Global Economic Growth or Local Economic Growth around the Globe: The Contribution of the G7

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I. Introduction

A few months ago, many in academia and – more frequently – in politics have expressed high-flying hopes that there lies a new economy before us. In mid-2001, the forecast are increasingly pessimistic, as the short-term growth perspectives in industrialised economies have diminished and stock prices in the respective areas (NASDAQ, New Market in Germany and the like) recently have fallen significantly. Does this imply, that the New Economy does not exist at all or that its time has passed? To answer this question, one should know what the phrase New Economy actually implies. In fact, there is no clear, single definition. Rather it is one of those concepts many of us are uncertain about. Some say that the 'Old Economy' represents things that, when you drop them on your feet, it hurts, whereas in the 'New Economy' it does not. This definition focuses on a certain industry, namely the IT sector. The latter still is a broad area as one can see when looking at the variety of firms represented by the NASDAQ. However, in my opinion, this definition has flaws. A new technological development or a new industry does not suffice to represent the New Economy. Too many New Economies of this kind have emerged and lost their importance over the past century. Instead of New Economy, this concept should rather be called Next Economy.

Interpreting the New Economy as a somehow new path of macroeconomic development (*Freytag* 2000, *Stiroh* 1999) rather than as a new industry, seems to be more promising as such a perspective can offer economic policy options. Therefore, in our view the phrase New Economy simply implies that the economy grows more rapidly and with lower inflation rates than before, possibly associated with less volatile business cycles. This definition reflects that for a New Economy to exist, there has to be a qualitative shift. How does a thus defined New Economy emerge? At least three factors contribute to such a development: information technologies, globalisation and appropriate economic policy. Especially the latter will be of importance for this paper, in which two questions are addressed: First, we will assess whether growth – in particular in the New Economy – is a global phenomenon, which demands for global action to be fostered. Second, the possible contribution of the G7 to growth in a global context will be discussed.

II. IT, Globalisation and the New Economy

In this section, two external factors, which can contribute to the New Economy, i.e. to higher rates of economic growth world-wide, are discussed. These factors are information technologies and globalisation. Information technologies and their applications such as electronic commerce can be defined as ubiquitous technologies (*German Council of Economic Experts* 2000, pp. 182ff), being applied by all sectors of the economy. As a consequence, one can hope that the general application of these technologies will increase productivity and flexibility in all sectors of the economy. There is a potential for increasing rates of economic growth.

Globalisation is strongly correlated with the emergence of information technologies. It is a process fuelled by new technological developments and political action, mainly within an international framework. The interesting feature of globalisation as compared with the elder concept of internationalisation is that globalisation implies the increasing interactivities of individuals around the world. Today, it is easily possible for individuals to communicate with one another all over the world without asking for permission. Some products, namely digital products such as music, books (written texts) and financial services can be traded online without any barriers. Thus, globalisation and IT offer an enormous potential for mutually beneficial trade and exchange. Recent research by development economists has displayed a potential of new IT for leapfrogging in developing countries (e.g. *Hiemenz* 2000).

However, besides creating these enormous economic opportunities, globalisation combined with IT exerts heavy pressure on all factors of production and demands adjustment both in the industrialised and industrialising worlds. Increasing competition drives some domestic firms into bankruptcy, resulting in job losses. In particular, the entry of the developing and transition countries into the international division of labour enhances the competition in labour-intensive goods. Consequently, less-skilled labour in industrialised countries faces fiercer competition and the prospect of falling real wages. If North-South trade intensifies, there will indeed be greater wage pressure on low-skill jobs in the developed world. However, the division of labour between industrialised and developing countries has another new facet: in addition to traditional trade in so-called Heckscher-Ohlin goods – trade depending on differences in factor endowment – there possibly is an increasing share of trade in IT applications. In the industrialised countries, this exerts even more pressure on the factors of production. Much is at stake, but much more is to gain. Therefore, economic policy directed at supporting economic growth is becoming increasingly difficult.

To benefit from these new opportunities, the developing countries have to create the foundations of the New Economy. First, they have to install a stable micro- and macroeconomic environment (in German: Konstanz der Wirtschaftspolitik), which enables individuals to make long-term dispositions and commitments. This is an old and evergreen challenge, to which only in a few countries all over the world a satisfying solution has been found. Second, to make better use of IT, a certain infrastructure consisting of adequate human and real capital is required. The G8 has shown its willingness to support the developing countries in facilitating the increasing use of IT, as well as in the rule-setting process by formulating a declaration of purpose called the "Okinawa Charter on Global Information Society".[1]

III. Is Growth a Global or a Local Phenomenon?

Economic growth is a long-term phenomenon, which depends on supply side factors. It can be observed globally, and a rate of global economic growth can be calculated. Thus, some argue that in a globalised world, economic problems should be solved globally. In this small section, we briefly summarise the main line of argument for the case that growth is a primarily local topic, which is influenced by local policies and has effects on local actors. Due to global competition however, there are interdependencies between different localities.

Following *Herbert Giersch* (1979), economic growth takes place in time and in space. As for time, a *Schumpeterian* framework is chosen explicitly focusing on disequilibrium, on dynamic competition, spontaneity and the like. Regarding the aspect of space, we can refer to *von Thünen* and his concentric circles around one centre. In the centre, there are scale economies in the supply of both public and private goods as well as congestion costs. The more distant a spot from the centre, the less economic activities emerge and the lower is the income. In *Giersch's* perspective, the world consists of several income cones. The centre is the top of the cone, as the income per capita there is the highest, and it declines depending on the distance from the center. An empirical example for an income cone is the Ruhr area in North Rhine Westphalia in the 1960s. Per capita income on the continent declined in all directions with the distance from this centre.

Among the causes of economic growth, human capital as well as investments in the real capital stock play a major role. Human capital enables the individuals in the centre to create knowledge and new products and production methods. Both forms of capital are scarce in a global context. Their scarcity differs among countries and regions. In the centre, they are accumulated and, therefore, less scarce than in the periphery. Nevertheless, the periphery – having a higher marginal efficiency of capital (MEC) – can attract human and real capital. In other words, the differences in MEC between equally distant locations are – generally speaking – caused by local economic policy differences. These are relevant both on the micro level and the macro level. The policy instruments, which are employed to diminish scarcity in human capital and physical capital, contain regulations, fiscal policy, monetary policy, trade policy, education policy

[1] For a critical analysis of the Okinawa Charter see *Freytag* and *Mai* (2001).

and the like. In other words: to create the foundations of the New Economy, economic policy must allow for a quick and flexible response to new challenges on the markets for goods and services. *Schumpeterian* behaviour must be allowed for and should promise a good return.

If local economic policy has flaws, the income cone is dented and the income per capita is lower than possible. The location does not attract enough capital (both human and real) to fill the gap. Local (or national) economic policy, therefore, is economic policy in a competitive environment. Locations compete for scarce mobile production factors in order to enhance the employment opportunities of the interregional immobile factors. The more capital they attract, the better are the prospects of individual localities for employment and growth. As a consequence, economic policy is a process of trial and error which is comparable to the *Schumpetarian* process of creative destruction. A government always has to fear that its competitors find new tools to attract more capital than before and drive it out of the own country.

Although growth rates in different regimes are increasingly interdependent through global competition, global growth as such is a statistical artefact. It is the weighted aggregate of all the local growth taking place around the globe. As such, it is not a meaningful concept for economic policy. It does not make sense to aim at a certain global rate of economic growth. In addition, given the competitive nature of economic policy, a globally installed growth policy is economically senseless. To summarise, economic growth is not a global challenge demanding for global answers. Nevertheless, it makes sense to look for the adequate policy for the world to properly prepare itself for the New Economy and to foster economic growth globally, i.e. everywhere on this planet. Apart from national governments, there may be a role for the G7. What can the G7 do to enhance growth on a global scale?

IV. The G7's Contribution to Growth around the Globe

Competition is not identical to laissez-faire. Rather, it needs rules. Otherwise, there may be cartels and collusive behaviour. This holds for enterprises as well as for governments. The G7 is a powerful institution, which is able to enormously influence the way rules are set, perceived and enforced. Therefore, it should be very careful and responsible when setting the global rules for economic policy. From a normative economic perspective, the options for the G7 to contribute to world-wide economic growth can take two directions:

First, the G7 should refrain from all those measures and actions likely to reduce global growth by giving wrong incentives to individuals and governments. Among these measure, three fields of action are prominent:

avoiding beggar-thy-neighbour policy on foreign exchange markets, avoiding unfair trade practices such as anti-dumping tariffs and socially or environmentally motivated protectionism. *Second*, the G7 can take steps to directly and actively facilitate growth at home. These steps include domestic structural reforms, stable monetary policy, encouraging the WTO to further liberalise international trade and to foster a reform of basic international organisations (IOs). In the following, we briefly show the economic rationale of these suggestions. We start with the first directions, suggesting what to avoid:

- Currently, beggar-thy-neighbour policy does not seem to be considered seriously as a policy option among G7 members. However, the downturn of the business cycle observed since the end of 2000, may be a temptation for governments to break the rules and to promote domestic economic activity by manipulating the exchange rate towards the major trading partners. In particular, a further slowdown in the US may cause friction between the US and the EU because of the undervalued Euro. Unfortunately, neither the Fed nor the ECB are responsible for exchange-rate policy (*Theuringer* 2001).
  A beggar-my-neighbour policy can be dangerous for three reasons. First, it creates bilateral tensions and domestic distortions. The G7 countries themselves loose by it. Second, other countries also may loose due to international spillovers. In addition, it may reduce international discipline and, thus, have a negative image effect. Other countries may feel embarrassed and react e.g. by raising trade barriers. The international economic climate may then seriously suffer. What was meant to be beggar-thy-neighbour policy, could result in what the literature refers to as beggar-thyself policy.

- In 1999, the G7 agreed on supporting the debt relief scheme for 41 poorest countries (the so-called Highly Indebted Poor Countries = HIPCs) established by the IMF and the World Bank.[2] The initiative was a response to high public pressure and does not seem to have caused an increase in development in the supported countries so far. There are only a few arguments in favour of debt reduction schemes (see *Dluhosch* 2001, pp. 85ff), but one very important and empirically valid against it: moral hazard. The countries subject to former debt reduction plans did not make the appropriate use of the aid, but became subject of the next round as they did not change their economic policy and focus on growth. The reason for this behaviour was that there was no credible commitment of the donor countries that there would be no further help for those abusing the relief. This pattern is – in contrast to the help –

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[2] See also IMF (2001) and *Bayne* (2001).

sustainable. Thus, the G7 should make clear that it is no longer willing to relieve debt in the future.[3] This leads to a much more promising and fruitful approach: aid by trade.

- Time and again, industrialised countries try to prevent competition from developing countries by imposing new trade barriers against the latter. In particular, anti-dumping measures have gained much importance in recent years. The EU and the US use this instrument widely. Apart from domestic distortions caused by anti-dumping legislation, e.g. a cartellisation of domestic markets (*Messerlin* 1990), this policy impedes development in the LDCs. A G7 initiative to gradually abolish anti-dumping legislation as well as safeguard clauses aiming at abandoning Articles VI and XIX, GATT, would be most valuable.
  On the same token, newer efforts to introduce social and environmental clauses into the multilateral trade framework, have to be judged very critically from a development point of view. In the first place, they can be seen as a trial to impose the G7's preferences on developing countries. There are good reasons to suppose that social and environmental protection are superior goods emerging with higher per-capita income. There are also good reasons for a positive link between trade, growth and social as well as environmental protection. In other words, to prevent trade for the sake of social and environmental protection is a contradiction in terms.[4] Thus, it cannot be ruled out that all claims to help the poor with social and environmental clauses are not more than veiled calls for protection (*Curzon-Price* 2000).

These are the most important policy measures to avoid for the G7. If the G7 countries managed to refrain from these and to reverse the discussion about trade policy, they would not only help the poor, but also foster domestic economic growth. In addition, there are a number of steps to be taken by the G7 to spur domestic economic growth, as the following remarks show. If growth rates in G7 countries rise, the abundance of capital to be invested in the periphery also increases.

- In most G7 countries, the economy is heavily in need of structural reforms. This has been emphasised by economists as well as by IOs analysing economic policies in G7 countries including the European Commission. For instance in Germany, the labour market design calls for a refurbishment to lower long-term unemployment and to allow for more competition. However, instead of taking the necessities of a

[3] Needless to say that it has to comply with the 1999 commitment.

[4] This does not rule out preventing child labour and other forms of exploitation if possible. However, it would be naive or unfair not to point out its opportunity costs (*Solow* 2000).

globalised world into account, the German government has recently pushed through a reform of the Industry Constitution Law, which has the tendency to even increase the – already strong – corporatist elements in the labour market. There are plenty of other examples, in particular in Continental Europe.

Such reforms will – after an adjustment period, making them politically unattractive – not only foster economic growth in the respective countries, but also lead to higher demand for goods from the developing world in G7 countries and, even more important, may function as a blueprint and encourage developing countries to copy them.

- A second task for G7-countries is to maintain macroeconomic stability. In the last decade, inflation has been on a historically low level, which was not only a benefit for the G7 countries themselves, but also helped with the disinflation processes in developing and transition countries. A number of the latter fixed their currency to the us-dollar or the d-mark (euro) via nominal anchor or currency board or even dollarised (eurorised). Most of them were able to import stability. There can be no doubt and it has been shown empirically that stability is positively correlated with economic growth; in other words: inflation is costly in terms of growth rates (*Barro* 1995). Therefore, the G7 has to stay on the stability track, which does not exclude a rethinking of monetary policy in the age of globalisation along the lines, *Paolo Savona* (2001) discusses.
- Another active policy program is directed at further trade liberalisation. This includes the serious compliance with the results of the Uruguay Round, i.e. the reduction of agricultural protection as well as the complete abandoning of the barriers to trade in textiles and apparel imposed by the multifibre agreement. It should also contain an initiative to start a new round in the next few years, which takes into account the wishes of developing and transition countries even more than the Uruguay Round. In particular, the G7 should make clear that social and environmental clauses are not suitable to foster development.[5]
- Finally, the G7 should play an active role in the process of reforming the IMF and the World Bank. These remarks are not meant to provide detailed plans on how to organise these institutions in the future. There have been made many suggestions, the most ambitious being the recommendations by the *Meltzer*-Commission (*Fratianni* and *Pattison* 2001).

[5] As mentioned earlier, they are unlikely to even meet the objectives aimed at with the clauses.

V. Conclusions

Although economic growth takes place locally and is dependent on local (national) economic policy, there is a high potential for the G7 to enhance it on a global level. This does not imply an activist, discretionary global macroeconomic policy co-ordination and ad-hoc measures, such as the politically attractive, but economically useless debt reduction scheme for poor and deficiently performing countries. Rather, there is good reason for activist policy on a global scale to be growth diminishing as it depresses policy competition.

The G7 mainly contributes to global economic growth through a solid, growth oriented domestic economic policy. The G7 countries should be completely selfish in the sense that their policies are directed to improving the economic performance in the G7 countries. These include structural reforms, trade liberalisation, stability oriented monetary policy and the like. As a side effect, growth potentials elsewhere are raised as markets are opened, purchasing power and, therefore, demand in G7 countries are increased and competition is spurred. If the G7 countries do their homework properly, the prospects of a New Economy as defined above, are bright – despite the latest downturn of the business cycle. The world still can make good use of the combination of appropriate economic policy, global competitive effects and IT.

The economic analysis seems to be straightforward. There is widespread agreement about the general direction – not necessarily about the details – economic policy in the G7 has to take at the beginning of the 21st century. However, political economy reasoning shows as clearly where the difficulties are, when transferring an appropriate theoretical policy suggestion into practical politics. It seems appropriate that both theorists and practitioners will pay more attention on the political economy of the G7 in the future.

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