The State of *Globalization*

A European insider surveys the scene.

BY JÜRGEN STARK

What has changed about the global economic structure since the early 1990s? An increasing proportion of economic activity is market-determined. Within a period of only fifteen years, major centrally planned economies have turned into market economies and several strongly regulated emerging market economies have implemented radical reforms.

All of this has stimulated very strong and ongoing growth dynamics. Consolidated and internationalized competitive conditions have ensued, continuously requiring adjustment from all economies. This challenge is accompanied in many advanced economies by demographic changes which require additional efforts.

Under realistic assumptions, the United States and Asia will remain the centers of gravity of the global economy in the coming years. However, without changes in the conduct of economic policy, this would also mean that the existing global current account imbalances would become even more pronounced, with an increasing risk of sudden exchange rate and financial markets movements.

Moreover, enormous challenges increase the vulnerabilities connected with current global imbalances. Changes in the global economic structures in the wake of globalization are particularly important. Production processes can be regionally

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fragmented to a greater extent than ever before. The number of tradable goods has risen sharply and many services have become tradable. The financial markets are closely integrated on a global scale. Economic policies, but also tax systems and regulations, are competing with one another internationally for capital investment and savings.

The number of countries affected by today's globalization processes is far larger than the number involved in earlier phases. This applies particularly to the global economic integration of emerging markets and developing countries. The shares which these countries have in the world's goods markets, direct investment flows, and portfolio inflows have expanded considerably.

The increasing integration of large emerging economies into the global economy means that the volume of world trade and global growth prospects will continue to rise. The so-called BRIC countries—Brazil, Russia, India, and China—are arousing particular interest in this respect, with China and India assuming a prominent role.

While China has established itself as the intra-Asian platform for the production of labor-intensive goods—especially for the United States—India's strategy is based on the export of services. However, China and India import a considerable volume of goods from other countries, particularly in Asia, and record only small current account deficits.

What obviously differentiates China and India from other emerging economies is their sheer size. Their combined population is roughly 2.5 billion, representing more than one-third of the world's population. The global economy is therefore confronted with an adjustment process of a special type and greater magnitude than those witnessed in the past. The growing range of goods and services from China and India, produced and supplied at low cost, will lead to significant changes in global production patterns, trade, and relative prices.

The continuous shift in the global economy's center of gravity toward Asia with its enormous labor reserves also means that the employment prospects not only for low-skilled but increasingly high-skilled employees in the industrial nations will continue to deteriorate. On the other hand, developing the as-yet inadequate infrastructure in these countries along with their rising demand for high-quality industrial goods will offer the industrial countries tremendous export opportunities.

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If the countries which today are at the leading edge of the global value-added chain maintain their advantages in the development and production of technology-intensive goods and services, they can but profit from the low-cost products from Asia. It is not absolute but comparative cost advantages which decide the pecking order of economies and regions in the context of the international division of labor.

This adjustment process to the changes in the world economy will vary from country to country and may result in economic and political tensions between the trading partners in these countries. Integration of the large emerging market economies involves the risk of increasing protectionism. Countries which see themselves as losers in the globalization process will resort to short-term isolation measures that endanger both the progress already made and further progress in the global division of labor.

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The shift in the global economic focus toward east and southeast Asia also raises the question of economic cooperation within Asia and its possible political implications—including the shift in the balance of power.

One has to bear in mind that rising regionalism is a global phenomenon because countries—large and small alike—have used this to respond to global challenges and developments. They integrate because they do not want to lose out in the global competition for export markets and foreign direct investments. And because of the dynamics in multilateral trade negotiations, small nations resort to regionalism in order to enhance their bargaining leverage and to gain some degree of international political influence.

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In spite of the dynamic developments in Asian economic cooperation, integration along EU lines is rather improbable. This is due partly to the diverging levels of economic performance, and partly to the lack of strong political institutions in Asia.

In fact, the various regional organizations in Asia are much less institutionalized than those in the European Union. Their chosen mode of interaction is intergovernmental. The established bodies have nothing more than an advisory function.

However, there is good reason to assume that regional integration will deepen in Asia. This leads to the interesting question: Who will be the main driving force of this process?

To cope with the challenges posed by globalization, a high degree of adaptability will be needed. The United States, with its flexible economy, comparatively favorable demographics, and high degree of penetration of the economy with information and communications technology, has every chance of successfully overcoming the challenges described. However, the U.S. current account deficit is a clear indication that there is a need for structural adjustment, too. The need to finance around 5.5 percent of U.S. GDP externally in 2004 has made the United States the biggest “debtor” in the world. This credit-financed “overconsumption” cannot be sustained in the long term, not even by the United States. A gradual adjustment process, which includes not only

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exchange rate changes and internal adjustment, but also higher growth rates outside the United States, would be desirable.

A crucial requirement if the U.S. current account deficit is to be reduced is that U.S. national savings must increase. The International Monetary Fund, the U.S. Federal Reserve, and also the G7 are therefore emphatically calling for reduction in government budget deficits.

Despite the progress that Japan has made in removing structural rigidities, there is still a need for reform if it wants to restrengthen its economic role in the region. Structural rigidities in the domestic market and, in particular, the age structure of the Japanese population are restricting its economic potential. This is also a reason why the OECD estimates Japan's annual potential growth at only just over 1 percent. The situation is compounded by the precarious state of public finances with the government debt level at almost 170 percent of GDP.

In the case of the emerging economies in East Asia, what matters is not the adjustment of existing structures, but rather the creation of new ones. The Asian countries must overcome the prevailing bilateralism to be able to benefit from the international division of labor more than has been the case thus far. This includes establishing an institutional framework for their regional cooperation.

China's political and economic development will depend largely on how the country deals with its growing internal imbalances such as the tension between urban and rural areas. In China, the most pressing reform project is the creation of a well-functioning financial system able to channel national savings toward efficient uses and as an important step toward more exchange rate flexibility. Furthermore, it is necessary to create a social security system for which the state-owned enterprises have hitherto been responsible as well as a framework for a market-oriented fiscal and monetary policy.

In Europe, the process of structural reforms must continue. Europe has problems. The most pressing include high unemployment, a lack of economic flexibility, and an aging population. However, one should not overlook the fact that more than ten million jobs have been created since 1997. That is two million more than in the United States. There has also been a maturing awareness of the need for reform. Reforms have now been introduced in the labor markets and social security systems. Following the accession of ten new members last year, the European Union now has a large single market which unites the purchasing power of 450 million citizens.

However, in view of its possibilities, the euro area's growth potential is low. The OECD estimates it to be about 2 percent per year; by comparison, the U.S. growth potential is estimated at over 3 percent. These growth differentials are to a large extent attributable to different rates of population growth. Even so, I am optimistic. With increasingly flexible economies, greater efforts in research and development, and greater willingness to be innovative and work longer hours, Europe is on the way to becoming an economically more dynamic region. Don't forget—the European Union has been an extraordinary success in terms of stabilizing the continent politically. Despite occasional setbacks, integration has made continuous advances and has culminated in a single currency.

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Today, globalization is by some argued to be mostly a triadization. The process of integration is at its most intense among the three regions that contain most of the world's developed market economies: North America, Western Europe, and East Asia. But we should also not forget South America and Africa.

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On the one hand, the United States and the European Union continue to be the "traditional" driving forces of the global economy, accounting for more than half of global trade and investment.

At the same time, the most dynamic growth region is non-Japan Asia. With globalized markets and increasing competition, the integration of large emerging markets is giving rise to structural adjustments in the global economy.

Forces of globalization and competitive markets are driving Americans, Europeans, and Asians together, not apart. This represents a major challenge since geo-economics and geopolitics are deeply intertwined. To rise to this challenge, a sound international framework must be in place in which all parties involved commit themselves to a multilateral approach. The integration of large emerging markets into the global economy cannot be allowed to lead to increased protectionism. Its consequences would have to be borne by all parties involved.

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With the appearance of new economic players on the international scene, the global economic structure is changing. The relevance of Japan, Europe, and the United States might be affected. What might be the impact on the regional and global balance of power?

One important aspect in this context are the huge internal imbalances in the leading Asian emerging economies. These imbalances may absorb much of the political energy in order to contain potential regional and social tensions and conflicts.

Thus, the United States is most likely—if not for sure—to remain the only economic, political, and military power. However, it is desirable that the United States remains open to international cooperation and multilateralism. Isolationism and unilateralism should not be real political options.

What is most likely to change globally are alliances and relationships. New alliances and altering relationships might affect the global role of individual countries.

What about Europe? Europe has the potential to become internationally more relevant again, economically and politically. Since the early 1990s, Europe has primarily dealt with its domestic problems in a rather inward-looking attitude. The Berlin Wall and the Iron curtain fell in 1989–90, and the former communist states in central and eastern Europe were transformed politically and economically. The path to EMU was prepared in the second half of the 1990s. The European Union was enlarged by ten new member states in 2004. Structural reforms were begun in the late 1990s.

The future international role of the European Union will depend on the speed and the results of the adjustment and reform process. To deepen political integration and to have a vision about Europe's future role are key. ◆