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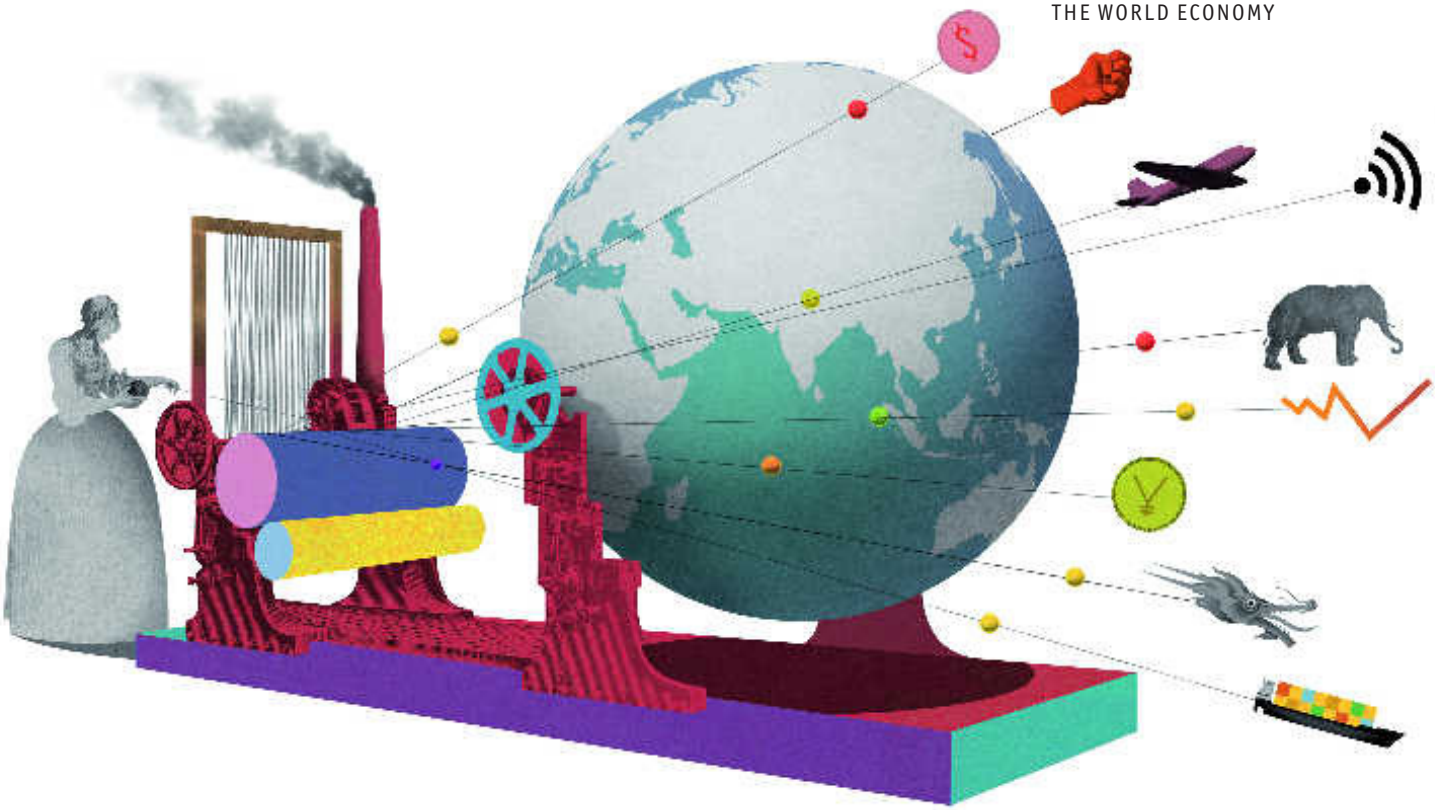
An open and shut case



An open and shut case

The consensus in favour of open economies is cracking, says John O'Sullivan. Is globalisation no longer a good thing?

THERE IS NOTHING dark, still less satanic, about the Revolution Mill in Greensboro, North Carolina. The tall yellow-brick chimney stack, with red bricks spelling "Revolution" down its length, was built a few years after the mill was established in 1900. It was a booming time for local enterprise. America's cotton industry was moving south from New England to take advantage of lower wages. The number of mills in the South more than doubled between 1890 and 1900, to 542. By 1938 Revolution Mill was the world's largest factory exclusively making flannel, producing 50m yards of cloth a year.

The main mill building still has the springy hardwood floors and original wooden joists installed in its heyday, but no clacking of looms has been heard here for over three decades. The mill ceased production in 1982, an early warning of another revolution on a global scale. The textile industry was starting a fresh migration in search of cheaper labour, this time in Latin America and Asia. Revolution Mill is a monument to an industry that lost out to globalisation.

In nearby Thomasville, there is another landmark to past industrial glory: a 30-foot (9-metre) replica of an upholstered chair. The Big Chair was erected in 1950 to mark the town's prowess in furniture-making, in which North Carolina was once America's leading state. But the success did not last. "In the 2000s half of Thomasville went to China," says T.J. Stout, boss of Carsons Hospitality, a local furniture-maker. Local makers of cabinets, dressers and the like lost sales to Asia, where labour-intensive production was cheaper.

The state is now finding new ways to do well. An hour's drive east from Greensboro is Durham, a city that is bursting with new firms. One is Bright View Technologies, with a modern headquarters on the city's outskirts, which makes film and reflectors to vary the pattern and diffusion of LED lights. The Liggett and Myers building in the city centre was once the home of the Chesterfield cigarette. The handsome building is now

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filling up with newer businesses, says Ted Conner of the Durham Chamber of Commerce. Duke University, the centre of much of the city's innovation, is taking some of the space for labs.

North Carolina exemplifies both the promise and the casualties of today's open economy. Yet even thriving local businesses there grumble that America gets the raw end of trade deals, and that foreign rivals benefit from unfair subsidies and lax regulation. In places that have found it harder to adapt to changing times, the rumblings tend to be louder. Across the Western world there is growing unease about globalisation and the lopsided, unstable sort of capitalism it is believed to have wrought.

Rising to the top

US household incomes
Ratio of 90th to 10th percentile
2014 dollars

Source: US Census Bureau

A backlash against freer trade is reshaping politics. Donald Trump has clinched an unlikely nomination as the Republican Party's candidate in November's presidential elections with the support of blue-collar men in America's South and its rustbelt. These are places that lost lots of manufacturing jobs in the decade after 2001, when America was hit by a surge of imports from China (which Mr Trump says he will keep out with punitive tariffs). Free trade now causes so much hostility that Hillary Clinton, the Democratic Party's presidential candidate, was forced to disown the Trans-Pacific Partnership (TPP), a trade deal with Asia that she herself helped to negotiate. Talks on a new trade deal with the European Union, the Transatlantic Trade and Investment Partnership (TTIP), have stalled. Senior politicians in Germany and France have turned against it in response to popular opposition to the pact, which is meant to lower investment and regulatory barriers between Europe and America.

Keep-out signs

The commitment to free movement of people within the EU has also come under strain. In June Britain, one of Europe's stronger economies, voted in a referendum to leave the EU after 43 years as a member. Support for Brexit was strong in the north of England and Wales, where much of Britain's manufacturing used to be; but it was firmest in places that had seen big increases in migrant populations in recent years. Since Britain's vote to leave, anti-establishment parties in France, the Netherlands, Germany, Italy and Austria have called for referendums on EU membership in their countries too. Such parties favour closed borders, caps on migration and barriers to trade. They are gaining in popularity and now hold sway in governments in eight EU countries. Mr Trump, for his part, has promised to build a wall along the border with Mexico to keep out immigrants.

There is growing disquiet, too, about the unfettered movement of capital. More of the value created by companies is intangible, and businesses that rely on selling ideas find it easier to set up shop where taxes are low. America has clamped down on so-called tax inversions, in which a big company moves to a low-tax country after agreeing to be bought by a smaller firm based there. Europeans grumble that American firms engage in too many clever tricks to avoid tax. In August the European Commission told Ireland to recoup up to €13 billion ($14.5 billion) in unpaid taxes from Apple, ruling that the company's low tax bill was a source of unfair competition.

Free movement of debt capital has meant that trouble in one part of the world (say, America's subprime crisis) quickly spreads to other parts. The fickleness of capital flows is one reason why the EU's most ambitious cross-border initiative, the euro, which has joined 19 of its 28 members in a currency union, is in trouble. In the euro's early years, countries such as Greece, Italy, Ireland, Portugal and Spain enjoyed ample credit and low borrowing costs, thanks to floods of private short-term capital from other EU countries. When crisis struck, that credit dried up and had to be replaced with massive official loans, from the ECB and from bail-out funds. The conditions attached to such support have caused relations between creditor countries such as Germany and debtors such as Greece to sour.

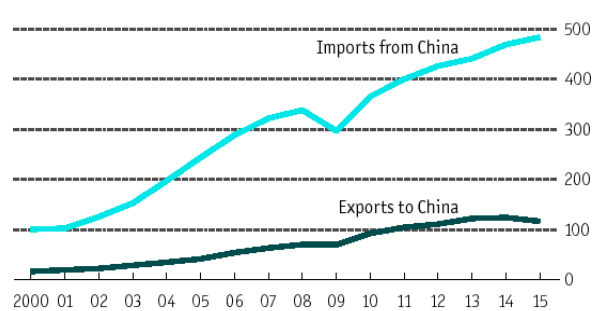
Some claim that the growing discontent in the rich world is not really about economics. After all, Britain and America, at least, have enjoyed reasonable GDP growth recently, and unemployment in both countries has dropped to around 5%. Instead, the argument goes, the revolt against economic openness reflects deeper anxieties about lost relative status. Some arise from the emergence of China as a global power; others are rooted within individual societies. For example, in parts of Europe opposition to migrants was prompted by the Syrian refugee crisis. It stems less from worries about the effect of immigration on wages or jobs than from a perceived threat to social cohesion.

But there is a material basis for discontent nevertheless, because a sluggish economic recovery has bypassed large groups of people. In America one in six working-age men without a college degree is not part of the workforce, according to an analysis by the Council of Economic Advisers, a White House think-tank. In Britain, though more people than ever are in work, wage rises have not kept up with inflation. Only in London and its hinterland in the south-east has real income per person risen above its level before the 2007-08 financial crisis. Most other rich countries are in the same boat. A report by the McKinsey Global Institute, a think-tank, found that the real incomes of two-thirds of households in 25 advanced economies were flat or fell between 2005 and 2014, compared with 2% in the previous decade. The few gains in a sluggish economy have gone to a salaried gentry.

This has fed a widespread sense that an open economy is good for a small elite but does nothing for the broad mass of people. Even academics and policymakers who used to welcome openness unreservedly are having second thoughts. They had always understood that free trade creates losers as well as winners, but thought that the disruption was transitory and the gains were big enough to compensate those who lose out. However, a body of new research suggests that China's integration into global trade caused more lasting damage than expected to some rich-world workers. Those displaced by a surge in imports from

Cause for concern

US merchandise trade with China, $bn



Source: US Census Bureau

China were concentrated in pockets of distress where alternative jobs were hard to come by.

It is not easy to establish a direct link between openness and wage inequality, but recent studies suggest that trade plays a bigger role than previously thought. Large-scale migration is increasingly understood to conflict with the welfare policy needed to shield workers from the disruptions of trade and technology.

The consensus in favour of unfettered capital mobility began to weaken after the East Asian crises of 1997-98. As the scale of capital flows grew, the doubts increased. A recent article by economists at the IMF entitled "Neoliberalism: Oversold?" argued that in certain cases the costs to economies of opening up to capital flows exceed the benefits.

Multiple hits

This special report will ask how far globalisation, defined as the freer flow of trade, people and capital around the world, is responsible for the world's economic ills and whether it is still, on balance, a good thing. A true reckoning is trickier than it might appear, and not just because the main elements of economic openness have different repercussions. Several other big upheavals have hit the world economy in recent decades, and the effects are hard to disentangle.

First, jobs and pay have been greatly affected by technological change. Much of the increase in wage inequality in rich countries stems from new technologies that make college-educated workers more valuable. At the same time companies' profitability has increasingly diverged. Online platforms such as Amazon, Google and Uber that act as matchmakers between consumers and producers or advertisers rely on network effects: the more users they have, the more useful they become. The firms that come to dominate such markets make spectacular returns compared with the also-rans. That has sometimes produced windfalls at the very top of the income distribution. At the same time the rapid decline in the cost of automation has left the low- and mid-skilled at risk of losing their jobs. All these changes have been amplified by globalisation, but would have been highly disruptive in any event.

The second source of turmoil was the financial crisis and the long, slow recovery that typically follows banking blow-ups. The credit boom before the crisis had helped to mask the problem of income inequality by boosting the price of homes and increasing the spending power of the low-paid. The subsequent bust destroyed both jobs and wealth, but the college-educated bounced back more quickly than others. The free flow of debt capital played a role in the build-up to the crisis, but much of the blame for it lies with lax bank regulation. Banking busts happened long before globalisation.

Superimposed on all this was a unique event: the rapid emergence of China as an economic power. Export-led growth has transformed China from a poor to a middle-income country, taking hundreds of millions of people out of poverty. This achievement is probably unrepeatable. As the price of capital goods continues to fall sharply, places with large pools of cheap labour, such as India or Africa, will find it harder to break into global supply chains, as China did so speedily and successfully.

This special report will disentangle these myriad influences to assess the impact of the free movement of goods, capital and people. It will conclude that some of the concerns about economic openness are valid. The strains inflicted by a more integrated global economy were underestimated, and too little effort went into helping those who lost out. But much of the criticism of openness is misguided, underplaying its benefits and blaming it for problems that have other causes. Rolling it back would leave everyone worse off. ■

Free trade

Coming and going

Truth and myth about the effects of openness to trade

IN MARCH 2000, two months before a crucial vote in America's Congress on whether to make normal trading relations with China permanent, Bill Clinton gave a press conference. In the first year of his presidency, 1993, he had made a bold case for the North Atlantic Free Trade Agreement (NAFTA) with Canada and Mexico, claiming it would create 200,000 jobs in America. Now, in the final year of his second term, he was even more bullish about a trade pact with China, which would allow that country to join the WTO. It would require China quickly to cut its average import tariff from 24% to 9%, to abolish import quotas and licences and to open up some industries to American investment. America, for its part, would not have to do anything. "This is a hundred-to-nothing deal for America when it comes to the economic consequences," said Mr Clinton.

Sixteen years on the mood is rather different. Job losses in manufacturing states such as Michigan, Ohio and Pennsylvania have made trade a key issue in America's presidential election. Donald Trump has risen to prominence in part by promising to impose steep tariffs on imports from China and Mexico, claiming America's trade deficit with both countries (see chart, next page) shows it is "losing". Hillary Clinton is no longer supporting the TPP trade deal she had earlier favoured. The demise of furniture-makers and textile firms, unable to compete with low-cost imports, belies the predictions made by her husband. Bernie Sanders, Mrs Clinton's opponent in the Democratic Party primaries, said trade deals had been "a disaster for American workers". A YouTube clip earlier this year showing the graceless manner in which bosses of Carrier, a maker of air-conditioners, told its workforce that it was moving production to Mexico seemed to

confirm every fear about the exodus of jobs and the heartlessness of capitalism.

What is behind the change in mood? The years after the NAFTA agreement came into force, in 1994, were actually rather good ones for America's economy, including manufacturing. But China's accession to the WTO caused a big shock. The country's size, and the speed at which it conquered rich-world markets for low-cost manufacturing, makes it unique. By 2013 it had captured one-fifth of all manufacturing exports worldwide, compared with a share of only 2% in 1991.

This coincided with a fresh decline in factory jobs in America. Between 1999 and 2011 America lost almost 6m manufacturing jobs in net terms. That may not be as dramatic as it sounds, since America is a large and dynamic place where around 5m jobs come and go every month. Still, when David Autor of the Massachusetts Institute of Technology (MIT), David Dorn of the University of Zurich and Gordon Hanson of the University of California, San Diego, looked into the job losses more closely, they found something worrying. At least one-fifth of the drop in factory jobs during that period was the direct result of competition from China.

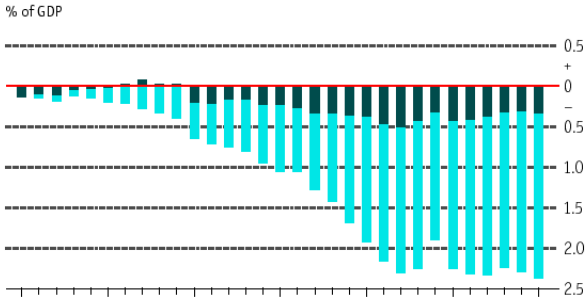
Moreover, the American workers who had lost those jobs neither found new ones close by nor searched for work farther afield. They either swelled the ranks of the unemployed or, more often, left the workforce. That contradicts the widespread belief that America's jobs market is fluid and flexible. When men lose a factory job, they often stay put. Those who managed to find new jobs were paid less than before and were working in industries that were vulnerable to competition from imports. In subsequent research, the authors found that lost factory jobs also had a depressing effect on aggregate demand (and thus non-manufacturing jobs) in the affected areas. In total, up to 2.4m jobs may have been lost, directly and indirectly, as a consequence of imports from China.

In other rich countries, regions or industries with heavy exposure to Chinese imports also suffered material losses in factory jobs. A study of Spain's jobs market by Vicente Donoso, of the Complutense University of Madrid, and others found that provinces with the greatest exposure to Chinese imports saw the largest falls in the share of manufacturing employment between 1999 and 2007, but this was compensated for by an increase in non-factory jobs. Research in Norway, though, found that the main effect was to raise unemployment. João Paulo Pessoa of the London School of Economics found that British workers in industries exposed to high levels of import competition from China spent more time out of work than those in other industries. A wide-ranging study of the effect on Germany of more trade with China and eastern Europe in the two decades after 1988 concluded that industries competing with imports suffered job losses, but these were outweighed by job gains in regions focused on export industries. Those gains were due almost entirely to trade with eastern Europe, not China.

Going south

US trade balance with: Mexico China

% of GDP

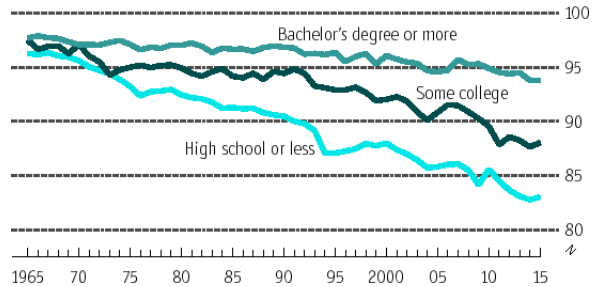


Sources: US Census Bureau; US Bureau of Economic Analysis

The risks of dropping out

US labour-force participation rate of males aged 25-54

By educational attainment, %



Sources: US Bureau of Labour Statistics; Council of Economic Advisers

China's accession to the WTO was supposed to be a great bonus for America. So why was its impact on trade and jobs so unexpectedly large? One reason was that China got a very significant advantage out of the pact. A paper by Justin Pierce, of the Federal Reserve, and Peter Schott, of Yale School of Management, argues that joining the WTO removed the risk for China of a steep increase in America's tariffs, making it less perilous for its companies to invest in new factories. The authors found that industries where the threat of tariff increases was most reduced suffered the greatest job losses in America. But the lopsided nature of trade between China and the rich world also played a part. After China joined the WTO, its current-account surplus widened from an average of around 2% of GDP in the 1990s to about 5% in the following decade. In other words, China saved more. That helps explain the modest offsetting gains in exports in the regions affected by Chinese imports.

Done workin'

It is important to note that America's growing inability to bounce back from losing manufacturing jobs predates the rise of China as an exporting power. A report published in June by the Council of Economic Advisers (CEA) charts the long-term decline in prime-aged men in America's workforce. It shows that in the mid-1960s almost all men aged between 25 and 54 were either in work or looking for a job, but that in the past half-century the participation rate for this group has dropped below 90%. In every recession the rate falls more sharply, and when the economy picks up again it fails to make up all the lost ground.

But there are big differences between the participation rates of different groups of men. In 1964 male high-school graduates were about as likely to be in the workforce as college-educated men, but now only 83% of those with a high-school degree or less are in the workforce, against 94% of those who finished college (see chart). This mirrors a growing divergence in wages. In the mid-1960s the pay of less educated men averaged 80% of college-educated ones, but by 2014 that proportion had fallen to 60%.

It is unlikely that men are dropping out of work voluntarily. More than a third of inactive men live in poverty; less than a quarter have a working spouse. So the most obvious explanation is a fall in demand for less-skilled men. That in turn is partly linked to a long-term decline in manufacturing, whose share of the jobs market peaked in the days when almost all prime-age

men worked. The CEA study found that states with a higher-than-average share of jobs in construction, mining and (to a lesser degree) manufacturing tend to have more prime-age men in the workforce. It does not help that men who lose their jobs are increasingly rooted in unemployment black spots. The propensity of people to move in search of work has dropped sharply since the early 1990s, for reasons that are not yet fully understood.

A steady drop in the share of prime-age men in the workforce going back half a century cannot be pinned on America signing free-trade agreements or China's emergence as an exporter of manufactures, both of which happened fairly recently. Factory jobs peaked in the 1970s, but manufacturing output has continued to increase. Indeed, America's share of world manufacturing output, on a value-added basis, has been fairly stable at a bit under a fifth for the past four decades. Thanks to advances in technology, fewer workers are needed to produce the same quantity of goods. But since trade with lower-cost countries and technological change have similar effects on labour-intensive production in the rich world, it is hard to disentangle their effects.

Still, some rich countries, such as Germany, Britain and Canada, have done rather better than America at keeping prime-age men in work, though others, including France, Italy and Spain, have done even worse. That is partly a matter of policy. Members of the OECD, a club of mostly rich countries, set aside an average of 0.6% of GDP a year for "active labour-market policies"—job centres, retraining schemes and employment subsidies—to ease the transition to new types of work. America spends just 0.1% of GDP. By neglecting those whose jobs have been swallowed by technology or imports, America's policymakers have fuelled some of the anger about freer trade.

Have trade deals really been a disaster for American workers? Trade with China seems to have had an unusually large effect. Since 1985, America has signed 15 free-trade agreements (FTAs) covering 20 countries. Exports to these countries account for nearly half of all the goods America sells abroad, even though FTA countries make up just a tenth of GDP outside America. In the five years after a new trade pact comes into force, America's exports to new FTA partners typically grow around three times as fast as its overall exports, at least keeping pace with imports. In 2012, exports to the 20 countries covered by FTAs grew twice as fast as the average. In America, exporting firms pay a wage premium of between 13% and 18%, compared with non-exporters. This is hardly a disaster.

America has run a trade deficit every year since 1976. On the other side of the global ledger are countries that consistently run big trade surpluses. These days the record is held not by China but by Germany, which last year had a current-account surplus of 8% of GDP (see chart). But this does not mean that America is "losing" at trade, as Mr Trump suggests, and China and Germany are winning. The purpose of exports is to pay for imports, either now or later. A trade surplus is not a virility symbol. In some cases, it is a sign of a strong national preference for saving (though other countries might describe it as a symptom of weak domestic demand). Countries rarely have balanced trade, where the value of exports and imports is exactly the same. It might seem plausible that restricting trade to eliminate deficits will create jobs, channelling existing demand towards goods made at home. But the reality is more complicated. In most rich countries, particularly America, the trade deficit widens when GDP growth is strong, and shrinks during recessions. The factors that drive demand for imports are the same as those that drive overall demand, and thus jobs. To balance trade, Americans would have to invest less or save more. Neither would create jobs.

It would help a sluggish world economy if surplus countries, like China and Germany, were to spend more on imports. But for America to aim to balance trade with any one country would be pointless. In any case, a finished product exported from China to America, say, will include components made in third countries, and probably only a small fraction of the value will have been added in China itself. Four-fifths of all trade takes place along supply chains within, or organised by, multinational firms. Slapping a tariff on imports of intermediate goods from, say, Mexico would raise the price of America's exports, which would probably be bad for its trade balance. Around 40% of the value of Mexico's exports of final goods to America, for instance, was added in America itself.

Sober advocates of free trade know that over time the gains from it come from greater efficiency, not from more jobs, the number of which is largely determined by demography and the strength of aggregate demand. It is easier to spot the link between freer trade and factory closures than the more dispersed benefits trade brings to workers across other industries. Exporting firms in all countries and across a variety of industries are more productive, grow faster and pay higher wages than non-exporting firms. But a lot of the gains from trade come from the direct benefit of cheaper imports and their indirect effect on productivity.

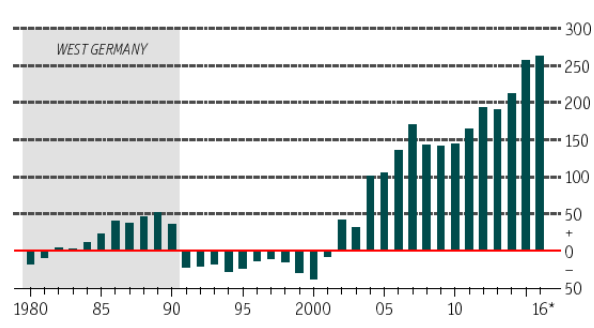
The cost of protectionism

A study by Pablo Fajgelbaum of the University of California, Los Angeles, and Amit Khandelwal, of Columbia University, suggests that in an average country, people on high incomes would lose 28% of their purchasing power if borders were closed to trade. But the poorest 10% of consumers would lose 63% of their spending power, because they buy relatively more imported goods. The authors find a bias of trade in favour of poorer people in all 40 countries in their study, which included 13 developing countries. An in-depth study of European industry by Nicholas Bloom, of Stanford University, Mirko Draca of Warwick University and John Van Reenen of the LSE found that import competition from China led to a decline in jobs and made life harder for low-tech firms in affected industries. But it also forced surviving firms to become more innovative: R&D spending, patent creation and the use of information technology all increased, as did total factor productivity.

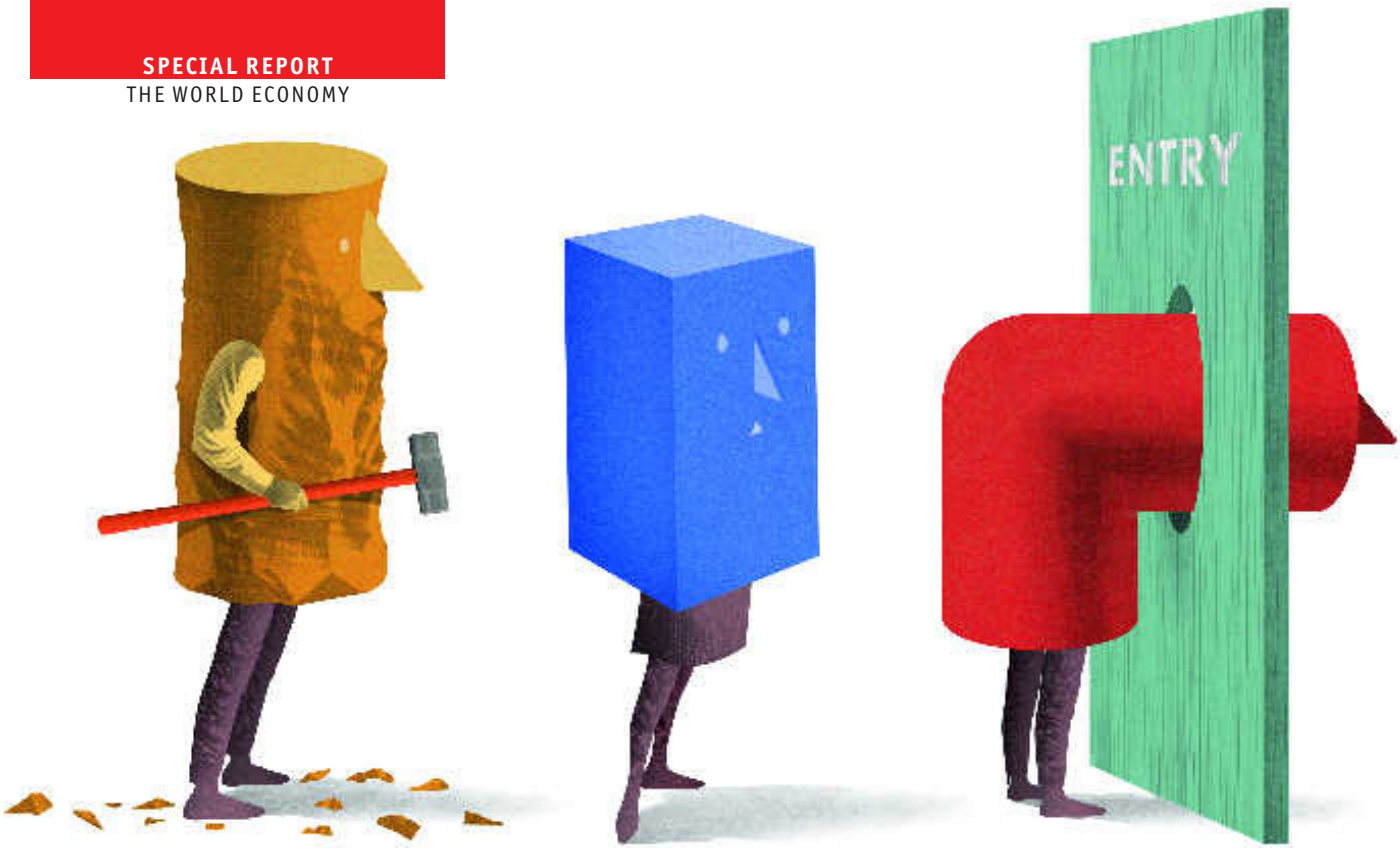
Taken together, these are large and permanent benefits. What is clear from the studies of Mr Autor and others is that the one-off integration of China had bigger and more lasting effects than expected. Too little attention has been paid in America to those whose jobs are displaced by new technology or imports. That has given an opening to protectionists, who are peddling a solution that will hurt the poor most. A similar sort of populism is rearing its head in Europe in response to migration. ■

Saving glutton

Germany's current-account balance, €bn



Source: IMF *Forecast



Migration

Needed but not wanted

Economic migrants are seen as a threat to jobs and the welfare state. The reality is more complex

STOKE-ON-TRENT in northern England is home to the world's second-oldest professional football club, Stoke City FC. Founded in 1863, it enjoyed its heyday in the mid-1970s, when the club came close to winning the top division. The playing style was described by its manager, Tony Waddington, as "the working man's ballet". These days the flair is often provided by players from far afield. More than half the first-team squad comes from outside Britain, mostly from other parts of Europe. But that is about as far as Europhilia in Stoke goes. In June's referendum on Britain's European Union membership, the city voted strongly for Brexit.

A study by Italo Colantone and Piero Stanig of Bocconi University in Milan found that areas where jobs are vulnerable to competition from Chinese imports, mainly those in Britain's faded industrial north, tended to be in favour of leaving. Stoke City FC are known as the Potters in tribute to the city's once-great pottery industry. But Stoke also seemed predestined to be a Brexit supporter on another count. An analysis by *The Economist* earlier this year found that in places such as Stoke, where the foreign-born population had increased by more than 200% between 2001 and 2014, a vote to leave was almost certain.

Immigration of low-skilled workers has become an increasingly contentious political issue in both America and Britain. Voters in host countries often see a sudden influx of people from places with lower wages, poorer working conditions and a less generous welfare system as a threat to their livelihoods and living standards. In America the debate is about whether migrants hold down the wages of native workers. In Britain the main concern is that migrants put additional pressure on housing, public health services, schools and transport systems.

Along with trade, migration is one of the two main sources of public anxiety about globalisation. For the host economy, the gains and drawbacks are similar to those from trade. Immigration enriches the workforce, allowing for a more finely graded specialisation that raises average productivity and living standards. Diverse workforces are likely to be more productive, especially in industries where success depends on specific knowledge, such as computing, health care and finance. By easing labour bottlenecks, low-skilled migrants help to keep down prices of goods and services.

The drawback for native workers is competition for jobs and public services. In principle, an influx of low-skilled workers depresses wages for competing native workers, in the same theoretical way that opening up to trade with poor countries does. The balance of benefits and costs will depend on income: the rich are likely to do better out of the bargain. Economists dispute the extent of the overall gains and losses to hosts and labour-sending countries respectively.

Come pick my strawberries

Some benefits are uncontested. For immigrants from poorer countries moving to Stoke, or indeed to any part of Britain, there are clear gains. They can hope for a better job, a marked improvement in their quality of life and access to better public services such as health care. Economic migrants are by definition a mobile labour force. Migration helps to deal with labour shortages in low- or mid-skilled industries, such as mining or agriculture, and in remote places where it is difficult to attract native workers. Migrants are also often granted work visas on the strength of having scarce skills.

Other elements of migration are more controversial. If host countries benefit from immigrants, then the countries that send them must be losing out on manpower, skills and tax revenue. The people who move are often the brightest and best—those with the get-up-and-go, the languages and the connections—so their country of origin may suffer a brain drain. A recent paper from the IMF puts a number on this. Between 1990 and 2012 al-

most 20m people moved from central, eastern and south-eastern Europe to richer countries in western Europe. This east-west migration accelerated after 2004 when eight eastern European countries, including Poland, the Czech Republic and Hungary, joined the EU. The IMF researchers reckon this exodus lowered cumulative population growth in labour-sending countries by eight percentage points. If those mostly young and skilled workers had stayed put, the gap with the EU in income per person would have been five percentage points narrower.

These results are open to dispute. Migrants typically move from places where economic prospects are poor, making it hard to establish whether weak growth is a cause or a consequence of their leaving. The chance of a better life elsewhere may also create a stronger incentive for those who remain to acquire new skills. Michael Clemens of the Centre for Global Development and Satish Chand of the Australian National University used a natural experiment provided by a military coup in Fiji in 1987 to study the effects of emigration on that country. The economy was split between indigenous Fijians and those of Indian origin. A large chunk of the second group, generally high-skilled, left after the coup. Most of them went to Australia and New Zealand, which admitted well-qualified migrants. It seemed the ideal opportunity to measure the effects of a brain drain.

What the researchers found was that the Indian Fijians who stayed behind started to acquire skills at a faster rate in order to be able to emigrate (or at least to have the option of doing so). They also concentrated on disciplines that allowed them to meet the skills-based immigration criteria most efficiently. The increased investment in skills was large enough to raise the stock of human capital net of the first wave of emigration, in which a fifth of the Indian-Fijian population left. The brain drain was fully offset.

What about the impact on host countries? Many native workers see uncontrolled immigration as a break with an implicit contract: that the state will look after its own. It creates a tension between immigration and the welfare state. That tension, though, is mostly policy-related. Where migrants' employment rate is higher than that of natives (as is the case with migrants within the EU), fears that immigration will add to the welfare burden are largely unfounded, though much depends on how welfare policies are designed. In America, for instance, only those who have paid into the public Social Security (pension) scheme for at least ten years are entitled to benefits. A well-designed policy could make immigration and welfare provision complementary.

The trouble is that at local level there is often a mismatch between the extra resources that immigrants add and the extra demand they create. Additional pressures on local public services are a particular problem in Britain, where central government raises taxes and allocates spending. Centralised budgets make it difficult for local authorities to respond flexibly to changes in local conditions, and strict planning rules limit the construction of new homes when demand surges.

Some other European countries deal with economic migration rather better than Britain does. In Denmark a lot of budgetary policy is made at municipal level, says Jacob Kirkegaard of the Peterson Institute for International Economics. If an area has an influx of migrants, it receives more local tax revenues to expand public amenities, build more schools, hire more doctors and so on.

Another concern among natives has been that immigrants put downward pressure on wages. In theory they should, but empirical studies come to different conclusions. On one side is George Borjas, of Harvard University, whose study in 2006 found that although immigration did not depress overall wages between 1980 and 2000, it did hold down the pay of the low-skilled by 5-10%. On the other side, David Card, of the University of California, Berkeley, concluded that there was no effect. His view was based on a study of the "Mariel boatlift", an unexpected surge in Cuban migrants to Miami in 1980. Mr Card reckoned that Miami had become accustomed to handling large inflows of unskilled migrants. Mr Borjas has recently looked at Mr Card's analysis again and claims that high-school dropouts, a subset of the low-skilled native workers in Mr Card's study, did in fact suffer a material fall in wages.

Many native workers see uncontrolled immigration as a break with an implicit contract: that the state will look after its own

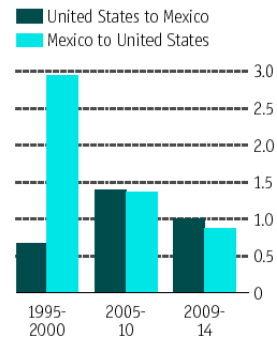
Until quite recently the academic literature treated migrants as substitutes for native workers. But what if they were complements; if low-skilled migrants helped to boost the productivity of low-skilled natives? Gianmarco Ottaviano, of the University of Bologna, and Giovanni Peri, of the University of California, Davis, find that for workers with at least a high-school qualification, the wage effects of low-skill immigration are positive if you drop the assumption that workers of the same age and education are perfect substitutes and that workers of one skill level, say cooks, do not affect the productivity of workers at other skill levels, say waiters or restaurant managers. The effect on the wages of high-school dropouts is only mildly negative. A paper by Marco Manacorda, Alan Manning and Jonathan Wadsworth, of the London School of Economics, similarly concludes that immigrants to Britain are imperfect substitutes for native-born workers, so they have little impact on natives' job prospects or wages. New immigrants tend to affect only the pay of recently arrived immigrants.

From these muddy waters, it is possible to draw two tentative conclusions about the broad impact of migration on wages. First, the effect on the bulk of low-skilled native workers has been fairly muted—perhaps because the way work is done changes in response to large-scale migration. However, the pay of some narrow categories of workers (say, farm labourers in Britain or high-school dropouts in America) may still be affected.

To deal with the tension between immigration and the welfare state, three rules suggest themselves. First, make benefits

Role reversal

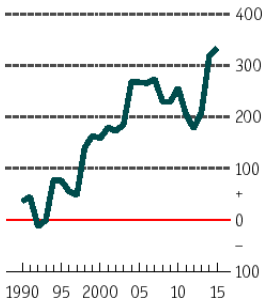
Migration, m



Source: Pew Research Centre

The fear factor

Net migration to Britain, '000



Source: National statistics

conditional on having paid into the system. Second, tie the funding of local public services to local tax revenues to ensure an automatic response to an influx of migrants. Third, restrict migration to prime-age, skilled workers who are more likely to get jobs and less likely to lose them in a recession.

But this may not be as straightforward as it sounds. Almost two-thirds of the new jobs that will be added to America's economy in the next decade will be low-skilled or mid-skilled jobs, according to a projection by the country's Bureau of Labour Statistics. Care workers, kitchen staff, auxiliary nurses and builders will be in strong demand in Europe, too. Such demand may not easily be met by indigenous workers, even at higher wages.

Will these jobs be filled in a black market or in a formal labour market? This is a question America has faced before. In the 1980s the baby-boomers were moving towards middle age, causing a spike in demand for young, low-skilled labour. This coincided with a demographic bulge in Mexico. An overhaul of America's immigration rules in 1986 regularised those Mexican workers who had arrived before 1982. Henceforth work visas would be granted only to high-skilled migrants. The interplay of supply and demand created a black market, causing the number of illegal migrants to reach 12m in 2007, when policing of the border was stepped up. It was only quite recently that the flow of migrants was reversed (see chart, previous page).

Europe now faces a supply-demand dynamic similar to America's in the 1980s. It has an ageing population, whereas on its doorstep, in the Middle East and Africa, populations are young and growing rapidly. A lesson from America's engagement with Mexico is that a formal system for low-skilled immigration, perhaps with fewer entitlements than for skilled workers, is far preferable to turning a blind eye to informal migration.

Only within the EU's borders is the free movement of people tied to the free movement of trade and capital. For the most part, enthusiasts for globalisation have rooted only for freer trade and open capital markets, not migration. Yet many of them are now having second thoughts about the benefits of unfettered capital too. ■

Capital mobility

The good, the bad and the ugly

Foreign direct investment is mostly welcome, but large short-term flows spell trouble

SHANNON AIRPORT ON Ireland's west coast has been a gateway from Europe to America since the 1940s. It was built across the estuary of the river Shannon from Foynes, a small town that had served in the interwar years as a refuelling stop for seaplanes and passengers on their way across the Atlantic. A local chef, Joe Sheridan, came up with the idea of Irish coffee when he added whiskey to the hot drinks served to shivering passengers from a Pan Am flying boat. In 1947 a catering manager, Brendan O'Regan, set up the world's first duty-free shop at Shannon, allowing transit passengers to buy tax-exempt goods.

Capital also disembarks in this part of Ireland, a country that, more than most, has been transformed by flows of capital from other places. In the 1980s Ireland seemed destined to be western Europe's perennial laggard: "The poorest of the rich", as a survey by *The Economist* put it in 1988. But within a decade Ireland had transformed itself into the Celtic tiger, Europe's unlikely answer to the booming economies of South-East Asia.

Central to this shift were American companies seeking a foothold in the EU ahead of the creation of the single market in goods in 1992 and lured by a well-educated, English-speaking workforce. The state offered inducements, such as grants and a low corporate-tax rate. Intel, a chipmaker, started production in Dublin in 1990. Other big firms followed. Boston Scientific, a maker of medical devices, set up shop in 1994 in Galway, an hour's drive from Shannon. A medical-technology and pharmaceutical cluster emerged in the region.

A textbook example

Thanks to foreign direct investment (FDI) of this kind, Ireland went from the poorest of the rich to among the richest. It was a textbook example of the benefits of capital flows. But Ireland is also an archetype of the malign side-effects of capital mobility. As it became richer, other countries took exception to its low corporate-tax rate, which they saw as simply a device to allow global companies to book profits in Ireland and save tax.

The scale of the problem was highlighted in July when Ireland's statistical office revealed that the country's GDP had grown by 26% in 2015. The figure said little about the health of the Irish economy. First, it was inflated by "tax inversions" in which a small Irish company acquires a bigger foreign one and the merged firm is registered in Ireland to benefit from its low corporate taxes. Last year saw a rush of transactions before a clampdown by America. Second, the GDP figures were distorted by the aircraft-leasing industry. The world's two largest lessor fleets are managed from Shannon, though many of the 4,000 registered aircraft will never touch down there.

But it is the damage wrought by short-term capital flows in Ireland that is most striking. After the launch of the euro in 1999, would-be homeowners were seduced by irresistibly low interest

rates set in Frankfurt. Irish banks borrowed heavily in the euro interbank market to fuel the property boom and to speculate on assets outside Ireland. Bank loans to the private sector grew by almost 30% a year in 2004-06, at the peak of the boom. When that boom turned to bust, the country suffered a brutal recession and had to be bailed out by the IMF. Ireland still bears the scars. Preliminary figures from this year's census show that almost 10% of homes in Ireland are permanently empty. Some of the worst-affected areas are in the west of Ireland, up or down the coast from Shannon. Ghost estates and failed bed-and-breakfast places are the legacy of a building boom that by 2007 had drawn one in eight of all workers into the construction industry.

Unimpeded capital flows should be a boon. Like global free trade, global capital markets offer broader opportunities. More and better openings usually make people richer. Globalised capital breaks the tie between domestic saving and investment, giving poor and low-saving countries the wherewithal to speed up GDP growth. For developing economies, capital mobility is a conduit for new technology, management know-how and business networks. It also allows investors to vote with their feet, encouraging governments to follow prudent regulatory, monetary and fiscal policies.

For a long time the liberal orthodoxy was against any kind of restriction on cross-border finance. A succession of financial calamities, starting in Latin America in the 1980s and continuing with the East Asian crisis of 1997-98, prompted a rethink. Rather than imposing discipline, access to foreign capital seemed to allow countries to get into bigger messes. Whereas academics argue about the pros and cons of free movement of goods or people, they now mostly agree that liberalising capital flows can sometimes do more harm than good. Politicians may occasionally rue the fickleness of international investors, but capital mobility is not, for the most part, a target for popular anger in the way free trade and immigration often are.

There is plenty of evidence of the trouble that floods of short-term capital can cause. In a paper published earlier this year, Atish Ghosh, Jonathan Ostry and Mahvash Qureshi, of the IMF, identified 152 "surge" episodes (periods of abnormally large capital flows) between 1980 and 2014 in 53 emerging markets. A fifth of such episodes subsequently led to a banking or currency crisis. The surges most likely to end in tears were those made up mainly of cross-border bank lending; FDI-based ones were less likely to create trouble. The euro crisis in general, and Ireland's spectacular banking bust in particular, have shown that the syndrome is not confined to developing countries.

Markets for capital are error-prone in a way that markets for goods are not. Stocks, bonds and property are subject to wild swings in value. When capital moves across borders, these failures are amplified by distance, unfamiliarity and exchange-rate risk. There is more scope for getting things wrong, and the resulting economic crises are typically on a larger scale. It is fine for foreign companies to build or buy offices, factories and infrastructure, but the benefits of foreigners buying bonds or stocks are less obvious, and such investments tend to be volatile. Developing countries' financial systems are not necessarily equipped to put inflows of this kind to productive use, still less to handle their sudden exit. Short-term foreign borrowing is often used to finance long-term domestic loans. The mismatch becomes even starker when the borrowing is in foreign currency. And countries subject to sustained inflows of hot money often contract "Dutch disease", a condition that drives up their currency beyond its fair value, leaving their export businesses unable to compete in international markets.

Too volatile for comfort?

Global gross capital flows, $trn

Source: IMF

Filtering the flows

Limits on capital flows other than FDI thus seem like a good idea. In 2012 the IMF conceded that capital controls of a temporary and targeted nature were warranted, as a last resort, where the scale of capital inflows put financial stability at risk and conventional monetary or fiscal policy was unable to respond effectively. But what can be done to stop bad capital flows while letting through the good ones?

One approach is an entry (or Tobin) tax, proportionate to the size of the capital inflow and levied at the time when currencies are exchanged. Such a tax would bear more heavily on short-term inflows. Until recently controls of this kind were believed to have little effect on capital inflows. But a recent paper by Marcos Chamon, of the IMF, and Márcio Garcia, of PUC-Rio, suggests that they may be more effective than previously thought.

The authors looked at the experience of Brazil, which in October 2009 imposed a 2% entry tax on portfolio investments. This was meant to stop the country's currency, the real, from appreciating further. It was soon raised to 4% and then to 6% in short order. At first the measures did not seem to work, but that changed when in mid-2011 they were supplemented with a tax on the notional value of derivatives. Messrs Chamon and Garcia estimate that up to 10% of the subsequent fall in the real was due to the intervention.

Once the real had fallen, in 2012, Brazil started to dismantle its capital controls. But if hot-money flows are an ever-present threat, would it not make more sense to have controls permanently in place? Michael Klein, of Tufts University, makes a distinction between "gates", episodic controls in response to sudden inflows of a certain kind, and "walls", long-standing controls on a broader range of assets. In a study of 44 countries between 1995 and 2010, he concluded that gates do not curb exchange-rate appreciation, raise GDP growth or stop the build-up of financial risks. But long-standing capital controls (walls) might.

The ten countries in Mr Klein's study with capital "walls", including China, on average saw a slower rate of growth in private debt relative to GDP and weaker growth in bank lending than the 34 other countries. They were also less likely to experience abnormal capital surges. That suggests walls are effective. But countries with walls are generally poorer than countries with gates. And when Mr Klein controlled for GDP per head, the statistical distinction between gated and walled countries mostly disappeared. Neither type of capital control had much effect.

This is an awkward finding. In principle, the flexibility of gates should make them a better instrument of control than walls, which can deter even the right sort of capital. Ideally capital controls should be tightened as inflows intensify. But gates may be ineffective for practical reasons. The tax rate required to

stem a flood of inflows might be unfeasibly high. And gates are likely to be more permeable than walls, because countries with long-standing controls will have learned how to police capital inflows effectively. China, for instance, has been able to control its nominal exchange rate from behind its imposing capital walls.

The best policy might be a mixture of both. Not everyone is convinced by Brazil's experiment. It showed that a tax has to be fairly high and broadly applied before it has much effect. That makes it difficult to levy it only on "bad" capital flows. And just as heavier policing in one area may simply shift crime to a neighbouring area, Tobin taxes may simply divert capital flows rather than deter them altogether. A study by Kristin Forbes, now a member of the Bank of England's monetary-policy committee, and others suggests that Brazil's Tobin tax encouraged emerging-market bond and equity funds to flood into other commodity-rich countries instead.

Observers with longer memories recall that before Brazil's experiment, Chile was held up as an exemplar of the wise use of capital controls. In the 1990s capital imports into Chile were subject to an interest-free deposit of 30% of the investment. Chile's central bank has since eschewed controls in favour of direct intervention in currency markets (selling pesos to build reserves when inflows are strong), a policy that has the virtue of being hard to circumvent. This helps guard against incipient Dutch disease, but it does little to deter inflows. If the main worry is too much lending on property, then macroprudential policy is probably a better bet. One useful measure is to limit the amount banks can lend as a proportion of the value of the property.

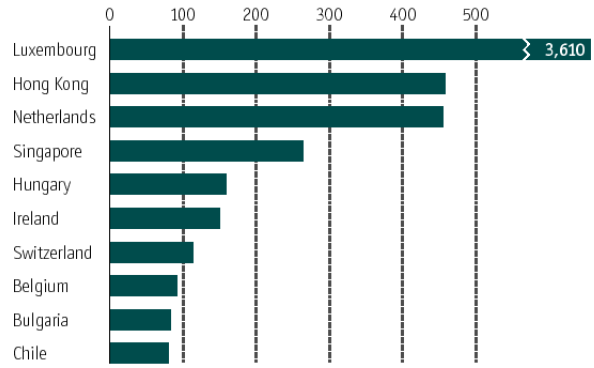
A taxing question

Economists in Ireland once made a distinction between the Celtic Tiger phase of the country's economic boom, which was powered by FDI, and a second, "bubble", phase, inflated by low interest rates and short-term capital. But these days FDI does not always result in a new factory, research facility or office building, with new jobs to match it. Often it amounts to a transfer of intangible assets for the purpose of lowering corporate tax.

Ireland is among the world's top countries for foreign direct investment relative to GDP (see chart). Most of the others on the list are also small countries with low rates of corporation tax. Luxembourg, for instance, accounts for 10% of the stock of global FDI but only 0.07% of world GDP. Competition is generally a good thing, but in matters of taxation that is not always true.

Where it matters

Foreign-direct-investment stock as % of GDP, selected countries, 2014



Source: IMF

The growing practice of using offshore investment to avoid corporate tax might make capital mobility the target of popular anger

Multinational companies are able to avoid tax because there are so few generally agreed principles of cross-border taxation. One approach, taken in America, is to tax a company's global income on the basis of where it is "resident" (where its headquarters are), regardless of where its profits are made. A second method, widely adopted in Europe, is to tax profits where they are generated. In practice the two are often used in combination. "You can play one country off against another so you're not resident anywhere," says an expert on the subject.

Globalisation and the growing importance of intangible assets, such as patents, have made concepts such as residence and sources of income much less useful. Supply chains are now so complex that it is hard to know where a source-based tax on profits should be applied. If the value of a drugs company lies mostly in its patents, for example, it can move to a tax haven and enjoy low taxes without uprooting any of its physical operations.

Purists argue that, since all taxes are ultimately borne by individuals, there is little point in chasing elusive companies all over the globe; better to abolish corporation tax and increase sales taxes instead. There are two objections to this. First, for reasons of equity it may be preferable to tax shareholders rather than consumers. Second, corporate taxes make up a large share of revenues in resource-rich poorer countries, where few workers are on formal payrolls and sales taxes are easy to evade.

One way of dealing with that might be a special regime of royalties or land taxes levied on mining companies. Michael Devereux, a tax expert at Oxford's Said Business School, predicts that in the long run tax competition and avoidance will erode rich countries' corporate-tax base. He proposes a value-added tax with deductions for labour costs and other inputs. That would approximate to a tax on excess profits, or "rents".

True FDI is an unalloyed benefit. But the growing practice of using offshore investment to avoid corporate tax might make capital mobility the target of popular anger, alongside trade and immigration. The EU's case against Apple may be just the beginning. Many people see footloose global companies and deregulation as the handmaidens of the worst kind of corporate practice. Yet economic ills such as weak real incomes, inequality and immobile workers may be partly due to a failure to liberalise product markets further. ■

Deregulation and competition

A lapse in concentration

A dearth of competition among firms helps explain wage inequality and a host of other ills

IN "THE FUGITIVE", a 1960s television drama, David Janssen plays Richard Kimble, a doctor wrongly convicted of murdering his wife who escapes on the way to his execution. He claims, but cannot prove, that he encountered a one-armed man minutes before he discovered his wife's dead body. After his escape he drifts from town to town trying to find the ghostly figure and to elude the man obsessed with recapturing him.

The damage that globalisation has done to America's economy is as obvious to some as Dr Kimble's guilt was to his pursuers. Careful academic studies have linked competition by Chinese manufacturers to the growing propensity of prime-aged men to drop out of the labour force. A pillar of trade theory says that increased commerce with labour-rich countries will depress the pay of the low-skilled; and some reckonings of wage inequality in America pin part of the blame on trade and migration. GDP growth has been sluggish during the long hangover from the financial crisis. The globalisation of finance provided the kindling for America's subprime crisis and spread its effects around the world. Globalisation is on the run. But might there be another brigand who bears responsibility for its alleged crimes?

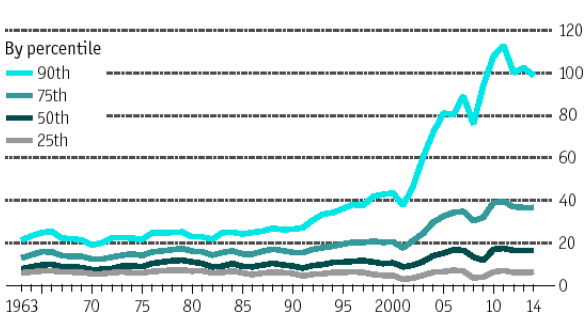
An intriguing line of research identifies an increase in the incidence of economic "rents" (profits over and above the levels needed to justify investment or input of work) as a possible villain. A study last year by Jason Furman, of the Council for Economic Advisers (CEA), and Peter Orszag, a former budget director for Barack Obama, found that the top 10% of firms by profit have pulled away sharply from the rest (see chart). Their return on capital invested rose from more than three times that of the median firm in the 1990s to eight times. This is way above any plausible cost of capital and likely to be pure rent. Those high returns are persistent. More than four-fifths of the firms that made a return of 25% or more in 2003 were still doing so ten years later.

Other research suggests that this increasingly skewed distribution of profits goes a long way to explaining the rise in wage inequality. A paper in 2014 by Erling Bath, Alex Bryson, James Davis and Richard Freeman found that most of the growing dispersion in individual pay since the 1970s is associated with variations in pay between companies, not within them. In other words, the most profitable companies pay handsomely and people who work for them earn more than the rest.

This finding was confirmed in a more recent study by Nicholas Bloom and David Price, both of Stanford University, with others, which found that virtually all of the rise in income inequality is explained by a growing dispersion in average wages paid by firms. This finding, the authors conclude, holds across all industries, regions and firm sizes. One of the most striking implications is that inequality within firms has not changed much: the relationship between managers' and shop-floor workers' pay in each firm is still roughly the same. But the gap between what the average and the best firms pay their workers at all levels has widened. Alan Krueger, of Princeton University, illustrated this point nicely at a presentation he gave while working at the CEA in 2013. Using data from the decade after 2003, he showed that where managers are well paid, so are janitors (see chart).

Well-fed top dogs

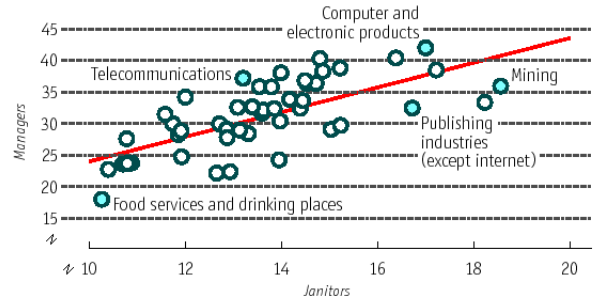
US publicly traded non-financial firms, return on invested capital*, %



Sources: McKinsey Solutions; Council of Economic Advisers *Excluding goodwill

A rising tide floats all boats

US, average hourly wages by industry, 2003-12, $, 2012 prices



Sources: US Census Bureau; US Bureau of Labour Statistics; Council of Economic Advisers

More power, more profit

This wider range of profits is likely to be related to increases in market power. Some of this is due to the rise of internet giants, which dominate their respective markets thanks to network effects. But many of America's industries have also become more concentrated by a slow creep of acquisitions. A study by *The Economist* earlier this year divided the economy into 900-odd sectors covered by the five-yearly economic census and found that two-thirds of them were more concentrated in 2012 than they had been in 1997. The weighted average share of the total held by the leading four firms in each sector rose from 26% to 32%.

America used to be famous for its workers' willingness to follow the jobs, but they have become far less mobile. A paper by Raven Molloy and Christopher Smith of the Federal Reserve and Abigail Wozniak of the University of Notre Dame finds that over the past three decades migration rates between states have fallen by at least a third for most age groups. For those aged between 20 and 24, the most mobile group, the annual rate of internal migration fell from 5.7% in 1981-89 to 3.3% in 2002-12.

Many of the reasons put forward for this are not wholly convincing. It cannot be the rise of the two-income family, because the trend to less mobility holds for workers of all ages. Nor is it the housing boom and bust: the decline in mobility started long before that, in the early 1990s, and has continued since. It is certainly not trade unions (membership of which has declined), labour-market regulation or unemployment benefits, claims for which have dropped sharply.

A few researchers have made an intriguing link between ▸▸

the decline in labour mobility and wider profit dispersion. The argument has several steps. The average age of established businesses has risen steadily because fewer new firms are formed. Startups have a high labour turnover, but in mature firms fewer people join and leave in any given year. The lower the churn rate of jobs, the fewer the opportunities for job-changers to find new work. So it is possible that less dynamism in American business, characterised by industry concentration and lower job turnover, has reduced the incentive for jobseekers to go and look for work in another state.

Another reason may be rent-seeking within the labour force itself. Another paper from the CEA finds that the share of America's workforce covered by state-licensing laws has risen to 25%, from less than 5% in the 1950s. Much of this red tape is unnecessary. On the most recent estimates, over 1,000 occupations are regulated in at least one state but only 60 are regulated in all states. The scope of the rules vary from state to state. A licensed security guard requires three years of training in Michigan but only around two weeks in most other states, for instance. Licensed workers can command higher pay than the unlicensed kind because entry to the occupation is restricted, so consumers have to pay more.

Success stories

For much of the past 40 years economic liberals have argued for the dismantling of barriers to the free flow of commerce, such as state monopolies, trade unions and restrictive practices. Such policies have produced some clear successes. In Britain the privatisation of monopoly utilities, such as British Telecom, and the opening up of other sectors to competition was a spur to productivity and innovation, leading to better and cheaper services for customers. In America the deregulation of airlines brought lower fares and an increase in the number of trips. Labour markets in America and Britain became more flexible, and unemployment has generally been lower than in continental Europe.

Deregulation is almost always a difficult task. Those whose interests are hurt by such reforms protest noisily. The political costs quickly become apparent, whereas the gains may not become clear before the next polling day. It is even harder to make changes when so many people feel that the cost of liberalising markets in the past was unfairly distributed. Critics of such liberalisation point to a decline in labour income as a share of GDP as evidence that wage earners have the odds stacked against them. They argue that blue-collar workers provide the flexibility, having to accept lower pay and less job security, whereas white-collar workers and bosses are protected. Increased openness to trade and the growing mobility of capital have made it harder for workers to push for pay rises, so they cling to the jobs they have. In an age of insecurity, it is hard to persuade anyone that they should give up such protections for the greater good.

Market power is supposed to be policed by competition agencies, but they have lost some of their vim, particularly in America, where competition cases are fought out in the courts. A landmark Supreme Court judgment in 2004 said monopoly profits were the just reward for innovation. That has made it harder for trustbusters to root out rent-seeking or block mergers. Most big firms got where they are by being good at what they do, not because of coddling by regulators. But if firms can hold onto their market share for years, they create distortions in the rest of the economy. Incumbent firms are powerful lobbyists.

Big tech firms also have a penchant for so-called "shoot-out" acquisitions, whereby a startup is bought to eliminate a budding rival. For many tech startups and their financiers, a buyout by one of the big platform companies is a badge of success. But if small firms cannot become independently big, the market power of incumbents is not sufficiently challenged.

Competition policy faces difficult questions in an age of superstar firms that dominate global markets. But the trickiest political problem for reformers is how to inject some dynamism into the economy without getting people even more worried about their livelihoods. Raising import tariffs or closing borders to people and capital is not the answer. Instead, policymakers should encourage more competition while putting in place adequate protections for those who lose out from it. ■

Saving globalisation

The reset button

How to make economic liberalism fairer and more effective

THERE MAY be few better advocates of the benefits to America of an open economy than Pin Ni, boss of Wanxiang America Corporation, part of a private firm based in Hangzhou that his father-in-law started as a bicycle-repair shop. Mr Ni launched the American subsidiary in 1994, suspending his studies at the University of Kentucky. He has been there ever since.

During the car-industry meltdown in 2007-09 the company began buying moribund car-part suppliers and restoring them to health. It pushed its acquisitions to concentrate on their strongest suits, usually the relationship with the car manufacturers and engineering. It helped them to source components more cheaply and to gain a foothold in the Chinese market. Mr Ni is effusive about the prospects for American exporters. America has firms with technology and brands that are coveted around the world, he says.

Such optimism about globalisation is all too rare these days. Neither candidate in America's presidential race is an advocate of free trade. "If Trump is elected, it's a mandate for isolationism," says a seasoned observer at a think-tank in Washington, DC. "If Clinton is elected, the best we can hope for is we don't go back very far." Britain's trading relationships with the rest of the world are up in the air, following the vote in June's referendum to leave the EU. France is hostile to TTIP, a proposed trade agreement between the EU and America. Even in Germany, the self-declared world export champion, politicians are turning against the deal in the face of public opposition. Globalisation is increasingly blamed for job losses, rising wage inequality and sluggish GDP growth.

How should politicians respond? Closing borders to trade, capital and people would cause great harm and do very little to tackle inequities in the economy. In some respects it would increase them. People on low pay spend a far greater proportion of their income on imports than the well-off. A growing body of research links economic maladies to more oligopolistic economies. Blocking imports would only entrench the market power of rent-seeking firms, further harming the prospects for higher productivity and pay.

Easing the pain

As borders have been steadily opened up, policies needed to complement globalisation have not kept pace, particularly in America. They need to catch up. A good place to start is demand management. The stability of the labour market depends on macroeconomic policies, not trade. In Europe the most effective policy would be to use public money to fix the banks. With monetary policy overstretched and bond yields low or negative, it is a shame that countries with room to borrow more, notably Germany, are seemingly addicted to thrift. The case for free trade is undermined when many countries in Europe are free to rack up persistent trade surpluses, which are a drag on global demand.

In America and Britain, a strong case can be made for locking in low-cost long-term funding to finance a programme to fix potholed roads and smarten up public spaces. Private pension funds with expertise in infrastructure have a role to play in such schemes. Rich-country central banks, notably the Federal Reserve, can afford to be more relaxed about the threat of inflation. An economy at full pelt begins to draw people into the workforce who were thought to have opted out for good. "Ex-felons were doing pretty well in 2000," notes Larry Mishel, of the Economic Policy Institute, a think-tank in Washington, DC. The risks of slamming the brakes on too quickly outweigh those of excessive policy stimulus.

Demand management is (or ought to be) the bread and butter of economic policy. Curing the ills that feed public opposition to globalisation requires efforts to address two other problems. The first is the job churn caused by shifts in trade and technology. Too little effort and money has been expended on taking care of those who have been hurt by the opening up of markets. America in particular makes little attempt to assist people find new jobs to replace lost ones. Extra help need not blunt the incentives to look for work. For instance, more generous jobless benefits could be made conditional on attending a back-to-work programme. A valid criticism of government training schemes is that they cannot keep up with the fast-changing demands of the jobs market. A better option would be a system of wage insurance. That would nudge workers to acquire new skills by taking a less well-paid job when they lose a good one.

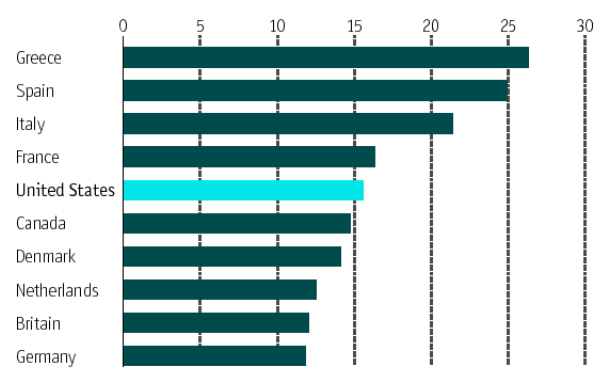
More competition is a hard sell when many people are already anxious about their jobs and income

Yet there is little point in helping people change careers if a lack of dynamism in the economy means that too few good jobs are being created. So a second prong of reform should be to spur greater competition so that startups can thrive and incumbent firms are kept on their toes. More competition is a hard sell when many people are already anxious about their jobs and income; but without it there is less chance of the dynamism that boosts productivity (and earnings) and creates new job opportunities. Europe has long been notorious for restrictive practices such as occupational licences, but state-level licences in America have proliferated almost unnoticed. Some are necessary, but most are simply a way of keeping prices higher and restricting entry.

Competition policy needs to become more vigorous. In America the startup rate (the share of new firms in the total num- ▸▸

Idle hands

Non-employment rates of males aged 25-54, 2015, %



Source: OECD

ber) has fallen steadily since 1980. Most industries have become more concentrated. The profits of the leading companies have pulled well ahead of the rest. America's courts have tended to view windfall profits as the rightful reward for innovation. There is much to be said for redrawing the boundaries of intellectual property so that incumbents can be more readily challenged. The growing habit of big tech firms to swallow startups that might become rivals is worrying. Such deals often suit both sides—the buyer gets the innovation and the startup makes a lucrative exit—but the practice saps dynamism from the economy. Trustbusters might be given more discretion when making judgments about how markets might evolve in future, though this is difficult to do well.

Make it a threesome

A three-pronged agenda of demand management, active labour-market policies and boosting competition would go a long way to tackling the problems that are unfairly laid at the door of globalisation. But a lot of the policies to make globalisation work better need international agreement to be fully effective. For instance, tackling troublesome capital flows requires co-ordination. A country might be able to head off capital inflows by taxing them, but it would only be diverting them to other countries that are more reluctant to impose capital controls. The best course would be to have a global standard on what sorts of controls are permissible and in what circumstances. The goal should be to ensure that individual countries retain control over their monetary policy.

One way to put a speed limit on short-term capital flows is to require asset managers globally to lock in investors in funds specialising in less liquid emerging or frontier markets. Long-term capital flows are generally more beneficial, but they will lose public support if they are seen primarily as a way of avoiding tax. There are few agreed international rules on the taxation of cross-border firms, though the OECD has started to work on this. Dani Rodrik, of Harvard University, argues that a good way to build public support for globalisation would be to link trade pacts with agreements on, for instance, the taxation of multinational companies. Such a deal would give national governments more rather than less policy autonomy.

Sceptics say that those who stand to lose from globalisation are given little thought when trade deals are signed. That is a fair point. But there is also a risk of the opposite error: that the enormous good that free trade has done for the bulk of humanity in both rich and poor countries over several decades is forgotten at times when people are feeling anxious about it. The benefits of globalisation are widely dispersed, often unseen and thus all too easily taken for granted.

There is a wrong-headed tendency to conflate support for liberal internationalism with pushing the interests of big companies to the detriment of the less well-off. The opposite is true. This newspaper started in 1843 to campaign for free trade in general, and in particular for the repeal of the Corns Laws, which increased the price of imported grain to the advantage of landowners. Richard Cobden, the manufacturer who led the campaign against the Corn Laws, remarked that the main barrier to repeal was the self-interest of the landowning classes, the "bread-taxing oligarchy, unprincipled, unfeeling, rapacious and plundering."

Cobden argued that free trade would have four benefits. It would underpin the success of British manufacturing by providing access to bigger markets. It would lower the price of imports, notably food, for the poorer classes. It would make English farming more efficient by creating more demand for its products in cities and manufacturing regions. And it would usher in a new era of international peace and amity by fostering trade that would be to the benefit of all countries that took part in it.

In contrast to popular caricature, free-traders are enemies of rent-seekers and those who are trying to protect their economic privileges. James Wilson, the founder of *The Economist*, said of the Corn Laws: "They are, in fact, laws passed by the seller to compel the buyer to give him more for his article than it is worth. They are laws enacted by the noble shopkeepers who rule us, to compel the nation to deal at their shop alone."

What Cobden and Wilson argued in the 19th century still holds. The free movement of goods, capital and people across borders is a source of greater choice and opportunity for those on both sides of the trade. What gives these arguments their force and staying power is that they happen to be true. ■

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