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1992: The End of the Line for the Current World Economy

Lester Thurow  
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United States with its Monroe Doctrine, and the Soviet Union--where each block aimed at reducing trade with the other blocks to the lowest possible level. Eventually the different blocks formed the basis for choosing up sides to fight World War II.

Trading blocks, however, need not be seen as a disaster. If we aim at managing trade between the blocks and not eliminating it, they may in fact be a vehicle for making the world grow faster than it is now growing. They may also be a necessary intermediate step on the way to truly integrated open world economy.

### TWO PROPOSITIONS ABOUT THE WORLD

- (1) Any organization of world trade, if it is to be successful, must be seen by all of the participants as something that makes them a winner-- something that allows them to grow faster than they would grow if they were not a player. If any country sees itself as a persistent loser, it will simply withdraw and go it alone.
- (2) The world is shifting from a single polar economic world where the United States was paramount to a multi-polar world where there are three relatively equal poles--the United States, Europe, and Japan.

Where the United States was much richer than the rest by the late 1980s in terms of per capita international purchasing power, it is just one of a number of relatively equal countries. As America's position shifted from one of effortless economic superiority to one of equality, its share of the world's GNP

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Since 1945 the world has been slowly but persistently moving toward an ever more integrated world economy. The very success of this trend, however, has undermined its very existence. What was possible in a single polar economic world centered around the United States becomes impossible in a multi-polar economic world where Europe, Japan, and the United States are economic peers.

In the next decade the world will be evolving toward three trading blocks-- Europe and some associated ex-British and French colonies, the United States and the rest of the Americas, Japan and the Pacific Rim--with the trade between these blocks being more accurately described as managed, rather than free, trade.

The shift in direction springs from a simple problem. What independent countries would have to do to make an integrated world economy work in a multi-polar world is simply beyond what they are prepared to do. Fiscal and monetary policies have to be coordinated. This requires yielding more economic sovereignty than anyone is prepared to yield. Each country's economic operating procedures have to be harmonized--organized in similar ways. No one is prepared to make the changes that this would require.

To use the words "trading blocks" is to summon up images of disaster. In the 1930s the world split into trading blocks--the British Empire, the French Union, the German Grossraumwirtschaft, the Japanese Co-prosperity sphere, the

fell from more than half to less than a quarter of the world's total.

This is a favorable development--even for Americans. It is, in the long run, better to live in a world where others are equally wealthy--even if one is occasionally envious.

But the very successes of the past make future evolution along the current track impossible. Economic arrangements that work in a single polar world simply do not work in a multi-polar world.

### THE SHIFT FROM WIN-WIN TO LOSE-LOSE

In the more than four decades since World War II, everyone played a win-win game. Imports that looked small to the United States (3-5% of the GNP) loomed large to the rest of the world because of America's giant relative size. Export opportunities were abundant for anyone who wanted to sell in the U.S. market.

These opportunities did not threaten America's economic position since it could easily export whatever was necessary to balance its international accounts. America could grow farm products that the rest of the world could not grow, it had raw materials the rest of the world did not have, and it could manufacture unique products the rest of the world could not technologically build. America's exports did not compete with products from the rest of the world. They filled gaps the rest of the world could not fill.

Everyone could be a winner. Foreigners could conquer American markets, but Americans did not care since they had unique non-competitive markets where they were supreme. Americans did not need to protect their own domestic markets or conquer existing foreign markets. If foreigners conquered rich American markets, this merely reinforced America's position as an economic and military superpower. Foreign successes contributed to American dominance.

Because of its size America could also serve as a locomotive for the world economy. Whenever the world threatened to sink into a recession or was growing too slowly, the U.S. could use its fiscal and monetary policies to stimulate demand--benefiting both American and foreign producers. With an American locomotive and American market opportunities, the world economy performed as it had never performed before.

The net result was win-win. America grew rapidly. The rest of the world grew even more rapidly. Everyone like the system since they would have performed much more poorly without the system.

But that very success converted a single polar world into a multi-polar world. The American locomotive gradually became too small to pull the rest of the train. A non-competitive export-import environment gradually evolved into a competitive export-import environment. The green revolution both in the developed and under-developed world destroyed U.S. markets for farm products. America shifted from being a large exporter of raw materials such as oil to being a large importer, and unique manufactured products that the rest of the

world could not technologically build disappeared as they caught up.

To balance its international accounts the U.S. had to conquer foreign markets and repeal foreign conquerors. To maintain its role as world locomotive the U.S. had to go ever deeper into international debt--sell off ever-larger fractions of its assets. With imports almost twice as large as exports, there were simply many more American losers than American winners.

Abroad the faltering U.S. locomotive led to much lower growth rates in Japan, growth rates so low in Europe that unemployment reached levels inconceivable just a few years earlier, and to negative growth rates in much of the debt-ridden Third World.

Meanwhile, the ever-lower dollar necessary to balance American exports and imports threatened the existence of whole industries abroad. Foreign firms faced losing their American markets, a market where they often sold more than they sold at home. Lower American wages would inevitably put downward pressures on Japanese and European wages.

What had been win-win from both the American and foreign perspective increasingly looked like lose-lose from both perspectives. In response slowly but surely the part of international trade that was managed by government agreements started to rise.

REQUIREMENTS OF A MULTI-POLAR INTEGRATED OPEN WORLD ECONOMY

To work a multi-polar integrated open world economy requires fiscal and monetary coordination among the major countries, in this case West Germany, Japan, and the United States. A common locomotive is needed and it can only be provided if the major countries stimulate or restrict their economies in unison.

There is no doubt that coordination can work. The world has just witnessed a demonstration of what can happen if coordination is possible. In 1988 almost every developed country will grow faster than it did in 1987, faster than it was predicted to grow in September 1987, and much faster than it was predicted to grow in November 1987. The coordinating event was, of course, the stock market crash of October 1987. In the aftermath of that crash every government envisioned its economy in a recession and all took prompt action to stimulate. In concert the stimulation worked. Much like a Ferrari when the accelerator is depressed, forward movement was almost instantaneous. In normal times, however, with uncoordinated feet on both brakes and accelerator, not much happens.

"Coordination" is one of those words that is easy to say but hard to do. For it means that each country must do things that

it does not want to do. If they wanted to do it, it would be unnecessary to ask for coordination

The current environment coordination requires the U.S. to balance its budget to lower world interest rates. Americans want neither to raise taxes nor cut government services. The West Germans must grow much faster over an extended period of time but they don't want to grow faster and suck in hundreds of thousands of guest workers. The Japanese must balance imports and exports with more imports but they don't want to hurt the domestic industries that must be harmed if imports are to rise by the tens of billions of dollars necessary to balance international accounts.

To work, the world economy needs stable currency values. No one will make the capital-intensive investments that are necessary for long-run rapid growth if fluctuating currency values make it impossible to determine where such heavy investments should be made to insure long-run profitability. Stability can be gotten from a dominant currency in a single polar world but requires monetary coordination so close in a multi-polar world that one might just as well have a world currency and a world central bank. Yet no one is about to give up their own central bank and replace it with a world central bank.

For the last decade the major countries of the world have demonstrated that they will not, except under very special circumstances, coordinate. This reality is not about to change.

A multi-polar open world economy also requires micro-economic harmonization--a level playing field. In a single polar world harmonization isn't

necessary since the very asymmetries of the relationship between the dominant country and other countries provides the sources of gain. No level playing field is necessary to prevent the charge of "foul."

Some of the necessary harmonization relates to government rules and regulations such as taxes but much of it relates to differences in the traditional ways in which business is done. Non-governmental non-tariff trade barriers must also be eliminated.

Regulations such as those governing anti-trust and banking cannot be left to each country. Japanese business groups with their interlocking ownership can hold monthly meetings to plot strategy in both the Japanese and American markets. American CEOs holding such a meeting would find themselves all in jail regardless of whether they were talking about the Japanese or the American market. But the opportunity to work out common

strategies of conquest in home or foreign markets cannot be permitted to only one side.

The German industrial system with pivotal bank holdings creates an economy where it is much more difficult for Englishmen to buy German firms than it is for Germans to buy English firms. Similarly, the very different Price/Earnings ratios in the Japanese stock market make it practically impossible for anyone to buy Japanese firms but financially easy for Japanese firms to buy almost everyone. If countries are not to feel like losers and withdraw from an open world economy, the ability to engage in hostile takeovers to acquire foreign assets must be roughly symmetric.

If distribution systems are owned or controlled by producers in one country (Japan), but open another (Holland), one set of exporters finds it much easier to get his products on store shelves than another. Phillips complains that for this reason it does not have equal access for its consumer products in Japan.

Labor practices likewise must be roughly similar. In an open world economy the high minimum wages of Europe are threatened by the low minimum wages of the United States. Long European vacations similarly are not viable given short vacations in the Pacific Rim. Production simply moves to those parts of the world where such benefits don't have to be paid thereby forcing such benefits to be eliminated.

In an open world economy everyone has to be willing to live with "factor price equalization"--a technical economic term but easily grasped. If you are

no more skilled than a Korean, have no more capital than a Korean, and work with no more technology than a Korean, then you will work for a Korean wage. Under the pressures of factor price equalization, the real wages of American non-supervisory workers have fallen 8 percent from their peak (1 percent in 1987) despite a growing economy.

Similarly, factor price equalization requires that if you are in the car business and Mr. Honda is willing to work for a three percent rate of return on capital that he has been willing to work for in the 14 years since Honda went into the automobile business, then you must be better at producing cars than Mr. Honda or be willing to work for the same three percent rate of return on capital. And if real interest rates are above that level in the credit markets where you borrow, then you have no choice but to close down.

It does not take profound analysis to understand that a profit-maximizing American firm interested in the after-tax returns on capital assets will most of the time lose out in the long run to a Japanese firm interested in maximizing value added (the difference between selling revenue and the costs of purchased materials and components).

Harmonization means that the Japanese must shift to the American system or that the Americans must shift to the Japanese system. Either would require major changes in the standard ways that Japanese or Americans do business.

Just as desired personal lifestyles differ from country to country so do desired economic ways of life. But they cannot differ in a multi-polar

integrated open world economy. To make the Common Market work as a real common market it must harmonize governmental and social non-tariff barriers. What is true for Europe is true for the entire world. Free trade is a real common market that requires just as much coordination and harmonization.

**THE BOTTOM LINE**

**FACT: An integrated open multi-polar world economy cannot be made to work without macro-economic coordination and micro-economic harmonization.**

**FACT:** Countries are unwilling to coordinate their macro-economic policies and don't want to harmonize their micro-economic ways of life.

**RESULT:**The movement toward an integrated open world economy has come to the end of the line.

### **A PRECIPITATING EVENT**

The integration of the EEC in 1992 will be the event that destroys the post-World War II movement toward a more integrated open world economy, but it should more accurately be seen not as a causal event but as a precipitating event. It will just make visible and speed up what would have occurred anyway.

In 1992 Europe must harmonize its non-tariff barriers. In the process it is going to become a much more restrictive market.

Consider the market for automobiles. The French strictly limit, the Italians essentially prohibit, and the Dutch freely permit the sale of Japanese cars. What are to be the common limits on Japanese cars after 1992? The rules will not be the Dutch rules, the average of the dutch and Italian rules, or even the French rules. They will be the Italian rules. The Italians

will insist. And everyone else will explicitly or implicitly support their stubbornness.

It does not take a European automotive genius to note that on neutral turf--the American market--the Japanese have scored what in boxing terms would be a TKO. Fiat and Renault have been driven out of the U.S. market completely. Volkswagen's market share is approaching the point where it will have no choice but to leave, and the market shares of upscale European producers such as Audi, Mercedes Benz, and BMW are rapidly eroding as the Japanese competition moves upscale. What the Japanese can do in America they can, if given a chance, do in Europe.

Any first-class observer also notes that the Japanese are building more production capacity in the U.S. than they can possibly use in America. Europeans may find it easy to keep Japanese cars out of the United States but they will find it much harder to keep American-built Japanese cars out of Europe. If they do so, Europeans will jeopardize their current market for luxury car exports to the United States and shake their military alliances with the United States. What looks like a Japanese-European fight will quickly become an American-European fight.

Beneath the current euphoria about 1992, where everyone talks as if they will be a winner, there must at this moment be a set of studies underway. Each company is asking its experts to determine whether it will be a winner or a loser in 1992.

If one looks at the distribution of firms in the United States and compares it with the existing distribution of firms in Europe, about one-third of these reports will come back with the conclusions that the firm commissioning the report will be a winner and two-thirds will come back with the message that the firm will be a loser.

If one looks at the distribution of economic activity in the United States, it is also likely that large areas will be losers. Some American states are empty and others have per capita incomes half the national average. Two-thirds of America's 3000 counties are losing population. In a common market with free labor mobility, workers must move to the most dynamic areas; economic activity seldom moves to where the workers are currently located.

When these reports are completed, the losing firms and areas will go to their governments or to the Common Market directly and demand redress--compensation. But from whom is the compensation to be gotten? Why, from outsiders, of course--that is by far the easiest political course.

Europe has harmonized in one and only one area, agriculture, and this is exactly what has happened. As far as outsiders are concerned the situation after harmonization is far worse than anything existing in any individual country before harmonization.

Foreign export markets in Europe after harmonization are going to be much smaller than before harmonization. This would be somewhat true in the best of cases (lowering barriers among insiders always raises the effective barriers on outsiders) but what will happen will not be the best of cases. If the history of the common market agricultural policies teaches any lesson, it teaches outsiders to expect the worst.

When foreigners charge "Fortress Europe," Europeans counter with the argument that they are only interested in reciprocity. It is important to understand that although the two terms sound very different, they are in fact identical.

Consider the ability of foreign banks to enter the Common Market. Under the doctrine of reciprocity, Europe can keep American banks out of Europe on the grounds that many American states do not permit interstate banking. If a European bank does not have access to all of America, an American bank cannot have access to Europe. Similarly, America does not allow banks to own shares in industrial firms. If European banks are not to have that privilege in America, then American banks cannot come to Europe where every bank has such rights.

Similarly, the Japanese cannot have access to the European retail system unless the Japanese are willing to change their current system where producers often control access to the retail market.

What are reciprocal subsidies? Europeans argue that direct Airbus subsidies are equivalent to indirect American subsidies that come via the Defense Department despite the fact that Boeing has no contracts for military airplanes. Often, but not always, they are of course right. The Defense Department investments in Sematech (a government-backed consortium to improve semiconductor production capabilities) has no military purposes. It is clearly a civilian industry policy hiding out as a military necessity designed to combat the Japanese.

What does one do with Japan where the whole distinction between public and private has little meaning? Are participating bonds investments equivalent to European state ownership or are they subsidies not to be permitted? Is holding down the real rate of interest on postal savings account a violation of reciprocity or merely a legitimate policy to stimulate economic growth?

There are no technical answers to these questions. Reciprocity could mean an open market or it could just as easily mean a closed market. In fact it means a closed market. Repeatedly in my trips to Europe I hear over and over again, "We are not going to let the Japanese do in Europe what they have already done in the United States." But as the automobile illustrates, separating the treatment of Japan from that of the United States is not going to be easy. One cannot keep out Japanese products without keeping out Japanese-American products. But where is the dividing line between American

and Japanese-American products to be found?

Europe does not want to operate under the harsh dictates of factor price equalization. It does not want to give up its economic way of life--its long vacations, its high minimum wages, its generous social welfare system. **Given these desires it has no choice but to isolate itself and not give to outsiders what it gives to insiders.** Harmony within Europe is going to be difficult enough without worrying about outsiders.

Since neither Japan nor America will be willing to change their economic way of life and adopt the post-1992 European economic way of life (whatever that is), 1992 is going to force the realization on everyone that the idea of an integrated open multi-polar economy is an idea whose time is past.

Europe will be blamed for the failure but in fact no one on either side of the Atlantic or Pacific is willing to do what would have to be done--change a majority of their standard operating procedures to bring them into harmony with the other two great polar blocks. For given the reality of two other equals, no one could expect to play this traditional economic game more than one-third of the time. Everyone would have to be prepared two-thirds of their economic way of life.

No one is prepared to do so.

### **A WORLD OF TRADING BLOCKS**

While economists always speak of trading blocks as if they were the ultimate

disaster, they need not be so. Interblock trading will be managed by governments, but they need not aim at eliminating it. There are real comparative advantages to be taken advantage of between blocks that will not require changes in lifestyles.

The economic losses from foregoing some of the advantages of comparative advantage are apt to be much smaller than economic descriptions would lead one to believe. The axiomatic advantages of free trade flow from the assumption that human welfare is dependent upon one and only one variable--the consumption goods and services that one can buy. In fact many other economic factors, such as the nature of one's job, contribute to human welfare. Man is a producing as well as a consuming animal. Economic welfare is quite rationally sacrificed to by other goods such as a more egalitarian society.

The axiomatic advantages of free trade also assume that full employment can at all points be maintained and that transition costs do not exist. In fact few countries have successfully maintained full employment in recent years and the transition costs of moving human and physical resources from one industry to another in response to the vagaries of world trade are often enormous.

This is especially true if one is dealing with man-made comparative advantage--the dominant form of comparative advantage in the modern technological age. The comparative advantages constructed by any one set of humans can presumably be duplicated by others. If interblock trade is managed even half intelligently the comparative advantages that automatically flow from

differences in natural resource endowments or difference in factor proportions can be maintained.

If greater degrees of block macro-economic coordination and micro-economic harmonization emerge than would be possible if the entire world had to coordinate and harmonize, then the real economic gains within blocks will undoubtedly swamp the hypothetical gains from an integrated open world economy.

Put bluntly, the world might grow faster with blocks than without blocks--it could hardly do worse than it has done thus far in the 1980s. An optimist might in fact say that continental free trade is in fact a necessary step to world free trade.

Rather than quarreling about which block is the most restrictive and hence causing the world to move toward trading blocks far better than accept the reality of trading blocks and get on about the job of understanding how we might manage trade between the blocks so that it doesn't deteriorate into the negative-sum games of the 1930s.

The best, especially when it is both impossible to obtain and not obviously that much better, should never stand in the way of the good.

Let us raise a toast to the success of trading blocks.