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Politicians Strive for Competitiveness

But in most situations, productivity is the better path to prosperity

Kevin Fletcher

COMPETITIVENESS, Michael Porter remarked in *The Competitive Advantage of Nations*, his 1990 best-selling book, means different things to different people. As a member of US President Ronald Reagan's competitiveness commission in the 1980s, the American economist met business leaders who believed it was about a global strategy to compete in world markets and members of Congress who thought it meant having a positive balance of trade. Today this commonly used term continues to defy definition and to divide opinion.

If increasing competitiveness means boosting productivity, economists would agree that this is almost always and everywhere a worthy goal. But they would also note that more productivity raises a country's welfare regardless of its effects on exports and even if the country doesn't trade at all with other countries.

Competitiveness, however, implies that relativity matters—that policymakers are less concerned about their country's absolute level of productivity than about how it compares with that of other countries. If another country's productivity is on the rise, it must be bad news, because their own country is becoming less competitive. Does this reasoning stand up?

Worrying about a competitor's productivity makes sense in a zero-sum competition like soccer. If another soccer team in the league gets better, it means that my team has a worse chance of winning the championship. However, a key insight from economics is that world trade is not a zero-sum game. By allowing each country to specialize in the goods and services it can produce most efficiently, global trade increases productivity worldwide, and everyone is better off.

Terms of trade

So is it good or bad for my country if a foreign country increases its productivity? As is usually the case in economics, the answer is, It depends.

When a foreign country produces a certain good more efficiently, it typically raises the global supply of this good, reducing its price. If your country is mainly an *exporter* of this good, the lower world price for your exports will typically make your country worse off. But if your country is mainly an *importer* of this good, the lower world price means your country will likely be better off because it will now pay less for imports.

In other words, the effect of a foreign country's higher productivity depends on how it affects your country's *terms of trade*—the price of your country's exports relative to the price of its imports.

For small countries (or regions) that specialize in the production of a few goods, these effects can be large. Suppose a small country specializes mainly in the production and export of a particular type of robot that becomes obsolete when foreign competitors invent a superior robot. The economic effects on the small country could be devastating.

Economists such as Paul Krugman, however, have shown that terms-of-trade effects from changes in productivity in foreign countries are typically small for large, diversified economies such as the US, China, and the European Union. This is because large economies rely less on foreign trade. Also, the trade that does occur tends to be spread across a range of products. Consequently, productivity improvements in other countries tend to affect both import and export prices, so the net effect is modest relative to the large gains from improvements in a country's *own* productivity.

Moreover, it's also typically easier for a country to affect its own productivity than that of another. This is why the focus of economic reforms in most countries should be increased productivity rather than increased competitiveness.

Export prices

A second strategy for raising a country's competitiveness is to reduce the price of its exports, which raises export sales volume. In countries with widespread collective bargaining, this can be done by keeping wage growth in check—provided businesses use the savings to hold output prices down.

Sometimes countries try to achieve a similar effect by attempting to weaken their currency—that is, changing its exchange rate so that each unit of foreign currency buys more units of domestic currency. Exchange rate depreciation is another way countries can try to reduce export prices (and wages) when measured in foreign currency, which gives their exports a competitive advantage in foreign markets.

But if a country is already near full employment, more demand for its exports will exceed its capacity to produce them. This excess demand will push up prices and wages, and the improvement in competitiveness will vanish.

To avoid this result, the government could combine currency depreciation with measures to reduce aggregate demand, such as raising taxes or cutting spending. Currency depreciation would then increase demand for exports, while fiscal tightening would reduce demand for domestically consumed goods. Together, such policies would shift employment and production toward export sectors and away from sectors that produce for domestic consumption and investment. National income would be unchanged, but national savings would be higher because the government would run larger fiscal surpluses (or smaller deficits), and domestic consumption would be lower.

Savings and investment

This example highlights a central fact of international economics: As a matter of accounting, a country's trade balance (exports minus imports) must equal the difference between its savings and investment. This is because investment is funded by savings—and if a country's savings exceed its domestic investment, the remainder must be invested in other countries. And a country will have the excess cash flow to be a net investor in other countries only if it runs a trade surplus. Conversely, countries can run trade deficits only if other countries loan them money (are net investors in them) to allow them to purchase more in imports than they sell in exports. (For simplicity, this discussion excludes capital income flows, which does not affect the key conclusions).

So if by raising "competitiveness," policymakers mean they want to increase their country's trade balance, this outcome is possible only with policies that raise national savings or reduce national investment. But is this a good idea? It depends on whether national savings and investment are where they should be, or far from it—because of policy distortions or market failures.

Legitimate concern

Sometimes weak competitiveness and savings-investment imbalances reflect major economic problems. For example, suppose lax financial sector oversight has allowed an influx of foreign capital to drive an unsustainable credit-fueled boom in consumption and speculative investment. Excessive demand for domestic consumption and investment would drive up domestic wages and prices, undermining the competitiveness of the country's exports and boosting import demand. The result? A hefty trade deficit.

In this situation, the country's lack of competitiveness (its large trade deficit) would be a source of legitimate concern: the flip side of an unsustainable credit-fueled bubble, destined to burst and inflict considerable damage.

Sometimes, though, national savings are too high, investment is too low, or both, which implies that a country is *too* competitive. For example, a country may be investing too little in public infrastructure. Spending more (and thus incurring a higher fiscal deficit) could boost the economy's productive capacity. Higher demand for domestic investment would likely increase domestic wages and prices relative to other countries and thus reduce the competitiveness of exports. But this adjustment would be part of the necessary process of shifting production capacity away from the export sector and toward the domestic investment sector. And if returns to domestic investment are higher than in the export sector, as is assumed in this case, this shift would increase the productive capacity of the economy as a whole.

To sum up, boosting competitiveness is a popular objective among policymakers. But a focus on economy-wide productivity, regardless of the effect on international trade, is often a more appropriate goal. Situations can arise in which a country's price level relative to its competitors is an economic problem leading to trade imbalances. But these situations are less common than most policymakers realize and can be difficult to identify, even with the aid of indicators economists use for this purpose. F&D

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