

Global: Daily Economic
Comment

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Economic Trends

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Offshoring Backlash

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- **Theory**
Over the long run, offshoring and the time-honored benefits of free trade appear to go hand in hand; international competition lowers costs and prices, thereby boosting the purchasing power and the standard of living of consumers around the world.
- **Practice**
In the context of America's jobless recovery, there is no tolerance for the long-run benefits of such theoretical effects; to the extent that offshoring accounts for any aspect of the current hiring shortfall, it becomes a lightning rod in the political debate.
- **From nontradable to tradable**
Courtesy of the Internet, there is now real-time connectivity between the knowledge content of offshore white-collar workers and parent companies in the West; in a no-pricing leverage era, US businesses have great incentive to exploit such options.
- **White-collar shock**
Well-educated, high-paid, middle-aged white-collar workers are losing their jobs for the first time ever; they are quick to realize that the offshoring phenomenon means that many of those jobs will be lost forever.
- **Politicians to the "rescue"**
American politicians sense this undercurrent of angst in the US labor market; in the Congress, the protectionist train has left the station, and both major presidential candidates have embraced the plight of the American worker.
- **Financial market risks**
The drumbeat of protectionism grows louder at precisely the moment when the US has a record current-account deficit, a weakening dollar, and an extraordinary dependence on Chinese financing.

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Offshoring Backlash

It's economics versus politics. The free-trade theory of globalization embraces the cross-border transfer of jobs. Political systems do not — especially as election cycles heat up. That heat is now being turned up in Washington, as incumbent politicians in both parties come face to face with the angst of America's jobless recovery. Jobs could well be the "hot button" in Campaign 2004. And offshoring — the transfer of high-wage US jobs to the low-wage developing world — could quite conceivably be the most contentious aspect of this debate and one of greatest risk factors for ever-complacent financial markets.

Like most economists, I, too, worship at the high altar of free-market competition and the trade liberalization that drives it. But that doesn't mean putting a positive spin on the painful dislocations that trade competition can spawn. Unfortunately, that was the mistake made recently by the Bush administration's chief economist, Gregory Mankiw, in his dismissive assessment of white-collar job losses due to offshoring. Like most economic theories, the optimal outcomes cited by Mankiw pertain to that ever-elusive long run. Over that timeframe, the basic conclusion of the theory of free trade is inarguable: International competition lowers costs and prices, thereby boosting the purchasing power and standard of living of consumers around the world. The practical problem in this case — as it is with most theories — is the concept of the long run. Sure, over a long enough timeframe, things will eventually work out according to this theoretical script. But the key word here is "eventually" — the stumbling block in presuming that academic theories map neatly into the shorter time horizons of financial markets and politics. Lord Keynes put it best in his 1923 *Tract on Monetary Reform*, cautioning, "In the long run, we're all dead."

History, of course, tells us that a lot can happen between now and that ever-elusive long run. That's precisely the risk in the great offshoring debate, in my view. As always, context defines the issues of contention. And in this case, the context is America's jobless recovery — an unprecedented hiring shortfall in the first 26 months of this "recovery" that has left private nonfarm payrolls fully 8 million workers below the path of the typical hiring upturn.

This is where the offshoring debate enters the equation. One of the pillars of trade theory is that wealthy industrial economies like America's can be broken down into two

basic segments of activity — tradables and nontradables. International competition has long been confined to the tradable goods, or manufacturing sector. By contrast, the nontradables sector was largely sheltered from tough competitive pressures, effectively shielding the 80% of America's private sector workforce that toils in services. Consequently, as competitive pressures drove down prices in tradable goods, the bulk of the economy and its workforce benefited from the resulting expansion of purchasing power. Advanced, knowledge-based economies thrive on this distinction between tradables and nontradables — manufacturing and services.

That critical distinction has now been blurred. In days of yore, it used to be that services had to be delivered in person, on site. Cross-border trade in services was unheard of. Now, courtesy of the Internet, that critical assumption has been turned inside out. There is now real-time connectivity between the knowledge content of offshore white-collar workers and parent companies in the West. That is a truly transforming event — it essentially converts many nontradables into tradables.

Maybe it's just a coincidence, but it turns out that the private services sector has accounted for 5.3 million jobs of the cyclical shortfall in total private hiring, by our reckoning. That underscores the extraordinary pressures that are now bearing down on what had long been the most powerful element of the Great American Job Machine. Not surprisingly, at the same time, the IT-enabled services export industry has sprung to life in places like India. Meanwhile, US businesses, still operating in a no-pricing-leverage climate, have little choice other than to continue in their unrelenting efforts to take out excess costs. The IT-enabled global labor arbitrage provides high-wage companies in the developed world with a new and very powerful means to execute that option. That means is offshoring.

Offshoring is seen as but a bump in the road for theorists like Mankiw. The presumption in this case is that an innovation-led, flexible US economy is able to uncover new sources of job creation that can fill the void left by this cross-border labor arbitrage. Yet that may be a heroic assumption for the foreseeable future. As nontradables become tradable, America's once shielded white-collar workers face increasingly intense competition from

increasingly well-educated foreign workers. And as skill sets converge around the world, the quick and seamless regeneration of hiring that underpins the theory of free trade starts to seem like an increasingly unrealistic assumption. It's not the theory of free trade that has been invalidated, as some have argued, such as New York Senator Charles Schumer (see Senator Charles Schumer and Paul Craig Roberts, "Second Thoughts on Free Trade," *The New York Times*, January 6, 2004). Ironically, it's that this theory now applies far more broadly than ever imagined.

This is where the debate gets politicized. Over the long sweep of the modern-day, post-World War II era, blue-collar workers bore the brunt of America's economic cycles. Laid off in bad times, rehired in good times, the US factory worker has grown accustomed to economic pain and distress. By contrast, the white-collar worker knew little of these travails — job security was almost treated as an entitlement. Those dreams are now being shattered. Well-educated, high-paid, middle-aged white-collar workers are losing their jobs for the first time ever. And they are quick to realize that the offshoring phenomenon means that many of those jobs will be lost forever. The result is an outbreak of white-collar shock that has now become a lightning rod in the political arena.

Politicians have quickly discovered that it does little good to argue that offshoring is not to be feared — that it is simply the way the world works. Fed Chairman Alan Greenspan encountered similar pushback in his latest give-and-take with the Congress over the employment issue. Nor is there any payback in quibbling over the order of magnitude of the offshoring phenomenon. Companies and their consultants tend to downplay the scale of such cross-border job shifts. That's because they are fearful that the Congress will retaliate with tax law changes that would penalize US

businesses for playing the global labor arbitrage. But a growing proportion of America's white-collar workers now see the future in very different terms. Not only is that true of those who have been laid off, but it is increasingly true of those who fear they may be next.

American politicians certainly sense this undercurrent of angst in the US labor market. The pro-labor mood in the Congress is both extreme and bipartisan. As one Capitol Hill veteran put it to me last fall when I was testifying on US-China relations, "The protectionist train has left the station." And the leading presidential candidates are jockeying for position to be on the "right side" of the jobs debate. Yesterday in Pennsylvania, President Bush said, "There are people looking for work because jobs have gone overseas. We need to act." Senator Kerry has expressed similar views. The real risk, of course, is that the politicians do the wrong thing. Bills have already been introduced in both houses of Congress that would put steep tariffs on all Chinese products sold in the US. There is talk of going after India and in putting tax penalties on US multinationals who shift jobs overseas. Several states have introduced legislation that bans offshoring contracts. And US immigration authorities have sharply reduced the cap on so-called H-1B visas that cover the entry of foreign IT workers.

The offshoring debate is not about to go away. Neither theory nor fact will temper the palpable sense of angst that has arisen in America's unprecedented jobless recovery. The drumbeat of protectionism grows louder at precisely the moment when the US has a record current-account deficit, a weakening dollar, and an extraordinary dependence on Chinese financing. It's a house of cards that has never seemed more precarious. Yet ever-complacent financial markets could care less. The risk is they will — sooner rather than later.

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