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Finance And Economics: Krugman's conundrum; Economics focus

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Abstract (Summary)

Opinion polls suggest that Americans have become increasingly convinced that globalisation harms ordinary workers. As a commentator, economist Paul Krugman has become more sceptical. It's no longer safe to assert that trade's impact on the income distribution in wealthy countries is fairly minor, he wrote on the VoxEU blog last year. There's a good case that it is big and getting bigger. He offered two reasons why. First, more of America's trade is with poor countries, such as China. Second, the growing fragmentation of production means more tasks have become tradable, increasing the universe of labour-intensive jobs in which Chinese workers compete with Americans. His new paper sets out to substantiate these assertions.

Full Text (937 words)

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The elusive link between trade and wage inequality

"THIS paper is the manifestation of a guilty conscience." With those words, Paul Krugman began the recent presentation of his new study of trade and wages at the Brookings Institution. Mr Krugman, a leading trade economist (as well as a New York Times columnist), had concluded in a 1995 Brookings paper* that trade with poor countries played only a small role in America's rising wage inequality, explaining perhaps one-tenth of the widening income gap between skilled and unskilled workers during the 1980s. Together with several studies in the mid-1990s that had similar findings, Mr Krugman's paper convinced economists that trade was a bit-part player in causing inequality. Other factors, particularly technological innovation that favoured those with skills, were much more important.

At some level that was a surprise. In theory, although trade brings gains to the economy as a whole, it can have substantial effects on the distribution of income. When a country with relatively more high-skilled workers (such as America) trades with poorer countries that have relatively more low-skilled workers, America's low skilled will lose out. But when the effect appeared modest, economists heaved a sigh of relief and moved on.

In recent years, however, the issue has returned. Opinion polls suggest that Americans have become increasingly convinced that globalisation harms ordinary workers. As a commentator, Mr Krugman has become more sceptical. "It's no longer safe to assert that trade's impact on the income distribution in wealthy countries is fairly minor," he wrote on the VoxEU blog last year. "There's a good case that it is big and getting bigger." He offered two reasons why. First, more of America's trade is with poor countries, such as China. Second, the growing fragmentation of production means more tasks have become tradable, increasing the universe of labour-intensive jobs in which Chinese workers compete with Americans. His new paper set out to substantiate these assertions.

That proved hard. Certainly, America's trade patterns have changed. Poor countries' share of commerce in manufactured goods has doubled. In contrast to the 1980s, the average wage of America's top-ten trading partners has fallen since 1990. All of which, you might think, would increase the impact of trade on wage inequality.

But by how much? If you simply update the approach used in Mr Krugman's 1995 paper to take into account today's trade patterns, you find that the effect on wages has increased. Josh Bivens, of the Economic Policy Institute, a Washington, DC, think-tank, did just that and found that trade widened wage inequality between skilled and unskilled workers by 6.9% in 2006 and 4.8% in 1995. But even with that increase, trade is still far from being the main cause of wage inequality. Lawrence Katz, a Harvard economist who discussed Mr Krugman's paper at Brookings, estimates

that, using Mr Bivens' approach, trade with poor countries can account for about 15% of the growth in the wage gap between skilled and unskilled workers since 1979.

Even this is almost certainly an overstatement. Many imports from China have moved up-market from easy-to-produce products, such as footwear, to more sophisticated goods, such as computers and electronics. As a result, to use economists' jargon, the "factor content" of American imports--in effect, the amount of skilled labour they contain--has not shifted downwards. Mr Katz says factor-based models suggest trade with poor countries explains only 5% of rising income inequality.

Mr Krugman argues that the effect is bigger, but that import statistics are too coarse to capture it. Thanks to the fragmentation of production, Chinese workers are doing the low-skill parts of producing computers. Just because computers from China are classified as skill-intensive in America's imports does not prevent them from hurting less-skilled American workers. Mr Krugman may be right but, as he admits, it is hard to prove.

Blame it on the rich

Robert Lawrence, another Harvard economist, has looked at the same evidence and reached rather different conclusions. In a new book, "Blue Collar Blues", he points out that the contours of American inequality sit ill with the idea that trade with poor countries is to blame. Once you measure income properly, the gap between white- and blue-collar workers has not risen that much since the late 1990s when China's global integration accelerated. The wages of the least skilled have improved relative to those in the middle. Some types of inequality have increased, notably the share of income going to the very richest. But there is little sign that wage inequality has behaved as traditional trade theory might suggest.

Mr Lawrence offers two reasons why. One possibility is that America no longer makes some of the low-skilled, labour-intensive goods that it imports. In those goods there are no domestic workers to lose out to foreign competition. Second, even when America does produce something that is imported from China, it may make it in a different way, with more machinery and only a few high-skilled workers. If imports from China and other poor countries compete with more-skilled American workers, they may displace workers but will not widen wage inequality.

Given the lack of fine-grained statistics, none of these studies settles the debate. It is possible that globalisation is becoming a bigger cause of American wage inequality. But contrary to the tone of the political debate, and the thrust of Mr Krugman's commentary, the evidence is inconclusive. "How can we quantify the actual effect of rising trade on wages?" Mr Krugman asked at the end of his paper. "The answer, given the current state of the data, is that we can't."

*The studies cited in the article can be found at www.economist.com.

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