed at least upper secondary education, compared to 54% in Spain, which combined with effective training opportunities rendered the labour force more mobile. Education is thus an important element of the required policy set allowing trade openness and high job turnover to be compatible with robust employment.
- **Social security systems and active labour market policies (ALMPs):** Globalisation is associated with intensified economic change, and adjustment to such change can mean dislocation for some workers and challenges in matching them with available vacancies or equipping them for new employment opportunities (OECD, 2007). An appropriate safety net, tailored to the specifics of a country, can make a substantial contribution in this regard, while ALMPs are an important instrument promoting reintegration of dislocated workers. As such, those two approaches are complementary and facilitate adjustment. An ICITE case study of Denmark highlights the “flexicurity” approach, which promotes the ability of employers to adjust their labour demand to changes in economic conditions, while providing relatively generous support to dislocated workers, subject to important requirements. Namely, the unemployed are required to seek employment or engage in training to acquire skills needed in the labour market. The ICITE case study of Italy shows that while trade brings benefits of specialisation, it also increases competitive pressures, which may render employment more precarious for some

segments of society (Iapadre, 2011). In Italy, which has a large shadow economy, the social protection system faces substantial challenges in assisting displaced workers. For example, workers on so-called non-standard labour contracts comprise a substantial share of the labour force, but are not entitled to standard social protection. This highlights the importance of a coherent and comprehensive social security system in order to boost the resilience of society to changes related to globalisation.

- **Business climate and infrastructure** – Ensuring an appropriate business climate is an important part of the mix in creating jobs, trade related or otherwise. Beyond sound macro-economic policies, the OECD Jobs Strategy points to such elements as appropriate wage-setting machinery, taxes and labour- and product-market regulations (OECD, 2006). Several of the ICITE country studies (e.g., France, Mexico and Spain), point to areas for improvement in this regard. In the context of trade, particularly in a developing country context, other elements such as inadequate infrastructure can also play a critical role. As noted in the recent *Aid For Trade* report by OECD and WTO (2011), “The quality of infrastructure is one of the most pervasive binding constraints to export growth, productivity increases, and increases in national incomes.” Shortfalls in business climate and infrastructure can impede the capacity to seize upon economic opportunities arising from market openness or to ensure full labour market benefits from trade.

What next for trade and jobs?

9. While the relationship between trade and jobs is complex, available empirical evidence points to substantial potential for positive labour market outcomes, as long as appropriate complementary policies are also in place. A growing body of fact-based policy analysis underway at OECD and through the ICITE project is providing insights as to the kinds of policies that may be most helpful in promoting improved labour market outcomes. From this work, it is clear that a creative approach to policy design is needed in order to respond appropriately to the changing nature of economic challenges, some short-term and others longer term in nature. Moreover, we also know that protectionism carries a substantial economic cost for consumers and the labour market, and thus offers no alternative to market openness. Given an appropriate policy framework, OECD analysis indicates that further market opening, with respect to tariff and non-tariff measures for goods and services, can deliver economic benefits including for labour markets (OECD et al, 2010). In the midst of sluggish recovery in the global economy and fears of “jobless growth”, there is every reason to maintain and expand open markets.