Common Fallacies about Globalization and International Business

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The 2016 US presidential election debates are unusually focused on trade and international business issues. Several myths and fallacies are propagated by different interest groups, without sound theoretical basis or empirical evidence. We identify four common fallacies about international business and explain why they are fallacies.

- Fallacy #1: The manufacturing fallacy - Manufacturing jobs are the basis of American prosperity
- Fallacy #2: The import fallacy - Imports make us poorer
- Fallacy #3: The foreign firm fallacy - Foreign firms always work against our interests, domestic firms always work in our interests
- Fallacy #4: The export fallacy - In order to export, you need to sell to buyers in foreign countries

Fallacy #1: The manufacturing fallacy.

There has been a rallying cry to bring manufacturing jobs back to America. President Obama has relentlessly focused on reviving the manufacturing sector during his road shows[123]. Yet, manufacturing continues to shrink as a percentage of total employment. According to some estimates, while the manufacturing output in the US has increased six times form between 1950 and 2008, the share of manufacturing jobs as a percentage of all jobs has decreased from about 30% to 10%. The reduction in the share of manufacturing jobs despite significant increase in manufacturing output is primarily due to tremendous productivity gains in manufacturing sector since the World War 2, which has come as a result of innovation in technology and management practices. This is not new. A similar trend is observed in the farm sector where productivity increases almost three times between 1950 and 2010, but the employment reduced from about nine million to less than 2 million during the same time period.

The job loss in the farm sector was due to increased use of heavy machinery and automation, and simultaneous migration of labor from the farm sector to manufacturing and service sectors. The loss of manufacturing jobs in the US is neither surprising, not unique. As we show in Figure 1, all major industrialized nations have experienced job losses in the manufacturing sector.

[1] Bring Manufacturing back to America - President Obama chose a factory in economically distressed Appalachia on Wednesday as the stage set to showcase his State of the Union proposals to strengthen American manufacturing. Asheville, NC, February 13, 2013

[2] President Obama focuses on manufacturing and standing up to China in Columbus campaign stop - "Today my administration is launching a new action against China, this one against illegal subsidies that encourage companies to ship auto parts, manufacturing jobs overseas, which directly hurts men and women on the assembly lines in Ohio and Michigan and throughout the Midwest." Columbus OH, September 17, 2012

[3] President Obama announces new Los Angeles-based manufacturing hub. Los Angeles, June 20, 2016

It is important to understand the underlying structure of different economies. The US, and many other advanced economies (e.g. UK) have become primarily service economies. As the structure of the US economy has changed, so have the drivers of value creation. The "Smile of the Value Creation" plot (in Figure 3) shows that advanced economies add greater value by focusing on non-repetitive, high value added activities such as innovation and marketing, while emerging markets concentrate on repetitive, low value added manufacturing jobs.

Clearly, value in advanced economies is created largely by specialized, non-repetitive activities, of which services is a big component. Rich countries are service economies and should remain so to maintain their competitive advantage.

Fallacy #2: The import fallacy

Another popular myth is that imports make a country poorer and a country must export more than it imports to be prosperous[4][5]. There are two major problems with this view. First, trade deficit (when countries import more than they export) is not detrimental for economic growth per se. The basic economics tells us that trade deficits result due to a gaps in savings and investment, and go hand in hand with the foreign investments which bridge the deficit gap.

As long as the domestic economy is an attractive destination for foreign capital, a country can afford to run deficits. Thus, an innovation driven economy, such as the US can support trade deficit year after year, by way of inflow of foreign capital. Foreign investment also brings several benefits for the domestic economy, including more and higher paying jobs. We further elaborate on this under the next fallacy. In the long run, trade deficits can be reduced by encouraging more savings, and not by restricting trade, which will only worsen the domestic economy.

It should also be noted that imports and exports go hand in hand. The top four export destinations for the US – Canada, the EU, Mexico and China – are also the top four countries from which we import. Even at the sub-national level, the top four exporting state in the US – Texas, Illinois, Kentucky, and Michigan – are also the top four importing states. Take the example of Boeing to further understand this point. Boeing 787, the jumbo jet, has been one of the export champions for the US economy with as many as 1,104 orders from 60 different customers from around the world. Boeing also sources its parts from many countries around the world for the 787 plane. The success of Boeing 787 is the success of disintegrated value chain model – if you do not source from the best in the world, you cannot export to the rest of the world.

Fallacy #3: The foreign firm fallacy

"What's good for General Motors is good for America" continues to be an election slogan for many politicians. The underlying rationale is that US firms are better for the US economy in terms of producing high paying jobs, and keeping jobs in the US.

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[4] Nearly 5 million U.S. manufacturing jobs – one out of every four – have been lost since implementation of the North American Free Trade Agreement (NAFTA) and the World Trade Organization (WTO) - *The Public Citizen*, January, 2012

[5] In 2014 the US imported about $500 billion more than we exported. That means US businesses lost $500 billion more in sales because of imports than they gained in sales through export.
What effect does losing $500 billion in sales have on US jobs? 3 million lost jobs. - *The Huffington Post*, January 12, 2016

The truth is that the US subsidiaries of foreign MNEs have an annual payroll of $438 billion with average wages of $77,632, which is 34% higher than the national average. These foreign subsidiaries buy about $1.8 trillion of local inputs, which accounts for about 80% of their total expenditure. They also produce $360 billion in US exports, which is about 23% of the total US exports. Additionally, they spend $45.2 billion annually on US-based R&D activities, which accounts for about 16% of all R&D performed by US companies.

While there are many domestic firms which are doing much good for the local economy, there is no reason to make a devil of the foreign firms. Compared to local firms, foreign firms, in general, source more locally, pay higher wages, perform more R&D intensive activities, and export more. More importantly, they provide strong linkages for domestic firms to participate in the global value chains, and thereby indirectly benefit the domestic firms. This takes us to the next fallacy.

Fallacy #4: The export fallacy

Traditional thinking about exports is that you need to sell to buyers in foreign countries. This was true when firms operated in silos set by organizational boundaries. This is no longer true in the modern economy which is structured through global value chains (GVC). Different organizations add value at different parts in the GVC. Thus, even though a firm may not be directly engaged in selling to a foreign buyer, it may be part of the GVC which engages with the foreign buyer at some stage.

Take the example of the GVC for aircrafts, presented in Figure 3. In a GVC, there are three sets of firms – original equipment manufacturers (OEMs), tier 1 suppliers, also known as primes and second tier suppliers. The OEMs are 'orchestrators' who conceptualize the product and develop its basic design. The manufacturing of critical components is then outsourced to tier 1 suppliers (specializers) who specialize in specific parts of the GVC. The specializers themselves rely on second tier suppliers for different components.

It is the orchestrators who may be engaged in exporting activities in big way. However, specializers and second tier suppliers also contribute to the success of the orchestrators by being an integral part of the GVC. Domestic firms can thus become proxy exporters by supplying to a local orchestrator. For example, by being a supplier to Boeing, a domestic firm is selling its product all over the world. Specializers can also export to foreign orchestrators domestically and get global exposure. Being part of a GVC in such indirect ways reduces the risks associated with direct exports while imparts critical learning that may be of much use should the firm decide to go international on its own.

Summary Insights

The discussion about above four fallacies gives us four important insights about globalization and international business. First, the value in advanced economies is based on services and not manufacturing, and the sooner policy makers and the general public acknowledge this fact, the sooner we can focus on issues that are important for our economy. Second, trade deficit is not always a bad thing, and importing is often a key to exporting success. More importantly, limiting exports is certainly not going to help in promoting domestic growth or even overcoming trade deficit. Third, on an average foreign firms are higher quality firms than domestic firms and provide many benefits for the domestic economy. Finally, connecting to a GVC creates exports and reduces risk, without any international activity.

Figure 1: Job Losses due to Productivity Gains

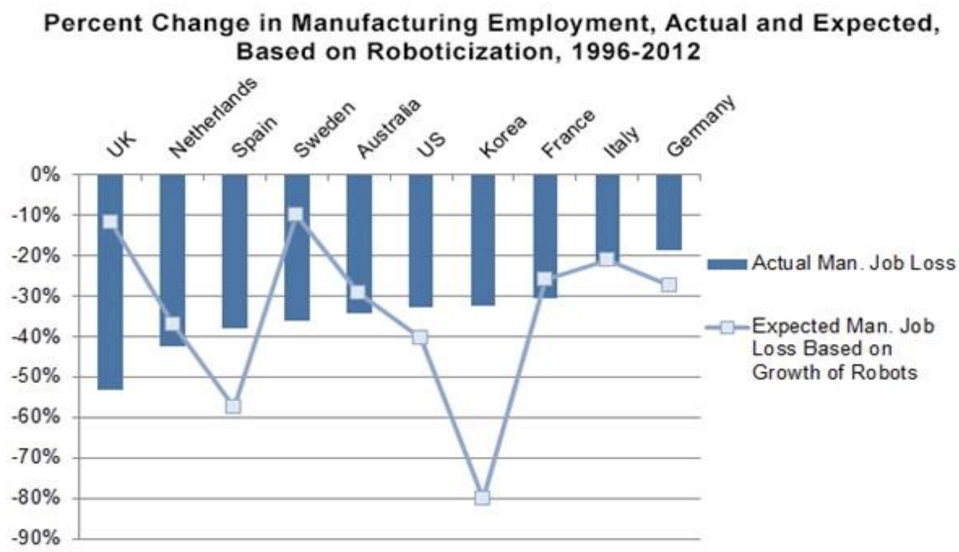
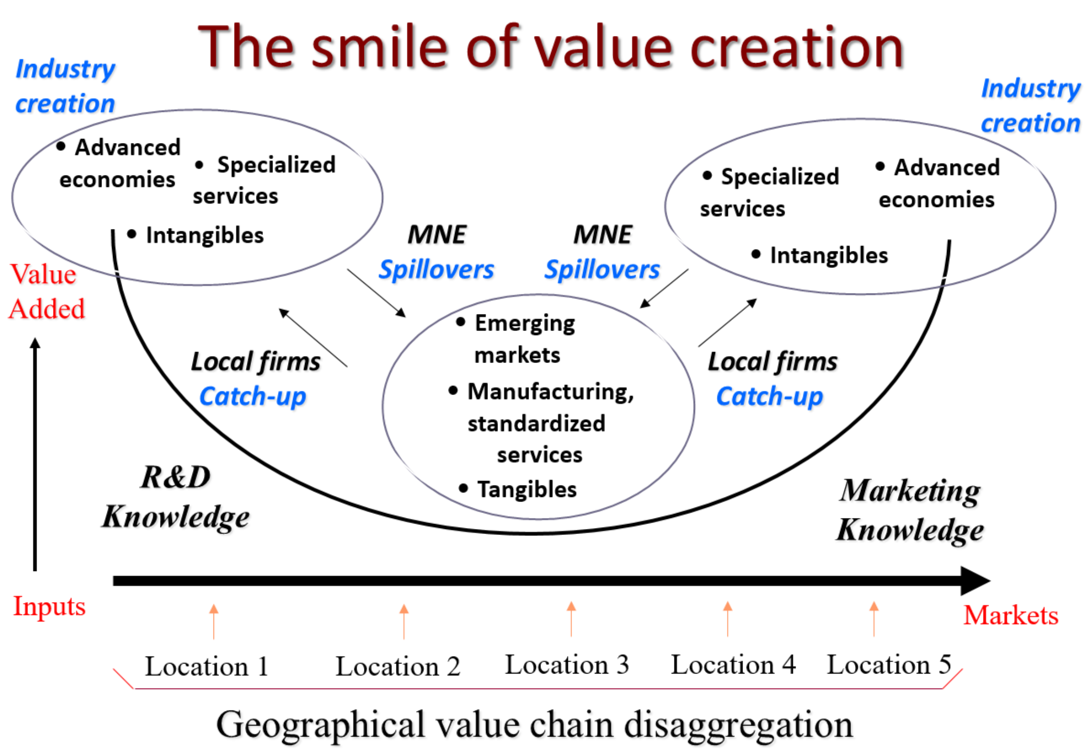
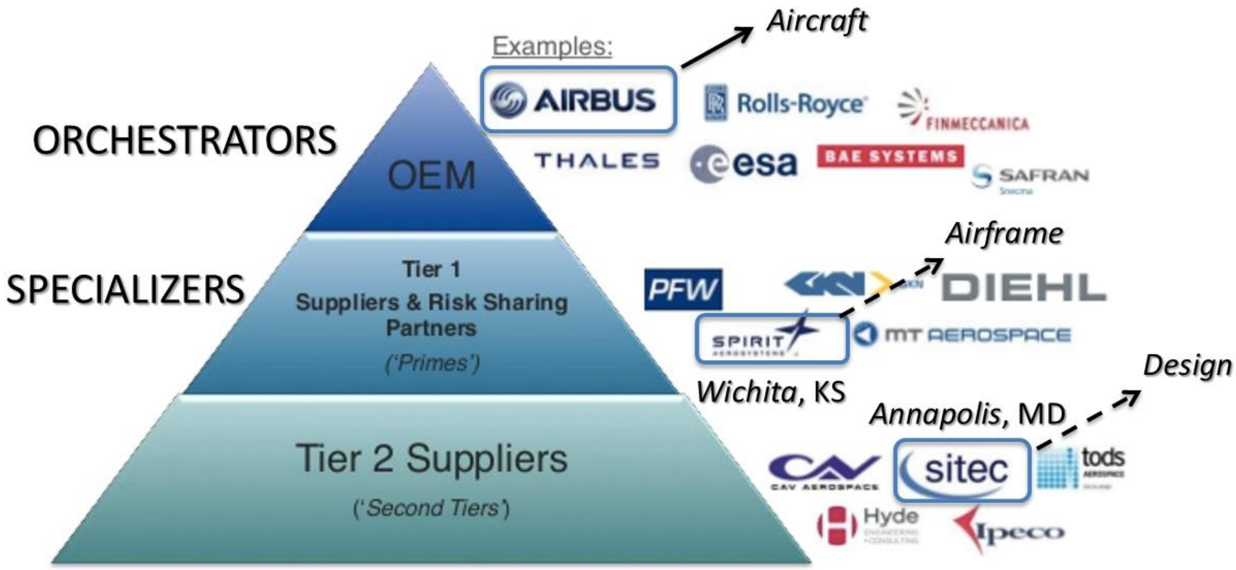


Figure 2: Value Creation in a Global Value Chain



Source: Mudambi, R. 2008. Journal of Economic Geography.

Figure 3: GVC for Aircraft Manufacturing



Source: Westworld Consulting Limited (www.westworldconsulting.com)