

Not so absolutely fabulous *The Economist* 4 November 1995

By themselves, low wages do not guarantee economic success

Protectionists in rich countries often complain that low wages give emerging economies, such as China or Malaysia, an unfair advantage. If it costs \$16 an hour to employ a worker in America (including fringe benefits), but less than \$1 in China, then, it is argued, as firms are ruthlessly undercut by third-world producers, free trade will threaten the prosperity of today's rich nations. This fear, however, is based upon a confusion of two economic concepts: 'absolute advantage' and 'comparative advantage'.

The distinction was first made by David Ricardo, an economist in the early 19th century. He introduced the concept of comparative advantage, which is the foundation of most economists' belief that all countries gain from trade.

According to the theory, absolute advantage (overall productivity differences between countries) should be reflected in differences in incomes, whereas comparative advantage (variations in productivity differences by sector) will determine the pattern of international trade. This is widely accepted by economists, yet there has been surprisingly little research in recent years to check the facts. A new paper* by Stephen Golub, an economist at Swarthmore College, Pennsylvania, puts the theories of absolute and comparative advantage to the test.

Start with the notion of absolute advantage. If low wages automatically meant low costs, the world's poorest countries would dominate world trade. It does not, because differences in wages reflect differences in productivity. Low wages in emerging economies go hand-in-hand with low productivity.

The reason for this link between wages and productivity is that if within an economy wages are less than the value of the output of an extra worker, firms will want to hire more workers and will thus push up wages. International trade will also tend to equalize labor costs per unit of output. If a country's unit labor costs are below world levels, increased demand for its goods, and hence for labor, will drive up either wages or the currency.

Using this framework, Mr Golub demonstrates that the so-called 'unfair' advantage of developing countries is nothing of the sort. In 1990 manufacturing wages in Malaysia were only 15% of those in America. Comparing productivity levels in different countries is trickier, because the value of output per person has to be converted into a common currency using some measure of purchasing-power-parity (ie, taking account of differences in price levels). Mr Golub estimates that Malaysia's average productivity in manufacturing was also about 15% of America's. In other words, average unit labor costs were roughly equal in the two countries.

Indeed, across a range of developed and developing countries, Mr Golub finds a broad

correlation between wage levels and productivity. Chart 1 shows that the cross-country differences in labor costs are much smaller than wage gaps alone suggest. According to Mr Golub's calculations, average unit labor costs in India and the Philippines were actually higher than in America in 1990.

Maybe, but another popular fear is that as developing nations acquire the latest technology, their productivity will soar to western levels, giving them a huge cost advantage. Yet both theory and evidence suggest that rising productivity will be matched by either higher wages or a stronger exchange rate. Over the past two decades South Korea, which has seen the biggest productivity leap of the economies studied, has also seen the biggest rise in real wages.

Indeed, in most emerging economies wages have risen even faster than productivity, narrowing the gap in unit labor costs with America. One big exception is Mexico, where wages fell after the 1980s debt crisis.

Comparatively speaking

Although average unit labor costs should tend to converge across countries, there will still be big differences between sectors, because countries' productivity gaps with America will differ from one industry to another. This is what gives rise to comparative advantage, the driving force behind international trade. If countries specialize in goods in which they have a comparative advantage – ie, those in which their relative productivity is higher – they will all gain.

Wages are roughly the same in different sectors, but if a developing country's productivity relative to America is higher than average in textiles, say, then its unit labor costs in textiles will be below America's. On the other hand, in more sophisticated industries, such as complex machinery, a developing country's productivity relative to America's will be below average – ie, America has a comparative advantage.

In theory, countries will be net exporters of goods in which they have a comparative advantage. Mr Golub puts this to the test by comparing bilateral trade flows and unit labor costs in different manufacturing sectors. In the majority of cases, relative productivity differences and hence differences in unit labor costs across sectors do seem to explain trade patterns in rich and poor countries alike.

Chart 2 shows a significant negative correlation between the ratio of American to Japanese exports in a particular industry and America's unit labor costs relative to Japan's in the same sector. Indeed, in terms of both absolute and comparative advantage, Mr Golub finds that the results for Japan are the most consistent with economic theory of the countries studied. So much for the popular view that 'Japan is different'.

*'Comparative and Absolute Advantage in the Asia Pacific Region'. By Stephen Golub. Federal Reserve Bank of San Francisco Working Paper, forthcoming