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Labor Markets in the United States and Latin America

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INTRODUCTION

The last quarter century has brought a remarkable transformation in economic relations between the United States and its neighbors in the Western Hemisphere. During the 1980s, individual countries in Latin America began to unilaterally remove quantitative restrictions on trade, lower tariffs on imports, and eliminate barriers to foreign investment. Most nations in the region have since joined the World Trade Organization. The United States helped reinforce these liberalizing tendencies by negotiating free trade agreements with Mexico, Chile, Peru, and the countries of Central America. Today, the economies of the Western Hemisphere are bound by extensive cross-border flows of goods, capital, and people.

Despite globalization's rapid advance, there are signs that the commitment to free trade is weakening. In the United States, opposition to trade is widespread, contributing to the unwillingness of the U.S. Congress to vote on a trade treaty with Colombia. During the recent presidential primary campaign, all three major Democratic candidates suggested that the North American Free Trade Agreement needed to be re-examined or even re-negotiated. The Free Trade Agreement of the Americas, which President Bush heavily touted during his first term in office, has largely disappeared from discussion. In Latin America, some countries are undergoing a bout of globalization fatigue. There is a strong sense that the gains from globalization have not been equally shared among members of society. Notably, the governments of Argentina, Bolivia, Ecuador, and Venezuela have expanded the role of the state in their economies and weakened support for open markets, with Nicaragua threatening to follow suit. We have arrived at a moment when the countries of the Western Hemisphere appear to be reevaluating the worth international economic integration.

Perhaps most surprisingly, for much of Latin America the United States is no longer the main impetus for further globalization. In space of a little more than a decade, China has emerged as a major trading partner for many countries in the region. In South America, whose economies tend to have a comparative advantage in primary commodities, China's dramatic economic growth has meant a substantial boost in the terms of trade and export earnings. Two decades after the Washington Consensus dominated the policy making agenda in Latin America, the United States appears to be losing its economic dominance in the region.

To help frame how a new U.S. president might approach trade policy toward Latin America, this memo provides an overview of the economic consequences of globalization in the region. I examine how greater international trade and investment have affected labor markets in the Western Hemisphere and how the costs and benefits of globalization have been distributed across individuals and regions. The exposition is organized around what I consider to be the robust findings of recent economic research on globalization. I close with lessons for policymakers from the region's experience with more open borders.

Trade Liberalization Raises Labor Productivity

As trade barriers have fallen in Latin America, U.S. exporters have expanded their foreign sales and new firms have established a presence in the region. A substantial body of academic research shows that not all firms are capable of penetrating foreign markets. Firms that do succeed in becoming exporters are noticeably different from non-exporters: they tend to be larger, to be more intensive in the use of physical capital and skilled labor, to be more

technologically advanced, and to have higher output per man-hour (Bernard, Jensen, Redding, and Schott, 2008). The causality appears to run from higher productivity to exporting, rather than in the reverse direction, as better-performing firms exhibit their superior tendencies even before they begin to sell goods abroad. There appear to be fixed costs associated with exporting, such that only more productive firms find it profitable to set up foreign distribution networks (Helpman, 2007). Thus, good firms select into exporting. Interestingly, this regularity holds not just in the United States and other developed countries, but in Latin America and other emerging regions, as well.

As a consequence of there being costs to breaking into foreign markets, relatively few U.S. firms actively participate in exporting to Latin America. It is typically the case that fewer than 20 percent of manufacturing firms in developed economies export *anywhere*. Yet, the size and productivity of exporting firms mean that trade with Latin America has important aggregate implications for the U.S. economy. As access to foreign markets allows larger and more productive U.S. firms to expand, these firms capture a larger share of total U.S. production, helping raise aggregate labor productivity. Improved access to foreign markets thus helps make U.S. manufacturing more productive, when taken as a whole. The same phenomenon has occurred in Latin America. In Argentina, Brazil, Chile, Colombia, and Mexico, among other countries in the region, research has found that falling trade barriers are associated with higher industrial productivity and greater adoption of new technology. Trade reform induces less productive firms to exit and more productive firms to expand, as better firms take advantage of new foreign market opportunities and access to new foreign inputs (Muendler, 2008).

The aggregate productivity gains associated with trade do not come for free. When more productive firms increase their employment, it will generally mean that some less productive firms will contract or go out of business altogether. Some workers in declining industries are rehired quickly but others are not. The reallocation of labor can be painful, as it may involve the movement of workers from one sector to another or even one region to another. Contracting industries often end up paying workers lower wages (Revenge, 1997). For older workers, in particular, having to change jobs as a result of import competition typically means a substantial loss in income (Kletzer, 2001). In Latin America, workers exiting manufacturing often end up in the informal sector. In Brazil and Colombia, at least, it appears that trade reform has contributed to greater informality (Goldberg and Pavcnik, 2007; Muendler and Menezes-Filho, 2008).

Economic theories of international trade have long emphasized that lowering trade barriers creates winners and losers. What recent research reveals is that one may find these winners and losers *within the same industry*, given it is only the better firms that tend to select into exporting. The expansion and contraction of industries is only one channel through which trade affects living standards. Below, I discuss attempts to estimate the quantitative magnitudes of the gains and losses of trade reform. Before getting to this discussion, it is worth considering other ways that globalization transforms firms and industries.

Trade Liberalization Strengthens Regional Production Networks

Traditional trade theory posits that international commerce arises from countries exploiting their comparative advantage. Chile's mineral deposits make it a low cost producer of copper, Argentina's abundant supplies of land allow it to export beef and soy beans (at least in the absence of export taxes), and U.S. supplies of skilled labor and financial capital make it a global powerhouse in high technology goods and information services. While much of Latin

America's commodity trade follows traditional patterns comparative advantage, the region's production of manufactures exhibits a distinct pattern of specialization.

In modern manufacturing economies, countries tend to specialize not in producing particular goods but in specific production tasks. Mexico's maquiladoras turn imported components into auto parts for the big three U.S. auto companies, Costa Rican establishments process electronic components into semiconductors for Intel and other multinational enterprises, and Honduran plants assemble fabric pieces into articles of clothing for global apparel manufacturers. In each case, the country's comparative advantage is not in an entire industry but in a particular stage of production. Falling trade barriers have allowed Latin America – and Mexico and Central America in particular – to participate in global production networks organized by multinational companies, most of which are headquartered in the United States. Within these networks, firms locate each stage of production in the country where it can be performed at least cost (Hanson and Feenstra, 2003). Because such networks necessitate substantial international trade in intermediate inputs or partially finished goods, low trade barriers are essential for their existence.

The expansion of regional production networks in the Western Hemisphere means that U.S. firms are able to obtain intermediate inputs at lower cost, allowing them to be more competitive relative to rival firms in Asia and Europe (Harrison and McMillan, 2006). In automobiles, apparel, electronics, and electrical machinery, the fate of U.S. companies is in part tied to the fate of their suppliers in Latin America. Trade liberalization is largely responsible for the integrated hemispheric production structure that has emerged. Were U.S. firms to lose access to the services provided by assembly plants and other input suppliers in Latin America, they would lose market share to their global competitors and be forced either to find new suppliers in Asia or to go out of business. Of course, many U.S. firms do source inputs to Asia. But in time sensitive products, having access to nearby suppliers is crucial. While China has succeeded in attracting some U.S. manufactures away from Mexico, it has been least successful in products where transport costs are high or where rapid delivery of goods is important for their market value (Hillberry and Hummels, 2005).

On the subject of China, its growth has been a mixed blessing for the region. China's emergence as an economic power has contributed to rising prices for the goods it imports and falling prices for the goods it exports. Rising prices for minerals, oil, and agricultural commodities have benefited much of South America, which is not very exposed to export competition from China. The same is not true for Mexico and Central America. Their export capabilities tend to be strong in industries in which China's capabilities are also strong (Hanson and Robertson, 2008), meaning China's growth is likely to worsen their terms of trade. The varying impact of China on countries in Latin America highlights heterogeneity in production structures in the region. While Mexico is a country overwhelmingly specialized in exporting manufacturing goods, the Andean countries and the Southern Cone are not.

One important benefit of global production networks for the United States is that it allows firms to smooth adjustment to shocks. At home, U.S. multinational companies perform headquarter operations – accounting, management, marketing, research and development, strategic planning – as well as some production activities. They outsource other production activities – in particular, those requiring relatively little skilled labor – to Latin America and other regions. When a shock to industry causes U.S. costs to rise, firms are able to adjust by outsourcing more production abroad. Global outsourcing thus helps reduce volatility for the U.S. economy, even as it raises volatility in Mexico and other countries to which the U.S.

outsources production (Bergin, Feenstra, and Hanson, 2007). Outsourcing, in effect, serves as a type of shock absorber for U.S. manufacturing industries.

Further reduction in trade barriers would allow regional production networks in the Western Hemisphere to be strengthened. Today, the primary barriers to trade for the United States come from sources other than import tariffs and quotas, including transport costs, currency volatility, insecure property rights, and language and other cultural differences (Anderson and van Wincoop, 2004). U.S. trade barriers are very low, with average tariffs under 3 percent, and they are low also in Latin America, averaging between 10 and 17 percent in most countries. Importantly, transport costs for Latin America are high relative to the United States. This may in part reflect poor infrastructure in the region and its geographic distance from major markets. An under-appreciated source of high transport costs in Latin America is market power exercised by shipping cartels. There is strong evidence that shipping companies collude to keep their prices high. Collusion is more feasible the smaller the number of firms that serve a particular market. Hummels, Lugovsky, and Skiba (2008) find that shipping company markups cause transport costs in Latin America to be 80 percent higher than they would be under perfect competition. Markups are high in Latin America in part because of the small number of shipping companies that serve the region, enabling the existing lines to exercise market power. Tariffs further insulate shipping companies from competition, allowing them to charge even higher markups on the price of their services. Reducing the market power of shipping companies would help further expand trade in the Western Hemisphere.

How do global production networks affect labor markets? Again, there are winners and losers. As U.S. firms move low-skill activities to Mexico, there is a reduction in demand for low-skill workers at home and an increase in demand for the high-skill workers that perform headquarter services. In the United States, global outsourcing tends to increase the wage gap between high and low skilled labor. At least for the 1980s and early 1990s, the increase in wage inequality coming from global outsourcing appeared to be relatively small, accounting for about one third of the observed rise in wage inequality in U.S. manufacturing (Feenstra and Hanson, 1999). Technological upgrading appeared to be a more important contributor to rising wage inequality. Research has yet to update these results to the late 1990s and early 2000s, when income inequality in the United States rose further still. We do not know whether in recent years trade has become a more important contributor to the spread in U.S. earnings for more and less skilled labor.

In Latin America, there is reason to believe global outsourcing also contributes to wage inequality, even though it is likely to raise the absolute wages of all workers. As the U.S. moves new production activities to Mexico, say, these are likely to be more skill intensive than the activities that Mexico was already performing. In the 1980s, maquiladoras were concentrated in apparel. Today, they are more concentrated in electronics. The result is that expansions in outsourcing increase the demand for skilled labor more than the demand for unskilled labor, causing wage inequality in Mexico to increase (Feenstra and Hanson, 2003). In Mexico, the regions that have had the most rapid growth in maquiladora employment have also seen the most rapid growth in the relative demand for skilled labor. While we do not know whether these results would apply to other countries that participate in global outsourcing, there is no reason to believe the logic would be qualitatively different.

Mexico exhibits other effects from the growth in global production networks that highlight the unequal benefits from globalization. Since keeping transport costs low are important for making production networks cost competitive, assembly plants in Mexico have tended to concentrate close to the U.S. border, even after regulatory changes permitted them to locate

throughout the country. As U.S.-Mexico trade has expanded, northern Mexico has enjoyed rising employment and wages relative to the rest of the country (Chiquiar, 2007; Hanson, 2007). Poverty has fallen faster in the region than elsewhere in Mexico. Because northern Mexico is richer than southern Mexico, globalization has contributed to an increase in regional income inequalities in the country. Southern Mexico, which has low education levels, suffers from inadequate infrastructure, and is far from the United States, is poorly positioned to take advantage of the opportunities afforded by improved access to the global markets. The Mexican experience is an important lesson in how trade reform may exacerbate differences in regional economic development, such that globalization bypasses some segments of society.

Trade Reform's Effect on Economic Growth is Ambiguous

With abundant evidence that trade reform improves industrial productivity and helps firms achieve cost savings through creating global production networks, one might think that positive growth effects from trade would be easy to establish. However, they are not. Trade certainly helps economies become more efficient. But this appears to be a one time increase in productivity, as trade induces less productive firms to exit, allows more productive firms to expand, and gives firms access to foreign inputs and technology that they lacked before. For trade to generate an increase in the long run *rate* of productivity growth, it must enhance incentives for innovation and/or long run capital accumulation. In theory, it is well known that the impact of trade reform on innovation and capital accumulation is ambiguous. Depending on the assumptions that one makes about the source of innovation, trade can help or hinder growth. The findings of recent empirical work are consistent with this ambiguity.

While countries that liberalized trade in the 1980s tended to enjoy higher rates of economic growth post reform, countries that liberalized trade in the 1970s or the 1990s did not (Wacziarg and Welch, 2003). There is no good reason why the growth effects of trade reform should vary across time, other than these impacts being context specific, a point that Dani Rodrik often makes. The experiences of post-trade reform Latin America bear out this reasoning. There is sound evidence, as I discuss below, that trade reform has raised living standards in the region. But there are no Asian-style growth miracles in Latin America. Until the 2000s, most countries had anemic growth during their post-reform periods. Per capita GDP in the region in 2000 was not substantially higher than in 1980. Recently, exports have contributed to higher growth in Latin America. Yet, the ongoing export-induced boom in the region is not a consequence of high productivity growth but of high prices for the region's export goods. Once prices for these goods fall, as surely they will, growth rates will fall as well.

There are many good reasons to recommend that countries adopt policies that keep trade barriers low, with achieving higher productivity levels and higher living standards being among them. Despite an immense amount of academic research on the subject, we cannot say that there is conclusive evidence that trade reform makes countries grow faster in the long run. Many at the World Bank would be sure to disagree, but it is counterproductive to suggest countries will enjoy higher growth rates if they simply lower their trade barriers. It might happen but then again it might not. Policymakers in Latin America may have gotten themselves into trouble by promising too much from trade liberalization. As president, Carlos Salinas famously suggested that trade liberalization and NAFTA would turn Mexico into a first world country. NAFTA has been good for Mexico but it has not delivered Korean or Taiwanese growth rates. Skepticism about globalization in Mexico today – and renewed support for populist politicians – may in part reflect the failure of NAFTA to deliver on Salinas' overly optimistic promises.

Lower Trade Barriers Lead to Higher Living Standards

Globalization brings many changes to an economy. It raises wages for some workers (those in expanding industries or exporting firms), it lowers wages for other workers (those in contracting industries or bankrupt firms), and it lowers prices for imported goods. For some individuals, expanded trade is unambiguously positive. It raises their incomes and gives them access to consumer goods at lower cost, meaning their real standard of living goes up. Workers in high-tech industries in the United States are clear winners from globalization. But for other workers the effects of globalization are ambiguous or even negative. Workers in the U.S. apparel industry have seen their wages fall, as imports from low-wage countries have surged. True, they can now purchase consumer goods at lower prices, but this may not be enough to compensate for lower nominal incomes.

To evaluate the aggregate consequences of globalization, we need to be able to identify the impact of increased trade on wages and prices for each individual in the economy. This is a daunting task. For the United States, it has not been attempted. There have been many studies based on computable general equilibrium models of how globalization affects the U.S. economy, but these are of unknown value. Such CGE models simulate the effects of trade based on strong assumptions about how the economy operates. This is a quite different exercise than the more valid approach of examining statistically how trade has in fact affected wages and prices based on actual experience.

What we can say for the U.S. is that globalization has contributed to higher wages for high skill workers and lower wages for low skill workers (Feenstra and Hanson, 2004), with the overall effects appearing to be modest. Regarding prices, increased trade with China and other low wage countries has lowered prices for consumer goods, with low income individuals enjoying the largest reduction in prices owing to the fact that they devote a larger share of their spending on imports from China (Broda and Romalis, 2008). The losses in nominal incomes that low skill workers suffer from import competition are in part made up for by lower import prices. When we examine U.S. trade with Latin America, the effects of trade on living standards are likely to be relatively small. Though Mexico is an important trading partner for the United States, the region overall is not large in economic terms. It would be hard to make the case that trade with and investment in Latin America has had dramatic effects on U.S. living standards, one way or the other. Certain industries (autos, electronics) and regions (Southwest) would exhibit large effects, but the aggregate effects are likely to be modest.

For Latin America, the effects of trade are larger, owing to the fact that most countries in the region are small players on the world stage. When they open to trade, imports and exports become a substantial part of their economies. Two recent studies perform the careful exercise of estimating how trade reform has affected living standards, both through its effects on wages and on prices. For Argentina and Mexico, trade raises average living standards (measured in terms of real income) in the economy. Porto (2006) finds that trade reform raised living standards for households throughout the income distribution, with poor households benefiting relatively more. Poorer households enjoyed larger increases in real income relative to other households. In Mexico, however, Nicita (2008) finds that it is richer households that have gained relatively more from trade reform. Poor households also benefit from trade liberalization on net, but their gains are smaller. To further complicate the picture, in Columbia Goldberg and Pavcnik (2007) find no effect of trade reform on urban poverty.

In summary, research suggests that the impact of trade with Latin America on aggregate U.S. incomes is small, with most economists believing the net effect to be positive. For Latin

America, the income gains appear to be larger, though comprehensive analysis has not been performed for all countries.

One lesson that does emerge is that trade reform may not be a very effective antipoverty strategy in all countries. In manufacturing, those benefiting most from trade liberalization are likely to be workers in exporting firms, who see demand for their services expand. Manufacturing exporters tend to be more productive firms that employ more skilled workers. They tend not to employ the poor in large numbers. The direct impact of trade reform on poverty, then, may be weak (Goldberg and Pavcnik, 2007). There are exceptions to this regularity. Where a country has a comparative advantage in agriculture and trade leads to an increase in agricultural production, the poor are likely to benefit. Vietnam is a case in point. Reduction in export controls in the country led to increased rice exports that contributed to lower poverty and less child labor. But few countries in Latin America fit this profile, as poor farmers tend not to produce export crops. Trade reform is certainly not at odds with poverty reduction but in most countries it is not a front line strategy for helping the poor, either.

Does International Trade Promote or Inhibit International Migration?

Immigration from Latin America is an issue of considerable policy importance for the United States. The region accounts 52 percent of the U.S. foreign born population; Mexico alone accounts for over 30 percent. Policymakers often present trade and immigration as alternative options for how the U.S. could engage the region: either the United States permits the free flow of goods and capital or it will see surges in the number of migrants coming across the border. In truth, the interaction between trade and immigration is likely to be minor.

For trade with Latin America to have a dramatic affect on U.S. immigration, it would have to be the case that changing U.S. trade barriers against the region would affect incomes substantially. If the U.S. were to raise trade restrictions on Latin America would immigration rise considerably? Consider the case of NAFTA. Even the most optimistic estimates suggest that NAFTA raised average income in Mexico by only 10 percent. Given that wages for comparably skilled workers from the U.S. and Mexico differ by a factor of nearly three (Hanson, 2007), a 10 percent change in income in Mexico one way or the other is unlikely to have a large effect on emigration from the country. Further, in Mexico most emigrants have historically come from the center of the country, with southern Mexico now accounting for a rising share of labor outflows. These are regions that have been relatively unaffected by trade with the United States, meaning that the direct impact of trade on the incomes of many prospective migrants is unlikely to be large. One could make the case that emigration from Mexico would be higher without NAFTA than with NAFTA, but one would have a hard time arguing that the difference would be substantial. Similar reasoning applies to other countries in Latin America.

Migration does appear to have affected wages in both the United States and Latin America. Though the question has been the subject of contentious academic debate, there is solid evidence that labor inflows have put downward pressure on wages of low skill workers in the United States and upward pressure on wages in Mexico (Aydemir and Borjas, 2007). U.S. employers and consumers appear to gain from immigration. For the migrants themselves, the increase in income from migration is substantial. They share these gains with family members back home through remittances. Adding the impacts of migration on income for U.S. residents, Mexican immigrants, and non-migrating Mexicans, it would appear that the aggregate gains from international migration for the two countries are strongly positive. While the impact of immigration on U.S. aggregate income appears to be small (Borjas, 2001), the income gains to migrants are large, and through remittances emigration appears to raise Mexican GDP (Mishra,

2007). On net, then, international migration appears to raise the collective GDP of Mexico and the United States. We do not have detailed analyses for other countries, but one would expect the qualitative findings to be similar.

There have been repeated calls to expand NAFTA to address cross border labor flows (and similar suggestions to broaden the mandate of the World Trade Organization to include international migration). Tying trade and immigration policies together would likely be a mistake. Trade agreements involve industry by industry negotiations to open markets among participating countries. With migration, there is little reciprocity. The United States is primarily a labor importer and Latin America is primarily a labor exporter. In negotiating over migration policy, the United States has all the bargaining power. Further complicating matters, any bilateral agreement on migration policy would have to address the sharing of income and payroll tax revenues between countries. Because the subject matter and the bargaining positions of countries in trade agreements differ so much from potential migration agreements, there is little to be gained from trying to create an umbrella framework that would cover both the flow goods and the flow of people.

Lessons for Policymakers

By way of conclusion, I summarize the key findings of recent research on globalization and labor markets that are relevant for policymakers thinking about how the United States should approach trade relations with Latin America.

- The direct benefits of new export opportunities are primarily captured by larger, more productive firms. More skilled workers and regions with better access to world markets are the actors best positioned to gain from globalization.
- While trade liberalization leads to gains in economic efficiency, there is mixed evidence as to whether it contributes to higher rates of economic growth.
- Latin America (and Mexico and Central America in particular) is an important player in regional production networks headed by U.S. multinational companies. Access to low-cost suppliers in Latin America helps make U.S. industries more competitive vis-à-vis Asia and Europe.
- Anti-competitive behavior by shipping companies keeps transport costs for Latin America high, which restricts the region's economic integration with the United States.
- Latin American countries differ greatly in their comparative advantage, with the Andean countries and the Southern Cone being low cost producers of primary commodities and Mexico specializing in manufacturing. China's growth has benefited the former but probably hurt the latter.
- Increased trade with low wage countries puts downward pressure on the wages of low skill U.S. workers and upward pressure on the wages of high skill U.S. workers (though the U.S. wage impacts of trade with Latin America appear to be small). On net, trade liberalization appears to have raised living standards in Latin America (and presumably in the United States as well).

- Trade policy is an indirect tool with which to address poverty in Latin America. More targeted approaches are likely to be much more effective in helping the poor.
- For the purpose of making policy, trade and immigration should be treated separately. While in the long run the two are connected, there are substantial complications in negotiating trade and migration agreements jointly.

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