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# Globalization's Gains Come With a Price

While Poor Benefit, Inequality Feeds A Backlash Overseas

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PUEBLA, Mexico -- Like millions of other low-wage workers here, Hermenegildo Flores was supposed to benefit from Mexico's decision to open its economy to foreign trade and investment in the 1990s. For a time, he did. As U.S. companies boosted purchases from Mexican factories, Mr. Flores's salary nearly doubled to \$68 a week in 2001.

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## TRADE'S DOWNSIDE?



Then foreign competition from places like India, Pakistan and El Salvador intensified: Mr. Flores, who sewed pockets onto blue jeans, says his foreman "would go around shouting, 'If you don't work harder, we are going to shut this plant down and move it to Central America.'" Today, Mr. Flores is unemployed, having accepted a \$900 buyout in April after the company switched to new machines.

A decade ago, the globalization of commerce promised to be a boon to low-wage workers in developing nations. As wealthy nations shed millions of jobs making apparel, electronics, and other goods, economists predicted that low-skilled workers in Latin America and Asia would benefit because there would be greater demand for their labor -- and better wages.

In some ways, globalization delivered as promised. But there was an unexpected consequence. As trade, foreign investment and technology have spread, the gap between economic haves and have-nots has frequently widened, not only in wealthy countries like the U.S. but in poorer ones like Mexico, Argentina, India and China as well. Many economists now say that the biggest winners by far are those with the education and skills to take advantage of new opportunities, leaving many lagging far behind. Incomes of low-skilled workers may rise, but incomes of skilled workers rise a lot faster.

"While globalization was expected to help the less skilled...in developing countries, there is overwhelming evidence that these are generally not better off, at least not relative to workers with higher skill or education levels," write economists Pinelopi Koujianou Goldberg of Yale University and Nina Pavcnik of Dartmouth in the spring issue of the Journal of Economic Literature.

Globalization deserves credit for helping lift many millions out of poverty and for improving standards of living of low-wage families. In developing countries around the world, globalization -- defined as trading and participating in the global economy -- has created a vibrant middle class that has elevated the standards of living for hundreds of millions of people. That's particularly true in China, where the incomes of low-skilled workers have consistently risen. The poor in countries like Vietnam and elsewhere in Southeast Asia have also benefited greatly since those countries have opened their economies. In many developing countries around the world, life expectancies and health care have improved, as have educational opportunities.

But because globalization is also creating more inequality, it is raising questions about how much inequality countries can bear and whether these gaps could ultimately produce a backlash that will undermine trade and investment liberalization around the world.

## Following the U.S.

Many developing nations seem to be following in the footsteps of the U.S., where the income gap has grown sharply since the early 1970s. A 2006 study of Latin America, a

region long marked by profound gaps between rich and poor, by World Bank economists Guillermo Perry and Marcelo Olarreaga found that the income divide deepened after economic liberalization in nine of the 12 countries examined.

While that could partly be explained by Latin America's slow rate of economic growth, income gaps are widening in fast-growing Asian nations as well, including Thailand and India. It's even grown in the past decade in South Korea, a country long known for an egalitarian commitment to education.

Then there's China. One of the fastest-growing economies in the world has generated significant wage gains for its rank and file. Yet income inequality is also growing because of the huge gains being posted by the upper crust. Between 1984 and 2004, China's income inequality as measured by the Gini index -- zero is perfect equality and 100 is perfect inequality -- increased to 47 from 29, according to World Bank researchers Martin Ravallion and Shaohua Chen. From 2000 to 2005, per-capita income of the bottom 10% of urban households in China rose 26% while those at the top saw gains of 133%.

While Mexico hasn't experienced the spectacular growth of China, wages of those at the bottom 10th percentile of urban full-time workers increased 12% between 1987, when the country first took steps toward opening its economy, and 2004. Since 2000, the percentage of Mexicans living in extreme poverty also has fallen below 20% for the first time ever in the nation's history.

Even so, skilled workers in Mexico still earn far more relative to unskilled workers than they did before liberalization. In 2004, urban full-time workers at the top 10th percentile earned 4.7 times more than those at the bottom 10th, compared with four times as much in 1987, according to Columbia University economists Eric Verhoogen and Kensuke Teshima.

By other measures, income inequality is far greater. The World Bank, for instance, estimates that the top 10% of Mexicans accounted for 39% of the country's total spending in 2004, while the bottom 10% accounted for less than 2%.

The consequences of widening income inequality are profound. Those without much education or skills often find themselves stuck in jobs in the underground economy that don't pay health-care or pension benefits. That's boosted immigration to better-off regions domestically or to the U.S. and Europe, where anti-immigrant sentiment is surging.

Growing inequality also feeds the populist argument that globalization is a sucker's game that benefits only the elites.

In Latin America, that sense of alienation has powered populist presidential candidates who won in Ecuador, Bolivia, Nicaragua and Venezuela and came close to carrying Mexico last year. In China, the ruling Communist Party worries that support for liberalization could crumble. The government needs to "safeguard social fairness and justice and ensure that all of the people share in the fruits of reform and development," said Chinese Premier Wen Jiabao in March.

How does globalization boost inequality? The question is too fresh to have definitive answers, but it's clear that international competition forces local firms to add skilled workers who can handle newer technology and shed workers who can't. Foreign firms bring new technology to developing nations and boost demand there for skilled workers by paying 10% to 20% more than domestic firms, says Dirk Willem te Velde, a research fellow at the Overseas Development Institute, a United Kingdom think tank.

Access to education also plays an important role. Developing nations rarely crank out enough college-trained workers to match growing demand, boosting the wages for fresh graduates. Unskilled workers who get laid off can't find retraining and add to the pool of workers looking for low-wage work.

The effects of globalization are vividly on display in Puebla, a lively city of 1.5 million known for its baroque churches and colonial architecture. Located between the port of Veracruz and Mexico City, 70 miles to the northwest, Puebla has long been a center of trade and textile. As with the rest of Mexico, its industries were protected after World War II by high walls of tariffs and quotas, and by restrictions on foreign investment.

During the 1970s, those barriers helped produce rapid economic growth, but the system collapsed in a debt crisis and deep recession that swept through Latin America in the 1980s. To restart the economy, Mexico began dismantling its import barriers in the mid-1980s and tied itself tightly to the world economy through the North American Free Trade Agreement, or Nafta, with the U.S. in 1994, and a passel of other trade accords since then. At the time, Mexico's politicians and economists predicted that globalization would produce many new jobs in Mexico, especially for those at the bottom, as companies that produce low-skilled goods set up shop south of the border.

"Mexican wages will not remain low if we are capable of growing," said Mexico's then-President, Carlos Salinas, in 1991 when he was promoting Nafta.

For a time, that turned out to be true. Towel-maker Industrias Cobitel SA picked up two big new U.S. customers after Nafta and doubled the number of production workers to 250 by 2000. Exports accounted for 40% of the company's sales in 2000, about triple the percentage before Nafta. Business was so brisk that many employers didn't care whether new hires had much schooling.

But foreign investment and competition also prompted a big demand for skilled labor. Local companies that had gotten by with outmoded machinery either upgraded or closed.

## Volkswagen's Impact

Volkswagen AG, the city's largest private employer, has had an especially large impact on the local economy. The company for years produced "Vochos," as VW Beetles are called in Mexico, on an old-fashioned production line where dents were banged out with mallets. But as Mexico opened its economy, VW ratcheted up the demands on its work force.

The company started building the new Beetle in Puebla in 1998 and followed with other models aimed at hard-to-please U.S. buyers. New machinery was imported. Now welds are done by lasers. Robots paint the exteriors of cars for an even finish. In the past decade, the company has doubled the number of engineers to 700 and is planning to add 100 more this year. They make between \$400 and \$600 a week and are college graduates.

At the same time, VW slashed its Puebla work force by about 15% since 2000 to 14,000, mostly eliminating assembly jobs, and outsourced production of seats, steering wheels and wire harnesses to factories in a sprawling industrial park outside the gates of the manicured VW campus. Assembly workers at those factories are paid about one-third the \$225 a week VW line workers make. Many auto-parts companies won't hire laid-off VW workers, figuring they can't make the financial adjustment.

Ricardo Mosqueda Martínez lost his job at VW and worked for a time at a parts supplier. "When I first saw the paycheck, I thought to myself, is this a joke?" he says. He didn't last long there. Like many other VW employees, Mr. Martínez ended up in Puebla's informal economy, working as a gypsy taxi driver and doing other jobs.

## Opening Opportunities

For Poblanos, as Puebla natives are called, with the right education, globalization has also opened opportunities that were absent in Mexico just a decade ago. Victor Pasilla, the 30-year-old son of a hospital security guard, makes \$600 a week designing oxygen sensors for a Puebla start-up, Biomedica Integral SA, which hopes to build neonatal surgical beds for export. "It's been a big leap," says Mr. Pasilla, who has helped outfit his parents' home, where he still lives, with its first telephone and computer. "My parents are quite proud that their children are moving upwards."

The surge of well-to-do residents has changed Puebla's look. In the once-poor south of the city, housing developments of small, brightly colored homes, each topped with water tanks, have opened for young families who have become eligible for mortgage financing. There are also two new shopping malls with international clothing stores, including Zara and Massimo Dutti.

Low-paid textile or auto-parts workers don't shop at Zara, although many now frequent the local Wal-Mart, which offers food, clothing and appliances at good prices. Low-wage workers live as they have for many years, in cramped urban tenements ringed with razor wire to keep out thieves.

Part of Mexico's problem is that U.S. manufacturers looking for bargain prices have rerouted orders to China, where wages are even lower. Cobitel, Puebla's towel maker, had to cut payroll after a big South Carolina textile customer shifted orders to China in 2004. Overall, Mexican textile jobs that pay health benefits, which peaked at 195,000 in 2000, fell by one-third to 127,000 this year, according to Labor Ministry statistics.

But China's success doesn't fully explain the puzzle of growing global income inequality. If it did, China's low-wage workers would have seen especially fast growth in income, reducing income inequality. While low wage workers have benefited, it's elite workers that have benefited most. In part, that's because the companies in China doing work for overseas markets usually look for a set of skills few Chinese have, such as foreign-language fluency and technical knowledge.

## Social Tensions

A flood of such well-paid workers has transformed the coastal city of Dalian, a magnet for investment from neighboring South Korea and Japan. The city's crumbling slums and boarded-up factories have given way to new shopping malls and fancy apartment

complexes, reflecting how millions of Chinese can now own their own homes, buy Western consumer goods and even travel abroad. But the accompanying surge in real-estate prices has made Dalian nearly unaffordable for lower-paid locals, who often complain they are being literally pushed out of the city.

"The fact that ordinary people in Dalian can't afford to buy a house in the city center is indisputable. The city government should reflect on this," one Dalian resident using the name Mu Fan wrote in a comment on a government-sponsored Web site.

Such social tensions have become an increasing political problem for the Communist Party, whose legitimacy rests on its ability to deliver a broad improvement in the populace's standard of living. Wary of being identified as favoring an urban elite, leaders have this year expanded social programs for the poorest and campaigned against wealthy people who flout tax and family-planning laws.

Expanded education can ease inequality, as more workers qualify for skilled jobs. In Mexico, the income gap has diminished somewhat since 2000, partly reflecting improved education levels. Since 2000, for instance, Puebla State Popular Autonomous University, a large private university, has added undergraduate degrees in such specialties as bionics, electronics and software and is planning to add degrees in biotechnology, power-grid administration and plastics.

Another major factor: So many Poblanos have given up on their home turf and migrated to the U.S. that competition has eased somewhat for lower-skilled jobs. The greater number of Poblanos working abroad has also increased the amount of cash being sent back home, boosting the incomes of many residents. In the past decade, New York has become a magnet for many Poblanos, so much so that *mole poblano*, a Puebla specialty, is now widely available for sale in the borough of Queens.

Mr. Flores, the unemployed tailor, has two brothers who have decamped for the U.S. but says he doesn't want to follow suit because he doesn't want to leave his wife and daughter. Instead, Mr. Flores is looking for work as a day laborer, building homes for Puebla's surging new middle class. "I have a fight in front of me trying to find work," he says.

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