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Malcolm H. Dunn*

Do Nations Compete Economically?

A Critical Comment on Prof. Krugman's Essay "Competitiveness: A Dangerous Obsession"

As opposed to the common idea that a country's economic fortunes are largely determined by its success on world markets, Paul R. Krugman, Professor of Economics at the Massachusetts Institute of Technology, holds the view that the world's leading nations are not to any important degree in competition with one another. The following article takes a different view.

Economists often take it for granted that the major economic problem facing any modern industrial economy is essentially one of competing on world markets. No wonder that so many books and articles have been published on this subject recently.¹ Many of them focus on the Triad, i.e. the economic rivalry between the United States, Japan and the European Community on world markets. Others concentrate on econometric and more theoretical problems such as, "How can we measure competitiveness of nations correctly?" or "What are the main factors determining a nation's competitiveness?"

As opposed to the common idea that a country's economic fortunes are largely determined by its success on world markets, Prof. Krugman (MIT) holds the view that the world's leading nations are not to any important degree in economic competition with one another, nor can any of their major economic problems be attributed to failures to compete on world markets. Beyond that, "thinking in terms of competitiveness leads, directly and indirectly, to bad economic policies on a wide range of issues..." (p. 30).² Instead of blaming foreign competition for the economic malaise of the world's leading nations, international factors have played a surprisingly small role in the economic difficulties of these countries. The problems are – according to Prof. Krugman – mostly home-made.

This article takes a different view. First, it argues that nations *do* compete economically, though in a different way than corporations do. Second, it tries to explain why defining the competitiveness of nations is so difficult and why so many definitions and measures are misleading. Third, it points out that *thinking* in terms of competitiveness is not threatening the international

economic system whereas the *competitive nature* of this system is: it embraces destabilizing forces which make building an institutional competitive framework an important task of economic policy.

Prof. Krugman's Line of Reasoning

Prof. Krugman begins his criticism with a comparison. If the term "competitiveness" is attributed to a corporation, we mean that the corporation's market position is sustainable, whereas the term "uncompetitiveness" refers to a situation where the corporation will cease to exist. Countries, however, "do not go out of business". This makes the concept of national competitiveness "elusive". Still, a few authors have tried to cope with this difficulty by defining national competitiveness as the combination of favourable trade performance often combined with a different factor, like per capita standard of living in a country, as did Laura D'Andrea Tyson 1991.³ There we find

¹ Krugman refers to Lester C. Thurow: *Head to Head: The Coming Economic Battle among Japan, Europe, and America*, New York 1992; Ira C. Magaziner and Robert B. Reich: *Minding America's Business: The Decline and Rise of the American Economy*, New York 1983; Ira C. Magaziner and Mark Patinkin: *The Silent War: Inside the Global Business Battles Shaping America's Future*, New York 1990; Edward N. Luttwak: *The Endangered American Dream: How to Stop the United States from Becoming a Third World Country and How to Win the Geo-economic Struggle for Industrial Supremacy*, New York 1993; Kevin P. Phillips: *Staying on Top: The Business Case for a National Industrial Strategy*, New York 1984; Clyde V. Prestowitz, Jr.: *Trading Places: How We Allowed Japan to Take the Lead*, New York 1988; William S. Dietrich: *In the Shadow of the Rising Sun: The Political Roots of American Economic Decline*, University Park (Pennsylvania State University Press) 1991; Jeffrey E. Garten: *A Cold Peace: America, Japan, Germany, and the Struggle for Supremacy*, New York 1992; and Wayne Sandholtz et al.: *The Highest Stakes: The Economic Foundations of the Next Security System*, Berkeley Roundtable on the International Economy (Oxford University Press), 1992.

² All quotations of this article refer to Prof. Krugman's essay "Competitiveness: A Dangerous Obsession" published in *Foreign Affairs*, March/April 1994, Vol. 73, No. 2, pp. 28-44, if not otherwise cited.

³ Laura D'Andrea Tyson: *Who's Bashing Whom? Trade Conflict in High-Technology Industries*, Washington 1992.

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competitiveness defined as "our ability to produce goods and services that meet the test of international competition while our citizens enjoy a standard of living that is both rising and sustainable" (p. 1). Other authors choose similar definitions whose common characteristic is the importance of international trade balance to a nation's competitiveness and wealth.

According to Prof. Krugman these definitions are misleading for two reasons. First, their explanatory power is limited and second, they are empirically wrong. They are limited because they only refer to national economies where international trade plays a major role. Countries, however, whose economies are not involved in international trade, like the United States in the 50s, are not influenced by the exchange rate level very much. The living standard of countries with very little international trade is therefore determined almost entirely by domestic factors, primarily by the rate of productivity growth. But even if one looks at those countries where trade plays an important role the hypotheses that the living standard of a country is determined by deteriorating terms of trade needs to be checked against the data. By quoting the national income accounts data published regularly by the US Commerce Department Prof. Krugman demonstrates that the growth rate of living standards is closely linked to the growth rate of domestic productivity – not productivity relative to competitors.

This leads Prof. Krugman to make an important statement on the nature of international trade. Whereas many authors hold the view that the living standard per capita of a country can only be improved by strengthening the competitive position of its corporations worldwide *at the cost* of other national economies, Prof. Krugman points out that international trade is not a zero-sum game: "If the European economy does well, it need not be at US expense; indeed if anything a successful European economy is likely to help the US economy by providing it with larger markets and selling it goods of superior quality at lower prices" (ibid., p. 34).

The economic interdependence of highly industrialised countries is not denied in this argumentation, but interpreted differently: the view of a "win-lose" competition between the leading economies, as Lester Thurow 1992 put it in his book "Head to Head", is

substituted by a "win-win" relationship of internationally interconnected economies. From this it is not very far to Prof. Krugman's point that the real danger of destabilizing the international trade order results from misleading *thinking* by the political elites and their economic advisers. The growing obsession with competitiveness is claimed to be responsible for trade conflicts, i.e. trade wars and protectionism, it could result in wasteful government spending supposedly to enhance the country's competitiveness and, even more important, it could affect the quality of economic discussion and policymaking negatively.

It remains to be explained why then the competitive metaphor is so attractive to many economists, politicians and businessmen. Prof. Krugman treats this question in Part iii of his article. Three reasons or motives are mentioned: "First, competitive images are exciting, and thrills sell tickets... Second, the idea that U.S. economic difficulties hinge crucially on failures in international competition ... makes those difficulties seem easier to solve." And third, "the rhetoric of competitiveness turns out to provide a good way either to justify hard choices or to avoid them" (ibid., p.39). For this reason the world's leaders "have found the competitive metaphor extremely useful as a political device" (ibid., p. 40). Not so Prof. Krugman in his final statement: "So let's start telling the truth: competitiveness is a meaningless word when applied to national economies. And the obsession with competitiveness is both wrong and dangerous" (ibid., p.44).

Nations Do Compete Economically

In the following I shall explain that countries do compete economically, though in a different way than corporations do. To understand the meaning of competition of countries it seems reasonable to keep in mind that countries are not only economic entities, but defined by political and social features too. The same applies to public policy. Improving the living standard per capita might be an economic objective of a political élite particularly if it is committed to democratic principles,⁵ but it is certainly not the only element within the politically defined goal system of a nation. Other motives like gaining bargaining power and influence on other countries, strengthening the country's position in international negotiations and institutions, increasing its prestige and military power, and so on, play an even greater role in public policy.

Ironically Prof. Krugman himself recognizes the point made here, by saying, "Of course, there is always a rivalry for status and power – countries that grow faster will see their political rank rise." But instead of taking this point seriously in order to grasp its economic consequences he

⁴ Prof. Krugman refers to Delors' presentation to the leaders of the nations of the European Community and President Clinton's patriotic appeal, calling on the nation to justify painful spending cuts and tax increases.

⁵ Other élites, particularly of those states ruled by an authoritarian regime, are simply not interested in achieving a higher living standard for the overall majority of people, though they might very well be interested in improving "their" national industry's competitiveness in order to collect rent.

continues, "But asserting that Japanese growth diminishes U.S. status is very different from saying that it reduces the U.S. standard of living – and it is the latter that the rhetoric of competitiveness asserts..." (ibid., p. 35).

Perhaps the *rhetoric* of competitiveness identifies the nation's competitiveness with the living standard p.c. but there is no reason to simply accept this view. For example, the rising standard of living in East Germany is not a sign of growing competitiveness of its industry but the effect of an enormous flow of capital aid and public spending on the social services. Or think of Singapore and Hong Kong whose industries meet international competition extremely well despite the fact that the living standard in both countries is comparatively low. In fact, one could easily argue that the competitiveness of a nation's economy depends on the comparative cost advantage including the costs of labour: the lower the costs of labour per unit of output in one industry compared to other competing industries in other countries the higher the competitiveness of this particular industry will be keeping all other factors unchanged. Many less developed countries spring to mind whose industry's competitiveness almost entirely depends on the nation's comparatively low wage level and therefore lower living standard. But even in highly industrialized countries, like Germany and Japan, the competitiveness of a national economy is at least to some extent dependent on the existing wage level of the overall economy.

Anyhow, it makes sense to distinguish carefully between the competitiveness of a country – a term which refers to the economic strength of a national economy on world markets – and its *possible* consequences, i.e. increasing or decreasing living standards in a particular country during a certain period of time. In fact, understanding the nature of competition of nations does imply a specific goal system *different* from simply increasing the living standard per capita in every country. The meaning of competition – to quote Morgenstern – is "one of struggle with others, of fight, of attempting to get ahead, or at least to hold one's place".⁶ So, if nations compete economically – which we have not proved yet – one has to find the *movens* which makes competition a

"win-lose game". Why should nations compete against each other if they were simply driven by the same motive of improving their people's living standards?

The first step to solve our problem is to consider the preliminary remark again. Political élites in all countries try to gain power and improve their status; this refers as much to the internal as to the external affairs of a country. The power motivation, however, is characterized by its "relativeness". Power is relative because it refers to all players. Power gained by one party implies power lost by other parties. As Chakraborty⁷ correctly points out, power relations are a typical example of "zero-sum games".

One could of course argue that we are not dealing with politics but with economics and competition in the field of political influence is not the same as gaining competitiveness economically. Correct! But no-one will deny that political motives affect the way nations act economically. The key point here is that the "win-lose" character of power motivation *determines* the way nations act economically, too.

First, striving for power is economically relevant because the realization of this political objective is closely linked to a nation's economic resources. States (or their political élites) treat their economy as the major source of economic means they need to achieve politically defined national interests: they demand taxes from their citizens and thus monopolize parts of the resources of society; they collect customs duties from their trading partners and borrow money from internal and external capital markets to finance their budgets. They establish an institutional framework of laws and regulations to reduce the transaction costs of business and spend money to promote their nation's industries in various ways. Finally, they recognize their economy's dependence upon international business when they compare the attractiveness of their country as a location of international business.

Second, in undertaking all these measures countries *compare themselves*: the more economic resources a country possesses *relative* to other countries, the more funds it can raise from its society without deteriorating its economic potential, the higher the attractiveness of a nation as a location of international business is compared to other locations and the more its national currency is accepted worldwide as a means of capital accumulation, the higher the economic and political power of a nation will be, keeping all other factors constant. Countries compete economically because they compete politically to gain regional and worldwide power and influence. Countries do not go out of business, but they might very well become dependent upon other countries to such an extent that their sovereignty is undermined.⁸

⁶ Oskar Morgenstern: Thirteen Critical Points in Economic Theory: An Interpretation, in: Journal of Economic Literature, Vol. 10, 1972, pp. 1163-1189, here p. 1164.

⁷ Cf. Rabindra N. Chakraborty: Der Nord-Süd-Konflikt als Problem der Konsensfindung bei konfliktierenden Zielen, in: Konjunkturpolitik, No. 5, 1991, pp. 296-315.

⁸ As Prestowitz correctly points out: "In the extreme, loss of economic competitiveness can weaken national security and cause greater vulnerability to political regimes and international cartels that may severely constrain a country's economic potential." (Clyde V. Prestowitz, Jr.: Playing to Win, in: Foreign Affairs, Vol. 73, No. 4, 1994, pp. 186-189, here p. 188.)

Third, as countries compete economically and promote their nation's industries trade *might* become a "zero-sum game". Take the Saudi Arabian order for \$6 billion of new airplanes as an example. The Europeans and the Americans make airplanes. The decision to give the order to US producers was influenced by political considerations of both governments. The welfare effects are obvious. The USA will gain jobs and income that Europe might have had but lost.⁹ Further examples how countries promote certain industries in worldwide competition spring to mind: Concorde, Airbus, Transrapid, etc. Clearly, all these examples demonstrate that trade is not always a "plus-sum game" as Prof. Krugman seems to indicate in his essay.

What makes things difficult to understand is the way this kind of politico-economic competition defines the "home basis" of a nation's economic potential. Contrary to the mercantilist state of former days, the term "national economy" does no longer refer to corporations who have their home basis within the country; rather it includes all kinds of business activities which *in total* contribute to the growth of a nation's GNP. In other words, the distinction between foreign and home based corporations becomes irrelevant from a political point of view if and as much as these firms contribute to the growth of the nation's purchasing power. In this sense an American transplant of General Motors like Opel in Germany is as much a German corporation as Volkswagen is. As we shall see in due course the difficulties of measuring the competitiveness of nations arise from the interconnectedness of international business relations and from the *internationalist* manner in which *national* interests are pursued nowadays.

Measuring Competitiveness

Prof. Krugman discusses the competitiveness of nations from the viewpoint of looking at the effects of international trade on the living standard per capita of a country. Not surprisingly he reaches the conclusion that the living standard depends on domestic factors particularly if trade plays a minor role in the home economy as is the case for the USA. But does this really mean that trade balances are unimportant to grasp the development of a nation's competitiveness as Prof. Krugman seems to indicate?

The growing trade surplus of Japan's industry is as

much a sign of gaining competitiveness in world markets as – on the other hand – the stable trade deficit of Great Britain demonstrates the decline of Britain's industry. Yet, every change of trade balances as an indicator of competitiveness needs to be interpreted carefully.¹⁰ If, to take an example mentioned by Prof. Krugman, a country like Mexico "was forced to run huge trade surpluses in the 1980s in order to pay the interest on its foreign debt" and "began to run large trade deficits after 1990 as foreign investors ... began to pour in new funds" (*ibid.*, p.31) then this clearly demonstrates that for trade balances to have an explanatory power we must first gain insight into the general development of a nation's purchasing power.¹¹

To measure competitiveness it is important to keep in mind that the underlying economic factors measured by an indicator (or a set of indicators) really correspond to the economic features of a country's economy. The strength of the US economy, for example, never rested on its export performance. As Prof. Krugman correctly points out, even today, US exports are only 10 percent of the value-added in the economy. The trade balance therefore is not an adequate indicator of the competitiveness of the US economy (as it is for trading nations like Germany and Japan). But that does not mean that international competition played a minor role for the US economy and its performance as Prof. Krugman claims.

On the contrary, the competitiveness of the US economy became apparent in the high productivity of its industries and in increasing values of foreign direct investment after World War II. US corporations were so competitive that they could finance transplants all over the world which not only contributed to the economic recovery of other countries but also to the growth of the US economy in general and thereby led to an increasing demand for the American currency as universal money. The steady rise of a national currency might therefore be a better indicator of a country's growing competitiveness than the trade balance is.¹²

No doubt, these examples already illustrate the

⁹ Cf. *ibid.*, p. 187.

¹⁰ Here Prof. Krugman is right again claiming that "in both theory and practice a trade surplus may be a sign of national weakness, a deficit a sign of strength." (*ibid.*, p.31) However, it is a funny way to argue *against* the concept of competitiveness by stating that the *consequences* of international competition, i.e. "national weakness" and "strength", cannot be measured by taking trade balances into account *only*!

¹¹ The same applies to a nation's capital account. Capital exports may indicate the capital growth of the home based industries which begin to invest in foreign locations in order to exploit the productive resources abroad, yet increasing capital exports may also be a sign of capital flight caused by an increasing inflation rate and comparatively high production costs.

¹² Yet, this need not be so. The rise of the American dollar between 1980 and 1985 was not a sign of an increasing competitiveness of the US economy but the consequence of a high level of interest rates demanded to finance an increasing government debt. As a consequence "American firms found it more difficult to export at a profit, and those producing for the domestic market faced stiffer foreign competition. That is, the economy became less competitive. After 1985 the dollar fell, so relative costs fell too. America became more competitive." *The Economist*, 1994, Vol. 331, p. 15.

difficulties in measuring the competitiveness of a national economy by using *one* indicator only or by *isolating* one economic factor from its economic environment. Further measurement problems arise because the concept of competitiveness encompasses many factors that impact on a country's macroeconomic performance. They include productivity, technological innovations, investments, export and import prices, trade and capital balances, working conditions, taxes, political stability etc. Measuring competitiveness therefore is always a complex matter of choices and compromises with the available data.¹³ As Cohen correctly points out: "Competitiveness is a reconsideration of a broad set of indicators, none of which tells the whole story but that together provide a highly legitimate focus."¹⁴

What makes things really difficult to evaluate is the fact that the driving factors behind a nation's competitive performance are often interconnected: growing capital exports may indirectly contribute to the trade performance of a country and *vice versa*. The growth of productivity in one country might trigger its export of advanced technologies, which – conversely – enables the producer country to gain productivity benefits from economies of scale. The growth of markets abroad may help the home based economy by providing it with larger markets and, on the other hand, improvements in the quality of the home made products and techniques may contribute to the productivity of other economies if they are exported to them.

The interconnectedness of factors determining a nation's economic competitiveness renders it difficult to *separate* causes and consequences in every single case. The interdependence of national economies, industries and markets contributes to these methodological difficulties.¹⁵ Finally, the term "competitiveness" often represents a future quantity of a country's performance. As opposed to this, all the indicators with which competitiveness is usually measured represent a past development. The prognostic strength of our judgements therefore depends on the extent to which we are in a position to describe the structural changes of an economy accurately. In such an analysis the term "competitiveness" then includes the flexibility with which a national economy is able to adapt to structural change, or, in the more favourable case, to internally anticipate it.¹⁶

All these difficulties clearly demonstrate that further

research is necessary to identify the factors which determine a nation's competitiveness and to specify the relations amongst them. However, one should not overestimate these measurement problems on the other hand. Many economic terms make sense and are useful despite the fact that they cannot be measured precisely – just think of Adam Smith's "Wealth of Nations". If some of the relevant factors of competitiveness are qualitative or do not lend themselves readily to quantification that does not mean that the theoretical concept itself is meaningless.

What Endangers the International System?

According to Prof. Krugman *thinking* in terms of competitiveness is dangerous to the international economic system. It might lead to trade conflict, perhaps even to a world trade war. This is a necessary conclusion if one accepts the general idea that every country benefits from world trade thanks to the law of comparative advantage. However, protectionist tendencies do appear and the reason why countries become protectionist is explained by Prof. Krugman: "Most of those who have preached the doctrine of competitiveness have not been old-fashioned protectionists. They want their countries to win the global game, not drop out. But what if, despite its best efforts, a country does not seem to be winning, or lacks confidence that it can?" (Ibid., p. 42)

Contrary to what Prof. Krugman intends to prove his own illustration rests on the realistic assumption that international competition selects winners and losers as does *every* competition – a competition where every player wins is clearly a *contradictio in adjecto* – yet he draws the wrong conclusion from this: "If a country, despite its best efforts does not seem to be winning", then the competitive nature of international economic relations is simply a matter of fact and not merely a fictitious imagination. Indeed, if the dangers of free trade were caused by a theoretical misunderstanding like the one Prof. Krugman claims to have found than they could easily be redressed. The examination of real trade conflicts, however, tells a different story.

Trade conflicts occur because the international economic system is driven by fierce competition of firms

¹³ Cf. OECD: OECD's Indicators of International Trade and Competitiveness, by M. Durand, J. Simon and C. Webb., Economics Department, Working Papers, No. 120., Paris 1992, p. 6.

¹⁴ Stephen S. Cohen: Speaking Freely, in: Foreign Affairs, Vol. 73, No. 4, 1994, pp. 194-197, here p. 197.

¹⁵ This is why Prof. Krugman believes that competitiveness is a meaningless word when applied to national economies. As should be clear, however, the key point is not that national economies become larger but that a nation's purchasing power may grow faster than that of other competing nations thereby improving the economic (and political) weight of a country at the cost of other countries.

¹⁶ Cf. Malcolm H. Dunn: Competitiveness and Technology Policy: The German Experience, in: Jahrbuch für Nationalökonomie und Statistik, Vol. 210/3-4, 1992, pp. 315-331.

and countries. Firms can become uncompetitive by losing their comparative advantages over their competitors, and so can countries, when their productivity growth rate falls behind and their industries underinvest in R&D. According to the McKinsey report on manufacturing productivity,¹⁷ Japanese corporations overtook American and German competitors in productivity in five branches under examination (cars, car parts, metalworking, steel and consumer electronics) by developing and implementing revolutionary innovations.¹⁸ As a consequence Japan's economy gained competitiveness at least in some important industries at the cost of the American and German producers. The stable bilateral trade surplus of Japan and a constant tendency of upward revaluation of the Japanese currency towards the American and German currencies bear witness to this development.¹⁹

Clearly, countries that succeed in international competition have no reason to become protectionist. The call for protectionism becomes stronger when a national economy loses its international competitiveness. But it is important to note that this must not be so. A lack of productivity can be overcome by strengthening the market forces instead of restricting them. As a matter of fact, the above-mentioned McKinsey report gives some evidence that "the greater the exposure of a productivity follower to competition with the productivity leader, the closer this industry's productivity will be to that of the leader" (chapter 3, p. 17). Global competition therefore appears to be very important in achieving (and sustaining) best practice productivity levels.²⁰ Given these findings the writers of this report come to the conclusion that barriers to transplants and trade are barriers to productivity improvement. To encourage global competition governments should instead phase out the variety of different trade restrictions and stop protecting non-competitive industries.

However, intensifying global competition by removing the barriers to competition is no highroad to success, especially if other competitors follow the same line of economic policy. National economies may decline *despite* their efforts to achieve competitiveness in open markets. Like any competitive system the competitive system of the world market demands a strong institutional framework built out of a whole set of regulations and institutions which mitigates against an individual country's protectionist means and, on the other hand, offers new opportunities by

granting the "ailing" nation credits in the key currencies, which it can use to promote its own economic growth, thereby improving its competitive position again. Finally, the pure existence of these regulations (laid down in the GATT), and institutions (IMF, World Bank, to mention only two of them) bears witness to the competitive nature of the international economic order. They would be superfluous, if nations were not competing economically and if "competitiveness applied to national economies is a meaningless word".

A Concluding Remark

As do many traditional economists, Prof. Krugman, who is certainly not a "traditionalist", paradoxically fails to notice the genuine political character of competition when applied to national *economies*, despite the fact that he recognizes the rivalry for status and power. However, he is right that governments tend to implement trade and industrial policies that cause harm, when they recognise that their economy is doing badly. He is right in pointing out that blaming foreign competition for unemployment and low wages is ineffective and—in many cases—flatly wrong, when they are caused by domestic factors. Finally, he is also right in his criticism of "careless arithmetic": competitiveness cannot simply be measured by the living standard or by starting at trade balances and their changes.

Yet, criticising measurement concepts does not imply that the subject of examination itself is meaningless. What the methodological and empirical difficulties do call for is the development of better measurement concepts of competitiveness than are common today. Beyond that, methodological and empirical problems in the field of science do not justify harmful political steps (like trade wars) taken to promote competitiveness. Despite the gaps in our knowledge of what determines the competitiveness of a national economy and how it can be measured, we know very much about the deteriorating effects of protectionist measures on national welfare, last but not least owing to Prof. Krugman's own brilliant contributions in the field of new trade theory.

¹⁹ Note here that saying Japan's industry gained competitiveness at the cost of the US economy does not imply that Japan's bilateral trade surplus is responsible for the unemployment rate in the US or the decline of real income growth. The unemployment rate and the growth of real income might very well be determined by domestic factors as Krugman and Lawrence point out. Cf. Paul R. Krugman and Robert Z. Lawrence: Trade, Jobs and Wages, in: Scientific American, Vol. 270, No. 4, 1994, pp. 22-27.

²⁰ Thurow's argumentation follows the same line of reasoning: "If the domestic economy is to succeed in moving to higher levels of productivity and income, it must first compete successfully in the global market... Put bluntly, those who don't compete abroad won't be productive at home." See Lester C. Thurow: Microchips, not Potato Chips, in: Foreign Affairs, Vol. 73, No. 4, 1992, pp. 189-192, here p. 190.

¹⁷ McKinsey Global Institute: Manufacturing Productivity, Washington 1993.

¹⁸ In four other industries – computers, soap and detergents, beer, and food processing – Japan is behind, by large margins in beer and processed food (cf. *ibid.*, p. 3).