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Grow the Lilliputians!

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We all know that today's world is flat and that whatever happens in Wall Street, Shanghai or Bangalore instantaneously affects our lives. But hold on. The more researchers look into the issue, the more they find that geography and distance matter, and the more they discover that large segments of our economies are sheltered from foreign competition. It all started about ten years ago with John McCallum's finding that a US state at the border with Canada trades more than ten time less with the neighbouring Canadian province than with the neighbouring US state. This was only the first in a series of studies which documented that borders still matter for trade, price convergence and the households' financial investments. In spite of the single market and all the talk about an integrated Europe, this is true on our continent too.

The latest piece of evidence in this vein is a research report by Thierry Mayer and my Bruegel colleague Gianmarco Ottaviano that was released last week by Bruegel and the Centre for Economic Policy Research. In cooperation with several country experts, including Claudia Buch from Tübingen, they have looked at the characteristics of firms that export and engage in foreign investment. Their findings are striking:

- First, internationalisation is for the few. A handful of firms are responsible for the bulk of foreign trade: in Germany, France and the UK, the majority of firms export less than 5% of their turnover. Only about 10% of firms export more than half of their turnover, and they account for 50% to 75% of total exports. Concentration is thus very high and it is even more pronounced for FDI;

- Second, the internationalised firms are better. Those which export more exhibit higher productivity, are more profitable and pay higher wages. Here again, the difference is even higher for firms engaged in FDI;

- Third, the main determinant of a country's export performance is the total number of exporters (rather the average exports by exporting firms). Germany is strong on international markets because it nurtures many more exporters than France, whose performance relies on a handful of champions rather than on the *Mittelstand*.

Those facts are consistent with anecdotal evidence. But they have important consequences. The most significant one is probably political. What Mayer and Ottaviano show is that competitiveness and export performance hardly matter for the vast majority of our countries' citizens, but that they matter considerably for a small subset of them. Of course, export performance has a bearing on all, but for the vast majority only indirectly. There is in a sense some truth in the (common and silly) metaphor about economic war: as in a war, only a few are on the frontline. This helps in understanding the debates we are having about globalisation. It is only for a small minority that it is a palpable reality. The valleys behind are still remarkably quiet.

The second consequence is that politicians and trade unionists are right when they point out that globalisation brings restructuring and plant closures. Economists have long argued – against everyday evidence – that the effects of lowering trade barriers were sectoral: some sectors thrived, other declined. Yet what this research shows is that strong and poor performers coexist within each sector. When trade barriers are lowered, the former thrive and

the latter decline or die. Therefore there are constituencies for protection within each sector, including those where the country has a comparative advantage (and there are also potential winners in sectors where the country has a disadvantage). This makes the politics of trade opening more complex.

The third consequence is that there is not much to hope for from promoting national or European champions. Globalised firms sell the world over and they do not need the government's help to know what to do. Actually, beyond the opening of some still closed markets there is often little public policy can do to improve their performance – and thereby the country's exports. But there is much to gain from enabling more firms to sell and compete on external markets. Modern industrial policy is about just that. It does not consist in engineering mergers or giving research contracts to the big players, but in creating the conditions that will allow the number of exporters to grow. This involves a well-trained workforce, access to capital, competition, and infrastructure.

So competitiveness policy is more painful than one would hope. Governments would like to send out the Gullivers and leave the Lilliputians quietly at home, but the way to success is just the opposite: forget the Gullivers, and grow the Lilliputians. Actually, this is just what Germany has done over the last ten years and it has paid off handsomely. It is high time the other European countries learnt the lesson.