Perspectives on the World Economy

By

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I. Introductory Remarks

1. The subject is admittedly very broad; it therefore requires a synoptic treatment. The broad question to focus on is this: What does past experience teach us about the prospects of world economic development in the remaining part of this century? After some preliminary methodological remarks on forecasting I shall state and then later discuss a number of propositions which I consider to be relevant lessons from the past for the future of the world economy.

2. Forecasting, surely, is necessary for rational action; yet in economic matters it is impossible except in the very broad sense of what Hayek calls "pattern prediction". The fundamental reasons are:

(i) The economic future is undetermined since it includes our own decisions in the market and in the field of economic and social policy. There is presumably no master plan of a goddess of history, and if there were one we would not be able to discover it.

(ii) Economics has not yet developed to such maturity that we know with any precision how the system works and with what result it will coordinate the decisions of hundreds of governments, thousands of organisations, millions of firms and billions of individuals and households who all have their own imperfect forecasting system and who often have very little reliable knowledge of how the system works. Note how much economists, econometricians and economic historians disagree on ex-post forecasting when the task is merely to explain how the market process actually worked in the past.

(iii) Although public choice theory has improved our understanding of the policy formation process we have no operational theory to predict changes in the policy environment, including changes in public sentiment.

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II. The Main Propositions

3. As a summary and as an introduction I should like to submit the following ten propositions:

Proposition I: The so-called "Stagnation Thesis" of half a century ago proved to be wrong on all accounts, both for the United States and the world economy. A closer look at the reasons why gives support to more optimistic perspectives for the next two or three decades.

Proposition II: The acceleration of economic growth in the advanced countries during the 1960s was bound to lead to supply bottlenecks and precipitated the economic malaise of the 1970s.

Proposition III: There are limits to economic growth as the title of the 1972 study of the Club of Rome suggests but they are social rather than physical.

Proposition IV: Economic growth continues to go along with changes in the structure of production; in the advanced countries it will lead to a further de-industrialisation and shift towards the information society.

Proposition V: This tendency helps to overcome structural rigidities and is likely to open up new opportunities for entrepreneurship and for more decentralised forms of organisation.

Proposition VI: The newly industrialising countries (NICs) in Southeast Asia and the Pacific region show a greater openness vis-à-vis the future and vis-à-vis the world economy and hence have a greater absorptive capacity with regard to foreign resources than most European-type countries in Latin America; they are, therefore, likely to catch up more quickly than the latter, but also more quickly than Japan did during the last century.

Proposition VII: Among the advanced regions of the Western World, North America and Japan are the locomotives. Europe, suffering from sclerosis, is lagging behind on the way to faster growth by – say – at least half a decade.

Proposition VIII: Real rates of interest will continue to remain high. Nevertheless, there is scope for a re-acceleration of world economic growth provided that real wages can be made to increase less than is warranted by productivity growth.

Proposition IX: The U.S. current account deficit, although temporarily helpful for solving the transfer problem of overindebted countries, will have to be transformed, however gradually, into a surplus for the benefit of world capital formation.

Proposition X: The international division of labour, inter-industry and intra-industry, remains a great source of productivity growth. Stemming the present tide of protectionism and initiating a new process of liberalisation would, therefore, shorten the transition to a process of faster world economic growth even if only a limited number of countries could be induced to participate.

4. Let me discuss and elaborate these ten points in the subsequent sections of the paper. The task is open-ended, the evidence necessarily incomplete, and there will remain ample food for thought and scope for research to substantiate alternative views.

III. The Failure of the Stagnation Thesis

5. At the end of World War II many economists in the U.S. were still so impressed by the depression of the 1930s that they believed in secular stagnation. Instead, the American economy as well as the world economy experienced a surprisingly strong acceleration of economic growth, just as capitalist development in the second half of the 19th century falsified the hypothesis of collapse which Marx and Engels had written into the Communist Manifesto of 1848. The modern stagnation thesis had four pillars and the same number of basic defects. Let me review them to spell out the lessons.

6. First: Keynes' so-called "psychological law" which postulates that consumption expenditures tend to rise less than incomes so that growth will come to an end with the saturation of final demand from private households, proved to be wrong for well-known reasons: *(i)* we have conspicuous consumption and *(ii)* there will always be product innovations for creating new wants; moreover *(iii)* in an uncertain world people have an unsatiable desire to acquire assets, financial and non-financial, including gold, for securing their livelihood and that of their offspring. What Keynes ignored was the system's openness vis-à-vis the future.

7. The second pillar was the argument of declining population growth. It made, of course, full sense only in combination with the saturation thesis. In actual fact, it was proved to be wrong by the postwar baby boom and by the population explosion in LDCs, not to mention international migration to wealthier countries and internal migration to cities.

8. Third: The supposition of a dearth of sufficiently capital absorbing innovations, made and extrapolated by the stagnationists, was already criticised at the time it originated [Terborgh, 1950] but rediscovered in a slightly different form for explaining the present stagnation as a "technological stalemate" [Mensch, 1979]. This technological argument ignored *(i)* the productivity of investment in human capital, *(ii)* competition in the production of knowledge, and *(iii)* the great potential importance for world economic growth of the international transfer of knowledge from advanced countries to those lagging parts of the world that are eager and well prepared to catch up. Although multinational corporations already existed in prewar times, their mushrooming in the postwar period and their role as vehicles for the technology transfer was grossly underestimated, to say the least.

9. Provincialism in space as well as in time was equally involved in the last of the four arguments brought forward to support the stagnation thesis: the diminishing of the American frontier, i.e. new land that had previously

offered profitable investment opportunities. How differently would the stagnationists have viewed the future had they broadened their vision to include the rest of the world economy, its re-integration through the liberalisation of trade and capital movements, and the wakening up of a capital hungry Third World?

10. In retrospect, the stagnation thesis turns out to be an attempt at explaining a Kondratieff downswing. Its fault was a misplaced emphasis on psychology, demography, technology, and geography. The emphasis was misplaced *(i)* because of the visions' provincialism in space and time and, more important, *(ii)* because of the failure to search for economic and social reasons, i.e. distortions in relative prices that were responsible for the fall and the low level of the marginal efficiency of investment. If the rewards to capital turn out to be insufficient for a level of investment necessary to absorb unemployed labour and other idle resources, then labour and other resources complementary to capital must have been overpriced (or overtaxed). And if everything is in excess supply except money as was the case in the Great Depression, then the real quantity of money is inadequate and needs to be increased, be it through price and wage reductions, be it through monetary-fiscal expansion. This leads us to the second proposition.

IV. Acceleration and Deceleration

11. Even in the U.S., which had been thought to show the characteristics of a mature economy, postwar economic growth on a per capita basis was until 1966 faster than at any other time for which figures are available [Kendrick, 1981, Table 1]. Although labour productivity started to advance less fast in the subsequent period (after 1966) U.S. real GNP continued to grow at almost the same rate until 1973 [Kendrick, 1981, Table 2]. 1973 is the watershed. This holds also for world economic growth. World production increased at an average annual growth rate of 6 per cent in the decade before 1973 and of only 2 per cent in the decade after 1973 [GATT, 1984, Table 1]. These are the facts. What is the explanation for the slowdown and for the stagnation from which the world is still suffering?

12. One answer is: accelerated growth produced important supply bottlenecks, and prices of other factors did not adequately adjust in many countries.

(i) As to Europe, the first supply bottleneck to emerge was a shortage of labour; in Europe's industrial centre the actual rate of growth started to exceed the natural rate in the 1960s, but growth could go on thanks to the inflow of immigrant labour. Europe at that time had excess capital formation and classical overemployment implying wages below the national equilibrium levels in immigrant countries. At the end of the 1960s, not unrelated to the Paris student revolt, wage levels quickly

adjusted, perhaps with some overshooting. Let me call this the revolt of labour in response to accelerated growth.

(ii) The second bottleneck to arise was that of land and natural resources, including the environment. The result was a cost push at the height of the business cycle in 1973. Its initial impact has been estimated for the OECD area to amount to 2 per cent of GNP. This cost push is often referred to as the first oil shock, a description which suggests that it was entirely exogenous and not related to the oil-intensive growth that preceded it. Although political events triggered the shock and although institutional changes of the oil market explain why the oil price was depressed in the 1960s and why it stayed excessively high after 1973, we may be well advised to endogenise this oil price hike as a delayed reaction that was combined with an overshooting. Not to everybody's surprise, it repeated itself at the height of the next business cycle in 1979.

(iii) Taken together, the revolt of land and the revolt of labour turned out to become the great cost push which brought the great long upswing to an end. Profits were squeezed, and the accumulation of capital was impaired. An accommodating monetary policy after the 1973 shock helped to reduce real interest rates and real wages in the U.S.; in Europe, where people were more inflation-sensitive, real interest rates declined very little and real wages turned out to be sticky at an excessively high level. Wage stickiness explains why Europe suffered a decline in employment in contrast to the U.S., where employment continued to expand, albeit not fast enough to prevent an increase in unemployment.

(iv) The fundamental relation between real wages and real interest rates was distorted in favour of wages; this led to classical unemployment. But as the real interest rate was depressed – to accommodate excessive wages – an excessive capital deepening took place, particularly in Europe. And as – under cost-push inflation – productive investment promised lower returns than investment in housing (where no complementary labour is needed in operating the capital equipment), too much was invested in housing and too little in creating highly productive jobs for permanent employment. As to technical progress, the distortion of factor prices in favour of wages must be presumed to have led to *(i)* a preference for labour-saving process innovations and a corresponding disregard for capital-saving paths of technical change and to *(ii)* a neglect of product innovations.

(v) Among the three centres of capitalist economic development Japan did best, while Europe turned out to be too rigid for quick adjustment. The result for Europe is "unemployment cum capital shortage" and a technological gap in product innovations, yet not in labour-saving

process innovations. By exporting equipment and transferring technology that is rather capital-intensive and labour-saving, Europe contributes to the persistence of classical unemployment with capital shortage in the less developed world.

(vi) The high real rates of interest prevailing after 1979 can be seen as a new factor impairing economic growth, but if real wages were correspondingly lower – as they apparently are in the U.S. – they would lead the world economy towards a less capital-intensive growth.

V. Socialist Limits to Economic Growth

13. In his Presidential Address to the American Economic Association in 1950, Joseph Schumpeter foresaw the "March into Socialism". What he meant was "the migration of people's economic affairs from the private into the public sphere" [Schumpeter, 1950, p. 446], implying – in Schumpeter's words – stabilisation policies, redistributive taxation, market regulation, and all types of security legislation [*ibid.*, p. 449]. Schumpeter drew the conclusion that "the stagnation thesis ... may come true after all if the private enterprise system is permanently burdened and regulated beyond its powers of endurance" [*ibid.*, p. 450].

14. Exactly this happened in many Western countries. A few facts may highlight the speed of the process.

- Between 1950 and 1980 government current revenue (including social security levies) as a proportion of GDP increased almost everywhere. The increase in percentage points over these three decades is 6 for Japan, 7 for the U.K., 9 for the U.S., 11 for West Germany, 12 for France and 22 for the Netherlands. In absolute terms Holland is the leader, Japan the least socialist among the large advanced countries on this score (figures from Maddison [1984, Table 4]).
- As to regulation, the tide is turning. However, Europe is still overregulated in those fields where deregulation has been forcefully carried out in the U.S. (trucking, airlines, financial services). Moreover, bureaucracy is conquering new fields, e.g. pollution control. Although difficult to prove statistically, redistribution as well as regulation must have contributed to stagnation by impairing the incentive system and by leading to moral hazard; we know this from casual observation.
- Finally, governments pay subsidies, sometimes thought to be a means of positive adjustment, in practice mostly turning out as a permanent dole to ailing firms and declining regions. As most of these subsidies are tied to investment, e.g. in the framework of regional policy, they certainly contributed to excess capital deepening, apart from delaying the process of "creative destruction".

- The West may have been able to afford a high degree of socialisation when the economy moved straight ahead and fast – almost mechanically – in the process of accelerated growth before 1973, but when efforts have to be doubled to master serious setbacks and adjustments, as in the period afterwards, an impairment of the people's motivation level must be considered a serious matter (as people seem to become gradually aware of in the public policy debate).

15. To conclude the discussion of this point we may say: there always have been and will be limits to growth (in the form of physical bottlenecks) but if the incentive system of the price mechanism is allowed to work flexibly and without much political and bureaucratic friction, the market will overcome or circumvent them, sometimes in anticipation and more often at least ex post. In the latter case we experience a crisis which becomes a challenge. It challenges our ability to learn and to mobilise our physical and mental reserves. Yet if physical bottlenecks arise in a phase of increasing social rigidity and unresponsiveness, the outcome will be slower growth.

VI. Economic Growth with Competitive Pressures from NICs

16. The world economy continues its process of industrialisation, but in advanced countries manufacturing has long ceased to be the fastest growing sector. In the course of the 1960s, imports of manufactured goods into the advanced countries increased fivefold, with an annual growth rate averaging more than 18 per cent up to 1973 [Balassa, 1979, p. 46]. This involved a fast substitution of imports for industrial production in these countries. It also reflects the success of export-oriented policies in a number of NICs. This trend will go on. Even in Japan, the latecomer among the advanced countries, the share of manufacturing in total employment has been declining since 1973 [OECD, 1984, p. 80, Table 15].

17. The gradual de-industrialisation of advanced countries seems to be inevitable for two reasons: The first one is the high income elasticity of demand for services in the rich countries themselves; the other one is given by the vast opportunities offered to industry in the densely populated and labour-rich areas in the poorer parts of the world, i.e. the NICs. In an integrated world economy, traditional industries will gradually migrate from the high-income areas with expensive labour to lower-income areas where labour is prepared to work harder for lower wages. Labour in the rich countries will, of course, defend its position with protectionist measures; and industry, gaining time behind high protective walls, will use the opportunity to adjust labour productivity to high wage claims by substituting capital for labour. Such defensive investment leads to what trade theorists call a reversal of factor intensities: standardised products are simultaneously produced in

countries with different factor endowments, but with techniques and factor intensities adjusted to the divergent factor endowments. An additional defensive measure in advanced countries, designed to defend existing jobs and excessive wages in the face of high unemployment is, of course, a compulsory shortening of the working week.

18. Defensive measures are no long-term cure; yet they exact a high price. Outward looking NICs need forward-looking partners among the rich countries. If the rich fail to develop new ideas and new products and processes they will find themselves overtaken by their followers once the latter, in the catching-up process, have learned enough to close the technological gap. This is why in the advanced countries the continuous production of new knowledge is indispensable for staying ahead. A rich country's average worker can hope to see his real wage increase from year to year without additional effort only if he (or she) makes himself (herself) complementary to persons and firms directly involved in producing innovations. This is why an elite is so important in highly advanced countries and why there have to be sufficiently great economic incentives to learn and to invest, to innovate and to be a first class performer for domestic and world markets. Incidentally, this also implies that the country offers and assures an atmosphere of political and economic freedom: a free market in ideas as well as in goods.

VII. Towards the Information Society in Advanced Countries

19. The trend of industrialisation in the less developed world can well continue in the future if the most advanced countries do not hesitate to move ahead towards the information society. In this respect Europe's efforts at promoting "high-tech" industries based on the microchip and at coordinating research efforts in these fields are encouraging. The French-inspired "Esprit" and "Eureka" programmes may deserve positive consideration as factors neutralising part of Europe's defensive import protection. Yet, they add, of course, to the cost of government and enlarge the scope of bureaucratic action. They may thus turn out to be much less valuable than their proponents in politics and the business community believe. In my opinion, they are definitely inferior to a more general improvement in the economic climate that would bring forth a more forward-looking social atmosphere. In large parts of Europe, new technologies still meet with great reservations, if not outright resistance, based on the fear that they might destroy rather than create jobs. This is, of course, an indirect effect of high wages, which – as mentioned earlier – distort technical progress at the expense of job-creating product innovations and capital-saving process innovations.

20. The move towards the information society will widen the scope for entrepreneurship and for individual decision making and responsibility. It will certainly offer work opportunities in numerous service occupations

which we cannot yet specify for lack of imagination and foresight. Entrepreneurship will, therefore, also be required of those who start their professional life, eager to find their own niche in the labour market. Although there will be more scope for decentralisation in the regional structure as well as in organisation, mobility and the ability to adjust will earn a high premium. This is one of the reasons why changes in the tax structure, leading to lower marginal taxes, as they are being discussed in a number of countries, would be timely to improve the incentive system for more socio-economic dynamism in the advanced parts of the world. Those who still equate progressiveness with egalitarianism rather than with sufficiently strong incentives for venturous entrepreneurial behaviour will disagree; they may change their mind once they have fully understood that the move from the industrial society to the information society is likely to involve a profound change from hierarchical organisation and collective action towards more individualism in economic performance and responsibility. In other words: if complementarity, hierarchy, and bigness are characteristics of industry and hardware production, they will recede into the background, making room for smallness, substitutability, competition, and a marginal productivity ethics within firms and in the market.

VIII. The Pacific as a Growth Pole

21. Among the three growth poles of the capitalist world, North America recently turned out to be the most dynamic, in contrast to Europe which had produced a miraculous growth in the 1950s and 1960s but which is now suffering from rigidities and a high level of (mostly) classical unemployment. Those who are skeptical about the U.S., surely with some justification because of its twin deficits in the budget and in the current account, will tie their hopes for world economic dynamism to Japan and the Pacific Basin.

22. In 1983 and 1984 Japan was able to expand its exports to the U.S. amounting to about a third of its total exports, almost twice as fast as the total imports of the U.S. increased [Bank for International Settlements, 1985, p. 98]. Japan gained market shares, even in Europe. Virtually all of the additional exports were in machinery and equipment. By means of additional imports, Japan transmitted the stimulus it had received mainly to Southeast Asia, including the People's Republic of China [*ibid.*, p. 99]. And it was mainly manufactured products that Japan additionally imported from these sources. This shows how successfully Japan and Asia have adjusted to the change in relative prices after 1973 and to technical progress, unparalleled elsewhere. The recent increase in Japan's current account surplus was almost fully matched by a net outflow of capital, i.e. portfolio investment and direct investment, the latter largely intended to counter protectionist pressures abroad.

23. The developing countries of Asia (including the People's Republic of China) had faster economic growth (4.7 per cent annually) than the countries of the OECD (including Japan, excluding Greece, Portugal, and Turkey) during the 1970s even if the oil exporters among the Asian developing countries are excluded. But Latin America (again excluding the oil exporters) performed better (6.1 per cent annually) in this competition for growth. However, its superiority was too shortlived; it ended when the U.S. moved into recession at the beginning of this decade and foreign indebtedness became the major limit to growth in Latin America. It is only after 1983 that this region has once again shown a positive growth rate – so far much below its performance in the 1970s. The developing countries of Asia, on the other hand, were able to almost completely isolate themselves from the world recession of the early 1980s; they have been growing faster than in the 1970s and faster than virtually all the rest of the world.

24. What is the explanation for this difference between Asia and Latin America? Numerous answers offer themselves, and most of them cannot be supported by numbers. The best answer – I guess – relates to openness. Latin America has strong relations to, and close similarities with, Europe. As pointed out earlier, Europe suffers from its labour market rigidities, the defensive nature of its investments, and an induced type of technological progress that strongly favours defensive (labour-saving) process innovations and neglects forward-looking product innovations. The name for this diagnosis is "Eurosclerosis". A system with sclerosis – like Europe or Latin America – can still grow if economic rents of some sort are available – like mannah from heaven – that offer themselves as tranquilisers or mollifiers in the interest groups' fight over the income distribution: *(i)* a technology rent to be gained in an export-led catching-up process, *(ii)* an improvement in the (static) terms of trade, *(iii)* a lowering of the real interest rate, *(iv)* foreign aid, *(v)* a budget deficit financed by inflation. When these rents disappear, making adjustment an imminent necessity, a sclerotic system is bound to shrink; the more so the less flexible it is. The deeper reason for the low adjustment potential is the individuals' reliance and dependence on organisations. These organisations have power to resist change, foster illusions, support attempts at finding culprits elsewhere, delay the individuals' recognition process and appear to be a barrier against the proverbial need that is the mother of invention.

25. Such a society may also be called corporatist. If it happens to come under hard constraints, the struggle over the income distribution may culminate in civil war and – as Latin American experience shows – in interim military dictatorships. One may also speak of an overpolitisation of economic life. The cure is less rather than more government, less rather than more collective action, and more rather than less reliance on individual responsibility in open markets. Alternatively, a corporatist society requires a high

preference for and a long tradition of consensus. This assessment, however subjective it may be, makes the people of Asia appear better equipped for continuous economic growth with structural change than in Latin America. This does not exclude a return to faster growth in Latin America, once the present phase of severe adjustment to high real interest rates has been successfully passed.

IX. The U.S. and the Pacific in Contrast to Europe and Latin America

26. Openness and consensus (or a good mixture of both) make the U.S. and Asia appear better suited for economic growth at this stage than Europe and Latin America. In the search for early indicators of a return to faster growth (that could be used as a basis for projections) we focus on *(i)* employment growth and *(ii)* the relative dynamism shown during the recent upswing.

27. As to employment, Europe's recent performance relative to the U.S. is embarrassing. It is true that in the 1970s employment in the EC still expanded, but it did so only slowly: with an annual rate of 0.2 per cent, only a third of the growth rate of population of working-age (0.6 per cent). This is in contrast to the U.S., where employment expanded faster (2 per cent) than working-age population (1.8 per cent). In the 1980s this performance gap has widened: an absolute decline of employment (-0.6 per cent annually) in Europe, a continued rise (0.8 per cent) in the U.S. [Blanchard *et al.*, 1985, p. 7]. To focus on employment rather than output growth as a performance indicator appears justified at least as long as employment is deficient. But even under more normal conditions, this focus has something to be said for it. When people have free access to employment they will produce the output they want, and can.

28. As to the dynamism during the recent upswing, we need only refer to the recent GATT report which deplores that the U.S. recovery had only a limited effect on Europe's overall economic performance. This in turn helps to explain the fact that the U.S. upswing hardly benefitted the developing countries in the Mediterranean and in other areas, including Sub-Saharan Africa, which are strongly linked to Europe [GATT, 1984, p.10]. It is true that in the meantime Europe's problems have been correctly diagnosed [see Commission of the European Communities, 1984], and that some governments have started to take steps in the right direction (Denmark, Germany, Holland, U.K.). But progress is bound to be slow. Judgement from the policy agenda in some of these countries leads one to the conclusion that major reforms, resembling those in the U.S. during the late 1970s and early 1980s, can hardly be expected to have their full effect within this decade. On this account, Europe is following the U.S. with a time lag of at least five years and, perhaps more realistically, of a whole decade.

29. The countries of Latin America are much more in disarray, with prospects much worse than those for Western Europe. Among them only Brazil could fully participate in the 1983 export upturn [GATT, 1984, p. 120]. In many countries, little can be expected before public sector financing has been placed on a sound basis as a precondition *(i)* for ending inflation, *(ii)* for making the price mechanism work as an efficient allocative device, and *(iii)* for improving the incentive system. But where is the political will to perform this task, where the public consensus that will allow democratic politicians to make a successful start and to carry it through?

30. While parts of Latin America are so rich in natural resources and once were as rich as Europe (e.g. Argentina), the sub-continent's image in the international business community and among investors is less bright than that of East Asia. Japan can be proud of having achieved in a hundred years what took Europe, as a forerunner, two hundred years to achieve; and South Korea or Taiwan may catch up even more quickly than Japan did in the past. The People's Republic of China, if it continues to pursue an outward-looking policy and a policy of decentralisation, could surprise us in reaching similar standards in a still shorter time span. This view is based on the observation that the people of Asia are quick to learn and that the new communication technologies, being capital-saving, will quickly find wide application and will speed up the learning process on a broad scale. China's integration in the world economy is likely to open up vast opportunities of mutually beneficial trade and allow the world economy to experience a new era of prosperity, perhaps already in the 1990s, comparable to the great boom in the two decades following World War II.

X. High Real Rates of Interest

31. High real rates of interest form the subject of many complaints. This indicates that they are one of the conditions to which the world economy still has not fully adjusted. The more people actually adjust and the more quickly they do it, the earlier will real interest rates go down substantially and make more investment projects of a given rate of return profitable, including public investments that raise the marginal efficiency of private investments. Adjustment itself will speed up growth even before real interest rates decline since, apart from reducing private and public consumption for the benefit of capital formation, it includes

- the lowering of unit labour costs to raise the level of profits, and
- the choice of capital-saving technologies which reduce capital costs per unit of output to make high real rates of interest less of an obstacle.

Needless to elaborate that the choice of more capital-saving techniques helps to reduce unemployment of the capital shortage type since it raises the number of permanent jobs that will be created with a given volume of investment. High real rates of interest thus are not a mere nuisance; they have a function to perform. And those firms and countries for which high interest rates are less of a burden because they refrained from running into overindebtedness in the 1970s will have better prospects during the present transition period than their competitors, e.g. the Latin American countries.

32. So far the real long-term rate of interest has hardly gone down during the last two or three years (see Bank for International Settlement [1985, p. 81]). In the first quarter of 1985 the real rate was about 8 per cent in North America, about 5 per cent in the EC and Japan, but only 1 per cent in Switzerland.

In North America the real rate is as much as 7 percentage points higher than in the 1970s and about 6 percentage points higher than in the late 1960s. In Japan, which had very low and even negative real rates of interest in the 1970s, the real rate is still 2.5 percentage points higher than in the late 1960s. Almost the same holds for the U.K., France, and Belgium. In Germany as in Switzerland, the decline in the 1970s was not as pronounced. Both countries now have real interest rates similar to those of the 1960s, however at a much lower rate of growth of (potential) output.

33. No doubt, government deficits are one explanation, fears of inflation are another one. If we want to probe deeper we have to ask why governments expanded and why inflation accelerated in the 1970s. Had we to find one general expression to characterise the 1970s and their heritage for the 1980s several suggestions come to mind: "populism", "permissiveness", "soft socialism", "living at the expense of the future". Schumpeter's "march into socialism" alluded to before and his "crisis of the tax state" would also give rise to the same associations. The best is perhaps to learn from Böhm-Bawerk and to say that the 1970s showed an increase in time preference, perhaps in response to the postwar baby boom, to which the rate of interest reacted with a long delay, a delay prolonged by the exploitation of money illusion in the accommodating inflation of the 1970s. Only when the accelerating inflation was forcefully brought to an end in late 1979, did the real interest rate shoot up, with a vengeance.

34. In this broad perspective, it appears that economic circumstances now are forcing governments to pursue a policy of fiscal conservatism. But this is not enough. Circumstances also require a policy of economic liberalism (in the traditional European sense of the term) which gives more scope to individual action and more emphasis on individual responsibilities. Individuals as well as governments will have to learn to respect the constraints of economic life. And if individuals want more income, they will have to demand it from themselves rather than from society. Casual observations suggest that the tide is indeed turning this way, however not without temporary setbacks.

XI. Coping with the Twin U.S. Deficits

35. The huge U.S. fiscal deficit which is a setback on the way to fiscal conservatism must be viewed as a result of failures *(i)* to cut government expenditures and *(ii)* to raise indirect taxes on consumption. It is these two failures rather than the income tax cuts that have to be blamed. In their absence, the U.S. upswing after the 1982 recession would have gone along with a greater increase in total savings and would have pulled in less capital from the poorer and more capital-hungry rest of the world.

36. Nevertheless, some temporary capital inflows would have (and should have) taken place anyhow in an upswing generated by an increase of the marginal efficiency of investment in the U.S. Moreover, higher real rates of interest than prevailed in the 1970s were due in any case in North America. But with higher savings in this area, the world level of interest rates might have been somewhat lower (although we saw that Swiss and German interest rates are back to what they were before 1970). The difference would not have wholly prevented the international debt crisis, but it might have made it a bit easier. On the other hand, we have to recognise that although "undersaving" in the U.S. was responsible for the current account deficit, this deficit also had its positive effect on the overindebted countries. In a historical perspective we see a parallel in the German reparation problem of the interwar period. Germany at that time tried hard to solve the fund-raising part of the problem, at the expense of total domestic absorption. However, it found no cooperative partner in the rest of the world for the solution of the transfer problem, i.e. a final recipient who was prepared to run a current account deficit. The U.S., as the lender of the inter-allied war financing, would have been this partner. Its refusal then to play its role surely contributed to the Great Depression of the world economy. This time, the U.S. behaved according to the rules of the game. Imagine what would have happened if real interest rates at the end of the inflationary 1970s had returned to normal levels, but with the U.S. running a current account surplus! Would we not have had a worldwide contraction instead of a debt crisis that actually has proved quite manageable so far? Apart from this, there are countries other than the U.S. which have budget deficits of similar proportions. They contribute to the worldwide capital shortage and to high interest rates, but not to the solution of the transfer problem. In contrast to the U.S., they have not produced an upswing with spillover effects; instead they benefit from an export-led upswing and run a current account surplus. Who is blaming them?

37. A winding down of the U.S. current account deficit is an absolute necessity in the medium run. Under conditions of balanced growth, rich countries ought to be capital exporters to allow poorer countries to fully develop their domestic resources in combination with complementary foreign resources: imported capital, foreign experts, imported and appropriately

adjusted technology. But in the short run, the overindebted countries must produce a current account surplus to show that they are fundamentally healthy and creditworthy, not living beyond their means but well prepared to invest, in the medium-run future, beyond their low domestic savings. At the present time, the U.S. is still considered to be an excellent debtor. When the overindebted countries have regained their standing, the U.S. will be looking less creditworthy than now. Then the time will have come to envisage an adjustment on both sides.

38. This picture leaves out Japan and Europe. Japan is and will remain a source of capital exports and will continue to run a current account surplus for supply-side reasons: oversaving in relation to domestic investment, foreign direct investment of fast growing firms for expanding their markets.

Europe still depends on export-led growth. Its major countries still have to develop a forward-looking social atmosphere and a set of relative prices sufficiently conducive to long-run autonomous investments – in contrast to defensive investments, on the one hand, and to short-term investments induced by demand, on the other hand. It is true that Europe has some excellent firms; they apparently have an unexploited potential for output growth and for foreign direct investment. However, in my judgement (which is necessarily impressionistic) they are too timid to push and too much accustomed to being pulled. Is there a role to be filled, a vacancy perhaps inherited from Europe's historic mercantilism and due to the fact that governments, once engines of productive investments in infrastructure and industry, have changed to become suppliers of social services and administrators of passing monopolies? If this is true, why has private enterprise not yet filled the gap? Is Europe in a phase of transition, characterised by excessive uncertainty about what is the duty of government and what the dynamic role of private enterprise? These are important questions; will economists supply the answer?

XII. Trade Liberalisation for Faster World Economic Growth

39. Periods of relative stagnation tend to be periods of protectionism. We experienced this in the 1970s as in the interwar period. It is part of a vicious circle process. We also know (from the experience both of the 1950s and the 1960s and of previous periods of accelerated growth) that trade liberalisation does play the same important role in a virtuous circle process. The fundamental reason is very simple: freer trade means a wider set of opportunities for mutually beneficial exchange, a greater scope for both competition and specialisation, more communication and encouraging information. Agreements among governments not to interfere at national frontiers are important for lowering the uncertainties involved in the international division of labour. They are for trade today what protection against pirates was for trade in medieval times.

40. The liberalisation of economic activity crossing frontiers is a supply-side policy par excellence. The time for a new round of liberalisation has come. Liberalisation should go along with a monetary policy designed to allow a faster expansion of demand. A concerted liberalisation would permit a concerted monetary expansion; yet no country needs to wait for invigorating its domestic resources. A unilateral monetary expansion is possible, but will afford more caution since an immediate exchange rate depreciation may lead to inflationary expectations. On the other hand, a concerted monetary expansion, apart from requiring time for preparation, may encourage monetary authorities to expand too much. A synchronised boom followed by a phase of anti-inflationary policies is not what the world economy needs after the experience of the "locomotive" strategy in the late 1970s.

41. In trade liberalisation, reciprocity is not required for economic reasons as many people think. A government can withdraw restrictions on the freedom of its citizens without waiting for other governments to do the same. It is only on political grounds that unilateral liberalisation appears next to impossible. The reason lies in the unequal representation of consumers and producers in the political arena. Liberalisation means more competition among suppliers and is, therefore, without doubt beneficial for final consumers and for those producers who use intermediate goods in production. It is true that we are all consumers; but in this capacity we have no strong interest to organise ourselves along product or industry lines. Organisations of traders are almost exclusively organisations of producers, with the exception of importers' associations. It is as producers that we have vital interests, and all producers want protection against outsiders, particularly if the latter are foreigners. Producers are nevertheless interested in liberalisation: domestic liberalisation for cheaper inputs, foreign liberalisation for better export prospects. Domestic consumers and their foreign suppliers are in the same boat; so are domestic suppliers as exporters and their foreign customers. Governments wanting to benefit domestic consumers must, therefore, find support among domestic producers by providing them freer access to foreign markets in return.

42. Reciprocity in liberalisation, necessary as it may be on political grounds, need not be universal. It can take place in groups whose members have decided to grant each other preferential treatment. The EC is such a club. Every club discriminates against non-members. If intra-club relations produce positive results, dynamic as well as static ones, they induce others to join, which involves paying the price of liberalisation. In the language of trade negotiations, such reciprocity is based on the rule of conditional – rather than unconditional – MFN treatment. Nothing can be said against it if the only condition of entry and membership fee is adequate trade liberalisation. Forming such a club which is open to others is a leadership task. From a static point of view, the situation that can be achieved in this way is imperfect at any

moment of time, but if its imperfection – the discrimination of non-members – is a dynamic force for enlarging the system (as it can be expected to be if openness is established as a rule) we can well consider it an investment for further improvement and growth.

43. Intra-European liberalisation would be high on my suggested policy agenda. Apart from trade, it should cover transportation, telecommunication, and financial services. What is at stake here is not so much allocative efficiency or X-efficiency, but deregulation of, and free entry into, markets that offer good prospects for growth. Some "free enterprise zones" in structurally weak regions should serve as test cases for demonstrating what internal liberalisation may include and what it could bring about. This appears most necessary for Europe's participation in a worldwide liberalisation round. Without quite specific information about what new opportunities are open for those workers that are going to lose their job under the pressure of import competition from the NICs, there will be little public support in Europe for freer trade in the world economy. It is true that more imports will induce more exports, particularly in a world that is hungry for capital and capital goods; but this gives little relief to those directly affected and to the politicians who compete for their votes. The argument that it is the role of entrepreneurs to discover new outlets and to attract workers to new work opportunities is too abstract to convince, particularly when profit expectations are not very bright and where regulations of all sorts must be suspected to be severe barriers to entry, among them measures to subsidise and to protect the ailing industries themselves.

XIII. Conclusion

44. In conclusion let me summarise: the world economy can be made to move again, perhaps not as fast as in the phase before 1973. But to this end many efforts, now absorbed in counterproductive distribution quarrels and in actions to defend indefensible positions, will have to be redirected in favour of future-oriented activities in markets that ought to be open. Economics can help in supplying the necessary orientation. Such orientation requires less than forecasting in positive economics, which has achieved scientific dignity. It is merely a kind of "normative pattern prediction" but perhaps not very much less useful.

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