

Nunnenkamp, Peter

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Peter Nunnenkamp\*

# The World Economy at the Crossroads

*The dramatic changes presently taking place in the world economic environment involve considerable risks, but at the same time offer significant opportunities which should not be ignored. Some of the major challenges the world economy is facing in the 1990s are discussed in the following article.*

Currently, the pessimists are riding high in the stakes on assessing the prospects of the world economy. A horror scenario for the end of this century may be summarized as follows. Severe trade imbalances in major industrial countries and some newly industrializing economies (NIEs) will have equipped the protectionist lobbies with seemingly convincing arguments, so that trade intervention will be the rule rather than the exception. The failure of the Uruguay Round will have resulted in bilateralism and regional trading blocs. The EC 1992-project of the Single European Market will have been perverted into a "Fortress Europe", thereby contributing to the failure of economic transformation of post-socialist economies in Eastern and Central Europe. Developing countries will have been pushed onto the sidelines as a consequence of trade diversion at their expense and the drying up of capital imports due to a shortage of global savings. Poverty-induced migration within Europe and from the Third World will have led to massive labour movements, which the affluent Western economies can no longer absorb. Cynics may add that we need not bother too much about all these threats. In their view, the planet will be destroyed anyway as Earth Summits such as in Rio de Janeiro in June 1992 will not stop environmental degradation.

Such concerns certainly cannot be dismissed easily. However, there is still the chance that bilateralism and regionalism can be contained. A breakthrough in multilateral trade negotiations is not out of range. European integration entails risks but at the same time it offers considerable chances for EC members and also for outsiders. Notwithstanding serious adjustment problems, the economic transformation of post-socialist countries promises new markets and provides the chance of a more efficient and growth-enhancing division of labour on a worldwide scale. Such opportunities may also be grasped by both developing and newly industrializing countries.

Sustained adjustment efforts in Eastern Europe and the Third World and a growth-oriented allocation of global savings will help contain migration. And, finally, the growing public concern about the environment puts considerable pressure on politicians to proceed from declarations of goodwill to policy implementation. Some of the major risks and chances the world economy is facing in the 1990s will be discussed in more detail in the following.

## Trading Blocs versus Multilateralism

An analysis of trade and foreign investment flows during the 1980s does not lend much support to the conventional wisdom of emerging trading blocs in the world economy.<sup>1</sup> The data suggest, rather, the development of closer economic links among the major industrial countries at the expense of developing countries and a further integration of the Asian NIEs into the world economy. Japan developed from a regional to an international economic power. The United States became a very important counterpart in the Asian-Pacific division of labour without sacrificing its economic interest across the Atlantic. This proves once again that international trade and capital flows are not a zero-sum game where intensified economic relations with new partners automatically reduce the importance of others.

However, the threat of increased bilateralism and regionalism is inherent in the trade policy of the United States and the EC. EC trade policy is characterized by a dichotomy between the commitment to liberal GATT rules and the desire to shield domestic producers from foreign competition. The result was an increasingly complex trade policy regime which is highly selective among products and extremely discriminatory among countries. The fear is that this tendency might be reinforced by the 1992-project of a Single European Market. The bright prospects offered

<sup>1</sup> Ulrich Hiemenz: Asian-Pacific Leadership: Implications for Foreign Economic Policy of Japan and the US, Working Paper No. 466, Institute of World Economics, Kiel 1991.

\* Institute of World Economics, Kiel, Germany.

by a prosperous EC market are dimmed to the extent that European economic integration is only accomplished by means of restricting access for non-members. The EC may be tempted to erect a "Fortress Europe" in order to facilitate the structural adjustment of member countries by reducing foreign competition.<sup>2</sup> The road further down towards bilateralism and regionalism in world trade may be paved by the EC causing a failure of the Uruguay Round.

A similar dichotomy is to be observed in US trade policy.<sup>3</sup> The US administration emphasizes most-favoured-nation treatment in multilateral negotiations, but US trade legislation reveals an increasing inclination to solve trade conflicts on a bilateral basis. The envisaged free-trade area among the United States, Canada and Mexico suggests an attempt to create a North American trading bloc as a countervailing force to European integration. Countries outside the region are concerned about the potential trade-diversion effects, particularly the impact on their exports to the United States.<sup>4</sup> President Bush's Enterprise of the Americas Initiative, launched in July 1990, appears to be a further step towards regionalism. This tendency will gain momentum if GATT negotiations remain blocked.

### Uruguay Round

The success of the Uruguay Round is of utmost importance to prevent the cementation of trading blocs. The protracted delay in reaching an agreement is depriving the world of large efficiency and welfare gains and continues to limit market access, particularly to the developing and post-socialist countries, many of which have unilaterally liberalized their trade and payments systems.<sup>5</sup> Further delays are likely because of political considerations, particularly the coming US elections. In the medium term, much depends on whether the US administration realizes that regionalism cannot be defeated by regionalism. Empirical evidence suggests that the perceived benefits of trade integration among partners with widely different levels of development have typically been fairly small.<sup>6</sup> They are no substitute for multilateral trade liberalization and the further globalization of production required for continued economic progress.

A multilateral approach may, therefore, dominate trade-policy initiatives by the United States in the future. Once bilateral trade frictions are resolved, the United States, Japan and the Asian NIEs can become important partners in multilateral negotiations.<sup>7</sup> They can join forces against protectionist threats in Europe and elsewhere. Such a powerful coalition will render it increasingly difficult for the EC to resist the resolution of the Uruguay Round. Enforced concessions with respect to price support, market access and export subsidies in agriculture, which remains the

major stumbling bloc, will probably result in a rather quick resolution of disputes in other areas of the GATT negotiations.<sup>8</sup>

The readiness of the EC to agree to multilateral trade liberalization may further increase if a "liberalization club" consisting of the United States, Japan and Asian NIEs wins further allies and the pressure is extended to other areas of international policy coordination. The post-socialist countries are potential allies. EC declarations on helping the integration of Eastern Europe into the Western market economy are not credible unless EC markets are completely open to the exports of post-socialist countries, particularly in the so-called sensitive product categories.

The pressure towards trade liberalization in agriculture, textiles and other labour-intensive sectors will mount once it is recognized that Western Europe has to shoulder a significant share of the opportunity costs of persistent protectionism. This refers primarily to the effects of import protection on the poverty-induced migration of unemployed and underemployed workers from Eastern Europe.<sup>9</sup> Furthermore, the bulk of future financial support for Eastern Europe will have to be provided by the EC if other OECD countries link a fair financial burden-sharing to the resolution of trade conflicts.

### Eastern Europe

The euphoria which followed the collapse of the communist regime in Eastern Europe has vanished. Overly optimistic assessments of short-term market chances and favourable investment opportunities have been replaced by scepticism about the speed and sustainability of economic transformation. Adjustment costs have proved to be larger than expected. Production has declined significantly in almost all post-socialist countries. Institution building, macroeconomic stabilization and structural reforms have been delayed in

<sup>2</sup> Ulrich Hiemenz: *The Future of Asia-Pacific Economies: A View from Europe*, Working Paper No. 460, Institute of World Economics, Kiel 1991; Horst Siebert: *Die neue wirtschaftliche Landschaft in Europa – Spekulationen über die Zukunft*, Discussion Paper No. 184, Institute of World Economics, Kiel 1992.

<sup>3</sup> Cf. Ulrich Hiemenz: *Asian-Pacific Leadership ...*, op. cit.

<sup>4</sup> International Monetary Fund (IMF): *World Economic Outlook*, Washington, October 1991, p. 42.

<sup>5</sup> Ibid.

<sup>6</sup> Rolf J. Langhammer, Ulrich Hiemenz: *Regional Integration among Developing Countries: Opportunities, Obstacles, Options*, Kiel Studies No. 232, Tübingen 1990.

<sup>7</sup> Cf. Ulrich Hiemenz: *Asian-Pacific Leadership ...*, op. cit.

<sup>8</sup> Rolf J. Langhammer: *Nachsitzen in der Uruguay-Runde: Zu viele Streitpunkte – zu wenig Ergebnisse*, Discussion Paper No. 170, Institute of World Economics, Kiel 1991.

<sup>9</sup> Cf. Horst Siebert, op. cit., p. 19.

several instances, particularly with respect to the privatization of industrial conglomerates. The attractiveness of the region for foreign investors has typically remained rather low.<sup>10</sup> The problems of economic transformation and the uncertainties about its ultimate outcome are highest for the Commonwealth of Independent States (CIS), and still high for countries such as Bulgaria and Romania. The prospects appear to be somewhat better for the Baltic states and considerably better for Czechoslovakia, Hungary and Poland.<sup>11</sup>

It is no longer disputed that a serious transition crisis cannot be avoided in the aftermath of the cosmic shock that hit the centrally planned economies. In the longer run, however, it is safe to predict that the economic landscape in Europe and beyond will change significantly. With ongoing reforms in Eastern Europe, new markets will develop and new competitors in international goods and capital markets will emerge. The time required for a successful economic transformation hinges critically on both domestic economic policies and support by the international community.<sup>12</sup> The two key elements of external assistance are improved access to industrial country markets and financial support for internal reform efforts. But the primary responsibility for carrying through the enormous task of transforming the post-socialist economies rests at home.

The following issues figure prominently among the domestic policy challenges to improve the economic prospects of Eastern Europe and to contain the transition crisis:

- ☐ A market-oriented institutional framework has to be established as quickly as possible. Most importantly, property rights must be clearly defined and enforced.
- ☐ Macroeconomic stabilization must be sustained. To this end, enterprises and banks must be subjected to hard budget constraints.
- ☐ The freeing of prices has to be supplemented by rapid privatization, favourable attitudes towards foreign investors and trade liberalization. Such a comprehensive approach helps induce a stronger supply response to market prices, stimulates capital formation and enhances efficiency-increasing competition.

<sup>10</sup> Stefanie Bessin et al.: *Weltwirtschaft nach der Rezession*, Thesen zum 44. Kieler Konjunkturgespräch, Discussion Paper No. 173, Institute of World Economics, Kiel 1991, p. 12.

<sup>11</sup> Cf. Horst Siebert, op. cit., p. 14.

<sup>12</sup> Cf. IMF, op. cit., pp. 58 ff.

<sup>13</sup> Peter Nunnenkamp: What Are the Future Prospects for the Third World? Current Problems and Conclusions for Development Co-operation, in: *Economics*, Vol. 43, 1991, pp. 7-27.

<sup>14</sup> Cf. IMF, op. cit., pp. 44 ff.

The successful transition of post-socialist countries to market economies is in the interest of Western Europe in particular, both politically and economically. Therefore, Western Europe should be prepared to bear the adjustment costs that will result for domestic producers from an increased world-market supply of agricultural and labour-intensive products from post-socialist countries. It would be extremely myopic to resist the redirection of trade flows and the relocation of production facilities in favour of Eastern Europe. The affluent European economies should be aware that East-West migration will gain momentum if trade and capital flows are restricted by protectionist measures.

### Fiercer Competition

The fiercer competition in international goods and capital markets may cause more serious adjustment problems for developing countries. The factor endowments of Latin American and Southeast Asian economies are similar to Eastern Europe. Hence, they will play in the same league in the 1990s as regards the locational competition for internationally mobile production factors. The Third World is concerned that trade preferences for East European countries could narrow the preference margins of developing countries and further reduce their sales opportunities, especially in EC markets. Fears are even more pronounced as concerns the availability for foreign capital. Official financial support for the economic transformation in Eastern Europe threatens to lead to reduced development aid to low-income countries in the Third World. Private foreign capital could also be diverted from developing countries and concentrated in Europe.<sup>13</sup>

The prospects of developing countries' attracting sufficient amounts of foreign capital depend, first, on whether there will be a shortage of global savings and, secondly, on their own economic policy framework. It is difficult to assess the justification of concerns about excessive claims on world resources in the future. The IMF has estimated that new demands for savings associated with reconstruction in the Middle East, German unification, and reforms in Central Europe and the CIS amount to about US\$ 100 billion per annum during 1992-1996.<sup>14</sup> Without a commensurate rise in the availability of global savings, this scenario would result in a rise of world interest rates of about half a percentage point. Over the medium term, higher interest rates would lead to the crowding out of domestic investment and a decline in output elsewhere in the world economy. Developing countries fear that they would be the first to suffer from such a decline.

Notwithstanding the anticipated decline in the private savings rate in industrial countries, a serious shortage of

global savings can be prevented if the absorption of savings by the governments of industrial countries is reduced during the coming years. This requires the full implementation of the deficit reduction plans announced in several countries, including the United States and Germany. Furthermore, the negative effects of a savings gap on world interest rates and incomes should be contained by linking official financial assistance to sustained stabilization policies and structural reforms in the recipient countries. This will help ensure that scarce resources are used in the most productive way.

The latter proposition applies not only to Eastern Europe, but also to developing countries. External financial support must be concentrated on countries the governments of which are committed to remove the internal bottlenecks to an improved attractiveness for foreign capital. There is little prospect of an increase in the flow of private capital unless macroeconomic and structural policy reforms are implemented and sustained<sup>15</sup>. Political instability and the lack of government credibility represent further policy challenges. However, generalized fears that developing countries cannot stand the fiercer locational competition for foreign capital and will be pushed onto the sidelines are unjustified. It appears more reasonable to predict a further differentiation within the Third World<sup>16</sup>. The risks inherent in changed world-market conditions will affect the developing countries to different degrees. And certain parts of the Third World are well prepared to grasp the opportunities that these changes will also bring.

□ In all probability, the Asian NIEs will remain competitive suppliers of manufactured goods and services, and continue to be favoured locations for foreign investors. The anticipated changes in the world economy create more opportunities than risks for them. The Asian-Pacific region is likely to remain the growth pole in the world economy throughout the 1990s.<sup>17</sup>

□ The heavily indebted countries of Latin America will rejoin world economic development and attract foreign capital only through credible and consistent reform efforts.

□ For sub-Saharan Africa, there is an acute danger that the region will slide further into economic ruin. High population growth as well as the lack of essential institutional and politico-economic prerequisites render it extremely difficult to overcome the persistent economic weakness.

<sup>15</sup> Ibid., pp. 61 ff.

<sup>16</sup> Cf. Peter Nunnenkamp, *op. cit.*

<sup>17</sup> World Bank: World Development Report 1992, Oxford 1992, pp. 32 f.

<sup>18</sup> Cf. IMF, *op. cit.*, p. 44.

<sup>19</sup> Horst Siebert, *op. cit.*, p. 19.

All in all, both post-socialist and developing countries must be aware that economic policy failures at home will become more telling in the future and result in even higher economic costs than in the past.

### Summary and Conclusions

Over the rest of this century, the locational competition for foreign capital as well as the competition in product markets will intensify. It would be naive to ignore the considerable risks associated with the dramatic changes in the world economic environment. At the same time, however, these changes offer the chance of a successful integration of Eastern Europe into the worldwide division of labour, sustainable development in the Third World, and continued growth in industrial countries. Such a prosperous world economy is an absolute necessity for mastering new challenges such as the conservation of the global environment.

It depends on the economic policy decisions of major players in the world economy whether the risks or the chances will dominate future global economic development. The main responsibility rests with the industrial countries. Their most important contribution to a favourable evolution of the world economy must be the conclusion of the Uruguay Round.<sup>18</sup> Unrestricted market access to industrial country markets must be granted to post-socialist and developing countries that have liberalized their trade systems unilaterally and pinned their hopes for growth and development on an outward-looking, market-oriented strategy. The adjustment problems of ailing industries in advanced economies should be alleviated according to the motto "protect the people, but not inefficient firms", i.e. by social policies rather than structural conservation measures.

The second major contribution by industrial countries to world economic progress must be sustained fiscal consolidation. In this way, they would help contain the shortage of global savings, which might arise from the persistent capital needs of developing countries and the new demands for foreign capital in Eastern Europe. Particularly Western Europe would be confronted with a massive influx of migrants if the economic reforms in the East and the South failed due to lack of foreign capital. Here, the motto should be "jobs to the people, rather than people to the jobs".<sup>19</sup>

It is up to the post-socialist and developing countries themselves, however, to become attractive locations for foreign risk capital. Experience tells that international assistance of whatever magnitude cannot be a substitute for sound macroeconomic management, appropriate incentive systems, government credibility and political stability in the recipient countries.